Morning Session - 1994 Meeting

1. Bigger meeting venue needed next year

WARREN BUFFETT: Put this over here.

CHARLIE MUNGER:

WARREN BUFFETT: Am I live yet? Yeah.

Morning.

AUDIENCE: Morning.

WARREN BUFFETT: We were a little worried today because we weren't sure from the reservations whether we can handle everybody, but it looks to me like there may be a couple seats left up there.

But I think next year, we're going to have to find a different spot because it looks to me like we're up about 600 this year from last year, and to be on the safe side we will seek out a larger spot.

Now, there are certain implications to that because, as some of the more experienced of you know, a few years ago we were holding this meeting at the Joslyn Museum, which is a temple of culture. (Laughter)

And we've now, of course, moved to an old vaudeville theater. And the only place in town that can hold us next year, I think, is the Ak-Sar-Ben Coliseum where they have keno and racetracks. (Laughter)

We are sliding down the cultural chain — (laughter) — just as Charlie predicted years ago. He saw all this coming. (Laughter)

2. Buffett loses "Miss Congeniality" title to Munger

WARREN BUFFETT: Charlie — I have some rather distressing news to report. There are always a few people that vote against everyone on the slate for directors and there's maybe a dozen or so people do that. And then there are others that single shot it, and they pick out people to vote against.

And, this will come as news to Charlie, I haven't told him yet. But he is the only one among our candidates for directors that received no negative votes this year. (Applause).

Hold it — hold it. No need to applaud.

I tell you, when you lose out the title of Miss Congeniality to Charlie, you know you're in trouble. (Laughter)

3. Meeting timetable

WARREN BUFFETT: Now, I'd like to tell you a little bit how we'll run this. We will have the business meeting in a hurry with the cooperation of all of you, and then we will introduce our managers who are here, and then we will have a Q&A period.

We will run that until 12 o'clock, at which point we'll break, and then at 12:15, if the hardcore want to stick around, we will have another hour or so until about 1:15 of questions.

So, you're free to leave, of course, any time and I've pointed out in the past that it's much better form if you leave while Charlie is talking rather than when I'm talking, but — (Laughter)

Feel free anytime, but you can — if you're panicked and you're worried about being conspicuous by leaving, you will be able to leave at noon.

We will have buses out front that will take you to the hotels or the airport or to any place in town in which we have a commercial interest. (Laughter)

We encourage you staying around on that basis.

4. Berkshire directors introduced

WARREN BUFFETT: Let's have the — let's get the business of the meeting out of the way. Then we can get on to more interesting things.

I will first introduce the Berkshire Hathaway directors that are present in addition to myself and —

First of all, there's Charlie, who is the vice chairman of Berkshire, and if the rest of you will stand.

We have Susan T. Buffett, Howard Buffett, Malcolm Chase III, and Walter Scott Jr. And that's it. (Applause)

5. Meeting quorum

WARREN BUFFETT: Also with us today are partners in the firm of Deloitte and Touche, our auditors, Mr. Ron Burgess and Mr. Craig Christiansen (PH).

They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter, secretary of Berkshire. He will make a written record of the proceedings.

Mr. Robert M. Fitzsimmons has been appointed inspector of election at this meeting. He will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg.

Proxy cards have been returned through last Friday representing 1,035,680 Berkshire shares to be voted by the proxy holders as indicated on the cards. That number of shares represents a quorum and we will therefore directly proceed with the meeting.

We will conduct the business of the meeting and then adjourn to the formal meeting — and then adjourn the formal meeting. After that, we will entertain questions that you might have.

First order of business will be a reading of the minutes of the last meeting of shareholders.

I recognize Mr. Walter Scott Jr. who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with.

WARREN BUFFETT: Do I hear a second?

VOICES: Seconded.

Motion has been moved and seconded. Are there any comments or questions? Hearing none, we will vote on the motion by voice vote. (Laughter)

All those in favor say aye.

VOICES: Aye.

WARREN BUFFETT: Opposed? The motion is carried and it's a vote.

Does the secretary have a report of the number of Berkshire shares outstanding entitled to vote and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent by first class mail to all shareholders of record on March 8, 1994, being the record date for this meeting, there were 1,177,750 shares of Berkshire common stock outstanding, with each share entitled to one vote on motions considered at the meeting. Of that number, 1,035,680 shares are represented at this meeting by proxies returned through last Friday.

6. Directors elected

WARREN BUFFETT: Thank you. We will proceed to elect directors.

If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person, he or she may do so.

Also, if any shareholder that's present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you.

Would those persons desiring ballots please identify themselves so that we may distribute them? Just raise your hand.

I now recognize Mr. Walter Scott Jr. to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Susan Buffett, Howard Buffett, Malcolm Chase, Charles Munger, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: Seconded.

WARREN BUFFETT: It's been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chase III, Charles T. Munger, and Walter Scott Jr. be elected as directors.

Are there any other nominations? Is there any discussion? Motions and nominations are ready to be acted upon.

If there are any shareholders voting in person, they should now mark their ballots and allow the ballots to be delivered to the inspector of elections.

Seeing none, will the proxy holders please also submit to the inspector of elections the ballot voting the proxies in accordance with the instructions they have received.

Mr. Fitzsimmons, when you're ready you may give your report.

ROBERT FITZSIMMONS: My report is ready. The ballot of the proxy holders received through last Friday cast not less than a 1,035,407 votes for each nominee.

That number far exceeds a majority of the number of all shares outstanding and a more precise count cannot change the results of the election.

However, the certification required by Delaware law regarding the precise count of the votes, including the votes cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Mr. Fitzsimmons.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chase III, Charles T. Munger, and Walter Scott Jr. have been elected as directors. (Applause)

7. Formal meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Walter Scott Jr. to place a motion before the meeting.

WALTER SCOTT: I move the meeting be adjourned.

WARREN BUFFETT: Second?

VOICES: Seconded.

The motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say aye?

VOICES: Aye

WARREN BUFFETT: Opposed say no, the meeting is adjourned. (Laughter)

It's democracy in Middle America. (Laughter)

8. Berkshire managers introduced

WARREN BUFFETT: Now, I'd like to introduce some of the people that make this place work to you. And if you would hold your applause until the end because there are quite a number of our managers here.

I'm not sure which ones for sure are here, some of them may be out tending the store as well.

But, first of all, from Nebraska Furniture Mart, Louie, Ron, and Irv Blumkin. I'm not sure who's here, but would you stand please, any of the Blumkins that are present?

OK, we've — looks like Irv. I can't quite see it.

From Borsheims, is Susan Jacques here? Susan? There she is. Susan had a record day yesterday. She just — (applause) — Susan became CEO just a few months ago and she's turning in records already. Keep it up. (Laughter)

And from Central States Indemnity, we have the Kizers. I'm not sure which ones are here, but there's Bill Sr., Bill Jr., John, and Dick.

Kizers, stand up. I think I can see him — John.

Don Wurster from National Indemnity.

Rod Eldred from the Homestate Companies.

Brad Kinstler from Cypress, our worker's comp company.

Ajit Jain, the big ticket writer in the East.

And Mike Goldberg, who runs our real estate finance group and also generally oversees the insurance group. Mike.

Gary Heldman from Fechheimers.

Chuck Huggins from See's, the candy man.

Stan Lipsey from the Buffalo News.

Chuck's been with us, incidentally, twenty-odd years. Stan's been working with me for well over 25 years.

Frank Rooney and Jim Issler from H.H. Brown.

Dave Hillstrom from Precision Steel.

Ralph Schey from Scott Fetzer.

Peter Lunder, who is with our newest acquisition, Dexter Shoe. And Harold Alfond, his partner, couldn't be with us because his wife is ill.

And finally, the manager that's been with Charlie and me the longest, Harry Bottle from K&W. Harry, you here? There's Harry.

Harry saved our bacon back in 19 — what? — 62 or so, when in some mad moment I went into the windmill business. And Harry got me out of it. (Laughter)

That's our group of managers and I appreciate it if you give them a hand. (Applause)

9. Midwest Express adding flights to Omaha

WARREN BUFFETT: I have one piece of good news about next year for you.

In addition to moving to larger quarters, they're going to add nonstop air service from New York, Washington, and Los Angeles here in the next few months, Midwest Express.

So, I hope they do very well with it and I hope that makes it easier for you to get into town.

10. Q&A logistics

WARREN BUFFETT: Now, in this — for the next two hours and 15 minutes or so, we'll have a session where we will take questions.

We have seven zones, three on the main floor. We'll go start over there with zone one and work across.

On the main floor, if you'll raise your hand, the person who is handling the mic will pass it to you and we'll try to not repeat any individual in any one zone till everyone in that zone has had a chance to ask one question. So, after you've been on once, let other people get a shot.

When we move up to the loge, we have one person there and in the case — and then we have three in the balcony, which is essentially full now.

And we would, up there, we would appreciate it if you would you leave your seat and go to the person with the mic. It'll be a little easier in both the loge and the balcony to handle it that way.

And if you'll go a little ahead of time, that way if there's a line of two or three you can you can line up for questions in both the loge and balcony.

So, whatever you'd care to ask. If you want an optimistic answer you'll, of course, direct your question to Charlie. If you'd like a little more realism you'll come to me and — (laughter).

11. Derivatives: dangerous combination of "ignorance and borrowed money"

WARREN BUFFETT: Let's start over in zone 1.

Sometimes we can't see too well from up here, but —

In fact, I can't even see the monitor right now, but do we have one over there?

And if you'll identify yourself by name and your hometown, we'd appreciate it.

AUDIENCE MEMBER: My name is Michael Mullen (PH) from Omaha.

Would you comment on the use of derivatives? I noticed that Dell computer stock was off 2 1/2 points Friday with the loss of derivatives.

WARREN BUFFETT: Question is about derivatives. We have in this room the author of the best thing you can read on that. There was an article in Fortune about a month ago or so by Carol Loomis on derivatives, and far and away it's the best article that has been written.

We also have some people in the room that do business in derivatives from Salomon.

And it's a very broad subject. It — as we said last year, I think someone asked what might be the big financial story of the '90s and we said we obviously don't know, but that if we had to pick a topic that it could well be derivatives because they lend themselves to the use of unusual amounts of leverage and they're sometimes not completely understood by the people involved.

And any time you combine ignorance and borrowed money — (laughter) — you can get some pretty interesting consequences. (Laughter)

Particularly when the numbers get vague. And you've seen that, of course, recently with the recent Procter and Gamble announcement.

Now, I don't know the details of the P&G derivatives, but I understand, at least from press reports, that what started out as interest rate swaps ended up with P&G writing puts on large quantities of U.S. and, I think, one other country's bonds. And any time you go from selling soap to writing puts on bonds, you've made a big jump. (Laughter)

And it — the ability to borrow enormous amounts of money combined with a chance to get either very rich or very poor very quickly, has historically been a recipe for trouble at some point.

Derivatives are not going to go away. They serve useful purposes and all that, but I'm just saying that it has that potential. We've seen a little bit of that.

I can't think of anything that we've done that would — can you think of anything we do that approaches derivatives, Charlie? Directly?

CHARLIE MUNGER: No. (Laughter)

WARREN BUFFETT: I may have to cut him off if he talks too long. (Laughter)

Is there anything you would like to add to your already extensive remarks? (Laughter)

CHARLIE MUNGER: No. (Laughter)

WARREN BUFFETT: OK.

12. Berkshire participated in Cap Cities stock buyback

WARREN BUFFETT: In that case we'll go to zone 2. (Laughter)

AUDIENCE MEMBER: My name is Hugh Stevenson (PH). I'm a shareholder from Atlanta.

My question involves the company's investment in the stock of Cap Cities. It's been my understanding in the past that that was regarded as one of the four, quote unquote, "permanent" holdings of the company.

So I was a little bit confused by the disposition of one million shares. Could you clarify that? Was my previous misunderstanding — was my previous understanding incorrect? Or has there been some change or is there a third possibility?

WARREN BUFFETT: Well, we have classified the Washington Post Company and Cap Cities and GEICO and Coke in the category of permanent holdings. And —

But in the case of three of those four, The Washington Post Company, I don't know, maybe seven or eight years ago, GEICO some years back, and now Cap Cities, we have participated in tenders where the company has repurchased shares.

Now the first two, the Post and GEICO, we participated proportionally. That was not feasible, and incidentally, not as attractive taxwise anymore.

The 1968 Tax Act changed the desirability of proportional redemptions of shares, from our standpoint. That point has been missed by a lot of journalists in commenting on it, but it just so happens that the commentary that has been written has been obsolete, in some cases, by six or seven years.

But, we did participate in the Cap Cities tender offer, just as we did in the Post and GEICO.

We still are, by far, the largest shareholder of Cap Cities. We think it's a superbly run operation in a business that looks a little tougher than it did 15 years ago, but looks a little bit better than it did 15 months ago.

Charlie, you have anything?

CHARLIE MUNGER: Uh, no. (Laughter)

WARREN BUFFETT: He’s thinking it over now though before — (Laughter)

13. Unlikely we’d buy company with no current cash flow

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Good morning. My name is Howard Bask (PH) and I’m from Kansas City. And I’ve got a theoretical value question for you.

If you were to buy a business and you bought it at its intrinsic value, what’s the minimum after-tax free cash flow yield you’d need to get?

WARREN BUFFETT: Well, your question is if we were buying all of a business and we’re buying at what we thought was intrinsic value, what was the minimum —

AUDIENCE MEMBER: Correct.

WARREN BUFFETT: — present earning power or what the present — the minimum discount rate of future streams?

AUDIENCE MEMBER: No, what’s the minimum current after-tax free cash flow yield you’d…

WARREN BUFFETT: We could conceivably buy a business — I don’t think we would be likely to — but we could we could conceivably buy a business that had no current after-tax cash flow. But, we would have to think it had a tremendous future.

But we would not find — obviously the current figures, particularly in the kind of businesses we buy, tend to be representative, we think, of what’s going to happen in the future.

But that would not necessarily have to be the case. You can argue, for example, in buying stocks, we bought GEICO at a time when it was losing significant money. We didn’t expect it to continue to lose significant money.

But if we think the present value of the future earning power is attractive enough compared to the purchase price, we would not be overwhelmed by what the first year’s figure would be.

Charlie, you want to add to that?

CHARLIE MUNGER: Yeah. We don’t care what we report in the first year or two of — after buying anything.

AUDIENCE MEMBER OFF MIC: (INAUDIBLE) on average over the years (INAUDIBLE).

WARREN BUFFETT: Well, I would say that in a world of 7 percent long-term bond rates that we would certainly want to think we were discounting future after-tax streams of cash at at least a 10 percent rate.

But that will depend on the certainty we feel about the business. The more certain we feel about a business, the closer we are willing to play it.

We have to feel pretty certain about any business before we're even interested at all. But there are still degrees of certainty, and —

If we thought we were getting a stream of cash over the next 30 years that we felt extremely certain about, we would use a discount rate that would be somewhat less than if it was one where we thought we might get some surprises in five or 10 years — possibility existed. Charlie?

CHARLIE MUNGER: Nothing to add.

14. Insurance business intrinsic value is well above book value

WARREN BUFFETT: OK. Zone 4.

AUDIENCE MEMBER: Morris Spence (PH) from Omaha, Nebraska.

You've made comments on several occasions about the intrinsic business value of the insurance operations. And in this year's report you state that the insurance business possesses an intrinsic value that exceeds book value by a large amount, larger, in fact, than is the case at any Berkshire — other Berkshire business.

I was wondering if you would explain in greater detail why you believe that to be true.

WARREN BUFFETT: Well, I — it's very hard to quantify, as we've said many times in the report. But, I think that it's clear that even taking fairly pessimistic assumptions, that the excess of intrinsic value over carrying value is higher, by some margin, for the insurance business.

And I think that the table in the report that shows you what our cost to float has been over the years, and also what the trend of float has been over the years, would, unless you thought that table had no validity for the future, I think that that table would tend to the point you in the direction of saying the insurance business does have a very significant excess of intrinsic value over carrying value.

Very hard number to put something on. But — and you don't want to extrapolate that table out. But I think that table shows that we started with maybe 20 million of float and that we're up to something close to three billion of float. And that that float has come to us at a cost that's extremely attractive, on average, over the years.

And just to pick an example, last year, when we actually had an underwriting profit, the value of that float was something over $200 million. And that figure was a lot bigger than it was 10 years ago or 20 years ago.

So that's — that is a stream — last year was unusually favorable, but that is a — that's a very significant stream of earnings, and it's one we feel we have reasonably good prospects in. So we feel very good about the insurance business.

15. Why Berkshire doesn't split its stock

WARREN BUFFETT: OK. Zone 5?

AUDIENCE MEMBER: My name is Cy Rademacher (PH) from Omaha.

Is there any point at which your stock would rise to the point where you might split the stock?

WARREN BUFFETT: Surprise, surprise. (Laughter)

I think I'll let Charlie answer that this year. (Laughs)

He's so popular with the shareholders that I can afford to let him take the tough questions. (Laughter)

CHARLIE MUNGER: I think the answer is no. (Laughter and applause)

I think the idea of carving ownerships in an enterprise into little, tiny $20 pieces is almost insane. And it's quite inefficient to service a $20 account and I don't see why there shouldn't be a minimum as a condition of joining some enterprise. Certainly we'd all feel that way if we were organizing a private enterprise.

WARREN BUFFETT: Yeah, we would not carve it up in $20 units.

We find it very — it's interesting because every company finds a way to fill up its common shareholder list. And you can start with the As and work through to the Zs and you'll — every company in the New York Stock Exchange, one way or another, has attracted some constituency of shareholders.

And frankly, we can't imagine a better constituency than is in this room. I mean, we have — we don't think we can improve on this group, and we followed certain policies that we think attracted certain types of shareholders and actually pushed away others.

And that is part of our eugenics program here at Berkshire. (Laughter)

CHARLIE MUNGER: Yeah, just look around this room and as you mingle with one another. This is a very outstanding group of people. And why would anybody want a different kind of a group?

WARREN BUFFETT: Yeah, if we cause — if we follow some policies that cause a whole bunch of people to buy Berkshire for the wrong reason, the only way they can buy it is to replace somebody in this room, or in this larger metaphorical room, of shareholders that we have.

So someone in one of these seats gets up and somebody else walks in. The question is do we have a better audience?

I don't think so. So I think that — I think Charlie said it very well.

16. Buffett is keeping his private jet

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Mr. Buffett, my name is Rob Na (PH) and I'm from Omaha, Nebraska.

My question is, given the recent announcement of Midwest Express and their nonstop jet service between East and West Coasts, will this cut down on your use of "The Indefensible?" (Laughter)

And will you use more commercial air travel?

WARREN BUFFETT: This is a question planted by Charlie. (Laughter)

I think you should know, I take it to the drugstore at the moment, and I — (Laughter)

No, it's just a question when I start sleeping in it at the hangar.

Nothing will cut back on "The Indefensible." It's being painted right now, but I told them to make it last a long time.

Charlie, though, was pointing out the merits of other kinds of transportation last night at the meeting of our managers. He might want to repeat those here.

CHARLIE MUNGER: Well, I just pointed out that the back of the plane arrived at the same time as the front of the plane, invariably. (Laughter)

WARREN BUFFETT: He's even more of an authority on buses, incidentally, if anybody has his — (Laughter)

17. Buffett's next goal in life

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: Mr. Buffett, my name's Allan Maxwell from Omaha. I've got two questions.

What is your next goal in life now that you're the richest man in the country?

WARREN BUFFETT: That's easy. It's to be the oldest man in the country. (Laughter and applause)

18. "Two yardsticks" for judging management

AUDIENCE MEMBER: Secondly, you talk about good management with corporations and that you try and buy companies with good management.

I feel that I have about as much chance of meeting good managers, other than yourself, as I do bringing Richard Nixon back to life.

How do I, as an average investor, find out what good management is?

WARREN BUFFETT: Well, I think you judge management by two yardsticks.

One is how well they run the business and I think you can learn a lot about that by reading about both what they've accomplished and what their competitors have accomplished, and seeing how they have allocated capital over time.

You have to have some understanding of the hand they were dealt when they themselves got a chance to play the hand.

But, if you understand something about the business they're in — and you can't understand it in every business, but you can find industries or companies where you can understand it — then you simply want to look at how well they have been doing in playing the hand, essentially, that's been dealt with them.

And then the second thing you want to figure out is how well that they treat their owners. And I think you can get a handle on that, oftentimes. A lot of times you can't. I mean it — they're many companies that obviously fall in — somewhere — in that 20th to 80th percentile and it's a little hard to pick out where they do fall.

But, I think you can usually figure out — I mean, it's not hard to figure out that, say, Bill Gates, or Tom Murphy, or Don Keough, or people like that, are really outstanding managers. And it's not hard to figure out who they're working for.

And I can give you some cases on the other end of the spectrum, too.

It's interesting how often the ones that, in my view, are the poor managers also turn out to be the ones that really don't think that much about the shareholders, too. The two often go hand in hand.

But, I think reading of reports — reading of competitors' reports — I think you'll get a fix on that in some cases. You don't have to — you know, you don't have to make a hundred correct judgments in this business or 50 correct judgments. You only have to make a few. And that's all we try to do.

And, generally speaking, the conclusions I've come to about managers have really come about the same way you can make yours. I mean they come about by reading reports rather than any intimate personal knowledge or — and knowing them personally at all.

So it — you know, read the proxy statements, see what they think of — see how they treat themselves versus how they treat the shareholders, look at what they have accomplished, considering what the hand was that they were dealt when they took over compared to what is going on in the industry.

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

Charlie?

CHARLIE MUNGER: Nothing to add.

19. How Berkshire keeps great managers

WARREN BUFFETT: Ok, we're back to zone 1.

AUDIENCE MEMBER: Hi there. My name is Lee. I'm from Palo Alto, California.

In meeting Ajit Jain, I've been very impressed over the years. And I think I even met his parents once they came from India.

Please comment on your deepest impressions of his personality and managerial skills, and also how you go about exactly keeping somebody who has such fine skills within the fold. He might go to Walt Disney someday and, you know, pull down 200 million.

WARREN BUFFETT: Well, if he gets offered 200 million — (laughs) — we may not compete too vigorously at that level. (Laughter)

We basically try to run a business so that — Charlie and I have two jobs. We have to identify and keep good managers interested after we've figured out who they are.

And that often is a little different here, because I would say a majority of our managers are financially independent, so that they don't go to work because they are worried about putting kids through school or putting food on the table. So they have to have some reason to go to work aside from that.

They have to be treated fairly in terms of compensation, but they also have to figure it is better than playing golf every day or whatever it may be.

And, so that's one of the jobs we have and we basically attack that the same way — we look at what they do the same way we look at what we do.

We've got a wonderful group of shareholders. Before I ran this, I had a partnership. I had a great group of partners. And essentially, I like to be left alone to do what I did. I like to be judged on the scorecard at the end of the year rather than on every stroke, and not second guessed in a way that was inappropriate.

I like to have people who understood the environment in which I was operating.

And so the important thing we do with managers, generally, is to find the .400 hitters and then not tell them how to swing, as I put in the report.

The second thing we do is allocate capital. And aside from that, we play bridge. (Laughter)

Pretty much what happens at Berkshire.

So, with any of the managers you might name here, we try to make it interesting and fun for them to run their business. We try to have a compensation arrangement that's appropriate for the kind of business they're in.

We have no company-wide compensation plan. We wouldn't dream of having some compensation expert or consultant come in and screw it up. (Laughter)

We try to — some businesses require a lot of capital that we're in, some require no capital. Some are easy businesses where good profit margins are a cinch to come by, but we're really paying for the extra beyond that. Some are very tough businesses to make money in.

And it would be crazy to have some huge framework that we try to place everybody in that — where one size would fit all.

People, generally, are compensated relating in some manner that relates to how their business does as opposed to — there's no reason to pay anybody based on how Berkshire does, because no one has responsibility for Berkshire except for Charlie and me.

And we try to make them responsible for their own units, compensated based on how those units do.

We try to understand the businesses they're in, so we know what the difference between a good performance and a bad performance —

And that's about — that's how we work with people.

We've had terrific luck over the years in retaining the managers that we wanted to retain. I think, largely, it's because — particularly if they sell us a business — to a great extent, the next day they're running it just as they were the day before. And they're having as much fun running their business as I am running Berkshire.

Charlie?

CHARLIE MUNGER: Well, I've got nothing to add, but I think that concept of treating the other fellow the way you'd like to be treated if the roles were reversed — it's so simple, when you stop to think about it, but —

It's a rare evening when Ajit and Warren aren't talking once on the phone. It's more than a business relationship, at least it seems that way to me.

WARREN BUFFETT: Yeah, well, it is. It will stay that way, too.

CHARLIE MUNGER: And by the way, we like our businesses — our relationships — to be more than a business relationship

WARREN BUFFETT: Charlie and I are very — we basically — it's a luxury but it's a luxury that we should try to nurture — we get to work with people we like. And it makes life a lot simpler.

It probably helps in that goal of being the oldest living American, too. (Laughter)

CHARLIE MUNGER: Yeah, and we tend to like people we admire. (Laughter)

WARREN BUFFETT: Yeah, who do we like that we don't admire, Charlie? (Laughter)

Start naming names. These people have names. (Laughter)

20. Guinness hurt by weak demand for scotch

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: My name is Peter Bevelin from Sweden.

How do you perceive Guinness long-term, economics growth-wise?

WARREN BUFFETT: Fitz — would you repeat that please, Fitz. What was it? What firm growth-wise?

VOICE: Guinness.

AUDIENCE MEMBER: Guinness.

WARREN BUFFETT: Oh, Guinness.

I'm not as much of an expert on Guinness' products as Charlie is.

CHARLIE MUNGER: We approved that. (Laughter)

WARREN BUFFETT: You didn't hear him. He said, "I approved that."

I made the decision to buy Guinness and Guinness has — it's down somewhat from — actually, the price in pounds is about the same but the pound is at about $1.46 or -7 against an average of $1.80-something, so we've had a significant exchange loss on that.

The — Guinness' — despite the name — you know, the main product, of course, is scotch. And that's where most of the money is made, although they make good money in brewing.

But, distilling is the main business. And, you know, the usage of scotch, particularly in this country, the trends have not been strong at all, but that was true when we bought it, too.

There are some countries around the world where it's grown and there are certain countries where it's a huge prestige item.

I mean, in certain parts of the Far East, the more you pay for scotch, the better you think people think of you. Which I don't understand completely, but I hope it continues. (Laughter)

But — the scotch — worldwide scotch consumption has not been anything to write home about.

Guinness makes a lot of money in the business. But, I would not — I don't see anything in the — in published history that would lead you to believe that the growth prospects, in terms of physical volume, are high for scotch.

The — Guinness itself, the beer, actually has shown pretty good growth rates in some countries. Actually, from a very tiny base in the U.S. as well.

But, they will have to do well in distilling or — I mean that will govern the outcome of Guinness.

I think Guinness is well run and it's a very important company in that business. But, I wouldn't count on a lot of physical growth.

Charlie, what — any consumer insights?

CHARLIE MUNGER: No. (Laughter)

21. Why Berkshire will be OK if Buffett dies suddenly

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Mr. Buffett, my name is Arthur Coleus (PH) from Canton, Massachusetts.

And I'd like to know how you'd respond to the question that my associates ask me when they say that Berkshire Hathaway has been a good investment up to now, but what happens to your investment if, God forbid, something happens to Mr. Warren Buffett?

WARREN BUFFETT: Well, I'm glad you didn't say Charlie Munger. (Laughter)

No, there — Berkshire will do just fine. We've got a wonderful group of businesses.

I've told you the two things I do in life. And, in terms of the managers we have, you have to come in and really want to mess it up, I would think. And we don't have anybody like that, in terms of succession plans at Berkshire.

And then there's the question of allocation of capital. And, you could do worse than just adding it to some of the positions that we already had.

The ownership is — if I die tonight, the ownership structure does not change. So, you've the same large block of stock that has every interest in having good successor management as I would.

I mean, there's no — there would be no greater interest. And it is not a complicated business. I mean, you ought to worry more about, if you own Microsoft, about Bill Gates, I think, or something of the sort.

But, this place is, you know, we've got a group down here that are running these. You didn't see me out at Borsheims selling any jewelry the other day. I mean, that's somebody else's job. So, I — it is not — it's not very complicated.

Incidentally, I think I'm in pretty good health. I mean this stuff (Coca-Cola) will do wonders for you if you'll just try it. (Laughter)

Charlie, do you want to add anything as the —?

CHARLIE MUNGER: Yeah. I think the prospects of Berkshire would be diminished — obviously diminished — if Warren were to drop off tomorrow morning. But it would still be one hell of a company and I think it would still do quite well.

I used to do legal work, when I was young, for Charlie Skouras. I heard him once say, my business, which was movie theaters like this one, was off 25 percent last year, and last year was off 25 percent from the year before, and that was off 25 percent from the year before, and then he pounded the table and he'd say, "But it's still one hell of a business."

WARREN BUFFETT: It's not a formula we want to test, incidentally.

CHARLIE MUNGER: No, no. (Laughter)

WARREN BUFFETT: It is one hell of a business that we've got here. I mean — and if you saw what happened at Berkshire headquarters, you would not worry as much. There's very little going on there that contributes to things. (Laughter)

We're, right now, at our peak of activity. This is it.

22. Easy answer: no reverse split, either

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: First of all, my name is Al Martin (PH) and my wife Terry (PH) is here with me. And I appreciate the invitation to attend this meeting.

I was a little bit dubious and quite excited at that game Saturday night. I didn't know which side was going to throw the game to the other one. But I did find out at the end.

The first question, actually, was somewhat answered, but not fully. Has the board considered a reverse split? My experience has been that —

WARREN BUFFETT: Would you like to make that a motion? There was a motion for a reserve — reverse split. (Laughter)

AUDIENCE MEMBER: I would say a two-for-one because if it were three or four-for-one I might end up with no shares. Or fractional shares.

But, anyway, my experience has been that all of the stocks that have split have gone down in the next two or three months or the next two or three years, including one which you are drinking, which is a flat Coke.

Also, I have observed Merck over the last several years to be hitting a low, which split three-for-one.

So, I think that, you know, the reasons for splitting stocks are to make it affordable. I found that every stock I ever bought was never affordable. I found the reason I bought it was because I couldn't afford not to buy it.

So that's a different philosophy, I guess, as somewhat shared indirectly with the boards running the stock.

The second question, which is — has to do with —

WARREN BUFFETT: Hope it's as easy as the first question. (Laughter)

AUDIENCE MEMBER: Well, I didn't want to wait for an answer of the first question for that reason, because it could be complicated and confusing and so forth.

23. Hillary Clinton's success as commodities trader

AUDIENCE MEMBER: The second question has to do with, could the board consider looking into a commodity broker, or a lawyer, or both, that could take action similar to Hillary Clinton's?

I think, you know, making your net worth go up by a factor of five overnight is more than enticing. Some of us might even want to wait for ten months to get a 100-to-1 return on the money.

WARREN BUFFETT: Well, I want to say — I want to say to you, when I saw that 530 percent in one day, it — Charlie has never done that for us.

I mean — (laughter) — it really caused me to reassess succession plans at Berkshire. (Laughter)

And Hillary may be free in a few years. (Laughter and applause)

I hope you're applauding over her coming to Berkshire, not — but I'll leave that up — (Laughter)

OK, that was their second question. (Laughs)

AUDIENCE MEMBER: That was my second question.

Of course, in my experience, it's been that most of us have thought through this situation and I guess it's pretty speculative, but I found out that the rules and laws that are made for trading are interpreted rather than enforced. And I think that applied to this particular case, so let's go on to the third question. (Laughter)

WARREN BUFFETT: Alright. They're getting easier. (Laughter)

24. Blue Chip Stamps is a disaster under Buffett and Munger

AUDIENCE MEMBER: This one is real easy. My wife was a collector of Blue Chip stamps for many, many years. And she brought some stamps with her. What should she do with them?

WARREN BUFFETT: Well, that — we can give you a definitive answer to that. Charlie and I entered the trading stamp business to apply our wizardry to it in what, 1969 or so, Charlie?

CHARLIE MUNGER: Yes.

WARREN BUFFETT: We were doing what then, about 110 million?

CHARLIE MUNGER: No, it went up to 120.

WARREN BUFFETT: OK. And then we arrived on the scene and we're going to do what, about 400,000 this year?

CHARLIE MUNGER: Yes.

WARREN BUFFETT: Yeah. (Laughter)

That shows you what can be done when your management gets active. (Laughter)

CHARLIE MUNGER: We have presided over a decline of 99 1/2 percent. (Laughter)

WARREN BUFFETT: Yeah. Yeah. But, we're waiting for a bounce — (Laughter)

I would say this. The trading stamp business, as those of you who have followed all know, it only works because of the float.

I mean, there — a very, very high percentage of the stamps in the '60s were cashed in. We have some years that we've gone up to 99 percent, I believe — we sampled the returns — because they were given out in such quantity.

But, our advice to anyone who has stamps is to save them because they're going to be collector's items, and besides if you bring them to us we have to give you merchandise for them.

Tell her to keep them. They'll do nothing but gain in value over years. (Laughter)

25. Stock split wouldn't raise long-term average price

WARREN BUFFETT: Going back, incidentally, to your point on the split.

I think most people think that the stock would sell for more money split.

A, we wouldn't necessarily think that was advisable in the first place.

But we — in the second place, we don't think it would necessarily be true over a period of time.

We think our stock is more likely to be rationally priced over time following the present policies than if we were to split it in some major way.

And we don't think the average price would necessarily be higher. We think that the volatility would probably be somewhat greater, and we see no way that volatility helps our shareholders as a group.

26. Fed Chairman Greenspan's actions are "quite sound"

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: I am Peg Gallagher from Omaha.

Mr. Buffett, are you interested in influencing Mr. Greenspan at the Fed to stop raising interest rates?

WARREN BUFFETT: Well, I wouldn't have any influence with him. He was on the board of Cap Cities some years ago and I know him a bit. But I don't think anyone would have any influence with Mr. Greenspan on that point.

But, I generally think that his actions have been quite sound during his period as Fed chief.

I mean, it's part of the job of the Fed, as Mr. Martin said many years ago, was to take away the punchbowl at the party, occasionally. And that's a very difficult, difficult policy to quantify working with markets day-by-day.

And, of course, it's always been the job of the Fed, basically, to lean against the wind. Which, of course, means if the wind changes, you fall flat on your face. But that's another question.

But the — I don't — I think what he has done is probably been somewhat appropriate. I think he's probably been surprised, a little bit, as to what has happened with long-term rates as he's nudged up short-term rates.

I think he was hoping that — this is just a guess on my part — that action, sort of early in the cycle on the short-term rate front, would — might make people feel more confident about the longer-term rates and therefore that the yield curve would flatten some. I don't know that. And, he may have been a little surprised on that.

But it's not an easy job he has. So, I would not second guess him myself.

Charlie, how do you feel about him?

CHARLIE MUNGER: Fine. (Laughter)

WARREN BUFFETT: Greenspan is safe. (Laughter)

27. Don't pay attention to what people say about stocks

WARREN BUFFETT: Zone 6.

MILLER: Mr. Buffett, I'm Lee Miller (PH) from St Louis.

There was an article in the April 18th Barron's that attempted to calculate the value behind each Berkshire Hathaway share.

I'm sure you have some views on that and I'd be very interested in your perspective on that issue.

WARREN BUFFETT: Yeah, there was an article about a week or so ago in Barron's. The same fellow wrote an article about four years ago reaching pretty much the same conclusion, and I hope he hasn't been short in between, but the — (Laughter)

I would say this. It is not the way I would calculate the intrinsic value of Berkshire.

But everyone in securities markets make choices on that. Every day somebody sells a few shares of Berkshire and someone sell — buys — and, you know, they are probably coming to differing opinions about valuation.

I would say that I found it strange that apparently he forgot we were in the insurance business, but that — that's not — (Applause).

It really doesn't make any difference. I mean, what — we don't pay any attention to what people say about Coca-Cola stock or Gillette stock or any of those things.

I mean, on any given day, two million shares of Coca-Cola may trade. That's a lot of people selling, a lot of people buying. If you talk to one person, you'd hear one thing, and you'd talk to another — you really should not make decisions in securities based on what other people think.

If you're doing that, you should think about doing something else, because it's —

A public opinion poll will just — it will not get you rich on Wall Street. So you really want to stick with businesses that you feel you can somehow evaluate yourself.

And, I don't think — I mean Charlie and I, we don't read anything about what business is going to be — the economy is going to do, or the market's going to do, or what anybody —

Anytime I see some article that says, you know, these analysts say this or that about some business, it just — it doesn't mean anything to us.

You cannot get rich with a weather vane.

28. Judge bank stock buybacks on case-by-case basis

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: I'm Edward Barr from Lexington, Kentucky, and I'd like to ask, given the amount of capital in the banking industry, do you think that more banks should be buying back significant amounts of their stock, like SunTrust, versus just the token amounts that they're buying back or just the authorized amounts?

And then also, related question in banking. Are they — are banks too focused on goodwill amortization when declining to buy other banks for cash, thereby using purchase accounting versus the normal practice in the industry of pooling accounting even when the stock they issue may be depressed or undervalued?

WARREN BUFFETT: Well, the first question about the capital in the industry — that — you really have to look at that on a bank-by-bank basis and there is a lot more repurchasing of shares by banks taking place.

You mentioned SunTrust, but National City is — they bought it back, I think, 5 percent of their — National City of Cleveland — bought back 5 percent of their stock in the first quarter.

There's much more repurchasing going on, and that's simply a judgment call by management that — as to the level of capital they need going forward, and what level of capital enables them to earn the return on equity that they think appropriate and whether they — what they feel like paying for their own shares.

So, I think you have to look at that on case-by-case.

We certainly like it, if we were to own a bank, we would — or own shares in a bank — we would like the idea of the bank repurchasing its stock at a price that we thought was attractive. We would think that they probably knew more about their own bank than some other bank they were going to buy and that if the numbers are right, it's an attractive way to use capital.

29. We don't pay attention to accounting of a transaction

WARREN BUFFETT: Your second question about goodwill amortization and purchase accounting versus pooling: we care not — at Berkshire, it absolutely makes no difference to us what accounting treatment we get on something. We are interested in the economics of a transaction.

Some banks — some businesses generally, most businesses perhaps — prefer pooling because they don't like to take a goodwill amortization charge.

We think our shareholders are smart enough, particularly if we make it clear to them — the accounting consequences — we think they're smart enough to look through to the economic reality of what Berkshire's businesses are all about.

And I think that some managements sell short their own ownership group by doing various kinds of financial acrobatics in order to have the charges come in a certain way rather than, as you point out, often they might be better off buying for cash rather than using their own stock as currency, but they may prefer to use their own stock because they avoid goodwill charges.

We've written a few things on goodwill in the past and past annual reports that might get to that subject.

We don't care what accounting — we sort of rewrite the accounting for any business that we're looking at, because in our heads we want to have, in effect, a standardized way of looking at businesses.

And if one company goes through pooling transactions and another goes through purchase transactions, we're going to recast them in our own minds so that there is comparability.

Charlie?

CHARLIE MUNGER: Yeah, the published accounting results are in accordance with standard convention and they're a place to start economic analysis. The figures are frequently quite silly on a functional basis. I'm not criticizing accounting conventions except for some. (Laughter)

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: But, I think it's just a place to start thinking about economic reality.

By their nature, they can't tie perfectly — they can't even tie very well — to economic reality.

WARREN BUFFETT: We regard it is a negative when we find a management that's preoccupied with accounting considerations. But, we find it so frequent that we can't afford to use it as a total exclusionary factor.

It really surprises me how many managements focus on accounting, and the time they spend on it, the — it's really unproductive.

If you find a management that doesn't care about the accounting but does explain to you in clear terms what's going on, I think you should regard that as a plus in owning a security.

30. Buffett praises new Salomon Brothers management

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: Mr. Buffett, my name is Bill Ackman. I'm from New York City. And my question relates to the appeal of Salomon Brothers as an investment.

You talked earlier about leverage and the dangers of leverage. Salomon is a business which is levered 30-to-1, which has very narrow margins, and earns a relatively modest return on equity, in light of the amount of leverage that they use. What is the appeal of the business to you?

WARREN BUFFETT: We have here today the chief executive of Salomon, Inc., the parent company, and also the chief executive of Salomon Brothers, the investment banking arm.

And, I would say one of the things we — Charlie and I — feel extraordinarily good about are the two fellows that are running that operation. They did an exceptional job under extraordinarily difficult circumstances, as did John Macfarlane, who's also here today.

The three of them — I mentioned four people in the annual report — and Salomon wouldn't be here today without those three. And it wouldn't be the company in the future that it's going to be without them. They did an absolutely fabulous job.

It's the sort of business that, as you point out, uses a lot of leverage. It doesn't — in one way it doesn't use as much as it looks like and in another way it uses even more than it looks like.

But — it — the test will be: A, whether they control that business in a way that that leverage does not prove dangerous, and secondly, what kind of returns on equity they earn while using it.

You certainly should expect to earn somewhat higher returns on equity when you are necessarily exposed to a small amount of systemic risk and significant amounts of borrowed money, than you would in a business that's an extremely plain vanilla business.

But, I don't know whether you've met Bob and Deryck, but, I think you'd feel better about having a leverage in their hands than about any other hand you can imagine.

Charlie?

CHARLIE MUNGER: Why don't we have those three gentlemen stand up?

WARREN BUFFETT: Yeah, you ought to give them a hand.

CHARLIE MUNGER: They really have done a job for Berkshire in this last year.

WARREN BUFFETT: Yeah, I'll lead the applause for them. Where are they? There they are. (Applause).

I mentioned this before, but it's worth mentioning again. Deryck took on the job of being the operating head of Salomon Brothers on what, August 18th, 1991.

He didn't know what — he couldn't know what he was getting into, exactly. He — two months later or three months later, we'd never had a conversation about compensation. He did not ask me for Berkshire, or my, guarantee for indemnification because he was walking in not knowing legal problems. We didn't know what we would finally uncover.

And he worked incredible hours to keep that place together, which was not easy.

Bob Denham, I called — I guess on the 23rd or so, 20th. I called him on a Friday. I got home on a Saturday, the 24th of August.

He was living a nice pleasant peaceful life in California. And had a first class law firm, a good group of clients, wife had a good job there.

And I told him I was in a mess and there wasn't any second choice and three days later he was back in New York and living in a small apartment in Battery City and handling the general counsel's job at Salomon.

They found John Macfarlane on that Sunday, on the 18th. I think he was running a triathlon or something.

Not a practice that Charlie and I follow, but, ah — (Laughter)

And he was yanked from that and came down, and I think John was over in New Jersey, but he holed up in the Downtown Athletic Club. And it was his job to keep funding what was then $150 billion balance sheet during a period when people right and left were canceling.

It's not because we weren't a good credit, but because they just didn't want to have anything to do with us for a while.

And the World Bank and the State of Texas pension fund and CalPERS, all these people were shutting off funding at a time — and funding in a business is — gentleman just indicated — is the lifeblood of an enterprise like Salomon.

And so those three deserve an enormous hand by — really by the Salomon shareholders — but by this group in turn because we have an important investment. So I thank them publicly. (Applause)

31. Wesco sold small savings and loan as regulations tightened after crisis

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: I'm Kelly Ranson from San Antonio, Texas.

And I wondered if you could comment on the Mutual Savings and Loan. There was just a footnote that the deposits have been assumed by a federal savings bank.

And also, what about the annual report for Wesco Financial that I know it used to be in the annual report for Berkshire. Just wondered if you could comment on that, please.

WARREN BUFFETT: The question is about — we — our 80 percent-owned subsidiary Wesco Financial sold its ownership in Mutual Savings and Loan of Pasadena last year. I'll let Charlie comment on that.

And then the second question is about the Wesco report, which is available to any Berkshire shareholder simply by writing Wesco. But, we found that the stapling problems and other things made it a little difficult to keep adding that every year to the report. So, now we just — we make it available to anyone who would, at Berkshire, who would like to have it.

But Charlie, want to comment on the sale of Mutual?

CHARLIE MUNGER: Yes. The savings and loan business became very much more heavily regulated after the huge nationwide collection of scandal and insolvency and so on.

And meanwhile, we had a very small savings and loan association. And the combination of the new regulation, and the fact that it was a very small part of our operation, made us decide that we were better off without it.

That does happen from time to time in Berkshire. We do exit once in a while.

And, by the way, we would reserve the right to change our mind. I always liked Lord Keynes when he said that he got new facts or new insights, why he changed his mind and then he'd say, what do you do? So we changed our mind.

WARREN BUFFETT: They start — they asked our directors at Mutual to start going to school on Saturday, didn't they, Charlie? Or something? I think that helped change our mind about Mutual.

CHARLIE MUNGER: There's a time to vote with your feet. (Laughter)

WARREN BUFFETT: And even your wallet.

32. Shoe industry is tough, but Dexter has great managers

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: (Inaudible) Chicago. Can you speak to some of the economic characteristics of the shoe industry that allow the business to be profitable and, in your view, attractive?

WARREN BUFFETT: I didn't hear that. Did you hear that, Charlie?

CHARLIE MUNGER: He wanted you to comment on the merits of the shoe industry.

WARREN BUFFETT: Well, I think our feelings for the shoe industry are very clear from what's been happening the last few years.

We think it's a great business to be in as long as you're in with Frank Rooney and Jim Issler and Peter Lunder and Harold Alfond. Otherwise, it hasn't been too good.

The — we have a couple of extraordinary shoe operations, but they're not extraordinary because we get our leather from different steers or anything of the sort.

It's — we have two companies, really three now that Lowell's been brought in, too, but that have truly extraordinary records. I think those same managements would have been enormous successes in any business they'd gone into.

But, they have gone into the — they are in the shoe business and the companies earn unusual returns on equity. They earn unusual returns on sale. They've got terrific trade reputations.

And I think that to the extent we can find ways to expand in the shoe business while employing those managements, we'll be very excited about doing so.

It isn't because we think that the shoe industry is any cinch, you know, per se, or anything of the sort. But we've got a lot of talent employed in the shoe business and whenever we've got talent we like to try and figure out a way to give them as big a domain as we can.

And it's not inconceivable that we would expand the shoe business, perhaps even significantly over time.

33. Buffett on investing in tobacco companies

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Yeah, thanks Mr. Buffett. My name is Stewart Hartman from Sioux City. After the brevity of the last question from section 4, I'll try to be extremely brief.

The — given the scrutiny that the tobacco business is going under right now, number one, what do you see as the business prospects for those huge cash cows? And, at any point, would that be attractive to you given their liability?

WARREN BUFFETT: The question is about the future of the tobacco business?

I don't — I probably know no more about that then you do because it's fraught with questions that relate to societal attitudes and you can form an opinion on that just as well as I could.

But, I would not like to have a significant percentage of my net worth in the tobacco business myself, but —

They may have better futures than I envision. I don't really think that I have special insights on that.

Charlie, you —?

CHARLIE MUNGER: No.

WARREN BUFFETT: You have to come to a conclusion as to how society is going to want to treat — and the present administration for that matter. And the economics of the business may be fine, but that doesn't mean it has a great future.

34. "Hard to argue with the market"

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: I'm Harriet Morton from Seattle, Washington.

I'm wondering, when you are considering an acquisition, how you look at the usefulness of the product?

WARREN BUFFETT: In looking at any business?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yeah. Well, obviously we look at what the market says is the utility. And the market has voted very heavily for Dexter Shoe, just to be an example.

I don't know many how many pairs of shoes they were turning out back in 1958 or thereabouts, but year after year, people have essentially voted for the utility of that product.

There are 750 million or so 8-ounce servings of one product or another from the Coca-Cola Company consumed every day around the world. And there are those of us who think the utility is very high. I can't make it through the day without a few. But there are other people that might rate it differently.

But essentially, people are going to get thirsty and if this is the way they take care of their thirst better than — and they prefer that to other forms — then I would rate the utility high of the product. But, I think it's hard to argue with the market on that.

I mean, people — some people may think that, you know, listening to a rock concert is not something of high utility. Other people might think it's terrific.

And so, we would judge that — I don't think we would come to an independent decision that there was some great utility residing in some product that had been available to the public for a long time, but that the public and not endorsed in any way.

Charlie?

CHARLIE MUNGER: Well, I think that's right. But, that's averaged out.

We're in a bunch of high-utility products. I mean, nurses' shoes, work shoes, casual shoes. We don't have a lot of, what, Italian pumps? (Laughter)

WARREN BUFFETT: Don't rule it out, Charlie. We may be here next year defending it. (Laughter)

CHARLIE MUNGER: Yeah, right, well.

No, I'm just saying, if you judge the existing portfolio as indicating what the future's likely to be like, why —

WARREN BUFFETT: Well, certainly a lot of essentials were sold out of Borsheims yesterday.

CHARLIE MUNGER: Yes. (Laughter and applause)

WARREN BUFFETT: I hear my family clapping.

35. No question from zone 6

WARREN BUFFETT: Zone 6.

VOICE: We have no question up here.

36. Insurers have "head in the sand" on catastrophes

WARREN BUFFETT: OK, zone 7.

AUDIENCE MEMBER: Good morning, Mr. Berkshire, uh, Buffett. (Laughter)

WARREN BUFFETT: I have a niece here who has a son named Berkshire so it —

AUDIENCE MEMBER: I'm Chris Blunt (PH) from Omaha.

My first question is, in years past, we've had samples of various products. When are we going to have some Guinness?

WARREN BUFFETT: Some what now?

AUDIENCE MEMBER: Guinness samples?

WARREN BUFFETT: (Laughs)

AUDIENCE MEMBER: And my second question is, in light of the multiple disasters that have taken place in LA, has that had any impact on the cats for Berkshire?

WARREN BUFFETT: On our super-cat business?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: The LA earthquake, which is originally — I believe the first estimate of insured damage was a billion-five, which struck us as kind of ludicrous, but has now escalated.

The last official estimate, the one we use that's a trigger in our policies, I think is either 4.5 billion or 4.8 billion. But it's going to be higher than that.

Our losses are fairly minor. If it gets to eight billion of insured damage, that would trigger another policy or two. But, I would say that the LA quake — which did considerably more damage, I think, than people would have anticipated from a 6.7 for various reasons having to do with how quakes operate — that quake is not going to turn out to be of any real — it's not the kind of super-cat that a 15 or $20 billion hurricane which hit Florida or Long Island or New England would be.

That's the kind of — we could lose — or we could pay out — 6 or $700 million in sort of a worst case super-cat. Now our total premiums this year might be, say, 250 million or something in that area.

So one super-cat in the wrong place would produce — and there could be more than one — could produce, we'll say, a $400 million or thereabouts underwriting loss from that business.

The LA quake is peanuts on that scale, but it wouldn't have taken a whole lot more in terms of numbers on the Richter scale, if it happened to have an epicenter where it did, and be of the type that it was, relatively shallow, that we could have had that sort of thing happen.

I think that the insurance industry has vastly underestimated — maybe not now, but up till a few years ago — the full potential of what a super-cat could do. But Hurricane Andrew and the LA quake may have been something of a wake-up call.

They were far from a worst-case situation. A really big Type Five hurricane on Long Island would end up leaving a lot of very major insurance companies in significant trouble.

We define our losses — essentially, 700 million sounds like a lot of money. It is a lot of money. But, there are limits on our policies. That is not true of people that are just writing the basic homeowners or business. Those losses could go off the chart.

There were certain companies in the LA quake that thought they had a — what they call a "probable maximum loss" for California quakes. And the LA quake, which was far from the worst case you can imagine, turned out to far exceed those probable maximum losses.

So, I think the industry has had, and may still have, its head in the sand a little bit, in terms of what can happen, either in terms of a quake in California or, more probably, in terms of a hurricane along the East Coast.

So far this year we're in reasonable shape, but that doesn't mean much because, by far, the larger exposure is in hurricanes and essentially 50 percent of the hurricanes hit in September. And about — I think it's about 15 percent would be in August. Close to 15 percent in October. So you have 80 percent, roughly, in those three months and there's a little tail on both sides.

But that's when you find out whether you've had a good or bad year in the super-cat business, basically.

It's a business we like at the right rates because there are very few people who can afford to write it at the level that the underlying company, the reinsured companies, need it. And we're in a position, if the rates are right, to do significant business.

Charlie?

CHARLIE MUNGER: Nothing to add.

37. Book recommendations

WARREN BUFFETT: Zone 1,

AUDIENCE MEMBER: Clayton Riley (PH) from Jacksonville, Florida.

This is a little different than all the other questions, but what were the three best books you read last year outside of the investment field? Why don't — even one will do.

WARREN BUFFETT: I'll give you — I'll tout a book first that I've read but that isn't available yet. But it will be in September.

The woman who wrote it, I believe, is in the audience and it's Ben Graham's biography, which will be available in September, by Janet Lowe. And I've read it and I think those of you who are interested in investments, for sure, will enjoy it. She's done a good job of capturing Ben.

One of the books I enjoyed a lot was written also by a shareholder who is not here because he's being sworn in, I believe today or tomorrow, maybe tomorrow, as head of the Voice of America.

And that's Geoff Cowan's book, which is on "The People v. Clarence Darrow." It's the story of the Clarence Darrow trial for, essentially, jury bribery in Los Angeles back around 1912, when the McNamara brothers had bombed the LA Times.

It's a fascinating book. Geoff uncovered a lot of information that the previous biographies of Darrow didn't have. I think you'd enjoy that.

Charlie?

CHARLIE MUNGER: Well, I very much enjoyed Connie Bruck's biography Master of the Game, which was a biography of Steve Ross, who headed Warner and later was, what, co-chairman of Time Warner.

WARREN BUFFETT: Yeah, he's a little more than co-chairman. (Laughs)

CHARLIE MUNGER: Yeah, and — she's a very insightful writer and it's a very interesting story.

I am rereading a book I really like, which is Van Doren's biography of Benjamin Franklin, which came out in 1952, and I'd almost forgotten how good a book it was. And that's available in paperback everywhere. We've never had anybody quite like Franklin in this country. Never again.

WARREN BUFFETT: He believed in compound interest, too, incidentally, as you may remember. (Laughter)

What did he — he set up those two little funds, one in Philadelphia, one in Boston?

CHARLIE MUNGER: Right.

WARREN BUFFETT: Yeah, to demonstrate the advantages of compound interest. I think that's the part Charlie's rereading. (Laughter)

38. Nike and Reebok

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Thank you for teaching me — teaching so much to all of us about business. My name is Mike Assail (PH) from New York City.

You mentioned earlier that Berkshire's shoe business was great, but that other shoe businesses were not so good.

What are the uncertainties of the global brand leaders that Berkshire seems to like? They like Coke and Gillette. The global brand leaders in the shoe business being Nike and Reebok.

What are their uncertainties, in terms of long-term competitive advantage, business economics, consumer behavior, and the other risk factors that you mentioned in the annual report this year? Thank you.

WARREN BUFFETT: So, you're really asking about the future prospects of Nike and Reebok?

Yeah. I don't know that much about those businesses. We do have one person in this audience, at least, who owns a lot of Reebok.

But I am not expressing a negative view in any way on that. I just — I don't understand that — I don't understand their competitive position and the likelihood of permanence of their competitive position over a 10 or 20 year period as well as I think I understand the position of Brown and Dexter.

That doesn't mean I think that it's inferior. Doesn't mean I think that we've got better businesses or anything.

I think we've got very good businesses. But I — I'm not — I haven't done the work and I'm not sure if I did the work I would understand them.

I think they are harder to understand, frankly, and to develop a fix on, than our kinds. But, they may be easier for other people who just have a better insight into that kind of business.

39. "You don't have to do exceptional things to get exceptional results"

WARREN BUFFETT: Some businesses are a lot easier to understand than others. And Charlie and I don't like difficult problems. I mean, we — if something is hard to figure, you know, we'd rather multiply by three than by pi. I mean it's just easier for us. (Laughter)

Charlie, you have any —?

CHARLIE MUNGER: Well, that is such an obvious point. And yet so many people think if they just hire somebody with the appropriate labels they can do something very difficult. That is one of the most dangerous ideas a human being can have.

All kinds of things just intrinsically create problems. The other day I was dealing with a problem and I said, this thing — it's a new building — and I said this thing has three things I've learned to fear: an architect, a contractor, and a hill. (Laughter)

And — if you go at life like that, I think you, at least, make fewer mistakes than people who think they can do anything by just hiring somebody with a label.

WARREN BUFFETT: We don't comment — excuse me, go ahead.

CHARLIE MUNGER: You don't have to hire out your thinking if you keep it simple.

WARREN BUFFETT: You don't have to do — we've said this before — but you don't have to do exceptional things to get exceptional results.

And some people think that if you jump over a seven-foot bar that the ribbon they pin on you is going to be worth more money than if you step over a one-foot bar. And it just isn't true in the investment world, at all.

So, you can do very ordinary things. I mean, what is complicated about this? But, you know, we're $3 billion pretax better off than we were a few years ago because of it.

There's nothing that I know about that product, or its distribution system, its finances, or anything, that, really, hundreds of thousands — or millions — of people aren't capable of, that they don't already know. They just don't do anything about it.

And similarly, if you get into some complicated business, you can get a report that's a thousand pages thick and you got Ph.D.s working on it, but it doesn't mean anything.

You know, what you've got is a report but you don't — it — you won't understand that business, what it's going to look like in 10 or 15 years.

The big thing to do is avoid being wrong. (Laughter)

CHARLIE MUNGER: There are some things that are so intrinsically dangerous. Another of my heroes is Mark Twain, who looked at the promoters of his day and he said, “A mine is a hole in the ground owned by a liar.” (Laughter)

And that’s the way I’ve come to look at projections. I mean, basically, I can remember, Warren and I were offered $2 million worth of projections once in the course of buying a business and the book was this thick.

WARREN BUFFETT: For nothing.

CHARLIE MUNGER: And, if we were given it for nothing, and we wouldn’t open it.

WARREN BUFFETT: We almost paid 2 million not to look at it. (Laughter)

It’s ridiculous. I do not understand why any buyer of a business looks at a bunch of projections put together by a seller or —

CHARLIE MUNGER: Or his agent.

WARREN BUFFETT: — or his agent.

I mean, it — you can almost say that it’s naive to think that that has any utility whatsoever. We just are not interested.

If we don’t have some idea ourselves of what we think the future is, to sit there and listen to some other guy who’s trying to sell us the business or get a commission on it tell us what the future’s going to be — it — like I say, it’s very naïve.

CHARLIE MUNGER: Yeah, and five years out.

WARREN BUFFETT: Yeah. We had a line in the report one time, “Don’t ask the barber whether you need a haircut.” And — (laughter) — it’s quite applicable to projections of — by sellers — of businesses.

40. Cutting USAir’s costs will be “enormously tough”

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Mr. Buffett, Greg Elright (PH) from Washington, DC.

In the last year, United Airlines and Northwest have resolved some of their financial problems by moving ownership over to the employees.

With USAir's current positions — uh, problems — what do you see as occurring with USAir and do you see any movement toward employee ownership? And how will that affect Berkshire's interest in the company?

WARREN BUFFETT: USAir has a cost structure which is non-viable in today's airline business. Now that, in an important way, involves its labor cost, but it involves other things, too. But it certainly involves its labor costs.

And they've stated this publicly. And I think — and they have — they are talking with their unions about it and they're talking with other people about other parts of their cost structure.

And I think you'll just see what unfolds in the next relatively few months, because there isn't any question that the cost structure is out of line. I think the cost structure could be brought into line. But whether it will be brought into line or not is another is another question.

And, looking backwards, the answer is not to get into businesses that need to solve problems like that. It's to — but — that was a mistake I made.

And I think in Seth Schofield you've got a manager who understands that business extremely well, who probably is as — in my view, anyway — is as well regarded and trusted by people who are going to have to make changes as anyone could be in that position. But that may not be enough. I mean that — there's enormous tensions when you need to take hundreds and hundreds of millions of dollars out of the cost structure of any business.

And when you need cooperative action, all by various groups, each one of which feels that maybe they're having to give a little more than some other group, and understandably feels that way, you know that is an enormously tough negotiating job.

I think Seth is as well-equipped for that as anyone. But I would not want to — you know, I cannot predict the outcome.

WARREN BUFFETT: Charlie, do you —?

CHARLIE MUNGER: Well, if I were a union leader, I would give Seth whatever he wants because he's not the kind of a fellow who would ask for more than he needs. And, it's perfectly obvious that's the correct decision on the labor side. But whether the obvious will be done or not is in the lap of the gods.

WARREN BUFFETT: It's a lot of people with a lot of different motivations and, I mean, those are really tough questions. I mean, we — Charlie and I've been involved in that sort of thing a few times and frequently it works out, but it's not preordained.

41. We're "not in any hurry" to retire

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: My name is Sheldon Scizick (PH) from Chicago, Illinois. I have two questions.

The first one is concerning Mr. Munger. We know what Mr. Buffett's retirement plans are. I was wondering what yours — your plans for the future concerning Berkshire are?

CHARLIE MUNGER: I have always preferred the system of retirement where you can't quite tell from observing from the outside whether the man is working or retired. (Laughter)

WARREN BUFFETT: He does it well, too. (Laughter)

CHARLIE MUNGER: You know, a problem in many businesses, particularly the more bureaucratic ones, is that your employees retire, but they don't tell you. (Laughter)

WARREN BUFFETT: I think I can speak for Charlie on this one.

Charlie and I are not in any hurry to retire. He's trying to outlast me, actually. (Laughter)

AUDIENCE MEMBER: Thank you.

42. Berkshire sold some Cap Cities shares in tender offer

AUDIENCE MEMBER: My second question is, I was just curious why you sold a portion of Cap Cities?

WARREN BUFFETT: We thought that — we thought it was a good idea for Cap Cities to have a tender offer. They had cash that we thought that they could not use in any — they were not likely to be able to use — in a better way than repurchasing their own shares because they do have some very good businesses.

They, and we, felt that a tender offer would not be successful, in terms of attracting a number of shares unless Berkshire were tendering. We felt the price was reasonable to tender at.

It turned out that the business was getting stronger during that period and various things were happening in media, so there were only 100,000 shares or so tendered outside of our million. That isn't necessarily what we thought was going to happen going in, but that is what happened.

It's acceptable to us, but that doesn't mean that it was the desired outcome. We would not have tendered all of our shares or anything of the sort.

We want to remain a substantial shareholder of Cap Cities. We've always — most of the time we favored Cap Cities buying in its stock and it's bought in a fair amount of stock since the ABC merger took place in 19 — started in 1986.

43. Structured settlements business isn't big, but is "perfectly satisfactory"

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Good morning. My name is Matt Voke (PH). I'm from Omaha.

In last year's meeting you made reference to structured settlements. I was wondering, how is that business progressing for you?

WARREN BUFFETT: Question's about the structured settlement business, which is a business in which Berkshire guarantees, in effect, an annuity to some claimant of another — usually — of another insurance company, who suffered an injury and instead of getting a lump sum now wants to get a stream of payments over many years in the future, sometimes going out 75 years.

We have set up a life company to do that business. We formerly did it all through our property-casualty companies. And, we have done some business, but it's not been a big business yet, and it may never be a big business.

It's a perfectly satisfactory business, but it's not an important item at present in the analysis of Berkshire's value.

Are you getting — having a problem with sound out there on this or no? Just — no?

44. No comment on Wrigley

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: My name is David Samra. I'm from San Francisco, California.

In your annual report, I noticed you mention Wrigley as being a company that has worldwide dominance, somewhat like Coca-Cola and Gillette. And, was curious to know if you had looked at the company in any detail. And, if so, whether or not — if you decided not to invest, what were the reasons why?

WARREN BUFFETT: Well, we wouldn't want to comment on a company like that because we might or might not be buying it. We might or might not be selling it. We might or might not buy or sell it in the future. (Laughter)

And, since it falls under that narrow definition of things that we don't talk about —

It’s a good illustration of a company that has a high market share worldwide, but you can understand the Wrigley Company just as well as I can. I have no insights in the — into the Wrigley Company that you wouldn’t have and I don’t — I wouldn’t want to go beyond that in giving you our evaluation of the company.

I hate to disappoint you on those, but on specific securities, we are not too forthcoming sometimes.

Charlie?

CHARLIE MUNGER: I’m good at not being forthcoming. (Laughter)

45. “No specific desire” to buy companies in certain parts of the world

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: Mr. Buffett, Kathleen Ambrose (PH) from Omaha.

I have a question regarding global diversification. Just in general, what do you look for in a company and, if so, as far as Europe or Latin America, if you’d like to be specific?

WARREN BUFFETT: The question is about global diversification.

All we want to be in is businesses that we understand, run by people that we like, and priced attractively compared to the future prospects.

So, there is no specific desire to either be in the rest of Europe, or the rest of the world, or Far East, or to avoid it.

It’s simply a factor that — it’s not a big factor. There may be more chances for growth in some countries.

We — 80 percent of Coca-Cola’s earnings, roughly, will come from outside the United States. Eighty percent of Guinness’s earnings will come from outside the United States, but they’re domiciled outside the United States, whereas Coca-Cola is domiciled here.

Certainly, in many cases, there are markets outside the United States that have way better prospects for growth than the U.S. market would have, but they probably have some other risks to them that this market may not have.

But, we, you know, we like the international prospects, obviously, of a company like Coke. We like the international prospects of a company like Gillette. Gillette earned 70 percent of its money outside this country.

So, if you look — on a look-through basis — Coke — we might this year get something like $150 million of earnings, indirectly, for Berkshire's interest from the rest of the world just through Coca-Cola alone.

But, we don't make any specific — we don't think in terms of, I like this region so I want to be there or something of a sort.

It's something that's specific to the companies we're looking at, then we'll try to evaluate that.

Coke is expanding in China. Well, it — you know — I think that — I forget what they showed last year, maybe 38 percent growth, or something like that, in cases. Maybe —

It's nice to have markets like that that are relatively untapped.

Actually, Gillette is expanding in China in a big way and the Chinese don't shave as often. And more of them are what they call "dry shavers" than "wet shavers" there, which is electric shavers.

But you know, maybe we could stick something in the Coke that would — (laughter)

Maybe a little synergy at Berkshire, finally. Who knows?

46. Hurricanes are bigger insurance risk than riots

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: Good morning. I'm Marshall Patton (PH) from Bandera, Texas.

And back to the insurance losses. What is the comparison between natural disasters, such as the earthquake, and so on, and the LA riots?

WARREN BUFFETT: Well, I'm not sure what the connection —

They, you know, they obviously can both lead to super-cats that we insure against, because if there is enough insured damage, it's likely to trigger a payment under some of our policies.

It would take some really big riot damage to get to our levels, because normally we don't kick in now until an event gets up to at least, you know, $5 billion or so of insured damage under a very large majority of our policies.

Something like a quake causes a fair amount of damage that is not insured, because of the extent that it's highways and things of that sort, public buildings. A lot of that is not insured.

But you get interesting questions on this. Usually we insure an event, but what's an event? If you go back to the riots that occurred after Martin Luther King was shot, you had riots in dozens of cities.

Is that one event or is that a multiple number of events? I mean, it was started by different people, but maybe arising from a common cause. Some of those things aren't actually very well-defined, even after hundreds of years of insurance law and custom, the experience of that. But I would say that rioting is very unlikely to get to a level that triggers our policy.

The big risks we face are quake and hurricanes, and hurricanes are a more significant risk than quake. They call them typhoons in the Pacific Ocean.

But floods, tremendous damage from floods last year. But basically there's not a lot of private flood insurance bought, so the insured losses do not get large.

Just watch the Weather Channel. (Laughter)

47. Why we have no short-term opinion on stocks

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Diane West (PH) from Corona Del Mar, California.

I know, Mr. Buffett, that you said that you don't read what other people say about the market or the economy, but do either you or Charlie have an opinion about how you think things are going to go? Are you bullish or bearish?

WARREN BUFFETT: You may have trouble believing this, but Charlie and I never have an opinion about the market because it wouldn't be any good and it might interfere with the opinions we have that are good. (Laughter)

If we're right about a business, if we think a business is attractive, it would be very foolish for us to not take action on that because we thought something about what the market was going to do, or anything of that sort.

Because we just don't know. And to give up something that you do know and that is profitable for something that you don't know and won't know because of that, it just doesn't make any sense to us, and it doesn't really make any difference to us.

I mean, I bought my first stock in, probably, April of 1942 when I was 11. And since then, I mean, actually World War II didn't look so good at that time. I mean, the prospects, they really didn't. I mean, you know, we were not doing well in the Pacific. I'm not sure I calculated that into my purchase of my three shares. (Laughter)

But I mean, just think of all the things that have happened since then, you know? Atomic weapons and major wars, presidents resigning, and all kinds of things, massive inflation at certain times.

To give up what you're doing well because of guesses about what's going to happen in some macro way just doesn't make any sense to us. The best thing that can happen from Berkshire's standpoint — we don't wish this on anybody — but is that over time is to have markets that go down a tremendous amount.

I mean, we are going to be buyers of things over time. And if you're going to be buyers of groceries over time, you like grocery prices to go down. If you're going to be buying cars over time, you like car prices to go down.

We buy businesses. We buy pieces of businesses: stocks. And we're going to be much better off if we can buy those things at an attractive price than if we can't.

So we don't have any fear at all. I mean, what we fear is an irrational bull market that's sustained for some long period of time.

You, as shareholders of Berkshire, unless you own your shares on borrowed money or are going to sell them in a very short period of time, are better off if stocks get cheaper, because it means that we can be doing more intelligent things on your behalf than would be the case otherwise.

But we have no idea what — and we wouldn't care what anybody thought about it. I mean, most of all ourselves. (Laughter)

Charlie, do you have anything?

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

WARREN BUFFETT: If you're right about the businesses, you'll end up doing fine.

We don't know, and we don't think about when something will happen. We think about what will happen. It's fairly, it's not so difficult to figure out what will happen. It's impossible, in our view, to figure out when it will happen. So we focus on what will happen.

This company in 1890 or thereabouts, the whole company sold for $2,000. It's got a market value now of about 50-odd-billion, you know?

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

We can't afford that mistake, basically. Yeah.

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

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, last year — I'm Tim Medley from Jackson, Mississippi — last year the question was asked about your preference for purchasing entire businesses versus parts of public companies.

You mentioned you prefer to buy private businesses because of the tax advantages and your attraction to the people in those businesses.

Are you finding today that there are better purchases within the private market versus in the public securities market?

WARREN BUFFETT: Well, I would answer that no.

We do not — we very seldom find something to buy on a negotiated basis for an entire business. We have certain size requirements. A big limiting factor is it has to be something we can understand. I mean, that eliminates 95 percent of the businesses.

And we don't pay any attention to them, but we get lots of proposals for things that just are totally outside the boundaries of what we've already said we're interested in.

We prefer to buy entire businesses, or 80 percent or greater interest in businesses, partly for the tax reasons you mentioned, and frankly, we like it better. We just, it's the kind of business we would like to build if we had our absolute druthers on it.

Counter to that is we can usually get more for our money in wonderful businesses, in terms of buying little pieces of them in the market, because the market is far more inefficient in pricing businesses than is the negotiated market.

You're not going to buy any bargains, and I mean, you shouldn't even approach the idea of buying a bargain in a negotiated purchase.

You want to buy it from people who are going to run it for you. You want to buy it from people who are intelligent enough to price their business properly, and they are. I mean, that's the way things are.

The market does not do that. The market — in the stock market, you get a chance to buy businesses at foolish prices, and that is why we end up with a lot of money in marketable securities.

If we absolutely had our choice, we would own a group of — we would own three times the number of businesses we own outright.

We're unlikely to get that opportunity over time, but periodically we'll get the chance to find something that fits our test.

And in between we will, when the market offers us the right prices, we will buy more, either businesses we already own pieces of, or we'll buy one or two new ones. Something's usually going on.

There are tax advantages to owning all of them, but that's more than offset by the fact that you'll never get a chance to buy the whole Coca-Cola Company or the whole Gillette company.

I mean, businesses like that, sensational businesses, are just not available. Sometimes you get a chance to make a sensible purchase in the market of such businesses.

Charlie?

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

And there's also a class of buyers for a hundred percent of businesses who are basically able and assured financial promoters. I'm talking about the leveraged buyout funds and so on.

And those people tend to have the upside, but not the downside, in the private arrangements they've made with their investors. And naturally, they tend to be somewhat optimistic.

And so we have formidable competition when we try and buy a hundred percent of businesses.

WARREN BUFFETT: Most managers are better off, in terms of their personal equation, if they're running something larger. And they're also better off if they're running something larger and more profitable.

But the first condition alone will usually leave them better off. We're only better off if we're running something that's more profitable. We also like it if it's larger, too.

But our equation, actually, our personal equation is actually different than a great many managers in that respect. Even if that didn't operate, I think most managers psychically would enjoy running something larger. And if you can pay for it with other people's money, I mean, that gets pretty attractive.

You know, how much would — and let's just say you're a baseball fan — well, how much would you pay to own whatever your hometown, the Yankees?

You might pay more if you were writing a check on someone else's bank account than if you were writing it on your own. It's been known to happen. (Laughter)

And in corporate America, animal spirits are there. And those are our competitors on buying entire businesses. In terms of buying securities, most managers don't even think about it.

It's very interesting to me, because they'll say that — they'll have somebody else manage their money in terms of portfolio securities. Well, all that is is a portfolio of businesses.

And I'll say, "Well, why don't you pick out your own portfolio?" And they'll say, "That's much too difficult."

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

49. Revealing Wesco's estimated intrinsic value was a "quirk"

WARREN BUFFETT: Zone 4.

Could you hold it a little closer to you? I can't hear too well.

It's hard to hear. Is the mic on there?

AUDIENCE MEMBER: It's on.

WARREN BUFFETT: OK, I can hear that fine.

AUDIENCE MEMBER: Let's try it one more time. Dan Raider (PH) —

WARREN BUFFETT: Got it.

AUDIENCE MEMBER: — San Mateo, California. This is a question for Mr. Munger.

In your most recent letter to shareholders in Wesco's annual report, you calculated the intrinsic value of Wesco at about $100 per share, and compared that to the then-current market price of Wesco of about $130 per share.

In the same letter, you stated that it was unclear whether at then-current market prices Berkshire or Wesco presented a better value to prospective purchasers.

In light of that, would you compare the intrinsic value of Berkshire to its current market price?

CHARLIE MUNGER: Well, the answer to that is no. (Laughter)

Berkshire has never calculated intrinsic value per share and reported it to the shareholders, and Wesco never did before this year.

We changed our mind at Wesco because we really thought some of the buyers had gone a little crazy, and a lot of things were being said to prospective shareholders that, in our opinion, were unwise.

And we don’t really like attracting — even though we’ve had nothing to do with it — we don’t like attracting people in at high prices that may not be wise.

So we departed from our long precedent, and we did in the Wesco report make an estimate of intrinsic value per share.

But we’re not changing the general policy. That was just a one-time quirk.

WARREN BUFFETT: Well, and also I think it’s true that the Wesco intrinsic value per share can be estimated by anyone within fairly close limits.

It just isn’t that complicated because there aren’t a number of businesses there that have values different than carrying values, or where they are, they’re all footnoted, in terms of numbers.

So it would be almost impossible to come up with numbers that are significantly different than the number Charlie put in there.

Berkshire has assets that, number one of which would be the insurance business, that it’s clear have very significant excess values, but one person might estimate those at maybe three times what somebody else would estimate them at. That’s less true of our other businesses, but it’s still true in a way, so that Berkshire’s range would be somewhat greater.

And as Charlie — we basically — we don’t want to disappoint people, but we also don’t want to disappoint ourselves. But we have our own yardsticks for what we think is doable.

We try to convey that as well as we can to the people who are partners in the business, and I think that we saw some things being published about Wesco that simply might have led to, and probably did lead to, some expectations that simply weren’t consonant with our own personal expectations. And that leaves us uncomfortable.

50. Risk is "inextricably wound up" in how long an asset is held

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Hello, my name is Charles Pyle (PH) from Ann Arbor, Michigan.

I'd like to ask you to expound on your view of risk in the financial world, and I ask that against the background of what appear to be a number of inconsistencies between your view of risk and the conventional view of risk.

I mention that in a recent article you pointed out inconsistency in the use of beta as a measure of risk, which is a common standard.

And I mention that derivatives are dangerous, and yet you feel comfortable playing at derivatives through Salomon Brothers. And betting on hurricanes is dangerous, and yet you feel comfortable playing with hurricanes through insurance companies.

So it appears that you have some view of risk that's inconsistent with what would appear on the face of it to be the conventional view of risk.

WARREN BUFFETT: Well, we do define risk as the possibility of harm or injury. And in that respect we think it's inextricably wound up in your time horizon for holding an asset.

I mean, if your risk is that you're going — if you intend to buy XYZ Corporation at 11:30 this morning and sell it out before the close today, I mean, that is, in our view, that is a very risky transaction. Because we think 50 percent of the time you're going to suffer some harm or injury.

If you have a time horizon on a business, we think the risk of buying something like Coca-Cola at the price we bought it at a few years ago is essentially, is so close to nil, in terms of our perspective holding period. But if you asked me the risk of buying Coca-Cola this morning and you're going to sell it tomorrow morning, I say that is a very risky transaction.

Now, as I pointed out in the annual report, it became very fashionable in the academic world, and then that spilled over into the financial markets, to define risk in terms of volatility, of which beta became a measure.

But that is no measure of risk to us. The risk, in terms of our super-cat business, is not that we lose money in any given year. We know we're going to lose money in some given day, that is for certain. And we're extremely likely to lose money in a given year.

Our time horizon of writing that business, you know, would be at least a decade. And we think the probability of losing money over a decade is low. So we feel that, in terms of our horizon of investment, that that is not a risky business. And it's a whole lot less risky than writing something that's much more predictable.

Interesting thing is that using conventional measures of risk, something whose return varies from year to year between plus-20 percent and plus-80 percent is riskier, as defined, than something whose return is 5 percent a year every year.

We just think the financial world has gone haywire in terms of measures of risk.

We look at what we do — we are perfectly willing to lose money on a given transaction, arbitrage being an example, any given insurance policy being another example. We are perfectly willing to lose money on any given transaction.

We are not willing to enter into transactions in which we think the probability of doing a number of mutually independent events, but of a similar type, has an expectancy of loss. And we hope that we are entering into our transactions where our calculations of those probabilities have validity.

And to do so, we try to narrow it down. There are a whole bunch of things we just won't do because we don't think we can write the equation on them.

But we, basically, Charlie and I by nature are pretty risk-averse. But we are very willing to enter into transactions —

We, if we knew it was an honest coin, and someone wanted to give us seven-to-five or something of the sort on one flip, how much of Berkshire's net worth would we put on that flip?

Well we would — it would sound like a big number to you. It would not be a huge percentage of the net worth, but it would be a significant number. We will do things when probabilities favor us.

Charlie?

CHARLIE MUNGER: Yeah, we, I would say we try and think like Fermat and Pascal as if they'd never heard of modern finance theory.

I really think that a lot of modern finance theory can only be described as disgusting. (Laughter)

51. Buffett favors a "steeply progressive" consumption tax

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Good morning, I'm Paul Miller (PH) from Kansas City, Missouri. I've got two questions.

First, not too long ago, I believe it was Fortune Magazine that ran an article regarding personal tax rates.

And at the risk of misquoting you, my recollection is that you favored higher personal rates, rates even higher than those proposed by those in Washington.

The second question is, I've heard Berkshire Hathaway referred to as nothing more than a high-priced rich man's mutual fund. Would you care to comment on that also?

WARREN BUFFETT: Well, on tax rates, if you ask me what I personally favor, I personally favor a steeply progressive consumption tax.

That has a little more attention being paid to it now, although the "steeply progressive" might be modified by most of the advocates of the consumption tax, maybe to "mildly progressive" or something of the sort.

There's a Nunn-Domenici proposal along that line, and there are other people that are talking about it more. It may be examined by the new Kerrey-Danforth Commission, of which we've got a member in the audience.

But I believe, in one way or another, I believe in progressive taxes. So I am not shocked in terms of my own situation, and I don't think Charlie is particularly, about having a progressive income tax.

Although, like I say, I think society would run better over time if it were a progressive consumption tax instead.

Do you want the comment on the tax situation, Charlie?

CHARLIE MUNGER: Well, I think there is a point at which income taxes become quite counterproductive if their progression is too high. But I don't think we're there yet.

WARREN BUFFETT: We think — at least I think — I'm extraordinarily well treated by this society, and I think most people with high incomes are. I think if you transported most of them to Bangladesh or Peru or something, they would find out how much of it is them and how much is the society.

And I think there's nothing better than a market system, in terms of motivating people and in terms of producing the goods and services that the society wants.

But I do think it gets a little out of whack, in terms of what the productivity may be of an outstanding teacher compared to somebody who is good at figuring out the intrinsic value of businesses.

I don't have a better system on the income side, but I think society should figure out some way to make those who are particularly blessed, in a sense, that have talents that get paid off enormously in a market system, to give back a fair amount of that to the society that produces that.

52. Berkshire isn't a "rich man's mutual fund"

WARREN BUFFETT: The question about Berkshire being I think it was, was it rich man's mutual fund or something like that?

We don't look at it that way at all. We look at it as a collection of businesses, and ideally we would own all of those businesses.

So it's, to the extent that a mutual fund owns stock in a lot of companies and diversifies among businesses and we try to own a lot of businesses ourselves, I guess that's true. But I guess you could say the same thing of General Electric, or an operation like that.

We are more prone to buy pieces of businesses than the typical manager, but we are trying to do, in a sense, the same thing Jack Welch is trying to do at General Electric, which is try to own a number of first-class businesses.

He gets to put the imprint of his own management, which I think is very good, on those businesses, and we are more hands-off, both in the businesses we own outright and in the ones that we own pieces of.

But we're going at it the same way. And General Electric has been very successful under Jack's leadership, and doing it his way.

We think, in terms of what we bring to the game, and the problems of putting money to work all the time, that our own system will work best for us.

Charlie?

CHARLIE MUNGER: Yeah, I've got nothing to add to that.

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

WARREN BUFFETT: Zone 1.

CHRISTOPHER DAVIS: Hello, I'm Christopher Davis from New York City.

I'm interested in that many of the holdings of Berkshire are in industries that are perceived as interest rate-sensitive industries, including Wells Fargo, Salomon, Freddie Mac, even GEICO. And yet you have an admitted sort of ambivalence towards interest rates or changes in interest rates.

And it therefore seems that you don't feel that those changes affect the fundamental attractiveness of those businesses.

I thought maybe you could share your thoughts on what you see in these businesses that the investment community as a whole is ignoring.

WARREN BUFFETT: Well, the value of every business, the value of a farm, the value of an apartment house, the value of any economic asset, is 100 percent sensitive to interest rates, because all you are doing in investing is transferring some money to somebody now in exchange for what you expect the stream of money to be, to come in, over a period of time. And the higher interest rates are, the less that present value is going to be.

So every business, by its nature, whether it's Coca-Cola or Gillette or Wells Fargo, is in its intrinsic valuation, is a hundred percent sensitive to interest rates.

Now, the question as to whether a Wells Fargo or a Freddie Mac or whatever it may be, whether their business gets better or worse internally, as opposed to the valuation process, because of higher interest rates, that is not easy to figure.

I mean, GEICO, if they write their insurance business at the same underwriting ratio — in other words they have the same loss and expense experience relative to premiums — they benefit by higher interest rates, obviously, over time, because they're a float business, and the float is worth more to them.

Now, externally, getting back to the valuation part, the present value of those earnings also becomes less then.

But the present value of Coke's earnings becomes less in a higher interest rate environment.

Wells Fargo, it's — whether they earn more or less money under any given interest rate scenario is hard to figure. There may be one short-term effect and there may be another long-term effect.

So I do not have to have a view on interest rates — and I don't have a view on interest rates — to make a decision as to an insurance business, or a mortgage guarantor business, or a banking business, or something of the sort, relative to making a judgment about Coke or Gillette.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

54. "Retroactive" insurance is small part of our business

WARREN BUFFETT: Zone two?

AUDIENCE MEMBER: Hello, I'm Benjamin Baron (PH) from New York.

Could you speak about your insurance business a little bit? And especially the retroactive policies you've been writing.

WARREN BUFFETT: Can we speak about the — you say the reinsurance business?

CHARLIE MUNGER: Retroactive —

WARREN BUFFETT: I heard the retroactive part, but the first part.

BENJAMIN BARON: The reinsurance and the retroactive, and also the market in Bermuda and how you see it as one of your potential markets.

WARREN BUFFETT: I think the retroactive market is, what's called "retroactive insurance," has been pretty well eliminated by developments in accounting.

So I would not expect us to really have any volume in retroactive-type policies.

Now, when we write workers' comp with a policy holder dividend, in effect that's a retroactive policy. But that's a relative — that's small part of Berkshire's business.

Did I answer what you were driving at there?

AUDIENCE MEMBER: (Inaudible)

WARREN BUFFETT: Pardon me?

AUDIENCE MEMBER: (Inaudible)

WARREN BUFFETT: Did you get that, Charlie?

55. "You don't find out who's been swimming naked until the tide goes out"

CHARLIE MUNGER: Just comment on the development of the insurance business in Bermuda.

WARREN BUFFETT: Oh, Bermuda is simply a, you know, a new competitor. They're not so new, I mean, there've been companies in Bermuda before.

But in the last 15 months, 18 months, maybe there's been 4 billion-plus raised. And because, for tax reasons — maybe other reasons as well, but certainly for tax reasons — that capacity has been concentrated in Bermuda-based, Bermuda-domiciled reinsurers.

But essentially there's no great difference between that type of competition and other reinsurers competition, except for the fact that that capacity is new and the money's just been raised, and so there may be some greater pressure on the managers of those businesses to go out and write business promptly than on somebody that's been around for 50 years.

But it's no plus for us any time new capacity enters any business that we're in, and that certainly goes for the reinsurance business.

Reinsurance business, by its nature, will be a business in which some very stupid things are done en masse periodically. I mean, you can be doing dumb things and not know it in reinsurance, and then all of a sudden wake up and find out, you know, the money is gone.

And it's what people have found out — and I used that line in the report a year ago — it's what people have found out that were speculating on bonds with (inaudible) margins recently, that, you know, you don't find out who's been swimming naked until the tide goes out. And — (laughter) — essentially that's what happens in reinsurance. You don't, you really don't find out who's been swimming naked until the wind blows at them.

56. When cash "piles up," it's not through choice

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: I'm Whitney Anderson (PH) from Miami, Florida. And my question is, right now, we are reading about various analysts and how you should, in their individual opinion, adjust your more cash, more stocks, more bonds because of …

How does Berkshire Hathaway feel about times of relative financial insecurity? Do you arrange for more cash reserves looking forward to a time when you might be able to buy? Or do you go along your path?

WARREN BUFFETT: I think the question is do we sort of get into asset allocation by maintaining given levels of cash, depending on some kind of outlook or something of the sort?

We don't really think that way at all. If we have cash, it's because we haven't found anything intelligent to do with it that day, in the way of buying into the kind of businesses we like.

And when we can't find anything for a while, the cash piles up. But that's not through choice, that's because we're failing at what we essentially are trying to do, which is to find things to buy, and —

We make no attempt to guess whether cash is going to be worth more three months from now or six months from now or a year from now.

So it is — you will never see — we don't have any meetings of any kind anyway at Berkshire, but we would never have an asset allocation meeting. We would — (laughter) — keep looking. I mean, Charlie's looking, I'm looking. Some of our managers are looking.

We're looking for things to buy that meet our tests, and if we showed no cash or short-term securities at year-end, we would love it, because it would mean that we'd found ways to employ the money in ways that we like.

I think I would have to admit that if we have a lot of money around, we are a little dumber than usual. I mean, it tends to make you careless.

And I would say that the best purchases are usually made when you have to sell something to raise the money to get them, because it just raises the bar a little bit that you jump over in the mental decisions.

But we have, I don't know what we'll show, but certainly well over a billion dollars of cash around, and that's not through choice. That is a — you can look at that as an index of failure on the part of your management.

And we will be happy when we can buy businesses, or small pieces of businesses, that use up that money.

57. Fannie Mae and Freddie Mac as investments

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Gentlemen, my name is Richard Sercer from Tucson, Arizona.

I understand that 40 percent of all home mortgages have been securitized by Fannie Mae and Freddie Mac, the duopoly.

I would, at the risk of asking you for a projection, since you've talked about projections before, I'd be interested in understanding what you think will happen to that market share over time for this duopoly. Thank you.

WARREN BUFFETT: Well, the answer to that doesn't involve much of a prediction. That market share is essentially certain to go up.

That doesn't mean that those are wonderful businesses to buy, but the market share is essentially certain to go up because the economics that those two entities possess, compared to other ways of intermediating money between investors and people who want to borrow, no one else has those economics.

So what holds the share of Freddie Mac and Fannie Mae down is the fact that they are only allowed to loan roughly $200,000 on any mortgage. That's a limiting factor. It's probably been a good thing for them that it has been a limiting factor, but they are shut out of part of the market.

But the market that they are in, they essentially have economics that other people can't touch for intermediating money, including the savings and loan business that we were in.

We had a business that intermediated money, went out and got it from depositors and lent it to people who wanted to borrow on a home.

Freddie Mac and Fannie Mae do it the same way. They don't do it exactly the same way, but they perform the same function. And they could do it so much more cheaply than we could do it by having branches or anything of the sort and paying the insurance fee we paid.

They're going to get the business. They should get the business. And so their market share will grow.

Charlie?

CHARLIE MUNGER: Well, I think that's right. (Laughter)

WARREN BUFFETT: You're doing great. (Laughter)

58. Increased information speed doesn't affect our decisions

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Good morning, I'm Sarah Pruitt (PH) from Milwaukee, Wisconsin.

And I wondered if you feel that the speed with which information is available and disseminated today has affected your business-buying decision process. And do you believe that speed has caused you to miss opportunities?

WARREN BUFFETT: Question about seas expanding?

CHARLIE MUNGER: No. Does the speed of information today affect our decision-making process?

WARREN BUFFETT: No, we — I would say that we perform about like we were doing 30 or 40 years ago.

I mean — (laughter) — we read annual reports.

It isn't the — the speed of information really doesn't make any difference to us. It's the processing and finally coming to some judgment that actually has some utility, that is, that it's a judgment about the price of a business or a part of a business, a security, versus what it's essentially worth.

And none of that involves anything to do, really, with quick information. It involves getting good information.

But usually that — it's not — we're not looking for needles in haystacks or anything of the sort. You know, we like haystacks, not needles, basically. And we want it to shout at us.

And I would say that, well, virtually everything we've done has been reading public reports, and then maybe asking questions around to ascertain trade positions or product strengths or something of that sort.

But we never have to — we can make decisions very fast. I mean, we get called on a business — or we can make up our mind whether we're interested in two or three minutes. That takes no time. We may have to do a little checking on a few things subsequently.

But we don't need to get — I can't think of anything where we really need lots of price data or things like that extremely fast to make any decisions.

We've got good management information systems in our operating businesses, but that's just another — that's a question of keeping inventories where they should be and all of that sort of thing.

I don't think the invest — I think you could be in someplace where the mails were delayed three weeks, and the quotations were delayed three weeks, and I think you could do just fine in investing.

59. Why a stock buyback is unlikely

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: James Pan (PH), New York City. I have a two-parter question.

One, do you think the stock price of Berkshire Hathaway is trading within 15 percent of its intrinsic value currently?

And two, if you think Berkshire Hathaway is undervalued with the amount of cash you have on your balance sheet, would you consider a buyback?

WARREN BUFFETT: The answer about a buyback is that we generally have felt that market conditions that would make Berkshire attractively priced is probably going to make other things even more attractively priced, because we think our shareholders are more rational than the shareholders of many companies.

It's more likely that we will find some wonderful business at a silly price than we will find Berkshire at a silly price as we go along. So — (applause) that tends to eliminate repurchases.

But it doesn't rule them out, but it explains why the circumstances will not arise very often where repurchases would make good sense.

60. Why we don't estimate our intrinsic value

WARREN BUFFETT: In terms of giving you a number on intrinsic value, I don't want to spoil your fun. I mean, you really should work that one out for yourself. (Laughter)

Charlie is the expert on intrinsic —

Do you have any comment for him, Charlie?

CHARLIE MUNGER: Well, your attitude on that subject reminds me of a famous headmaster who used to address the graduating class every year. And he'd say, "You know," he says, "Five percent of you people are going to end up criminals." And he says, "I know exactly who you are." (Laughter)

And he said, "But I'm not going to tell you, because it would deprive your lives of a sense of excitement." (Laughter)

If you stop to think about it, the companies that constantly told their shareholders what the intrinsic value was were the real estate holding companies in corporate form.

And I must say, that the amount of folly and misbehavior that crept into that process was disgusting. We would be just associating with a bad group if we were to change our ways.

WARREN BUFFETT: Bill Zeckendorf Sr. I think was probably the first one to do that, with Webb and Knapp back in the late '50s. I still have those annual reports. And he would announce, you know, like, to eight decimal places what the intrinsic value of Webb and Knapp was. And he did it right till the day they filed for Chapter 11. (Laughter)

CHARLIE MUNGER: I remember that well, because somebody said that he fell into bankruptcy. And somebody else said, "How can you fall off a pancake?" (Laughter)

WARREN BUFFETT: Beware of people that give you a lot of numbers about their businesses. I mean, in terms of projections or valuations or that sort of thing.

We try to give you all of the numbers that we would use ourselves in making our own calculations of value.

We really — if you read the Berkshire reports, you essentially — you have all the information that Charlie and I would use in making a decision about the security.

And if there's anything really lacking in that respect, you know, we would actually — we would truly appreciate hearing from you, because we want to have that kind of information in the report. But then we want you to make the calculation.

But we've stuck, I mean, that material, for example, on the float in the insurance business, we consider that quite relevant, obviously, because we use up almost a page printing it. It's pretty serious stuff at Berkshire. (Laughter)

But that is relevant. I mean, your interpretation may be different than mine or Charlie's, but those are important numbers.

And we could give you a lot of baloney about satisfied policyholders, you know, in Lincoln, Nebraska. It wouldn't tell you a thing about what the company's worth — and have pictures of them, and happy, you know, receiving the check from the agent and all of that. (Laughter)

We're not going to do that.

61. Buffett on Peter Lynch

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: Mike Macy (PH) from Indianapolis.

I have really enjoyed reading your annual letters and your annual report, and I've gone back and read all of the older ones, too. They're terrific.

I have also enjoyed reading the two books by Peter Lynch, and I see a lot of commonalities between the two of you, the way you think, your philosophy, et cetera.

I'd certainly appreciate it if you'd make a few comments on what you think of Peter Lynch, the things he says in his two books, and the advice that he gives to investors. Thank you.

WARREN BUFFETT: Well, I know Peter. I don't know him well, but we've played bridge together in Omaha as a matter of fact.

I like him personally, and obviously he has an outstanding record. And he has written those two books, which have been bestsellers, about his investment philosophy. I don't really have anything — you know, I'm not going to embroider on his.

There's certainly a fair amount of overlap. There's some difference.

Peter, obviously, likes to diversify a lot more than I do. He owns more stocks than the names of companies I can remember. I mean, but that's Peter. (Laughter)

And, you know, I've said in investing, in the past, that there's more than one way to get to heaven. And there isn't a true religion in this, but there's some very useful religions.

And Peter's got one, and I think we've got one that's useful, too. And there is a lot of overlap.

But I would not do as well if I tried to do it the way Peter does it, and he probably wouldn't do as well if he tried to do it exactly the way I'd do it.

I like him personally very much. He's a high-grade guy.

62. We'll only write insurance when prices make sense

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, my name is Dave Lankes (PH). I'm a senior editor at Business Insurance Magazine.

A two-part question for you. Can you explain a little bit regarding your primary insurance operations? What drove up written premiums by more than 50 percent last year, and if you expect that to continue this year?

And then regarding your earlier comments on the stupid things reinsurers can do en masse, can you explain what potential pitfalls that the new cat facilities in Bermuda will have to avoid that you feel Berkshire Hathaway won't fall into?

WARREN BUFFETT: Well, the first question about our primary insurance figures, you'll find it way in the back someplace. But they're a little distorted because we bought Central States Indemnity, what would it be, late in the year '92. So there's a lot more premium volume in there for Central States in '93 than there was in '92.

Our basic — National Indemnity's basic insurance, which is commercial, auto, and general liability, premium volume was fairly flat, the Homestate operation fairly flat, Cypress up somewhat. But those numbers were not anything like the changes —

So our business last year, pro forma for including Central States Indemnity for all of '92, would not have shown a dramatic change. There really hasn't been much happening in our primary business, except that it's been run, it's done very well, but it is not growing or exploding. And that's true this year as well as last year.

It's a good business. And it could grow in certain kinds of markets very substantially, but it is not growing in this market, and it did not grow last year, although its underwriting was very good.

In the reinsurance business, I think, essentially, the difference in our reinsurance business from many others, you know — it doesn't include them all in a place like Bermuda — is essentially the difference that may exist in our operations and securities versus other people.

We will offer reinsurance at any time in very large quantities at prices we think make sense. But we won't do business if we don't think it makes sense, just like we will buy securities, to the extent of the cash we have available, if they make sense. But we have no interest in being in the stock market per say just to be in it. We want to own securities that make sense to us.

I think for most managements, if the only thing they're in is the reinsurance business, they may like it better when prices make sense, but they will, I think they will be prone to do quite a bit of business when prices don't make sense as well, because there's no alternative, except to give the money back to the owners. And that is not something that most managements, you know, do somersaults over. (Laughter)

So, I think we are in a favored position, essentially being — having the flexibility of capital allocation that lets us take the lack of business with a certain equanimity that most managements probably can't, because of their sole focus on the business.

Rates will get silly, in all likelihood, after a period when nothing much happens, when you've had a couple of years of good experience.

We price to what we think is exposure. We don't price to experience. I mean, the fact that there was no big hurricane last year — I forget the name of the one that was coming in at North Carolina and then veered out essentially — but to us, it has nothing to do with the rates next year whether that hurricane actually came in in a big way or veered out into the Atlantic again. I mean, we are pricing to exposure.

And everyone says that, but the market tends to price and respond to experience, and generally to recent experience. That's why all the retrocessional operations in London, you know, in the spiral, went busted, because they priced, in our view, they priced to experience rather than to exposure.

It's very hard not to do that, to be there year after year with business coming by and investors expecting this of you and not do that.

But we will never knowingly do that. We may get influenced subconsciously in some way to do that, but we will not do that any more than we will accept stock market norms as being the proper way for us to invest money and equities.

Basically, when you lay out money or accept insurance risks, you really have to think for yourself. You cannot let the market think for you.

Charlie?

CHARLIE MUNGER: Yeah, I think Berkshire is basically a very old-fashioned kind of a place. And it tries to exert discipline to stay old-fashioned.

And I don't mean old-fashioned stupid, I mean, you know, the eternal verity, so to speak, basic mathematics, you know, basic horse sense, basic fear, basic discriminations regarding human nature, all very old-fashioned. And if you just do that with a certain amount of discipline, I think it's likely to work out quite well.

63. Praise from Sandy Gottesman

WARREN BUFFETT: Zone 3.

DAVID GOTTESMAN: David Gottesman from New York.

It's no wonder that this meeting draws stockholders from all over the country. And despite the talk about age today, I'm happy to say this meeting gets better every year.

Berkshire stands unique in American business as a company whose name has become synonymous with management excellence.

Unlike many American corporations, we, as stockholders, don't have to worry about reorganizations, large write-offs, massive restructurings, overstated earnings, and overpaid executives with strategic visions.

Instead, year in and year out, we enjoy the benefits of the common sense and brilliance of Charlie and Warren. (APPLAUSE)

WARREN BUFFETT: What did you say your name was? (Laughter)

DAVID GOTTESMAN: I want to add to that, to say nothing of your good humor.

It's easy to take such consistently outstanding results for granted, but we in this room are the direct beneficiaries of their efforts.

By our presence here today, we show our appreciation to them for their exceptional performance. But we can also demonstrate in another way. I would like to suggest we give them a rousing hand of applause for a job well done. Thank you. (APPLAUSE)

WARREN BUFFETT: Thank you. That was Sandy Gottesman. We've worked together for 30-odd years, and he's finally got that down. I appreciate that, Sandy. (Laughter)

64. Brief adjournment

WARREN BUFFETT: With that, we will adjourn. And anyone who wants to stay around, we'll reconvene in 15 minutes, and then we'll be here till about 1:15.

Afternoon Session - 1994 Meeting

1. No comment on Guinness investment

WARREN BUFFETT: Zone 2 now. Well, I don't know where zone 2 is, but we'll — (laughs)

AUDIENCE MEMBER: Do you feel basically the same about your investment in Guinness now as when you made the investment, in terms of the company?

WARREN BUFFETT: Well, I wouldn't like to comment on anything that we own, in terms of how we rate them as desirability or anything. I mean, whether it's Coke or Gillette or anything that — we made decisions at a given time, at a given price, which you can figure out by looking at our purchases.

But we may be buying or selling any of those securities right as we talk. And we simply don't think it's in the interest of Berkshire shareholders as a group to be talking about things that we could be buying or selling.

2. World Book's sales slide: "I wish I knew the answer"

WARREN BUFFETT: OK?

AUDIENCE MEMBER: Hi, David Winters, from Mountain Lakes, New Jersey.

Just wondering, World Book's had a tough time lately, and I'm wondering if there's things you're doing to try to improve that.

And also, The Buffalo News has been fabulous. And I'm kind of wondering what's driving The Buffalo News?

WARREN BUFFETT: Buffalo News is doing what?

AUDIENCE MEMBER: Fabulously.

WARREN BUFFETT: Yeah, it's doing well, right. Well, I would say you got to give credit Stan Lipsey — I'm not sure whether Stan's here right now, but — who's been running the News.

World Book, in terms of unit sales — as we put in the report — have fallen off significantly the last few years. It's actually surprising, in a sense, how well the profits have held up because they've done a good job, a very good job, in that respect.

And as we put in the report, we don't know the answer, precisely. We are, Ralph Schey is — has taken some actions — is taking some actions — that he thinks will improve the operations. Ralph's record as a manager is absolutely at the top of the list. I mean, it — I wrote about it in the 1992 report.

In 1993, Ralph did even better. I mean, it was a — fabulous. I think, probably, may have been 110 or so million pre-tax on 90-some million of average equity capital, or something of the sort. So it's a fabulous record.

But Encyclopedia Britannica, as you probably know, ran at a loss last year. The encyclopedia business has been very — has been poor. Could be due to electronic competition, could be due to recruiting problems for salespeople. Obviously, it can be a combination of many factors.

If we knew the answer, we'd have — you wouldn't be seeing those figures right now. But it is a top item of attention for Ralph. He takes anything that's not performing as well as before very seriously. And we will see what happens.

But I don't have a prediction on it. I wish I knew the answer. I don't see any variables to, in any intelligent way, tell you or — we put in the report the best we could do on that.

The profitability has, like I say, has been pretty good. But obviously, current trends of new sales will catch up with us at some point, unless we boost unit sales.

I don't think our market share, if you look at print encyclopedias, has fallen. But I can't be sure of that, but I think that's probably true. But there are an awful lot of encyclopedias going out there as part of a bundled product with computer sales.

3. Breaking up Berkshire wouldn't help

WARREN BUFFETT: How are we going to do this, is there?

VOICE: We got three now.

WARREN BUFFETT: OK, I'll let you hand the mic to whomever, you —

VOICE: (Inaudible) three.

AUDIENCE MEMBER: Lee again, from Palo Alto. By Omaha standards you are a relatively young man.

And every year, you point out that Berkshire's size now precludes you from making the great, relatively small trades which made your reputation.

How much thought have you given to breaking up Berkshire into smaller entities?

WARREN BUFFETT: How much what?

AUDIENCE MEMBER: How much thought have you given into breaking up Berkshire into smaller entities, which would allow you to make those nice, small, wonderful trades that you made from the beginning?

WARREN BUFFETT: It wouldn't do any good to break into smaller entities, because I'd still own, you know, we'd still have 10 billion-plus of capital to be responsible for, wherever it would be.

So, the — we could distribute it out to the shareholders, and let them make their own decisions, obviously. And any time we thought that we weren't going to get more than a dollar of value per dollar retained, that, obviously, would be the course to follow.

But there's no magic to creating multiple little — I mean, we could call Berkshire Two, Berkshire Three, Berkshire Four, but you still got the problem. There's $10 billion to invest, and it doesn't really solve anything.

Charlie, do you have any thoughts on that?

CHARLIE MUNGER: No, the — Berkshire is incredibly decentralized, in the — in terms of power and decisions resting in the operating divisions. In terms of the marketable securities, it's incredibly centralized.

And so far, we have not had any big penalty from not being able to do the things that we did when we were young. Eventually we will reach the penalty.

WARREN BUFFETT: Yeah, I think we're — there's no question we could earn higher percentage returns working with $100,000, though, than $10 billion. But, yeah — but it hasn't hurt us as much as we thought it would, as size has increased.

But your universe of opportunity shrinks. But it shrinks no matter — I mean, you can set it up in 20 bank accounts or one bank account, but you still — the universe still has to fit the 10 billion, in aggregate.

4. "Absolutely sensational job" by General Dynamics management

WARREN BUFFETT: Now, how are we doing this? Do we have another zone over there? Yeah.

AUDIENCE MEMBER: Michael Bunyaner (PH), New York City.

Two questions. One, last year you discussed in your annual report your investment in General Dynamics. And you also gave your proxy to the company and its management. This year, it appears you have sold the stock.

WARREN BUFFETT: This year, what?

AUDIENCE MEMBER: This year, it appears that you have sold the stock in General Dynamics.

What has changed that you sold 20 percent of your stake? This is question number one, and I have number two.

WARREN BUFFETT: Probably inappropriate to be talking about what we're buying or selling, except to the extent that we make a public — have to make a public announcement, which, on something like General Dynamics, we've got 13G requirements if we change by more than 5 percent.

And we also have — as long as we own more than 10 percent — we have monthly reporting requirements under Form 4.

We think the management of General Dynamics has done an absolutely sensational job.

Obviously, also it isn't the kind of business, basically, that we have a 20-year view on, or something of the sort. So, it's — the shareholders of General Dynamics have been extraordinarily well-served by the management of that company. And we've — we're thankful, because we prospered accordingly.

AUDIENCE MEMBER: But should I take from this comment that you have changed your view about the business itself?

WARREN BUFFETT: Pardon me?

AUDIENCE MEMBER: Should I take from your comment that you have changed your view about the business itself?

WARREN BUFFETT: No, no. I think you take my comments as saying just what I've said. (Laughs)

AUDIENCE MEMBER: OK. (Laughter)

Question number two, could you tell me —

WARREN BUFFETT: I think we want to give people a chance around the room, and then when, in the zone you're in, when a second question comes along, it will be fine. But we want to get as many people in this hour as we can, because this is the hard core here.

5. No encouragement for short-term stockholders

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: It appeared to me that in 1993 the variation between the stock price for the high and the low was much greater than years in the past. Would you mind commenting on that?

WARREN BUFFETT: Well, there was more volatility in the price of Berkshire last year. And as I put in the annual report, the stock overperformed the business last year.

Now, over any 10 or 20 or 30-year history, every year the stock is going to perform a little differently, at least, from the business. I mean, it may slightly underperform, or slightly overperform.

We would prefer that those variations be as small as possible. But there was more variability last year than historically's been the case. Although we've had one or two other — we had a few years like that. We —

Our best way to handle that is to give all the information we can to shareholders and prospective shareholders, and follow policies that we think will induce the investment-oriented with long time horizons to join us, and not to encourage other people. But, occasionally — you know, we can't guarantee that result.

One of the things that was interesting to me, I don't know whether it was three months ago or when, but I happened to be talking to the [NYSE] specialist, terrific specialist, Jimmy Maguire. He had to leave, but he was here earlier in the session.

And I think, at the time, the stock was around 16,000 or something like that. And he had some rather significant stop-loss orders on the books at 15-5, or thereabouts, involving some hundreds of shares.

And that to me is a signal that, you know, we have some people that are — in my view — are not really the kind of owners that we would like to attract. Because why somebody wants to put in an order to sell something for 15,500 that they don't want to sell at 16,000 is beyond me, but — (Laughter)

The idea of people using stop-loss orders with Berkshire, obviously — it tells me that we've got some people in that are using it as trading vehicle of some sort, or have some totally non-investment-type calculations in their mind.

I don't think we have very many of them. But obviously, if we have enough people like that, you will have a more volatile stock than if you have a whole bunch of people who look at it as something that they're going to hold for the rest of their life.

And the stock did go down at that time and hit 15,500. And there were — that — I think it was close to 300 shares, which is 4 1/2 million dollars' worth of stock.

And somebody made a decision, apparently, that they — or some small number of people — made a decision that they wanted to sell something at 15,500 that they could have sold for 16,000. The lower it went, the better they liked it, apparently. I mean, the better they liked the sale. (Laughter)

Which, you know, has always struck me as like having a house that you like, and you're living in, and, you know, it's worth $100,000 and you tell your broker, you know, if anybody ever comes along and offers 90, you want to sell it. I mean, it doesn't — (laughter) — make any sense to me.

But it has — I would say that there's been some small — I think, relatively small — tendency for people to get — relatively few people — but to get more interested in the price of the stock in terms of — and thinking of it in terms of whether it's going to go up or down in the next six months, than might formerly have been the case.

I think we're unusually well-blessed in that respect, in that we've got people who basically want to own it for a very long time.

But to the extent that you get people who were owning it because they think the stock market's going to go up, or something of that sort's going to happen, that is not good news from our standpoint, and it will increase the volatility in it.

We will do nothing to encourage that.

6. Berkshire benefits when the stock market falls

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Yes, Mr. Buffett, Steve Lang (PH) from Toronto.

I was just curious about when you were saying that one of the best things that could happen to shareholders is the — the market goes down and you're able to buy good businesses at foolish prices.

And then a little on, you were saying that we could judge your ability to do what it is that you feel you should be doing by how much cash you have in the account at any given point in time, and —

WARREN BUFFETT: By what?

AUDIENCE MEMBER: By the amount of cash that you have in the account. In other words, I guess, what you feel you're supposed to be doing is investing the cash in good businesses.

So I'm just wondering about that kind of dichotomy. Where does the cash come from if the market does go down, if you've been successful in your first ability? Would that be from the cash flow on the operations of the business from the float?

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: Is that —?

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: So really, the success of the company then is, to some degree, the fact that you're able to dollar-cost average into the market on an ongoing basis? Is that right?

WARREN BUFFETT: Well, it isn't that precise. But A, we do generate cash in considerable amounts, so that we will not husband cash, simply because we think the market's going to go down, in order to buy something.

But obviously, as cash comes in, we're always looking for things to do. And the cheaper that the market is generally, the more likely it is that we will find something that we understand and that we like, and that the price will be attractive, and that we will do it.

But it isn't like we can change around the whole portfolio then, because that doesn't gain us anything. I mean, we'd be selling things at lower prices to buy things at lower prices.

But to the extent that we have net cash coming in — which we do, and which we will have — on balance, we're, you know, we're adding to our businesses at more attractive prices than would be the other case.

And it's no prediction on any given company. I mean, whether it's Gillette or Coke, or anything. It might be something we already own, it might be something we don't own. But we welcome the chance to buy more shares.

We're not wishing it on anybody. But if you asked us next month whether Berkshire would be better off if the whole stock market were down 50 percent or where it is now, we would be better off if it was down 50 percent, whether we had any cash on hand now or not, because we would be generating cash to buy things.

7. Salomon's compensation: "Far from ideal"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Byron Ransdell (PH) from Raleigh, North Carolina. Thanks for your hospitality to this weekend.

WARREN BUFFETT: Well, we thank you for coming, too.

AUDIENCE MEMBER: My question concerns Salomon, Inc., and more specifically, Salomon Brothers. I know that you were on the board of directors, I think, from '87 to the current time. Very much interested in compensation there, and maybe on the compensation committee.

Between 1987 and 1992, Salomon's financial results were quite dismal in a very lumpy way, but overall, quite dismal.

In your opinion, if the compensation had been rational during this time, would Salomon have shown results that would make it a quite decent business?

WARREN BUFFETT: Would Salomon — if the compensation —

CHARLIE MUNGER: If the past compensation —

WARREN BUFFETT: — had been more rational —

CHARLIE MUNGER: — decisions had been more rational, '87 to the current time, would Salomon have done better? Yeah, was that it?

AUDIENCE MEMBER: Yes, sir.

WARREN BUFFETT: Well, I would — yeah, I would say that, if the present people and the present compensation philosophy — which allows for very large payments for very large results — I think the company would have done better, yeah.

It — you're going to see very big numbers paid in Wall Street. That's the nature of it. The trick is to pay them only when you're getting very big results for the owners. I mean, it — there's no way you're going to pay numbers that look like numbers in other industries, and get great results for owners.

But if you pay these big numbers, I think you should be getting very good results for owners.

And there — the old system was not — I mean, it wasn't totally off the mark on that. But it was far from an ideal system, in my view.

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

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Warren, I have one question.

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

(BREAK IN RECORDING)

WARREN BUFFETT: — five million shares, as I remember, of Coke sometime in the early fall or thereby — I don't remember exactly — last year. And the puts, I think the premium was around 7 1/2 million dollars, and they were priced around 35.

We have not done that very often, and we're unlikely to do very much of it. For one thing, there are position limits on puts, which don't apply to us, but they apply to the brokers for which we do them. And those position limits were not clear before that. But we could probably write puts on that same amount by doing it through a bunch of different brokers.

It's not something we're really very likely to do. I was happy to do it, and in that particular case, we made 7 1/2 million dollars.

But we're better off, probably — if we like something well enough to write a put on it, we're probably better off buying the security itself, and particularly since we can't do it in the kind of quantities that really would make it meaningful to Berkshire.

There are securities I would not mind writing puts for 10 million shares or something, but I — that probably — it's probably allowable for us to do it. It's not allowed — we'd probably have to do it through multiple brokers to get the job done.

And on balance, I don't think it's as useful a way to spend my time as just looking for securities to buy outright.

Charlie, you have anything?

CHARLIE MUNGER: No.

9. Don't believe reports on what we're buying or selling

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Mr. Buffett, I'm from West Point. And my name is Rogers.

A couple of months ago, there were stories in The World-Herald that Berkshire Hathaway had taken a large position in Philip Morris, and UST. But in your annual report, I don't see anything about that. Can you comment?

WARREN BUFFETT: Yeah, I would say, in the last two years maybe — I'm just approximating — I've probably seen reports in either The Wall Street Journal, or USA Today — maybe picked up by The Associated Press, or in The Herald, but in papers of some significance — I've probably seen stories that we were buying maybe any one of 10 companies in aggregate over that period of time. I would say a significant majority were erroneous.

We don't correct the erroneous ones, because if we don't correct the erroneous ones — if we correct the erroneous ones, and don't say anything about the correct ones, in effect we're identifying the correct ones, too.

So we will never comment on those stories, no matter how ridiculous they are.

And it's interesting because, you know, they keep getting printed. And frankly, from our standpoint, the fact that most of them are inaccurate is probably useful to us. We don't do anything to encourage it, but it — the fact that people are reading that we are buying A, B, C, or X, Y, Z when we aren't — you know, that's — I don't think people should be buying stocks because they're reading in the paper that we're buying something. But if they do, they may get cured of it at some point.

Maybe the newspapers will even get cured of writing the stories when they don't know, you know, what the facts are.

But it's something we live with, and we'll probably continue to live with.

And I would say that based on history, if you read something about us buying or selling something, other than through reports we've filed with the SEC or regulatory bodies, the chances are well over 50 percent — that I can tell you, based on history, is correct — well over 50 percent that it's wrong.

10. Unlikely Berkshire will be a Dow or S&P 500 stock

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Do you expect that Berkshire will become one of the Standard & Poor 500 stocks, or a Dow Jones stock?

WARREN BUFFETT: Well, I think it's unlikely it ever becomes a Dow Jones stock.

I don't know what the criteria are for the S&P 500. But I imagine there's some reason why we don't fit. I don't know whether they have questions about number of shares outstanding or — I've never checked with S&P.

I wouldn't be surprised if we have the largest market capitalization of any company that isn't in the S&P, although I don't know that. But they may have some criteria that preclude Berkshire being part of it.

I've always thought it would be very interesting, for those of you who like to think about such things, that if we were part of the S&P 500, and enough people became indexed so that 60 percent of the market was indexed, and if Charlie and I wouldn't sell, which we wouldn't, it'd be an interesting proposition as to how the index funds would ever get their 60 percent if they tried to replicate the S&P.

It'd be — I don't know whether they have rules even about concentration of ownership. That same line of thinking might have applied to Walmart, or some company.

Because just take the extreme example of a company that had 90 percent of its stock owned by one individual, and 12 percent of the money in the market were indexed, and the 90 percent wouldn't sell, it would bring back the Northern Pacific Corner or something of the sort.

In any event, I don't think that's going to be a problem. And I don't think we are going to end up being in either index, so —

11. Diversify if you don't understand businesses

WARREN BUFFETT: Yeah, zone 1?

AUDIENCE MEMBER: Mr. Buffett, my name is Aaron Morris (PH). I'm from California.

What I wanted to know was how you think about how large a position you're willing to take in a given security, both in your case, where you have new cash coming in that you can invest, and in the case of an investor, where they have a fixed amount of capital, and they're trying to decide what's the most (inaudible) security that they really love?

WARREN BUFFETT: Well, Charlie and I have — probably at our present size, we will never find anything that we get as much money into as we want. Don't you think that's probably true, Charlie? If we really like it?

CHARLIE MUNGER: Yeah, I think that's quite likely.

WARREN BUFFETT: Yeah, so we will probably never hit the limit. We would love to. We'd love to find something we felt that strongly about, and occasionally we do.

But we won't get as much money into it as we would wish, or as if we were running a million dollars of our own money or some number like that, so —

We are willing to put a lot of money into a single security. When I ran the partnership, the limit I got to was about 40 percent in a single stock. I think Charlie, when you ran your partnership, you had more than 40 percent in —

CHARLIE MUNGER: Sure. (Laughter)

WARREN BUFFETT: And we would do the same thing if we were running smaller partnerships, or our own capital were smaller and we were running that ourselves.

Because, no, we're not going to do that unless we think we understand the business very well, and we think the nature of the business, what we're paying for it, the people running it, and all of that lead up to virtually no risk, and —

But you find those things, occasionally. And we would put — assuming it were that much more attractive than the second, and third, and fourth choices — we would put a big percentage of our net worth in it.

We only advise you to do that — well, we probably don't advise you to do it all, maybe — but we would only advise you to do it, if you're doing it based on your conclusions about — your own ideas of value, and something that you really feel you know enough to buy the whole business, if your funds were sufficient, and it was being offered to you. You ought to really understand the business.

But people do that all the time, incidentally, in private businesses, which have got terrible prospects. I mean, they buy dry cleaning establishments, or filling stations, or whatever, and they put very high —franchises of some kind — they put a very high percentage of their net worth into something — a business that's very risky, basically. I mean, it —

People put all their money in a farm, you know. It's a business. It's subject to all kinds of business risk.

So it's not crazy, if you understand the business well, and if the price is sufficiently attractive, to put a very significant percentage of your net worth in. If you don't understand businesses, then you're better off diversifying and fairly widely diversifying.

Zone — go ahead. Sorry

CHARLIE: Berkshire has a substantial shareholder whose father accumulated the original position, and when he died he left a very large estate, practically all of which was in two securities, Berkshire and one other outstanding company.

A bank was co-trustee. And the bank trust officer said you've got to diversify this. And, you know, it was a very large estate.

And the young man who was co-trustee with the bank said, “Well,” he says, “you know, if my father believed the way you do, he might have been a trust officer in a bank instead of — (laughter) — leaving this large estate.” (Applause)

And that young man holds the Berkshire to this day. And I suppose the bank is still giving the same advice. (Laughter)

12. We don’t like to “give you our answers” on Coca-Cola

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Mr. Buffett, this is Chuck Peterson (PH) from Omaha.

And I was just wondering if you could comment on the Coca-Cola Company — you haven’t really talked about it too much today — in regards to what you foresee over the next five years, the earnings per share growth, and where this growth is, perhaps, going to come from.

WARREN BUFFETT: Was that the question, about the growth of Coke?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: You really have to come to your own conclusion.

Coca-Cola Company writes — their annual reports are extremely good. I mean, they’re very informative. You know, you —

My guess is that, at least, if you read a few of the reports, you’d absolutely know as much about the Coca-Cola Company as I would.

But in the end, you have to make your own decisions about growth potential, profitability potential, and all that.

But the one thing I can assure you is that, probably, if you spend a relatively small amount of time on it, the facts that you will have available to you for making a decision on that question will be just as good, essentially, as the facts you’d get if you’d worked at the Coca-Cola Company for 20 years, or if you were a food and beverage analyst in Wall Street or anything of the sort.

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

But we don’t like you to give you our answers. I mean, that would not be a good idea.

13. Allianz deal was “close to a wash”

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: David — I'm sorry — David Swab (PH) from Austin, Texas.

I have a question pertaining to the convertible bonds that were outstanding for about four years.

Any thoughts on, if you're a teacher, to grade if that was a good deal, bad deal, how the money was employed compared to the cost of getting out of the bonds? Any thoughts?

WARREN BUFFETT: Charlie what? Did you get that?

CHARLIE MUNGER: He wants to know if you think, in retrospect, your deal with Allianz was a good deal for Berkshire.

WARREN BUFFETT: No, I would say that if I knew everything at the time that we did the Allianz deal — which was a convertible shareholder coupon debenture — if I knew everything now — then — that I know now, would we have done it? Probably pretty close. We had relatively few bonds converted when we called — when he called them. And so — that — it really wasn't a negative in that sense.

But if we'd had more — we could have easily had a lot more converted. And that would not have been so good, obviously, if we'd ended up selling a lot of stock at 11,800 or whatever it was.

It's very hard to measure exactly what we did with the 400 million or so that we took in at the time. So, money being fungible, separating that 400 million from other resources to measure the — what happened on the plus side from having the money — is hard to do.

But my guess is, if you could play the whole hand over again, it probably was maybe a tiny minus to have issued them. What do you think, Charlie?

CHARLIE MUNGER: It's certainly close to a wash.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Now, you could ask about USAir, and that is one we would have been well to duck. (Laughter)

WARREN BUFFETT: And I might say Charlie had nothing to do with that decision. (Laughter) He didn't even know about it till I did it. And when he knew about it, hmmm. (Laughter)

14. "Size is a disadvantage" in buying and selling

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Mr. Buffett, I'm Joe Sirdevan from Toronto.

With respect to Berkshire's non-permanent, but large — and therefore, illiquid — holdings, what is your strategy for managing market impact on sales, given the intense scrutiny that Berkshire's under by the market?

WARREN BUFFETT: I didn't get that either. You get that?

CHARLIE MUNGER: I'm not hearing that very well.

WARREN BUFFETT: Yeah, I don't know whether you're too close to the mic — we're having a little trouble on that.

CHARLIE MUNGER: Speak a little more slowly.

WARREN BUFFETT: Or maybe the monitor can repeat that and — would you repeat the question?

AUDIENCE MEMBER: Sorry. Just with respect to Berkshire's large non-permanent holdings that are, therefore, illiquid, I'm just wondering what your strategy is for managing market impact when you do decide to sell portions of those holdings, given the intense scrutiny you're under?

WARREN BUFFETT: Yeah, question about the things we might sell, and what's going to happen to the market when we sell them.

That depends. I mean, it can be a very significant impact. It can be a negligible impact.

And it depends on market conditions, it depends on whether we might sell in a couple of large blocks to some institutions, it depends on — it could be, you know, there could be a tender off or something of the sort we would sell through. So, it's hard to measure.

But it is a disadvantage. Size is a disadvantage, you're absolutely correct in the basic point, both in buying and in selling. And we don't know any way around that.

We allow for it, in terms of what we expect, you know, the kind of possibilities we need to see. And we do — we sell so infrequently, that it's not a crusher of a negative point, but it's a negative we have that you do not.

15. No key man insurance for Buffett and Munger

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: My name is Anna (inaudible). I'm from Roanoke, Virginia.

Does Berkshire Hathaway or any of its subsidiaries have key man insurance on you and Mr. Munger?

CHARLIE MUNGER: Does Berkshire have key man insurance on —

WARREN BUFFETT: Oh, no. No. We have no life insurance, to my knowledge, on anyone except the maybe standard — the group life contracts people have. We have no key man insurance.

It really doesn't — it wouldn't be material.

I mean, that if we have a market value of 18 billion or something like that, if it really didn't — if it — a one — if it made a 1 percent difference, it'd be $180 million.

And basically, the math of intelligently selling insurance is better than the math of intelligently buying insurance. (Laughter and applause)

16. Guinness-VNMH restructuring was "logical"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Mr. Buffett, I'm Barry Siskind (PH) from Mesa, Arizona. Long-time admirer of yours. Question pertains to Guinness.

I remember reading in a publication I greatly respect, Outstanding Investor Digest by [editor] Henry Emerson in New York, that back in — I think it was '58 or '59, you made an investment in Cuba, decided to never to make an investment outside the United States again at that time.

Have subsequently invested in Guinness. I'm a fellow investor in Guinness. I've invested in Guinness for — and its sister company, Louis Vuitton Moët Hennessy — for over five years. And I'm very happy with those investments, by the way.

There's been a restructuring, as you know, of the Guinness-LVMH relationship, where Guinness no longer owns 24 percent of LVMH. Rather, it owns only its distilling, or I should say, alcoholic beverage-related businesses —

WARREN BUFFETT: The Moët Hennessy part.

AUDIENCE MEMBER: Right, the Moët Hennessy part.

The other parts of LVMH are showing better results these days, namely the Louis Vuitton luggage, as well as the Christian Dior perfume. They've also expanded into the newspaper business this past year, a business that you understand.

Do you intend to look at the possibility, first of all, of participating in those businesses that you no longer own now — with the restructured Guinness-LVMH deal — through some other form?

And the second question relates to the currency risk inherent in the Guinness investment, having bought it at about $1.80, as you mentioned, pound sterling now down to about $1.48.

The cost of hedging foreign currency through the FX has diminished through the combination of lower interest rates in the U.K., and higher interest rates, most recently in the U.S., to just about zero.

I take it we're all investors in companies, not speculators in currencies. So, the second part of the question is, do you intend to do anything about the currency risk portion of that investment?

WARREN BUFFETT: Well LVMH, which as you mentioned was 24 percent owned by Guinness — you know, that's one of thousands of securities that we could be a buyer or a seller of. So, I really don't want to comment on LVMH's specific attractiveness, or lack thereof.

And Guinness, I think what Guinness did was quite logical. I mean, their interest in that operation was basically through the distribution advantages that it gave to Guinness's own brands around the world, to be hooked up with Moët Hennessy, and vice versa. So, I think what they did was logical.

You can — the question of the exchange rate and all of that — the exchange rate, in terms of what they got in the spirits business, versus what they gave up in the luggage business, as in Christian Dior and a few things. You can form your own opinion on that.

But I think the logic was sound. But in terms of whether we want to be in LVMH by itself, that's like any other security, which we really can't answer.

17. Berkshire doesn't hedge currencies

WARREN BUFFETT: Second question related to —

CHARLIE MUNGER: Hedging.

WARREN BUFFETT: Hedge. Yeah, the hedging of currency —

CHARLIE MUNGER: Do we hedge?

WARREN BUFFETT: The answer to that is we don't. And Coca-Cola, as I mentioned, gets 80 percent of their earnings from a variety of currencies, the yen and the mark being two very important ones. They're going to be getting a very high percentage five years from now, 10 years from now.

They do certain currency transactions, but it's a practical matter. If you own Coca-Cola, you own a bunch of foreign bonds with coupons on them, denominated in local currencies, that go on forever.

Now, should you try and engage in currency swaps on all those coupons — you don't know what those coupons are yet, because you don't know how much they're going to earn in Japan or Germany, but you do know it's going to go on for decades, and it's — they're going to be very significant sums.

Should you try and engage in a whole bunch of currency swaps to go on out and convert all that stream into dollars or anything?

We basically don't think it's worth it. We don't think our opinion on currencies is any good. We don't think — we think the market probably know — well, we know it knows as much about it — it probably knows more about currencies, but it — we don't know — we do not know more than the market does about currencies.

So there are costs to hedging. And even though interest rate structures may cause the curve to look flat going out forward, so that, in effect, there's no contango on it, there's still the cost — there are costs in it. Now, it's a relatively efficient market, so that they're not huge.

But we see no reason to incur those costs with what we regard as a — totally, a 50-50 proposition. And it really doesn't go out that far anyway. I mean, we could do it for a couple of years.

But if you take that — the way we look at businesses, being the discounted flow of future cash out between now and Judgment Day, we can't really hedge that kind of a risk anyway. We could keep rolling hedges, but there's a cost to it that we don't want to incur.

We don't — we wouldn't worry a whole lot about whether some portion of our earnings, whether it's from Guinness, whether it's from Coke, whether it's from Gillette, are denominated at some mixture of marks, and pounds, and yen, and dollars, or whether they're all in dollars.

We'd slightly prefer if it were all in dollars, but we don't lose sleep over the fact that it may be coming from a mix of currencies like that. We wouldn't like it, in terms of, obviously, some very weak currencies.

18. Insurance intrinsic value far exceeds book value

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Lawrence Grawning (PH), Mill Valley, California.

On page 13 of the annual report, in — talking about the insurance operation, you say that it possesses an intrinsic value that exceeds its book value by a "large amount — larger, in fact, than is the case at any other Berkshire business."

To refine an earlier question that was asked, could you tell me whether you mean that it is larger in — by a percentage or in absolute dollars, that is —

WARREN BUFFETT: By absolute dollars. And —

AUDIENCE MEMBER: That's what you're referring to?

WARREN BUFFETT: Yeah, by absolute — it's very hard to stick a percentage figure on the insurance business, because we have so much capital in there that —

And then — and we have other businesses. I think that the — we've got businesses with a book value of in the tens of millions that are worth in the many hundreds of millions. So, you couldn't apply that to the insurance company (Inaudible). So, it's absolute dollars.

But in terms of absolute dollars, we think the excess of intrinsic value over carrying value — at least I do — is substantially greater for the insurance business than any other business we own.

Charlie, do you have any —

CHARLIE MUNGER: No —

WARREN BUFFETT: — thoughts on that?

CHARLIE MUNGER: — that's exactly right.

19. No concerns on Coca-Cola succession

AUDIENCE MEMBER: Joe Little (PH), Vancouver, Canada.

Does the management succession issue for the top job at Coca-Cola concern you?

WARREN BUFFETT: Management picture, you'd do what with the —?

AUDIENCE MEMBER: The management succession issue over the next several years.

WARREN BUFFETT: Oh, yeah.

AUDIENCE MEMBER: The top job. Does that concern you?

WARREN BUFFETT: At Coca-Cola —

AUDIENCE MEMBER: Yeah.

WARREN BUFFETT: I think any announcement that — from that would come with — from Coca-Cola.

CHARLIE MUNGER: He said do you like it?

AUDIENCE MEMBER: Does it concern you?

CHARLIE MUNGER: Does it concern you?

WARREN BUFFETT: Oh, I'm not concerned at all, no. No, Coca-Cola is very well managed. (Laughs)

20. Salomon CEO's $24M bonus target "hellishly hard to hit"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Chris Stavrou (PH) from New York.

According to the latest Salomon Brothers proxy, if [Chairman and CEO] Deryck [Maughan] earns 30 percent on allocated equity of Salomon Brothers, provided that that's at least 10 percent above the return for competitors, he could earn a bonus of $24 million.

My question is whether that return number is reduced by a charge for preferred dividends?

WARREN BUFFETT: I, Charlie, do you remember on the comp committee —?

CHARLIE MUNGER: I can't remember the detail on that.

WARREN BUFFETT: I think the equity — I — my — I'm fairly sure, but I'm not positive, that the equity figure would include our preferred, but not non-convertible preferreds.

And it would apply to the earnings applicable to the — to our preferred plus common, but not — but it would be after dividends on non-convertible preferred.

But I, you know, I'm not on the comp committee, and I have not read the description that carefully.

CHARLIE MUNGER: Well, I am, and I can't remember. (Laughter)

But I will tell you, one thing I do remember about that, and that is a target which would be one — would be hellishly hard to hit.

WARREN BUFFETT: It'd be unbelievable. I mean —

CHARLIE MUNGER: That's is, you're talking about Babe Ruth —

WARREN BUFFETT: Squared.

CHARLIE MUNGER: Yeah, doing 150 home runs in a season instead of a — if that happens, you'll be very glad to pay the money. (Laughter)

WARREN BUFFETT: Very. Under either calculation, yeah. It really — but it, you know, I'm glad it's there. (Laughs)

I hope Deryck's paying attention to it.

21. Salomon is a "better company than it was some years back"

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Hi, I'm Chris Davis again, from New York.

I wanted to ask if you — I feel there's such a huge discrepancy between the valuation of some of your holdings versus others, in terms of the market valuation, in terms of price-to-earnings, price-to-book.

In your opinion, do the growth prospects of Salomon Brothers, or the quality — or your anticipation of your ability to clip the coupons at Salomon Brothers — justify such a dramatic discount to the growth prospects of Coca-Cola or Gillette, in terms of our ability as Berkshire shareholders to clip those coupons?

And if you could explain, or perhaps share your thoughts on why the market perception, if it is — justifies that distinction?

WARREN BUFFETT: Yeah, I'm not sure I can answer that question without getting into a discussion of the relative merits of the two companies — or the three companies — you mentioned, at these prices, but —

Salomon and Coca-Cola are obviously very different kinds of businesses, or Salomon and Gillette. And Charlie and I do our best to try to understand the businesses.

Obviously, it's easier to understand the future of a Coca-Cola than it is a Salomon. But that doesn't mean it's a better buy.

And what you see at any given time in our holdings is partly the historical accident, even, of when we bought, and when we had money available, and all that. But it reflected an affirmative decision at that point, obviously.

Our guess would be that the — you know, we would feel reasonably good about anything that we owned, in terms of the price at which we bought it, and the facts at the time we bought it. And the facts change over time.

Salomon, I think, is a better company now than it was some years back. But it's still in a business that's — can be very volatile, and it has a small amount — as does any investment banking firm and as any commercial banking firm — of systemic risk. I mean, you can't get rid of that.

Charlie, you want to?

CHARLIE MUNGER: No, I've got nothing to add.

22. Calculating intrinsic value

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Thank you. Sean Barry, Regina, Canada.

Mr. Buffett, you've indicated that most of us in this room could acquire a lot of the information that you and Charlie acquire through the annual reports. Yet you both also indicated that the GAAP rules, a lot of times, leave a little to be desired.

Could you perhaps give an indication as to how you and Charlie come up with the economic value, or the intrinsic value, of the businesses that you finally decide to invest in? And a little bit about the process that you go through with that? Thank you.

WARREN BUFFETT: Well, the — in the 1992 annual report, we discuss that a fair amount.

But the economic value of any asset, essentially, is the present value, the appropriate interest rate, of all the future streams of cash going in or out of the business.

And there are all kinds of businesses that Charlie and I don't think we have the faintest idea what that future stream will look like. And if we don't have the faintest idea what the future stream is going to look like, we don't have the faintest idea what it's worth, now. Now that —

So, if you think you know what the price of a stock should be today, but you don't think you have any idea what the stream of cash will be over the next 20 years, you've got cognitive dissonance, I guess, is what they call it. (Laughter) The —

So we are looking for things where we feel — fairly high degree of probability — that we can come within a range of looking at those numbers out over a period of time, and then we discount them back.

And we are more concerned with the certainty of those numbers than we are with getting the one that looks absolutely the cheapest, but based upon numbers that we don't have any — we don't have great confidence in.

And that's basically what economic value is all about.

The numbers in any accounting report mean nothing, per se, as to economic value. They are guidelines to tell you something about how to get at economic value.

But they don't tell you anything. It — there are no answers in the financial statements. There are guidelines to enable you to figure out the answer. And to figure out that answer, you have to understand something about business.

You don't have to understand a lot about mathematics. I mean, the math is not complicated. But you do have to understand something about the business.

But that's the same thing you would do if you were going to buy an apartment house, or a farm, or any other small business you might be interested in.

You would try to figure out what you are laying out currently, and what you are likely to get back over time, and how certain you felt about getting it, and how it compared to other alternatives. That's all we do, we just do it with large businesses, basically.

The accounting figures are very helpful to us, in the sense that they generally guide us to what we should be thinking about.

And of course, if we find numbers where it looks like people are taking the most optimistic interpretation of things that they can under GAAP and all of that, we get very worried about people who look like they massage the numbers in any way. And there are plenty of people that do.

23. Growth alone doesn't make a company a good investment

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: I'm Howard Bask (PH). I'm from Kansas City.

When you are estimating a growth rate on a company (inaudible), a very predictable company, I imagine you apply a big margin of safety to it. What kind of rate do you generally apply? I mean, high single digits?

WARREN BUFFETT: In the margin of safety, or —

AUDIENCE MEMBER: What kind of growth rate would you, on a predictable company, might you —

WARREN BUFFETT: We are willing to —

AUDIENCE MEMBER: — stab at?

WARREN BUFFETT: — buy companies that aren't going to grow at all.

AUDIENCE MEMBER: OK.

WARREN BUFFETT: It — assuming we get enough for our money when we do it. So, it — we are not looking — we are looking at projecting numbers out, as to what kind of cash we think we'll get back over time.

But you know, would you rather have a savings — if you're going to put a million dollars in a savings account, would you rather have something that paid you 10 percent a year and never changed, or would you rather have something that paid you 2 percent a year and increased at 10 percent a year? Well, you can work out the math to answer those questions.

But you can certainly have a situation where there's absolutely no growth in the business, and it's a much better investment than some company that's going to grow at very substantial rates, particularly if they're going to need capital in order to grow.

There's a huge difference in the business that grows and requires a lot of capital to do so, and the business that grows, and doesn't require capital.

And I would say that, generally, financial analysts do not give adequate weight to the difference in those. In fact, it's amazing how little attention is paid to that. Believe me, if you're investing, you should pay a lot of attention to it.

Charlie?

CHARLIE MUNGER: I agree with that. But it's fairly simple, but it's not so simple it can all be explained in one sentence. (Laughter)

WARREN BUFFETT: Our — some of our best businesses that we own outright don't grow. But they throw off lots of money, which we can use to buy something else. And therefore, our capital is growing, without physical growth being in the business.

And we are much better off being in that kind of situation [than] being in some business that, itself, is growing, but that takes up all the money in order to grow, and doesn't produce at high returns as we go along. A lot of managements don't understand that very well, actually.

24. Capital allocation shouldn't be delegated

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Byron Wien from New York.

You said that you decentralized the operating decisions, but centralized the capital allocation decisions.

What kind of staff do you have in Omaha to help you with the capital allocation decisions and the stock selection decisions you make? Or do you and Charlie do that, pretty much, by yourselves?

WARREN BUFFETT: Yeah, we don't have any staff to help us on it. I mean, basically we tell them to mail all the money to Omaha — (laughter) — and then when we get there, we put our arms around it. (Laughs)

And we allocate all the capital ourselves. I mean, that is our job.

And we don't feel we should delegate, I mean, we wouldn't do it anyway. Our personalities aren't such that we would delegate our — allocating our own money to someone — letting somebody else allocate our own money.

But we feel that's our job. And it's interesting, and we've — I've written about this in the past — that that's an important job for most managements. There's some companies where it's not, but it's a — it usually is a very important job for most managements.

And if you take a CEO that's in a job for 10 years, and he has a business that earns, say, 12 percent on equity, and he's — and he pays out a third, that means he's got 8 percent per year of equity. I mean, when you think of his tenure in office, how much capital he's allocated, it's an enormous factor over time.

And yet, probably relatively few chief executives are either trained for, or are selected on, the basis of their ability to allocate capital. I mean, they get there through other routes.

So, I've said it's like somebody playing the piano all their life, and then getting to Carnegie Hall and they hand him a violin. I mean, it is a different function than most — than the route — than the functions that exist along the routes to the CEO's job at most companies.

And so many CEOs, when they get there, think they can solve it by either having a staff that does it, or by hiring consultants, or whatever it may be.

And in our view, that is — and that's a terrible mistake, because it's — it is, if not the key function of the CEO, it's one of two or three key functions at say 80 or 90 percent of all companies.

And if you can't do it yourself, you're going to make a lot of mistakes. You may make a lot of mistakes even if you do it yourself. But if you —

You know, you wouldn't want anybody in any other position of that importance in the company essentially saying, "I don't know how to do this, so I'm going to have somebody else do it," when it's their key responsibility. But that's the way it works in business.

And Charlie and I take responsibility for all capital allocation decisions, other than just, sort of, routine expenditures at the operating businesses. And we don't get into those at all.

I mean, if our managers are spending three or four million dollars a year on machinery — or if one of them is, I mean — on machinery, equipment, plants, new leases — we have no review process on that. We don't have a staff at headquarters. We don't waste the time to do that.

We think those people know how to allocate the money that relates to the actual operations of their business. We think, in terms of the capital that is generated above that, that that's our job.

Charlie, anything —?

CHARLIE MUNGER: I would say we have practically nobody at headquarters in Omaha. One of the reasons Warren shines up so well is, you know, he's being compared to practically nobody. (Laughter)

WARREN BUFFETT: I might say if — one interesting — when we're having this meeting, for example, I think there's one person there in the office. I mean, the rest of them are down here helping on the meeting. I mean, it —

CHARLIE MUNGER: Here we are, Warren and I are selling candy and encyclopedias, and so forth. The chief financial officer of Berkshire Hathaway is handling the microphones. I mean, this makes Southwest Airlines look like they don't understand —

WARREN BUFFETT: Cost control. (Laughter)

CHARLIE MUNGER: — cost accounting, yeah. It's a very old-fashioned place.

And by the way, speaking of hawking our merchandise, if any of you have safety deposit boxes full of Berkshire Hathaway certificates, and have children or grandchildren who don't have World Book in print in the house, you are making a very serious error.

That is a marvelous thing for — to have in the house with —

WARREN BUFFETT: And the discount only applies —

CHARLIE MUNGER: — full of young people.

WAWRREN BUFFETT: The discount only applies today — (laughs) — incidentally. I think that's right.

CHARLIE MUNGER: It is. That is, it may not be selling too well because of the current vogue for encyclopedias on computers. And by the way, those encyclopedias that are available are inferior compared to World Book, which is very user-friendly for children, and I like it that way myself. And —

WARREN BUFFETT: We —

CHARLIE MUNGER: That is one product you really ought to buy.

WARREN BUFFETT: We both use it, personally. I mean, I keep a set at the office, and a set at home. And I —

CHARLIE MUNGER: I give away more of that product —

WARREN BUFFETT: — I use it a lot.

CHARLIE MUNGER: — than other product that Berkshire Hathaway makes in any subsidiary. It's a perfectly fabulous human achievement. To edit a thing, to — that user friendly, with that much wisdom encapsulated. It is a — it's a fabulous thing.

25. Keynes: Great "wisdom" about investing

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: (Inaudible) from Houston, Texas. From time to time, you have quoted John Maynard Keynes, the British economist.

So, I would assume that you have read the investment writings very extensively. What are two or three investment lessons, in your opinion, one can learn from that economist?

WARREN BUFFETT: Well, I forget which, I think it's chapter eight of "The General Theory," do you remember Charlie? Or is it chapter —

CHARLIE MUNGER: No.

WARREN BUFFETT: There's one chapter in "The General Theory" that relates to markets, and the psychology of markets, and the behavior of market participants and so on, that probably is, aside from Ben Graham's two chapters, eight and 20, in "The Intelligent Investor" — I think you'll find you'll get as much wisdom from reading that as anything written in investments. And you'll know it when you see it in "The General Theory."

It's a chapter that jumps out to you about securities and so on. And I — could be chapter eight, but I may be wrong on that. But I would recommend reading that.

Keynes and Graham, from vastly different starting points, came to the same conclusion at about the same time in the '30s, as to the soundest way to invest over time. They differed some on their ideas on diversification. Keynes believed in diversifying far less than did Graham.

But Keynes started off with the wrong theory, I would say, in the '20s and essentially tried to predict business cycles in markets, and then shifted to fundamental analysis of businesses in the '30s, and did extremely well.

And about the same time, Graham was writing his first material. I think Janet Lowe, in her book on Ben Graham, actually has a little correspondence that took place between Keynes and Ben. So I would advise you to read that.

And there's some letters of his that he — of Keynes' — that he wrote to co-trustees of life insurance societies, and colleges, and so on, that I think you'd find interesting, too.

SYNC TRANSCRIPT TO VIDEO

Morning Session - 1995 Meeting

1. Welcome

WARREN BUFFETT: Morning. I'm Warren Buffett, the chairman of Berkshire Hathaway. And on my left is Charlie Munger, the vice chairman and my partner. And we'll try to get him to say a few words at some point in the proceedings. (Laughter)

The format today is going to be just slightly different.

We have one item to — normally, we breeze through the meeting pretty fast, and we'll do that, but we have one item of business on the preferred stock that I could tell caused some confusion with people. So, I'll discuss that a little bit.

And if, before the vote on that, anybody would like to talk about the preferred issue, we'll have any comments or questions at that time. And then we'll breeze through the rest of the meeting, and then we'll open it up. And I'll have one announcement to make then, too.

And then after that, we'll go for, maybe, close to noon. And feel free, earlier, anybody that would like to leave, you're free to, obviously, at any time. Better form to do it while Charlie's talking, as I've mentioned. (Laughter) And you'll have to be quick. (Laughter)

But then we'll have a break a little before noon for a few minutes, while a more orderly retreat can be conducted. And we'll have buses outside to take you back to the hotels or to any of the commercial establishments that Berkshire's involved in.

And then because so many of the — we have people here, at least based on the tickets reserved, from 49 of the 50 states. Only Vermont is absent. We have — but we have Alaska, we have a delegation from every place.

We have people from Australia, Israel, Sweden, France, the U.K., 40-some from Canada. So, a lot of people have come a long way. So, Charlie and I will stick around.

In fact, we'll eat our lunch right up here. And we will — you don't want to watch what we eat. The — but the — well, we'll stick around until perhaps as late as even 3 o'clock, but if the crowd gets below a couple of hundred, then we'll feel we can cut it off.

But we do want to answer everyone's questions. You people are part owners of the company. And any question that relates to your ownership of Berkshire, we want to be able to give you a chance to ask.

And it's tough because of the numbers of people here. I don't know how many are in the other room. But there're about 3,300, I believe, in this room. And we want to get to you — to all of you. So, that will come after the meeting.

Now, we've got a little business to take care of.

2. Election of directors

WARREN BUFFETT: The meeting will come to order. And I'll first introduce the directors of Berkshire, in addition to myself. They're right down here. And if you'll stand up when I give your name.

Susan T. Buffett (Applause).

Howard Buffett (Applause)

These are names we found in the phone book, you can understand — (Laughter)

Malcolm Chace, III (Applause)

And Walter Scott Jr. (Applause)

Also with us today are partners in the firm of Deloitte and Touche, our auditors, Mr. Ron Burgess and Mr. Craig Christiansen (PH). They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Mr. Robert M. Fitzsimmons has been appointed inspector of elections at this meeting. He will certify to the account of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc Hamburg. Proxy cards have been returned through last Friday representing 998,258 Berkshire shares to be voted by the proxy holders as indicated on the cards.

That number of shares represents a quorum, and we will therefore directly proceed with the meeting. We will conduct the business of the meeting and then adjourn the formal meeting. After that we'll entertain questions you might have.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott Jr. who will place a motion before the meeting.

WALTER SCOTT JR.: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: Do I hear a second? (Laughter)

VOICE: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions? We'll vote on the motion by voice vote. All of those in favor say, "Aye."

VOICES: Aye.

WARREN BUFFETT: Opposed? The motion is carried. (Laughter)

Does the secretary have a report of the number of Berkshire shares outstanding entitled to vote and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent by first-class mail to all shareholders of record on March 7, 1995, being the record date for this meeting, there were 1,177,750 shares of Berkshire common stock outstanding, with each share entitled to one vote on motions considered at the meeting.

Of that number, 998,258 shares are represented at this meeting by proxies returned through last Friday.

WARREN BUFFETT: Thank you. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the two items of business provided for in the proxy statement, he or she may do so.

Also, if any shareholder that's present has not turned in a proxy and desires a ballot in order to vote in person on these two items, you may do so. If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish two ballots to you, one for each item.

Would those persons desiring ballots please identify themselves so we may distribute them? Just raise your hand and you'll get one.

The first item of business of this meeting is to elect directors. I now recognize Mr. Walter Scott Jr. to place a motion before the meeting with respect to election of directors.

WALTER SCOTT JR.: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chase, III, Charles T. Munger and Walter Scott Jr. be elected as directors.

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chase, III, Charles T. Munger and Walter Scott Jr. be elected as directors. Are there any other nominations? There any discussion? You're doing fine. (Laughter)

The nominations are ready to be acted upon. If there are shareholders voting in person, they should now mark their ballots on the election for directors and allow the ballots to be delivered to the inspector of election. Collect those, please.

Would the proxy holders please also submit to the inspector of elections, a ballot on the election of directors, voting the proxies in accordance with the instructions they've received?

Mr. Fitzsimmons, when you're ready, you may give your report.

ROBERT FITZSIMMONS: My report is ready. The ballot of the proxy holders received through last Friday cast not less than 996,892 votes for each nominee. That number far exceeds a majority of the number of shares outstanding.

The certification required by Delaware law regarding the precise count of the votes, including the votes cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Mr. Fitzsimmons. Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chase, III, Charles T. Munger and Walter Scott Jr. Have been elected as directors.

3. Motion authorizing preferred stock

WARREN BUFFETT: The second item of business at this meeting is to consider the recommendation of the board of directors to amend the company's certificate of incorporation.

The proposed amendment would add a provision to the certificate of incorporation authorizing the board of directors to issue up to one million shares of preferred stock in one or more series, with such preferences, limitations, and relative rights as the board of directors may determine.

Now, we discussed this some in the annual report. But I would say — and we'll find out the exact number — but I think we probably had 11 or 12 — maybe 12,000 or so shares voted against the proposal. And I think we had a couple thousand shares that abstained.

And since there really is no downside to the proposal, that indicated to me that I'd not done a very adequate job of explaining the logic of authorizing the preferred. So, I'd like to discuss that for a minute now.

And I'd also like anybody that would like to ask questions about it, they can do so now. We can talk about it later, too. But if you'd like to do it before the vote, that'd be fine.

The authorization is just that. It's an authorization. It's not a command to issue shares. It's not a directive. It simply gives the directors of the company the ability, in a situation where it makes sense for the company to issue preferred shares, to do so.

Now, when we acquire businesses — and I'll tell you about one when we're through with this in a few minutes — when we acquire businesses, sometimes the seller of the business wants cash. Sometimes they would like common stock.

And it's certainly possible, as one potential seller did last year, that they wanted, in that case, a convertible preferred stock.

Now, from our standpoint, as long as the value of the consideration that we give equates, we really don't care, aside from a question of tax basis we might obtain, but we —

In other economic respects, we don't care what form of consideration we use, because we will equate the value of cash, versus a straight preferred, versus a convertible preferred, versus common stock, whatever it may be.

So, if the worry is that we will do something dumb in issuing the preferred stock, you should — that's a perfectly valid worry. But you should worry just as much we'll do something dumb in terms of using cash or common stock.

I mean, if we're going to do something unintelligent, we can do it with a variety of instruments. (Laughter)

And we will not get more licentious in our behavior or anything simply because we have the preferred stock.

And the preferred stock may offer sellers of a business the chance to do a tax-free exchange with us. And they may not want common stock, because they may have an ownership situation where they don't want to run the risk of common stock ownership. And that's why our preferred is flexible as to terms.

Because we could give those people a straight preferred with a coupon that made it worth par at the time we issued it. And then they would know what their income would be for the next umpteen years. And that may be of paramount interest to them.

We could issue them an adjustable-rate preferred, which as money market conditions change, would also change its coupon. And then they would be sure of a constant principal value for the rest of their lifetimes. And one or both of those factors could be more important to one seller or another.

So that we simply have more forms of currency available to make acquisitions if we have the ability to issue various forms of preferred. Because a preferred stock, if it's properly structured, allows for the possibility of a tax-free transaction with a seller. And that's important to many sellers.

Now, in the end, many sellers will prefer cash, just as in the past. And probably most of the sellers that don't want cash will want common stock. But we will have a preferred stock available.

We're only authorizing a million shares because under Delaware law, there's an annual — I think there's an annual fee. I know there's an initial fee. And I think there's an annual fee that relates to the amount of shares authorized.

So, if we authorized a hundred million shares, we would be paying a larger annual fee, which is something Mr. Munger wouldn't let me do. (Laughter)

So what we will do, if we issue this, we will issue — undoubtedly, we will issue some sub-shares so that the numbers of shares, for taxation purposes, is relatively limited.

But that we will issue sub-shares to make it easier to make change, essentially, in the market.

We may issue — if the occasion demands — we may issue a convertible preferred. But that convertible preferred would not be worth any more, at the time we issue it, than a straight preferred. We would adjust, in terms of the coupon, and the conversion price, and so on.

So we can equate various forms of currency to fit the desires of the seller of the business. And this is simply one more tool to do it. There's no downside, like I say, unless we do something stupid.

And if we do something stupid with this, we would do something stupid with cash or whatever. So it —we probably should've done this some time ago, but we never had a case of a seller wanting that form of currency before.

And so it just — and we always felt we could get it authorized promptly. But there's no reason to lose a couple of months, if a transaction is pending, to call a meeting to get this on the books. So, it's simply one more tool.

And if there are — anybody that has any questions or comments on the preferred, like I say, you can hold them until later, but I'd be glad to have them before we have the vote. Do we have any?

Yeah, there's a question over there. If you'll wait just a second, we'll get a microphone to you.

When you ask questions, now or later, if you'll give your name and where you live, I'd appreciate it.

AUDIENCE MEMBER: Hi, my name is Dr. Lawrence Wasser. I'm from New York.

My question is this. If you want to buy a business and the people in the business want cash, you have to have cash, cash that — you know, this kind of cash.

WARREN BUFFETT: We're familiar with it.

AUDIENCE MEMBER: Yeah. (Laughter and applause)

But it strikes me that the preferred isn't really cash, it's fiat currency. That is, it's currency that we can create.

WARREN BUFFETT: That's true. It's like common stock in that respect. It is the — it is a form — it is an alternate form of currency, and — but it is —

Just in terms of common stock, for example, assuming we had enough authorized, we have an unlimited ability to create currency. Now, if we created the wrong price, it dilutes the value of the old currency. But go ahead on.

AUDIENCE MEMBER: Until we vote in the affirmative, which I'm sure that this group will probably do because of their confidence in you, but until we vote in the affirmative, it doesn't exist.

WARREN BUFFETT: That is correct. That would be true, incidentally, with common stock. If we had no more authorized common stock out than we had issued, we have, I think, a million and a half authorized.

But let's assume that we'd issued all that we had authorized. Until more was authorized by the shareholders, there would — it would not be available to be issued.

AUDIENCE MEMBER: But if more were authorized by the shareholders then isn't it true that the value of the shareholders' holding would be diluted?

WARREN BUFFETT: Only if we receive less in value than we give. That's the key to it.

I mean, if we issue $200 million worth of preferred and we receive a business that's only worth 150 million, there's no question you're worse off than before. So are we, incidentally. But we're all worse off.

The — and that's true if we give cash that's worth more for a business than the business is worth. If we give 200 million of cash for a business that's worth a 150 million, we are worse off. We may not have issued a share of stock. But we have diluted the value of your stock if we do that.

As long as we get value received, in terms of whether — of cash, common stock, or preferred stock — then you are not diluted in terms of value. It's an important point.

And obviously, a number of companies, as you may have — Charlie and I have commented about in reports and elsewhere — a number of companies, in our opinion, have issued common stock, particularly, which has a value greater than what they receive.

And — when they do that, they are running what I — what John Medlin of the Wachovia called a "chain letter in reverse." (Laughter)

And that's cost American shareholders a lot of money. I don't think it'll cost them any money at Berkshire. But it's a perfectly valid worry for shareholders to have.

Because a management can build an empire just by issuing these little pieces of paper, which they feel don't cost them anything.

I think Charlie had one story about that in the past. You want to comment on that, Charlie? No-names basis, of course. (Laughs)

CHARLIE MUNGER: There was a particular bank where one of the officers wanted stock options, pointed out to the management that they could issue all these shares and it didn't cost anything.

Now, imagine hiring a manager who thinks that way and paying them money — (laughter) — to behave like Judas in your very midst.

WARREN BUFFETT: We have had conversations with managers — (laughter) — where they tell us how fortunate they feel because the stock is down and they can issue options cheaper.

Now, if they were issuing those to the third parties, you know, I'm not sure whether they'd have exactly the same attitude.

But we have no feeling that we're getting richer when we issue shares. We have a feeling we're getting richer when we get at least as much value in a business as the shares are worth that we issue. And we don't intend to issue them under any other circumstances. But it's a perfectly valid worry.

AUDIENCE MEMBER: The second part of the question is that, obviously, with preferred issue, you have a situation where the common shareholder is — moves to the back of the line, as it were.

Why should the common shareholder in this room want to step to the back of the line if he's at the front of the line now?

WARREN BUFFETT: Well, it — but it's also true if we buy a business for cash, and we — let's say we borrow the money, the bank that we borrow the money from will come ahead of the common shareholder.

There's no question. Any time you move — you engage in transactions that involve the capital structure, you are changing the potential for each part of the capital structure.

If you issue a lot of common and you've got some debt outstanding, you've generally improved the position of the debt.

And the question really becomes whether you think that the position of the common shareholder is improved by issuing either preferred stock, or perhaps borrowing a lot of money, to make an acquisition.

I mean, a couple of times in the history of Berkshire, we've borrowed money to buy something, to buy a business. And when we do that, we are placing a bank, or an insurance company, or whomever, ahead of the position of the common shareholder. We did that when we issued some debt a few years back.

And there's a question of weighing whether the common shareholders are going to be better off by borrowing money. But borrowing money is not necessarily at all harmful to shareholders — although certainly, if it's carried to excess, it is.

And the preferred is a form of quasi-borrowed money that does rank ahead of the common shareholder. But then, at the same time, we're adding a business which we think is going to benefit the shareholder, if we issue that. So that's the tradeoff.

Yeah.

AUDIENCE MEMBER: My name is Matt Zuckerman (PH). I'm from Miami, Florida.

My question is, it seems to me that there's some requirement for shareholder votes if convertible stock — preferred stock — is issued beyond a certain limit. What are those limits?

WARREN BUFFETT: There are no limits on the conversion term that we might do. But for example, if we were going to issue a convertible preferred — now we have no plans to do it, but it could happen. In fact, it might well happen this year.

The — we would — and the alternative, we'll say, was giving somebody a hundred million dollars in cash for a business. If we were to issue a straight preferred, we would figure out what a hundred million dollars' worth of a straight preferred would sell for, what coupon would be necessary.

And that would depend on call provisions and a few things. But for a triple-A credit like Berkshire, you know, it would be somewhere in the area of 7 percent or thereabouts. And then they would have no participation in the upside of the common.

If they wanted something that was sure to maintain its principal value, then you have to issue an adjustable-rate preferred that will keep its value around par.

That preferred might have an initial coupon of, say, 5 percent or something of the sort, because it has the ability to go up or down based on interest rates. But it would always be worth about par.

If we were to issue a convertible preferred, it might have a conversion price of, just to pick a figure, 28,000 or something of the sort, and a coupon well below the coupon on a straight preferred.

And so, whatever we did, they would equate out in our mind as to the value we were giving.

We're not going to give 120 percent of X if we're only willing to pay a hundred percent of X, just because the form of a deal changes.

But you may well see us issue, at some point — you may see us issue a convertible preferred. You may see us issue a straight preferred. You may see us issue an adjustable-rate preferred. I hope we do something because I'd like, you know —

AUDIENCE MEMBER: Yeah. Based on —

WARREN BUFFETT: If we do it, we'll think we're better off.

AUDIENCE MEMBER: Well, based on your past performance, I'm sure you'll get more value than you give.

WARREN BUFFETT: Well.

AUDIENCE MEMBER: But in any case, it was my understanding that if the amount of shares issued for a conversion of a convertible issue were greater than 20 percent of the total amount of shares outstanding, then it would require a vote of the stockholders, under Delaware law. I may be wrong.

WARREN BUFFETT: I think it's a stock exchange rule, isn't it, Charlie?

CHARLIE MUNGER: Yes.

WARREN BUFFETT: You're right about the rule, but —

CHARLIE MUNGER: It's a New York Stock Exchange rule.

WARREN BUFFETT: It's a New York Stock Exchange rule. That would be $5 billion-plus of deal. And, you know, we would love to make a $5 billion deal, but I don't think we're going to do it.

So I would say that the chances of any acquisition being large enough so that it requires a shareholder vote is probably slim.

But it isn't because we wouldn't be interested. (Laughter)

And you know, if we have one, we'll be coming back to you — (laughter) — with the votes already in hand. (Laughter and applause)

Are there any other questions on the preferred? We can talk more about it later, too. I just want to — oh, here we are. Sure.

AUDIENCE MEMBER: Good morning, Mr. Buffett.

WARREN BUFFETT: Morning.

AUDIENCE MEMBER: I'm Raina Di Costiloy (PH) from Chicago. I'm very proud to be here. And I've seen you grow so, that pretty soon we're going to be out in a football field. (Laughter)

I think your explanation was very helpful. Because as I read this, and I'm sure many of the other lay folk, I didn't understand what you —

WARREN BUFFETT: (Inaudible)

RAYNA DI COSTILOY: — what you were doing. And you mentioned the preferred stock. But in the prospectus, it's not clear whether it would be the convertible preferred, the straight preferred. And you cleared that, answering a few other questions, but some of the people felt it would dilute their stock.

WARREN BUFFETT: Yeah. Well, I should've made that clear in the annual report. And I'm glad I've had this chance to do it today.

Anything else on the preferred? OK.

AUDIENCE MEMBER: You don't have to come back to the shareholders for a vote, after these shares are authorized, for the terms of it. And you've discussed this in terms of buying companies.

My question is, you yourself, through Berkshire Hathaway, own the preferred shares of several companies: Salomon, USAir, American Express.

Do those shareholders have to vote on the terms of the preferred shares that you bought for those companies? Or is that left at the board of directors' decision level.

WARREN BUFFETT: Those —

AUDIENCE MEMBER: Could you clarify that point?

WARREN BUFFETT: Go — excuse me, go ahead.

AUDIENCE MEMBER: Could you clarify that point, please?

WARREN BUFFETT: Yeah. We bought a — I think we've probably bought six issues of preferred directly from companies.

And since none of those triggered that New York Stock Exchange rule that we discussed earlier — and they could've if they'd been somewhat larger, but they didn't — none of those deals had to be approved by the shareholders.

I think the only deal we've had with a company that had to be approved by the shareholders was when we bought the Cap Cities/ABC stock. Well, we bought early in 1986. I think it was approved by their shareholders in 1985.

But the only situations where it would've had to have been approved is if it triggered the New York Stock Exchange rule. And our purchases were not that large that they did that.

Any other questions? Yeah, there's one more.

AUDIENCE MEMBER: My name is Dale Vocawitz (PH). I'm from Champagne, Illinois.

A recent issue of Barron's indicated that it may be possible to issue a best of all possible worlds preferred, that being one where the dividend looks like interest to the issuer and is tax-deductible.

And to the purchaser, it would qualify for the dividends received deduction. Do you think that structure might be possible with these shares?

WARREN BUFFETT: Well, we haven't thought about that. I know what you're talking about on that, but I don't think it would be possible.

For one thing, I don't think you probably have a tax-free deal that way. Charlie, do you?

CHARLIE MUNGER: We probably wouldn't try and be that cute. (Laughter)

WARREN BUFFETT: I've got several quips in mind, but I think I'll keep them to myself. (Laughter)

My guess is that that form does not work for a long time. I know what you're talking about on it, but my guess is it doesn't.

Some companies — then we'll get on with this — but some companies care about the consideration they give in a deal, whether it's cash, or preferred, or so on, because they care about the accounting treatment that they get.

They want — they usually want pooling treatment rather than purchase accounting treatment. I won't get into that here. I know it's going to disappoint you, but I won't get into that here. Although I may in the next annual report.

And that is of absolutely no consequence to us. We care not a wit about the accounting treatment that we receive. We feel that we have a shareholder body that's intelligent enough to understand the economic reality of a transaction.

And that by playing various games, in terms of how we try to structure it, and maybe flow part of the purchase price back through the income statement or anything of the sort, which is done — that's not something that we care about at all.

We would rather do whatever makes the most sense for us and for the seller, and then explain to you whatever accounting peculiarities may arise out of the transaction. And that probably differentiates us from most companies. And it probably helps us make a deal, occasionally.

Anything else?

AUDIENCE MEMBER: — really

WARREN BUFFETT: OK, now I can hear you fine.

DALE VOCAWITZ: OK. And I was wondering, will there be any opportunity for shareholders who may find the preferred issue preferable, for any number of reasons, to participate in that?

WARREN BUFFETT: Well, if we issued a preferred and it became actively traded — let's say it was a company with many shareholders instead of a few. Obviously, that would be something that any new or present shareholder could make a decision on whether they preferred that issue than others.

We could, but have no plans of doing it and I don't see it happening, we could offer to exchange preferred for present common.

And it's conceivable a few people would have an interest, but the — most people have self-selected in terms of the kind of security they want to own in terms of owning Berkshire common.

So it's unlikely they would want to switch into a preferred, because they would — we wouldn't have a premium of value, it would just be an alternative security.

We could do that, though. I mean, and it would probably be a tax-free deal.

We have no plans of doing that, but it's something that if we ever thought that enough people might want, we could offer it. But no one would be obliged to take it. It's a good question.

OK? We'll move on.

Is there a motion to adopt the board of directors' recommendation?

WALTER SCOTT JR.: I move the adoption of the amendment to the fourth article of the certificate of corporation as set forth in exhibit A of the company's proxy statement for this meeting.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: Motion's been made and seconded to adopt the proposed amendment to certificate of incorporation. Any further discussion?

We are ready to act upon the motion. If there are any shareholders voting in person, they should now mark their ballot on the proposed amendment to the certificate of incorporation and allow the ballots to be delivered to the inspector of election.

Collecting a few there. Would the proxy holders please also submit to the inspector of elections a ballot on the proposed amendment voting the proxies in accordance with the instructions they have received?

We'll wait just a second here.

Mr. Fitzsimmons, when you're ready you may give your report.

ROBERT FITZSIMMONS: My report is ready. The ballot of the proxy holders received through last Friday cast lot — not less than 928,889 in favor of the proposed amendment to the certificate of incorporation.

That number far exceeds the majority of the number of all shares outstanding. The certification required by Delaware law regarding the precise count of the votes, including the votes cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Mr. Fitzsimmons. The amendment to the certificate of incorporation as set forth in exhibit A to the proxy statement for this meeting is approved.

After adjournment of the business meeting, I will respond to questions that you may have that relate to the businesses of Berkshire, but do not call for any action at this meeting.

Does anyone have any further business to come before this meeting before we adjourn? If not, I recognize Walter Scott Jr. to place a motion before the meeting.

WALTER SCOTT JR.: I move this meeting be adjourned.

VOICE: I second the motion.

WARREN BUFFETT: Motion to adjourn has been made and seconded. We will vote by voice. Any discussion? If not, all in favor say, "Aye."

AUDIENCE: Aye.

WARREN BUFFETT: All opposed say, "No." The meeting is adjourned. (Laughter)

4. Helzberg's Diamonds acquisition

WARREN BUFFETT: Now, I'd like to tell you about one thing that — since the annual report — that some of you probably read about in the papers, but maybe not all of you have heard about.

Just shortly after the annual report was issued, we completed a transaction with Helzberg's Diamonds, with Barnett Helzberg, who's here today. Barnett, would you stand up, please? All right. There he is. Give him a hand. (Applause)

You may be interested in how it came about, because Barnett attended two of the last three meetings of Berkshire. He had a few shares in an IRA account, and he was here last year.

And shortly after this meeting, I was back in New York City. And I was crossing the street at 58th Street, right near the Plaza Hotel on 5th Avenue. And a woman said, "Mr. Buffett," and I turned around.

And she came up, and she said she'd attended the annual meeting last year — or a few days ago — and said that she enjoyed it. And I said, "That's terrific," and I started to cross again.

And Barnett had been about 30 or 40 feet away. I didn't know him, and he had heard this woman. So, he said the same thing. And I turned around. And we shook hands. First time I'd met him, and he said, "You know," he said, "I might have a business you'd be interested in."

And I get that all the time, so — (Laughter)

So I said, "Well, why don't you write me?" And a time went by, and I got a letter from Barnett. And he'd been thinking about doing something with the business his father had started in 1950, and based in Kansas City that whole time. And he'd been exploring various avenues.

But probably, in some part because of his background as Berkshire shareholder, he had some specific interest in the company becoming associated with Berkshire. He cared very much about the company having a permanent home.

He cared very much about it having an environment in which it could grow and be run autonomously and be based in Kansas City. And he wanted to receive something in exchange — that he was happy to own for the rest of his life.

And so, we worked out a transaction shortly — just very shortly after the annual report went to press.

And so now Berkshire, as of 12:01, I guess, yesterday morning, the deal closed. There's this waiting period because of the Hart-Scott-Rodino Act and a few other things.

The transaction closed. And now Berkshire is the owner of Helzberg's Diamonds, which has roughly 150 stores around, perhaps, 26 or 27 states. I'm not sure the exact number. And mostly in malls, although some others. It's been enormously successful.

Barnett brought in Jeff Comment, who formerly ran Wanamaker's about eight years ago, I guess it is.

And the company has both expanded in its traditional format — it's gone with a new format recently, which has been very successful.

It is — in its position in the jewelry industry, it tends to compete with a Zales or Gordon's, but it does a far, far better job.

Their sales, per store, on roughly equivalent square footage, will be very close to double what competitors achieve.

It's got a magnificent morale, and organizational structure. And the people — Barnett was very generous with people in making the sale. He took it out of his own pocket to treat people right because they'd done such a terrific job over the years.

And I think you'll see Helzberg's become a very big factor in Berkshire over time. And it just shows you what can come out of these annual meetings. So, the rest of you, you know, do your stuff. (Laughter)

So anyway, that is an acquisition that was made for — largely for common stock. It did not involve preferred, and — because Barnett preferred common.

And — but different people have different needs. And sometimes there's a group of shareholders that can have different priorities. And that's the reason we want to have various currencies.

If we had not been able to use common stock, we would not have made this transaction, because Barnett has been in no hurry to write a large check to the government. And we can help him in that respect with a common stock deal.

So anyway, we're glad to have Helzberg's become part of Berkshire. I wouldn't be surprised if we have another announcement or two in the next year before we have the next meeting. I hope so. But there's no guarantees.

5. Buffetts on the board adds stability

WARREN BUFFETT: Now we're going to turn the meeting open for questions. We'll do it as we've done before. We've got this room divided into six zones. And if you will raise your hand, the monitor in that — in your zone will recognize you. And we'll keep going around.

We will not go to a second person in any zone until we've exhausted all those who have yet to ask their first question. We have — we also have a zone in the overflow room. So, there'll be a total of seven.

And we'll just keep going around, if you'll identify yourself, please. And we'll be delighted to answer your questions. And the more, the better. So, we'll start with zone 1.

AUDIENCE MEMBER: My name is Fred Elfell Jr. (PH) from Sacramento, California.

And I wanted to ask if you could elaborate upon the logic of adding two family members to the board of trustees?

WARREN BUFFETT: Well, it's terrific for family harmony, just to start with. (Laughter)

The — as I've talked about in the annual report, the — if I die tonight, you know, my stock goes to my wife, who is a member of the board of directors.

And she will own that stock until her death, when it will go to a foundation. So, there is a desire to have as long a term and permanent ownership structure as can really be done, in terms of planning, and the tax laws, and so on.

I mean, I — we have invited people like Helzberg's to join in with Berkshire into what we think is a particularly advantageous way for them to conduct a business and to know the future that they're joining.

And part of knowing the future that they're joining involves knowing that the ownership is stable. And it will be stable for a very long period of time in Berkshire, probably about as long as you can — anybody can plan for in this world.

After my death, the family would not be involved in the management of the business, but they'd be involved in the ownership of the business.

And you would have a very large concentrated ownership position, going well on into the foundation, that would care very much about having the best management structure in place.

And to, in effect, prepare for that over time, I think it's very advisable that family members who will not be involved in management, but who will have a key ownership role to play, become more and more familiar with the business and the philosophy behind it.

I discussed that some in the — I guess, it was the 1993 annual report, because I think it's important that you understand.

And anybody that wants to sell us a business — if you've built a business since 1915, and you care enormously about it, and you care about the people that you've developed, but you've got something else you want to do in life, it's more than, you know, advertising your car in the paper to sell it.

I mean, it is an important — a very important transaction to you. Not just in terms of how much money you receive, but in terms of who you deliver thousands of people that have joined you — who you deliver them to.

And I think we have a structure that is about as good as you can do. Nothing is forever.

But we have a structure that's about as good as you can do, in terms of people knowing what they're getting into when they make a deal with us and being able to count on the conditions that prevail at the time of the deal, continuing for a long period in the future.

Many people — I had a fellow tell me the other day about a business where he'd been wooed by the acquirer. And, you know, the day after the deal, they came in and fired the top half-dozen people. They had a secret plan all along. Well, I don't think you run into much of that.

But what you do run into is the company that's the acquiring company, itself, either being acquired or some new management coming along, or some new management consultant coming along, and saying, "Well, this doesn't fit our strategic plan anymore, so let's dump this division."

And people that join in with Berkshire can be relatively, I think, comfortable about nothing like that happening.

Charlie, you want to elaborate on —

CHARLIE MUNGER: No. (Laughter)

WARREN BUFFETT: I was hoping Charlie would have a near-life experience this morning. (Laughter)

Keep encouraging him.

6. No comment on Kerkorian’s Chrysler bid

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Hello. My name is Jim Lichty (PH) from Des Moines. I’m interested in, like, Chrysler. Can you make a comment on the Chrysler Corporation? (Laughter)

WARREN BUFFETT: No, I don’t think I can make a comment on Chrysler. (Laughter)

I think Salomon Brothers, incidentally, has been retained by them. We have nothing to do with it. Charlie and I — I read that in the paper.

And Charlie and I are not familiar with — normally — with investment banking arrangements at Salomon.

But it has been in the paper that Salomon’s involved with that. We have no involvement.

Charlie, you’re not interested in commenting on the question? No? (Laughter)

Try him on something else.

7. Managers need to know “money costs money”

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: I’m Jim Vardaman (PH) from Jackson, Mississippi.

In describing the — your allocation of capital to your wholly-owned subsidiaries, you wrote in the annual report that, quote, you “charge managers a high rate for incremental capital they employ and credit them at an equally high rate for capital they release,” end quote.

How do you determine this high rate, and how do they determine how much capital they can release?

WARREN BUFFETT: Well, what we try to do with those — the question's about incentive arrangements we have with managers or other situations, where we either advance capital to a wholly-owned subsidiary or withdraw it — usually, that ties in with the compensation plan.

And we want our managers to understand just how highly we do value capital. And we feel there's nothing that creates a better understanding than to charge them for it.

So, we have different arrangements. Sometimes it's based a little on the history of the company. It may be based a little bit on the industry. It may be based on interest rates at the time that we first draw it up.

We have arrangements depending on the — on those variables and perhaps some others and perhaps just, you know, how we felt the day we drew it up, that range between 14 percent and 20 percent, in terms of capital advanced.

And sometimes we have an arrangement where, if it's a seasonal business where, for a few months of the year, when they have a seasonal requirement, we give it to them very cheap at LIBOR.

But, if they use more capital over — beyond that, we start saying, "Well, that's permanent capital," so we charge them considerably more.

Now, if we buy a business that's using a couple hundred million of capital, and we work out a bonus arrangement, and the manager figures out a way to do the business with less capital, we may credit him at a very high rate — same rate we would use in charging him — in terms of his bonus arrangement.

So, we believe in managers knowing that money costs money. And I would say that, just generally, my experience in business is that most managers, when using their own money, understand that money costs money.

But sometimes managers, when using other people's money, start thinking of it a little bit like free money. And that's a habit we don't want to encourage around Berkshire.

We — by sticking these rates on capital, we are telling the people who run our business how much capital is worth to us.

And I think that's a useful guideline, in terms of the decisions they're making, because we don't make very many decisions about our operating business. We make very, very few. I don't see capital budgets, in most cases, from our hundred percent-owned subsidiaries.

And if I don't see them, no one else sees them. I mean, we have no staff at headquarters looking at this kind of thing.

We give them great responsibility on it. But we do want them to know how we calibrate the use of capital. And so far, I would say, it's really worked quite well.

Our managers don't mind being measured, and they like getting a — I think they enjoy seeing a batting average posted. And a batting average that does not include a cost of capital is a phony batting average.

Charlie?

CHARLIE MUNGER: Well, I certainly agree. (Laughter)

WARREN BUFFETT: And his name isn't even Buffett. I mean — (Laughter)

8. The two reasons for buying insurance

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Hi, my name's Dave Lancasam (PH) with Business Insurance Magazine.

The sum of property-casualty risk management experts are advising commercial insurance buyers to forge five- and 10-year policies with their property-casualty insurers to promote stronger partnerships with their insurers, as well as to maintain the smooth PC market of the past seven, eight years.

Do you believe this idea will take hold for most policyholders? And if so, what would be the implications for policyholders' costs and insurers' underwriting results?

WARREN BUFFETT: The question is about partnerships between, probably, commercial policyholders and their insurers. And there are a lot of ways of doing that by various retrospective plans or adjustable rates of various sorts, and self-insured retentions, and that sort of thing.

As a general matter, there are only two reasons for buying insurance. One is to protect yourself against a loss that you are unable or unwilling to bear yourself. And that is partly a — an objective decision. It's partly subjective.

For example, a manager that's terribly worried that his board of directors may second-guess him if he has an uninsured loss, is going to buy a lot more protection, probably, than the company really needs.

But he knows he's never going to have to go in front of his board of directors and say, "We just had a million-dollar fire loss."

And then the next question the director asks is, "Was it insured?" And then he doesn't want to answer no.

So, he may do something that is very unintelligent from the company's standpoint merely to protect his own position.

But the reason for buying insurance is, whether — and this is true of life insurance, it's true of property-casualty, it's true of personal insurance, it's true of commercial insurance — is to protect against losses that you're unwilling or unable to bear yourself.

Or the second reason, which occasionally comes up, is if you think the insurance company is actually selling you a policy that's too cheap, so that you really expect, over a period of time, to have a mathematical advantage by buying insurance.

Well, we try to avoid selling the second kind and to concentrate on selling the first kind.

And we think any company we can sell insurance to — and of course, we — much of the insurance we sell is to other insurance companies. I mean, we are a reinsurer, in very large part.

We are selling them insurance against a loss that they are either unable or unwilling to sustain.

And a typical case, you know, might be a company that had a lot of homeowners policies in California. And if those include earthquake coverage, they may not be able to sustain the kind of loss that is possible, even though they want to keep a distribution system in place that merchandises en masse to homeowners in California.

So, we will write a policy. They may take the first 5 million of loss, they may take the first 50 million of loss — depends on their own capabilities — but then they come to us.

And we are really uniquely situated to take care of problems that no else — that the companies can't bear themselves and that they can't find anybody else to insure.

But we really don't want to insure someone for a loss that they can afford themselves, because if we're doing that it may because they're dumb. But it may be because they also have a loss expectancy that's higher than the premium we're charging, which is not what we're trying to do in business.

I think that — I think probably, as compared to 30 years ago, that risk managers at corporations are probably more intelligent about the way they buy their insurance than many years ago. I think it's become a — I think they're more sophisticated and they've thought it through better.

But there's a lot of insurance — there's some — there's a fair amount of insurance bought that doesn't make sense. And there's a fair amount of insurance that isn't bought that should be bought.

There are certain companies that are exposing themselves in this country to losses which would wipe them out. And they prefer not to buy reinsurance because it's, quote, "expensive." But what they're really doing is betting on something that won't happen very often, happening not at all.

And if you take a huge hurricane on Long Island or you take a major quake in California, there are a number of companies that are not — that have not positioned themselves to withstand those losses.

And if you're a 63-year-old CEO and you figure, "I'm going to retire in a couple of years," you know, the odds are pretty good that it won't happen on your watch.

But the — it will happen on somebody's watch. And we try to sell reinsurance to those people. And usually, we do. But sometimes we don't.

Charlie?

CHARLIE MUNGER: Nothing to add. (Laughter)

9. "We can sustain shocks … that others can't"

WARREN BUFFETT: OK. Zone 5.

He's saving himself. He'll be dynamite when he gets going. (Laughter)

AUDIENCE MEMBER: My name is Hugh Stephenson (PH). I'm a shareholder from Atlanta, Georgia. My question involves the company's catastrophe lines of insurance.

It seems that there's a relative ease of entry into that business through Bermuda-based companies and others. And given the importance of that business to the overall company, I'm curious how the ease of entry into the business affects its long-term competitive position and its rates of return?

WARREN BUFFETT: Well, you're very right, there is an ease of entry into the catastrophe business. And, you know, it's sort of attractive for — it's particularly attractive for promoters.

Because if you start an insurance company to write earthquake insurance in California and you raise a few hundred million dollars, you'll either have essentially have no losses or, if you write enough of it, you'll go broke. And most years, you'll have no losses.

So, if your intention is to sell your stock publicly in a year or two, that — the odds are very good that you will have a beautiful record for a couple of years. And you can sell.

And, you know, maybe one time out of ten, you'll go broke. And nine times out of ten, you'll sell to somebody else who will eventually go broke.

And it — there is — there's real ease of entry. The only thing that may restrict that is that if the buyer is sophisticated enough to question the viability of that company under really extreme conditions, which is the only conditions that count when you're buying catastrophe insurance, that may restrict it.

The second thing is, of course, none of the people that have started up can offer anywhere near the amount of coverage that Berkshire has. Berkshire is really one of a kind in terms of its capital strength in the business.

I'm — I don't think any money in Bermuda that I can remember — I don't think Ajit's out there. But I don't think anybody has a billion of net worth. And you know, we have — at present, we probably have close to 13 billion of net worth and considerably more of value.

So we can sustain shocks, and we will sustain shocks, I should add, that others can't. And we try to get paid appropriately for that.

But when we say we can take a billion-dollar loss, we can take a billion-dollar loss. And we will have a billion-dollar loss at some point.

And anyone buying it knows we can take it, or something greater. And they should know that very few other — very few of our competitors can. So, there's competition.

We do an unusual proportion of our business with the eight or ten largest insurance — reinsurance companies and insurance companies in the world. So, we really have established with the people who understand the real risks of the business.

They come to Berkshire and — a lot more often than they stop in Bermuda, because they know that we'll pay. And they've been around long enough to know that, in the end, that's what really counts with an insurance company.

If the rates — if there were enough capacity at really ridiculous rates, I mean, in the end, we wouldn't be writing that business at that time. But I don't think that will happen. It certainly hasn't happened so far. And if it happens, you know, so be it. We'll all play golf until the loss occurs.

Charlie? (Laughter)

CHARLIE MUNGER: Nothing to add.

10. Graham's principles for high-tech stocks?

WARREN BUFFETT: Zone 6? Or did we do — yeah.

AUDIENCE MEMBER: Chairmen, most company Berkshire invest at this time are not high in — are not in high-technology sector. What we have seen in the last few years, that there seems to be a significant growth, both in sales and earnings of the high-technology area.

And also, what invest — what U.S. shareholder believe that the times are changing from a brand name to high-technology.

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

WARREN BUFFETT: Well, I think it would sell. (Laughter)

The question about — Charlie and I won't be able to do it. We — Charlie probably understands high-tech. But you can see how hard it is to get any information out of him. So — (laughter) — he hasn't told me yet.

We try not to get into things we — that we don't understand. And if we're going to lose your money, we want to be able to come before you, you know, next year and tell you we lost your money because we thought this and it turned out to be that.

We don't want to say, you know, somebody wrote us a report saying if, you know, "This is what's going to happen," in some field that we don't understand and that, therefore, we lost your money by following someone else's advice. So, we won't do it ourselves.

At — I think that the principles — I think Ben Graham's principles — are perfectly valid when applied to high-tech companies. It's that we don't know how to do it, but that doesn't mean somebody else doesn't know how to do it.

My guess is that if Bill Gates were thinking about some company in an arena that he understood and that I didn't understand, he would apply much the same way of thinking about the investment decision that I would. He would just understand the business.

I might think I understand Coca-Cola or Gillette. And he may have a — he may have the ability to understand a lot of other businesses that seems as clear to him as Coke or Gillette would seem to me.

I think once he identified those, he would apply pretty much the same yardsticks in deciding how to act.

I think he would act — I think he would have a margin of safety principle that might be a little different because there's essentially more risk in a high-tech company. But he would still have the margin of safety principle on a — sort of adjusted for the mathematical risk of loss in his mind.

He would have — he would look at it as a business, not as a stock.

You know, he would not buy it on borrowed money. I mean, it — a bunch of principles would be carried through.

But our circle of things we understand is really unlikely to enlarge, maybe a tiny bit here or there. But if the capital doesn't get too large, the circle's OK.

And — but we will not —if we have trouble finding things within our circle, we will not enlarge the circle. You know, we'll wait. That's our approach.

11. USAir: "You don't have to make it back the way you lost it"

WARREN BUFFETT: Now, how are we set up for Zone 7? Can we do it out — yeah, here we are.

AUDIENCE MEMBER: Are you there? Hi, I'm Susie Taylor (PH) from Lincoln, Nebraska.

By way of explaining — we wrote down the value of USAir, reflecting our investment's current market value.

You had a good explanation in your report as to why the economics of the business are unattractive. And I presume, given the choice, we wouldn't do it over again.

WARREN BUFFETT: I think that's a fair assumption. (Laughter)

I should mention, anybody wanted to ask about USAir, we put them in the other room, just so you'll know why. (Laughter)

AUDIENCE MEMBER: And then the second part is better.

WARREN BUFFETT: But I'm watching you. I can see you on the monitor. (Laughs)

AUDIENCE MEMBER: And quoting from your profound statement, "You don't have to make it back the way you lost it."

WARREN BUFFETT: Right.

AUDIENCE MEMBER: Wouldn't it be a good idea to put that 89 million in something you are really behind as opposed to USAir?

WARREN BUFFETT: Well, that's a very good question. Because it is true that a very important principle in investing is you don't have to make it back the way you lost it. And in fact, it's usually a mistake to make — try and make it back the way that you lost it.

And we have — when we write our — an investment down, as we did with USAir at 89 million, we probably think it's worth something more than that. But we tend to want to be on the conservative side. But it's worth a whole lot less than we paid.

And the nature of that preferred, as well as other private issues we've bought, usually makes it quite difficult to sell. That's one of the things we know going in.

When we bought preferred, some people thought that we were getting unusually favorable terms. I haven't heard from them lately on USAir, but — (Laughter)

But one of the considerations in that is that, if you buy a hundred shares of a preferred that's being offered through a securities firm, from the same issuer, you can sell it tomorrow. And we are restricted, in some ways legally, and in other ways simply by the way that markets work, from disposing of holdings like that.

And we know that there's an extra cost involved to us if we should try to sell, or it may be impossible.

And that's not of great importance with us because we don't buy things to sell, but it's of some importance.

And we are not in the same position owning our Series A preferred of USAir as we would be if we bought a thousand shares or 5,000 shares of the Series B preferred, I believe it is, that trades on the New York Stock Exchange. That would be very saleable.

And our preferred could well even be saleable at a price modestly above what we carry it for, but it would require — it would not be very easy to do.

It might — if it were do — if we went about to do it, we could probably — assuming we could do it at all — we could probably get a little more money for it.

But it would not be easy to do, partly because of legal restrictions. Charlie and I are on the board. That complicates things.

We always know something that, just by being on the board, that the public doesn't know. So, that complicates things.

And in the end, we usually find that dealing with anything where we've got fiduciary obligations is, maybe, not practical at all. And if it is, it's probably more trouble than it's worth.

Charlie?

CHARLIE MUNGER: Well, it's certainly been an interesting experience, the USAir experience. (Laughter)

WARREN BUFFETT: Is that it, Charlie? OK. No, he —

CHARLIE MUNGER: I'd like to repeat that business about not having to get it back the way you lost it. You know, that's the reason so many people are ruined by gambling.

They get behind and then they feel they have to get it back the way they lost it. It's a deep part of the human nature.

And it's very smart just to lick it by will, and little phrases like that are very useful.

WARREN BUFFETT: Yeah, one of the important things in stocks is that the stock does not know that you own it. You know, you have all these feelings about it. You know, and — (laughter) — you remember what you paid, you know? (Laughter)

You remember who told you about it. All these little things, you know?

And it — you know, it doesn't give a damn, you know? (Laughter)

It just sits there. And it — you know, a stock at 50, somebody's paid a hundred, they feel terrible. Somebody else paid 10, they feel wonderful. All these feelings, and it has no impact whatsoever.

And so, it's — as Charlie says, gambling is the classic example. Someone builds a business over years. You know, that, they know how to do.

And then they go out some place and get into a mathematically disadvantageous game. Start losing it and they think they've got to make it back, not only the way they lost it, but that night. And — (laughter) it's a great mistake.

12. Beware of complicated fads and "high priests"

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: My name is Donald Stone. I'm from Riverside, Connecticut. I'm — this is my second shareholders meeting, ever, at age 61. So, I'm really very privileged to be here.

My first was Coca-Cola a week and a half ago. And there were only 200 people there. I'm trying to figure this out. (Laughter)

I think the rule is that the number of people present is in direct proportion to the price of the shares.

WARREN BUFFETT: Well, in that case, we won't split. (Laughter)

AUDIENCE MEMBER: OK.

Prefatory comment to my question: the November 24th, 1994 issue of Fortune Magazine had an article, a featured article, entitled "America's Greatest Wealth Builders," dealing with the concepts of market value added and economic value added.

It was with great glee that I noticed that Coca-Cola was number two on that list, second only to General Electric, and that Coca-Cola had done twice as well as Pepsi-Cola, number nine on the list, with one-third as much capitalization.

My question is this: whether the concept of market value added and economic value added, as such, or any of its variants, is a concept that's applicable and useful to Berkshire Hathaway as a whole, or in analyzing its line of business segments?

I'd really like to hear from Charlie Munger on this first. (Laughter) Because I've heard —

WARREN BUFFETT: So would I. (Laughter)

AUDIENCE MEMBER: I've heard —

WARREN BUFFETT: Charlie?

AUDIENCE MEMBER: I've heard that he's thought a lot about this particular subject.

WARREN BUFFETT: Right.

CHARLIE MUNGER: If Warren is using economic value added exactly the way they're now teaching it in the business schools, he hasn't told me.

Obviously, the concept has some merit in it. But the exact formal methods, I don't believe we use.

Warren, are you using this stuff secretly?

WARREN BUFFETT: No, we — (laughter) — in a sense, they're trying to get at the same thing we do. Or we're trying to get at the same thing they do. But I think it's — A, I think it has some flaws in it.

Although I think it generally comes out with the right answers, it sort of forces itself to come out with the right answers.

But I really don't think you need that sort of thing. I mean, I do not think it's that complicated to figure out, you know, where it makes sense to put money. You can make mistakes doing it. But in terms of the mental manipulations you go through, I don't think it's a very complicated subject.

And I don't think that — I think that the people marketing one or another fad in management tend to make them a little more complicated than needed so that you have to call in the high priest.

And, you know, it — if all that really counts is the Ten Commandments, you know, it's very tough on religious counselors and everything. (Laughs)

It doesn't take — it just doesn't make it complicated enough.

And I think there's some of that in — quite a bit of that — in management consulting and in the books that you see and all of that, that come out.

CHARLIE MUNGER: It's way less silly than the capital assets pricing model. So that, at least academia's improving. (Laughter)

WARREN BUFFETT: Really, yeah. The capital asset pricing model, which is — I don't know how much it's used now. Certainly — you know, they had these great waves of popularity. You get that in management. You get it in investing. I mean, real estate, you know, may have been popular, or international.

I — you can read Pensions & Investment magazine, which is a pretty good magazine. But you can just see these fads sort of going through. And then they have seminars on them and everything. And, you know, the investment bankers create product to satisfy the demand.

And there're these fads in management — I mean, obviously, listening to your customer and things like that, I mean, that is — nothing makes more sense. But it's hard to write a 300-page book that just says, "Listen to your customer." (Laughter)

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

You know, I really didn't need to read the November issue — 1994 issue of Fortune — to know that Coca-Cola had added a lot of value. (Laughter)

We added about 4 billion-some of value to Berkshire. That's good enough for me. (Laughter)

13. Derivatives: "Potential for mistakes and mischief"

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: My name is Maurus Spence (PH) from Omaha, Nebraska. I have a two-part question on derivatives.

Does Berkshire Hathaway currently, or had they in the past, engaged in strategies involving derivatives?

If so, do you as CEO, fully understand these financial instruments? (Laughter)

WARREN BUFFETT: Whoever suggested that crazy notion? (Laughter)

AUDIENCE MEMBER: Finally, would Charlie care — you or Charlie — care to comment on the use of these by other financial institutions?

WARREN BUFFETT: The question about derivatives — the reason I inject that remark — in a Fortune article that all of you should read if you haven't, I suggested that the use of derivatives would be dramatically reduced if the CEO had to say in the report whether he understood them or not, and — (Laughter)

The answer to your question, though, is we have two types, I guess it would be, of derivative transactions, of very modest size. But that doesn't mean we wouldn't — if the conditions were right, we either wouldn't have them on a much greater scale now, or we wouldn't have done it in the past.

We have two types of transactions, and I do understand them. And there are times when there are things that we would want to do — not often — but there would be times when they could be best accomplished by a transaction involving a derivative security. And we wouldn't hesitate to do so.

We would obviously care very much about the counterparty, because that transaction is just a little piece of paper between two people. And it's going to cause one of the two to have to do something painful at the end of the period, usually, which is to write a check to the other person.

And therefore, you want to be sure that that person will be both willing and able to write the check. And so, we're probably more concerned about counterparty risk than most people might be.

Last year and the year before, I think I said that derivatives often combine borrowed money with ignorance, and that that is a rather dangerous combination. And I think that we've seen some of that in the last year.

When you can engage in, sort of, non-physical transactions that involve hundreds of millions, or billions, or tens of billions of dollars, as long as you can get some party on the other side to accept your signature, that really has — that has the potential for a lot of mistakes and mischief.

And if you've looked at the formulas involved in some, particularly I guess, interest rate-type derivative instruments, it is really hard to conceive of how any business purpose could be solved by the creation of those instruments.

I mean, they essentially had a huge, really, gambling element to them.

And I use that in the terms of engaging in a risk that doesn't even need to be created, as opposed to speculative aspects. They involved a creation of risk, not the transfer of risk, you know, not the moderation of risk, but the creation of risk on a huge scale.

And it may be fortunate that in the last year, half a dozen or so cases of people that have gotten into trouble on them have come out because it — that may tend to moderate the troubles of the future.

The potential is huge. I mean, you can do things in the derivative markets —

Well, I've used this example before, but in borrowing money on securities, the Federal Reserve of the U.S. Government decided many decades ago that society had an interest in limiting the degree to which people could use borrowed money in buying securities.

They had the example of the 1920s, with what was 10 percent margin. That was regarded as contributing to the Great Crash.

So, the government, through the Fed, established margin requirements and said, "I don't care if you're John D. Rockefeller," you know, "You're going to have to put up 50 percent of the cost of buying your General Motors stock," or whatever it may be.

And they said that maybe Mr. Rockefeller doesn't need that, but society needs that. They don't — we don't want a bunch of people on thin margins gambling, you know, essentially, in shares, where the ripple effects can cause all kinds of problems for society.

And that's still a law. But it means nothing anymore because various derivative instruments have made 10 percent margins of the 1920s, you know, look like what a small-town banker in Nebraska would regard as conservative, compared to what goes on.

So, it's been an interesting history. You know, like I say, perhaps the experiences of the last year — they've got everybody focused on derivatives. Nobody knows exactly what to do about them.

Berkshire Hathaway will — if we think something makes sense and Charlie and I understand it — we may find ways to use them to what we think will be our advantage.

Charlie, you want to add anything on that?

CHARLIE MUNGER: Well, I disapprove even more than you do, which is hard.

If I were running the world, we wouldn't have options exchanges. The derivative transactions would be about 5 percent of what they are. And the complexity of the contracts would go way down. The clearing systems would be tougher.

I think the world has gone a little bonkers. And I'm very happy that I'm not so located in life that I have to be an apologist for it.

You know, a lot of these people, I feel sorry for them. You know, they had great banks. And they have to go before people, sometimes even including their children and friends, and argue that these things are wonderful.

14. Salomon's murky future

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Good morning. I'm John Nugier (PH) from Kingsburg, California. And my question relates to Salomon.

And where — I'm just asking if you could take us out the next two or three years in your vision. It started out as a good investment. You got a good return on it, or your interest.

And it's clearly had some problems. And we have gotten in deeper and deeper as those problems have continued. And it doesn't look like it's superbright.

So, it — you must understand where it's going. But could you just give us where you see it going in the next two or three years?

WARREN BUFFETT: Well, no, I think it's very difficult to forecast where Salomon or, really, almost any major investment bank, slash, trading house will do over actually the next two or three months, let alone the next two or three years.

The nature of that business is obviously far more volatile than the blade and razor business. Now the — and the tough part is assessing over a longer period of time whether — because of volatility, it's much harder to assess whether — what the average returns might be from a business.

And the answer is, Charlie and I, probably, if we were to try and write the forecast for the next two or three years, we would not have a high — a feeling that we had a high probability of being able to predict what that company, or other companies in that industry either, would earn three years out or would probably have in the way of average earnings.

Our own commitment is to a $700 million preferred issue, which has five redemption dates starting in October 31st of this year and then every year thereafter.

On those dates, we can either take cash or stock. And that's an advantage, obviously, to have an option. Any time you have an option in this world, it's to an advantage — it's to your advantage.

It may be a very small advantage, but it's — giving options is generally a mistake, and accepting options is usually a good idea, if it doesn't cost you anything.

And we will — the other thing about options is you don't make a decision on them until you have to make a decision. But — so, we, in addition to that $700 million of preferred, which in our view is a hundred percent money-good — I mean, we'd like to own more of that.

But we also have about 6 million-odd shares of common, which we paid perhaps $48 a share for, or something in that area. In any event, considerably more than the present market of 35 or '6. So, we have a loss of probably 80 or $90 million, or some number like that, at market in the common.

The preferred has actually treated us fine. We've received $63 million a year.

Incidentally, by owning the amount of common we own, this probably isn't generally known, but — or recognized — if you own 20 percent of the voting power of a company, you have a somewhat different dividends-received credit. You have somewhat different tax treatment than if you own less than 20 percent.

So, until we own that common, we paid somewhat more tax on our preferred dividend than we now pay. It's not a huge item, but it's not immaterial, either.

Charlie?

CHARLIE MUNGER: Well, I certainly agree, it's hard to forecast what's going to happen in the big investment banking, dash — slash, trading houses.

I would like to say that Berkshire Hathaway was a large customer of Salomon long before we bought the preferred, and that we've had marvelous service over the years.

I think Salomon's going to be around for a long time, rendering very good service to various clients.

WARREN BUFFETT: We sold —

CHARLIE MUNGER: Satisfied clients.

WARREN BUFFETT: We sold our first debt issue of Berkshire, I think, in 1973, through Salomon. So, we've had an investing banking relationship for 21 or 22 years there. And actually, we'd done business with them before that in various other ways. So, it's a long-term relationship.

But there's no question about Salomon being around. The question — and that's why our preferred is absolutely money-good.

But the question is what the average return on capital will be. And we knew that was difficult to predict when we went in. And we found out it's even more difficult to predict than we thought.

15. Honoring mutual fund pioneer Phil Carret

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Thank you for the opportunity. Dick Jensen (PH) from Omaha, a fellow Nebraska University supporter.

A rather convoluted question: very interested in your recent purchase and your future intention of American Express. And as I understand the company, I know it's a rather involved and complicated and rather expansive company, insofar as it has its interest in many areas.

I know one of which, of course, is the credit card. But there's also the major part of the organization of IDS and others that I don't even know about.

And I wondered, what your hopes are for that investment.

And I also, just recently, as perhaps you have, became curious to know if you are personally acquainted with Mr. Phil Carret, I believe, his name is. And how about the purchase of his firm in your future? Thank you.

WARREN BUFFETT: Dick, I think Phil Carret is here today. Phil?

CHARLIE MUNGER: He's right back there.

WARREN BUFFETT: Phil, would you stand up? There he is. (Applause)

Give him a hand.

Phil is 98. I first met him in 1952, 43 years ago. He attends every eclipse around the world. And you can run into him in some very strange places.

Wrote his first book on securities, I believe, in 1924. I — am I right on that, Phil? Yeah.

And wrote an autobiography here, recently.

Probably the greatest long-term investment record in this country's history. And — but I think — I, you know, my impression is that Phil sold part, or a good bit, of Pioneer some years ago, which he managed for decades, many decades.

In fact, I first learned about Phil when I was leafing through Moody's Banks and Financial Manual 40-odd years ago, and I saw this company with this great record and with some securities that looked terribly interesting.

So, we got in touch. And he was out in Omaha and we got acquainted. It — so, anybody that can get Phil to talk to them, listen carefully. I advise that.

16. Cards are key to future of American Express

WARREN BUFFETT: The question about American Express: we own just under 10 percent of American Express. And obviously, even though you mentioned they're in a number of businesses, the — by far, the key, the most important factor in American Express's future for a good many years to come — a great many years to come — will be the credit card.

And that is a business that has become, and will forever, probably, become ever more competitive. I mean, I followed it since — I think I met Ralph Schneider at the Diners' Club in the late 1950s.

And American Express entered into the credit card business out of fear. I mean, they were worried about what the credit card was going to do to their traveler's check business. Traveler's check business had been originated back in 1890-something, I believe.

And that was, in turn, building off of the old express business where, I think, it was Henry Wells and William Fargo, they would chain themselves to the express boxes as they delivered them through the — to the West.

And they decided that maybe issuing traveler's checks would a little easier — (laughter) — than carrying all this stuff around.

So, that — the traveler's check was the — evolved out of the express business.

And the credit card business with American Express arose out of fear of what — particularly Diners' Club at the time. They were all terrified of Diners' Club, which got this — got the jump on everybody.

And they became enormously successful with it. And the American Express card, as you know, had a terribly strong position in what they called the "travel and entertainment" part of the card business.

And of course, the banks entered in on a big scale. And Visa's been enormously successful.

So, the card has a strong franchise in certain areas, like the corporate card. Although people like First Bank System are very aggressive in going after them there.

The card — but the card has a significant franchise, but it does not have the breadth of franchise that it had many years ago.

For a while, it was "the" card. And now it's "the" card in certain areas, but nothing like as broad an area as before.

It has certain, very important, advantages and economic strengths and it has some weaknesses. And you have to suss those, in deciding where it'll be in the year 2000 or 2005.

And we think that the management of American Express thinks well about the question of how to — how you keep the card special in certain situations. And they've reacted to the merchant backlash for higher discount fees, I think, in an intelligent way.

So, we'll see how it all plays out. But the key — IDS, which has now been renamed, but is a very big part of American Express — it accounts for close to a third of their earnings — but the real key will be how the card does over time.

Charlie?

CHARLIE MUNGER: Nothing to add.

17. "Corruption won" in stock option accounting rule

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Hi, my name is Philip King (PH) from San Francisco.

And my question has to do with how the FASB has caved in on the stock option proposal.

And the people opposed to the proposal argue that it would hurt capital formation for companies and that the cost of stock options is already reflected in shares outstanding, in fully diluted calculations.

And I was curious, what is your feelings about what's happened?

WARREN BUFFETT: Well, as those of you have followed this issue — FASB did cave, and they were — they hated it. I mean, they knew they were right. Matter of fact, most of the, what are now, I guess, the big six auditing firms, many years ago, sided with the position.

But in my opinion, the auditing firms caved to their clients, in that respect.

In terms of capital formation, I would argue that the most intelligent form of capital formation follows from the most accurate form of accounting.

I mean, it — if all the companies with — whose names began with A through M didn't have to count depreciation and all the ones with N through Z did, or something, you know, that might help in capital formation for companies that were — had names with A thru M. And incidentally, they probably all change their names.

But I don't think that bad accounting is an aid to capital formation. In fact, I think probably over time, it distorts capital formation.

Because if we were to pay all of the shareholders with — I mean, all of the people who worked for Berkshire Hathaway — in stock, and therefore record no wage expense, you know, we might be able to sucker in a bunch of people who thought the earnings were real.

But that would not be a great step forward for capital formation, in my view.

I really think that — you know, I've talked privately to a number of managers about this. And they understand it. But they, you know, they prefer the present situation. And they used a lot of muscle in Washington many years ago.

And I think I have this authenticated now. This fellow — mathematics professor — sent me some material after I'd written this. I try to get a little proof after the fact when I can.

I believe it was in the Indiana legislature, where a legislator introduced a bill to change the value of pi, the mathematical symbol pi, to three. Because he said that it was too difficult for the schoolchildren to work with this — (laughter) — complicated 3.14159.

And he was right. I mean, it was difficult. And I — and Congress, in connection with the stock option question, received all kinds of pressure to, in turn, pressure FASB and the SEC to not count stock option costs as part of compensation.

I've never met anybody that wanted to be compensated that felt that, if he received his present salary plus an option, he was not getting compensated more than if he just received a salary. So, he thought it was compensation.

And I will tell you that if we'd been issuing options over a period of time at Berkshire for things unrelated to the performance of the entire business, that we would've had a cost, perhaps measuring in the billions of dollars, whether it was recorded or not.

So, it goes back to Bishop Berkeley's question of whether a tree that falls in the forest and doesn't make a sound, you know, when — et cetera.

But it — I think it is — I really think that it makes you a bit of a cynic about American business when you see the extent to which a group has pressured — even to the extent of talking about financial — withdrawing financial support from the Financial Accounting Standards Board — the degree to which they've pressured people to make sure the value of pi stays at three instead of 3.14, simply because it was their own ox that was being gored a bit.

In any event, it's — it looks like it's all over now for some time. In fact, now they're pressuring them to even weaken further the standards that have been set. So, self-interest is alive and well in corporate America.

Charlie?

CHARLIE MUNGER: Yeah, I think dishonor won. And I think that — I think it is quite important for a civilization to have sound engineering and good accounting.

And it is a very regrettable episode, leading politicians — leading venture capitalists.

I think to some extent, it's an indictment of the educational system, that this thing could be so widely looked at, and so wrongly.

WARREN BUFFETT: It's bad enough people want to cheat on their accounting. And they do cheat on their accounting. But to want it to be endorsed as the system —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — is really kind of disgusting.

CHARLIE MUNGER: Yeah, corruption won.

WARREN BUFFETT: Well, put us down on undecided on that and we'll move on to zone 6. (Laughter)

18. Why there's no video of Berkshire meetings

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger, Mike Lee-Chin from Hamilton, Ontario.

Could you consider availing a videotape of this meeting to us, the shareholders?

CHARLIE MUNGER: I didn't quite get that.

AUDIENCE MEMBER: Would you consider availing this videotape of the shareholder — this particular shareholder meeting to us, the shareholders?

CHARLIE MUNGER: Distributing a videotape?

WARREN BUFFETT: A transcript or a videotape?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yeah, we've had that suggested a number of times. It's a good suggestion, and we've considered it.

The thing we're worried about, in connection with that, is discouraging attendance.

I mean, it — (laughter) — we'd hate to have two people here asking questions and then send it out to tens of thousands. So — (laughter) — in the end —

CHARLIE MUNGER: Particularly if it might make sales go down at the jewelry store.

WARREN BUFFETT: Yeah. (Laughter and applause)

Since we were just attacking hypocrisy in American business, Charlie felt like he should add that to my comments. (Laughter)

But we — it's a close call on that because we would like everybody —

Of course, we try to cover a great many subjects in the annual report. But we like the idea of the meeting — answering a lot of shareholders questions.

We don't want to discourage attendance. And it's fun to have everybody come in and ask questions.

And the chances are, if we had far fewer people, we would have, you know, far more — far fewer — good questions. So that the quality of the meeting is enhanced, I think, by having a lot of people come.

But you've come a long way, so I can understand why you might be interested in a transcript. (Laughs)

I apprentice that. Thank you.

AUDIENCE MEMBER: — or no. Is that a yes or a no?

WARREN BUFFETT: It's — (Laughter)

CHARLIE MUNGER: It was a no.

WARREN BUFFETT: It's a no.

AUDIENCE MEMBER: OK. (Applause)

WARREN BUFFETT: Most everything we say is a no. But we have various ways of getting there. (Laughter)

19. Berkshire meetings boost Borsheims' sales

WARREN BUFFETT: OK. Zone 7 from the other room, I can see you.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger.

I was wondering if you could tell us what the sales at Borsheims were yesterday and how it compared to a year ago?

WARREN BUFFETT: Well, I can tell you how it compared to a year ago. They were 15 percent above a year ago. And a year ago it was 40-odd percent above the year before. And I forget how much that was before.

So, we keep setting records. But we haven't announced any numbers. But it's a pretty good size number. You're a sporty crowd.

AUDIENCE MEMBER: Thank you. (Laughter)

20. An "idiot" could successfully run Berkshire

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Good morning. My name is Patrick Terhune from Fort Lauderdale, Florida.

And first of all, I see, per your request, there are a lot of people who wore red in honor of the Cornhuskers. (Applause)

Of course, my team was the — or is the Miami Hurricanes. And I've got my green and orange on under my clothes. So — but if we were to lose, I'm glad we lost to Nebraska and Tom Osborne.

I've got a request for Warren and Charlie, and that is, recognizing that the value, both intrinsic and extrinsic, of Berkshire Hathaway, is the result of your combined skills in acquiring growth companies and with your prudent and expert investing of the company's capital for growth, I'd like to know if you have a plan — a succession plan — to be executed in the event, God forbid, something happens to one or both of you, which would remove your input to the strategic decisions.

I sincerely hope you're in the process of developing individuals to carry forward your collective visions and to manage the company's resources as effectively and as profitably as is being done now.

WARREN BUFFETT: Well, I appreciate that question. And the answer is, obviously, we do care enormously about that because both Charlie and I — in addition to a lot of other reasons, but in — we both have a very significant percentage of our net worth in Berkshire.

And neither one of us has figured out how to sell it all exactly, you know, 15 minutes before we get hit by a truck. So, we will not have the jump on the rest of you.

And therefore, our continuing interest will go — financially — will go well, well beyond our deaths.

And it will — in terms of foundations or something like that, it will go to organizations that we care very much about having maximum resources available to.

So, we do have some plans. We don't name names or anything of the sort.

It's not quite as tough as you might think because we have a collection of fabulous businesses. Some of them owned totally, some of them owned in part.

And I don't think razor blade sales or Coca-Cola sales are going to fall off dramatically the day Charlie or I die. It — we've got some great businesses. And then same is true of the wholly-owned businesses.

So the question is more that of allocating capital in the future. And you know, that's a problem for Charlie and me right now, simply because of the size with — it's not easy to find things to do that make sense with lots of money.

And sometimes a year will go by and we don't find anything. And other times a year goes by, and we think we found something, but it turns out we were wrong.

So, it's not easy. But we think we will have some very smart people working on that.

And we don't think it will be the end of the world if they don't find anything the first year, because the businesses will run very well.

We have a big advantage in that, as contrasted to virtually almost every other company, we, now and in the future, are willing — eager — to buy parts of wonderful businesses or all of them.

I mean, most managements have a — most investors are limited to buying parts of businesses. And most managers, psychologically, are geared to owning all of something that they can run themselves.

We — you know, it's like, I think Woody Allen said some years ago, the advantage of being bisexual is it doubles your chances of a date on Saturday night. (Laughter)

And we can go either direction, in that respect. (Laughter)

And our successors will also. So very — Charlie, you want to add anything?

CHARLIE MUNGER: I think few business operations have ever been constructed to require so little continuing intelligence in corporate headquarters. (Laughter)

An idiot who was willing just to sit here would have a very good record long after the present incumbents were dead.

WARREN BUFFETT: I think that's true.

CHARLIE MUNGER: Yeah. I think it would be a little better if Warren would keep alive, in terms of allocating the new capital. I don't think we'll easily replace Warren.

But, you know, we don't have to keep getting rich at the same rate we have in the past. (Laughter)

WARREN BUFFETT: That's a tie vote. (Laughter)

21. Decisions so obvious that exact numbers aren't needed

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Hi, this —

WARREN BUFFETT: (Inaudible)

AUDIENCE MEMBER: — Keith Briar from San Francisco.

I have a question. When you're valuing the companies and you discount back the future earnings that you talk about, how many years out do you generally go? And if you don't go out a general number of years, how do you arrive at that time period?

WARREN BUFFETT: Well, that's a very good question. And it's — I mean, it's the heart of investing or buying businesses, which we regard as the same thing, but —

And it is the framework in which we operate. I mean, we are trying to look at businesses in terms of what kind of cash can they produce, if we're buying all of them, or will they produce, if we're buying part of them. And there's a difference. And then at what discount rate do we bring it back.

And I think your question was how far out do we look, and all that.

Despite the fact that we can define that in a very kind of simple and direct equation, you know, we are — we've never actually sat down and written out a set of numbers to relate that equation.

We do it in our heads, in a way, obviously. I mean, that's what it's all about.

But there is no piece of paper. And we never — there never was a piece of paper that shows what our calculation on Helzberg's or See's Candy or The Buffalo News was, in that respect.

So, it would be attaching a little more scientific quality to our analysis than there really is, if I gave you some gobbledygook about, "Well, we do it for 18 years and stick a terminal value on and do all of this."

We are sitting in the office thinking about that question with each business or each investment. And we have discount rates, in a general way, in mind.

But we really like the decision to be obvious enough to us that it doesn't require making a detailed calculation.

And it's the framework. But it's not applied in the sense that we actually fill in all the variables.

Is that a fair way of stating it, Charlie?

CHARLIE MUNGER: Yeah. Berkshire is being run the way Thomas Hunt Morgan, the great Nobel laureate, ran the biology department at Caltech.

He banned the Friden calculator, which was the computer of that era. And people said, "How can you do this? Every place else in Caltech, we have Friden calculators going everywhere."

And he said, "Well, we're picking up these great nuggets of gold just by organized common sense, and resources are short, and we're not going to resort to any damn placer mining as long as we can pick up these major aggregations of gold."

That's the way Berkshire works. And I hope the placer mining era will never come.

Somebody once subpoenaed our staffing papers on some acquisition. And of course, not only did we not have any staffing papers, we didn't have any staff. (Laughter and applause)

22. "Something will happen" and we want to be ready

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: I'm Tom Morrow (PH) from Laguna Beach, California. And the question I have to ask pertains to the issuance of the new stock.

And again, as Charles mentioned, is there some potential gold mine out there that you have specifically in mind with the — some large acquisition that you have specifically in mind at this time, without revealing any strategic secrets?

WARREN BUFFETT: Yeah. There are things we would like to do. Whether we ever get a chance to do them or not is another question. But you know, I will be surprised if, in the next five years, we haven't used some preferred stock one time or another.

As I mentioned in the report, we had one last year that if we'd done it, it would've involved the issuance of maybe a billion dollars' worth of — no, more than that, I'm sorry — a couple billion dollars' worth of preferred.

That one isn't going to happen, in my view. I mean, it — there's one chance in a hundred it'll — it could happen or something of the sort — but, probably, it isn't going to happen.

On the other hand, we want to be prepared for it. Something will happen. That's always been our experience.

You know, we have sat through some dry spells. And this is true in both the stock market and the acquisition business.

You know, I closed up the partnership in 1969 because there was nothing that made sense to do. And I'm glad I did because that situation prevailed in '71 and '2.

But in 1973 and '4, you know, there were all kinds of things to do.

And that will happen from time to time. People will behave, particularly in markets, just as foolishly in the future as they have in the past. It'll come at unexpected times. But we will get a chance to do something.

Now, that's more of a cash-type purchase, obviously, in the market. But we will get a chance to use the preferred.

And we will try to think about big things. We may not find them. But Charlie and I, the larger something is, the more interested we are.

23. Big assets make float more flexible

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Jim Moss (PH) from Los Angeles.

I was reading through your annual report. And to me, an eye-popping number in there was the amount of float in 1994, at a cost of less than zero — I think it was $3 billion.

And I was wondering if there are any restrictions on your investment of that money, or can that go into your marketable equity securities?

WARREN BUFFETT: The question relates to — we have that long table we put in — we introduced about four years ago or so in the annual report, that shows the amount of float and the cost of float.

And that's a very important table. It — in terms of our operating businesses, that's probably the most important piece of information in the report.

And that float is, as you noted, well over $3 billion now — last year, because of various favorable factors, including the fact that our super-cat business was favorable, but also, because our other insurance businesses did very well — amazingly well.

The cost of that float, which is money that we're holding that eventually — does not belong to us, but will go to somebody else. The cost of that float was less than zero, and that is a very valuable asset.

And the question is, how much flexibility we have in investing that, which I think was the core of your question.

The answer is we have a lot of flexibility. We are not disadvantaged by that money being in float, as opposed to equity, really, in any significant way.

Now, if we had a very limited amount of equity and a very large amount of float, we would impose a lot of restrictions on ourselves as to how we would do it, because we would want to be very sure that we were in a position to distribute that float, in effect, to policyholders, or claimants, or whatever it may be at the time that was appropriate.

But we have so much net worth that, in effect, that float is just about as useful to us as equity money. And that means quite useful. It's a big asset of Berkshire's.

24. Not feeling threatened by Beardstown Ladies

WARREN BUFFETT: Let's see, we've got zone 5.

AUDIENCE MEMBER: Susan Scott (PH) from Madison, Wisconsin.

On a more serious note, are you beginning to feel threatened by the success of the Beardstown Ladies? (Laughter)

WARREN BUFFETT: Which lady?

CHARLIE MUNGER: I —

WARREN BUFFETT: Which lady was that? I —

CHARLIE MUNGER: I didn't get it.

WARREN BUFFETT: I got everything except what lady that was.

AUDIENCE MEMBER: The Beardstown Ladies, the investment group?

WARREN BUFFETT: Oh, that group. Yeah, the best-seller. Yeah. I have not read that book. I hate to admit that to an audience of shareholders, that I —

This is a book that's — I think it's probably number, I don't know, seven or eight or something like that on the Times best-seller list, and been up there for a couple of months now.

It's a group — an investment group — that, apparently, is sharing with the world their secrets of success.

I'm always suspicious of people when they're sharing with the world any great ideas on investments. But we are not threatened at the moment, no. (Laughter)

25. Economics of the moat and the castle

WARREN BUFFETT: Zone 6.

WARREN BUFFETT: Mike Assail (PH) from New York City.

In the mistake du jour section of the annual report, you mentioned a fundamental rule of economics that you missed. I'd like to know the two or three most important fundamental rules of economics you habitually get right.

In other words, what are the fundamental rules of economics you used to make money for Berkshire?

And I'm not talking about Ben Graham's principles here, but rather, rules of economics which may be found in an economics textbook. Thank you.

WARREN BUFFETT: We — Yeah, we try to — I mean, we try to follow Ben's principles, in terms of the attitude we bring toward both investing and in buying businesses.

But the most important thing you can — you know, what we're trying to do is we're trying to find a business with a wide and long-lasting moat around it, surround — protecting a terrific economic castle with an honest lord in charge of the castle.

And in essence, that's what business is all about. I mean, you want to be the lord of the castle, yourself. In which case, you don't worry about that last factor.

But what you're trying to — what we're trying to find is a business that, for one reason or another — it can be because it's the low-cost producer in some area, it can be because it has a natural franchise because of surface capabilities, it could be because of its position in the consumers' mind, it can be because of a technological advantage, or any kind of reason at all, that it has this moat around it.

And then our — then what we have to decide is — all moats are subject to attack in a capitalistic system, so everybody is going to try and — if you've got a big castle in there, people are going to be trying to figure out how to get to it.

And what we have to decide — and most moats aren't worth a damn in, you know, in capitalism. I mean, that's the nature of it. And it's a constructive thing that that's the case.

But we are trying to figure out what is keeping — why is that castle still standing? And what's going to keep it standing or cause it not to be standing five, 10, 20 years from now. What are the key factors? And how permanent are they? How much do they depend on the genius of the lord in the castle?

And then if we feel good about the moat, then we try to figure out whether, you know, the lord is going to try to take it all for himself, whether he's likely to do something stupid with the proceeds, et cetera. But that's the way we look at businesses.

Charlie, you want to add anything?

CHARLIE MUNGER: Well, I think he wants it translated into the ordinary terms of economics. The honest lord is low agency cost. That's the word in economics.

And the microeconomic business advantages are, by and large, advantages of scale — scale of market dominance, which can be a retailer that just has huge advantages in terms of buying cheaper and enjoying higher sales per square foot.

So you're — by and large, you're talking economies of scale. You can have scale of intelligence. In other words, you can have a lord with enough extra intelligence that he has a big advantage. So you're — by and large, you're talking scale advantages and low agency costs.

WARREN BUFFETT: Yeah, to some extent, Charlie and I try and distinguish between businesses where you have to have been smart once and businesses where you have to stay smart.

And, I mean, retailing is a good case of a business where you have to stay smart.

But you can — you are under attack all of the time. People are in your store. If you're doing something successful, they're in your store the next day trying to figure out what it is about your success that they can transplant and maybe add a little something on in their own situation. So, you cannot coast in retailing.

There are other businesses where you only have to be smart once, at least for a very long time. There was once a southern publisher who was doing very well with his newspaper. And someone asked him the secret of his success. And he said monopoly and nepotism. (Laughter)

And I mean, he wasn't so dumb. I mean, he didn't have any illusions about himself.

And if you had a big network of television affiliates station 30 years ago, there's still a major difference between good management and bad management. I mean, a major difference.

But you could be a terrible manager and make a fortune, basically. Because the one decision to own the network TV affiliate overcame almost any deficiency that existed from that point forward.

And that would not be true if you were the first one to come up with some concept in retailing or something of the sort. I mean, you would have to be out there defending it every day.

Ideally, you know, is you want terrific management at a terrific business. And that's what we look for.

But as we pointed out in the past, if you have to choose between the two, get a terrific business.

Charlie, any more?

CHARLIE MUNGER: No.

26. Compliments for Helzbergs of Kansas City

WARREN BUFFETT: Let's see, zone 7, I believe is next?

VOICE: No questions from zone 7.

WARREN BUFFETT: OK. How about zone 1?

AUDIENCE MEMBER: Paul Miller (PH) from Kansas City.

First, I'd like to comment on your purchase of Kansas City-based Helzberg Jewelers. You commented about Barnett Helzberg and his — what he's done, retailing-wise.

For those of us in Kansas City, you've also picked up Barnett and Shirley Helzberg, who are the first family in philanthropy in Kansas City.

And for the shareholders in this room, the Helzbergs are wonderful people. And to have them added to this group of companies says miles about Warren Buffett and that they pick companies based upon their management and their people.

So, kudos to Berkshire Hathaway for picking up the Helzbergs, and thanks to the Helzbergs for everything they've done to Kansas City. Now, my — (Applause)

WARREN BUFFETT: Appreciate that. (Applause)

27. Putting a value on the subsidiaries

AUDIENCE MEMBER: My question relates to value. We can look in the annual report, and we can all see the purchase of a Washington Post, for instance, for $10 million that has a value today of 420 million.

But discerning the value of the other consortium of non-publicly traded businesses, the Nebraska Furniture Marts, the Borsheims, et cetera — the value of their purchase price over the years versus their value today, how can we understand that value and how is it reflected in the annual reports?

WARREN BUFFETT: Yeah, well we try to — that's a good question. We try to give you the information that we would want in answering that question, in the annual report.

Part of it, we do in those pages where we say it's not according to GAAP accounting. But there's a lot of useful information in there.

We're not — we don't stick a number on each company. But we try to give you enough information about the capital employ, the margins, and all of that sort of thing on the bigger businesses that you can make estimates that are probably just about as good as ours.

WARREN BUFFETT: Charlie and I would not need more information than is in the report to come up with a pretty good idea of what the controlled businesses are worth. And there's no information we're holding back that we think would be of any real importance in evaluating those businesses.

But you're right, it's a lot easier with marketable securities than it is — at least in terms of current numbers — than it is with the wholly-owned businesses.

The wholly-owned businesses, generally speaking, some of them are worth a whole lot more than we've — than they're carried on the books for. And we feel pretty good about, essentially, all of them.

But they're — they've turned out remarkably well, I would say that, over the years. And my guess is that they keep working pretty well.

We have managers in a number of those businesses here. I'm not going to introduce them all because we have so many that it would take a considerable period of time.

But you named The Washington Post. In the front row there, close to the front row, we have Don Keough, would you step up, of Coca-Cola? (Applause)

And we have Kay Graham for the Post. (Applause)

And Tom Murphy from Cap Cities. (Applause)

CHARLIE MUNGER: Is Paul Hazen here, too?

WARREN BUFFETT: And I'm going to try and do — well, there's a whole bunch more. I don't want to get — but I — but those three were sitting together and I was struck by the fact that if — those three combined, we have about 6 1/2 billion of profit in, so far. (Laughs)

So, I would say that that's a — (Applause) —

Those are three businesses that have been fantastic. And like — I emphasize "so far" because we'd like to be able to name a bigger number in the future.

But we have a group of managers, both at the controlled companies and at the partly-owned companies, that have just created incredible value for Berkshire.

I mean, Charlie and I sit around and read the paper every day and a lot of magazines and things, watch OJ Simpson or whatever it may be. (Laughter)

And these people are out there creating a ton of value for us. So, we're not going to change it. That —

28. Salomon Brothers culture clash

WARREN BUFFETT: Now, let's see. I think, zone — is it zone 2 now? Or is it — yeah.

AUDIENCE MEMBER: Hello. I'm Tim Palmer (PH) from Dillon, Colorado. I have a question for you regarding Salomon.

In the past week, there's been an article in The New York Times, The Wall Street Journal, and I believe it's Businessweek, that were rather unflattering, as far as what's going on with the management and your selection. There seems to be a — somewhat of a cultural clash there.

I don't know that to be a fact. But I wondered, number one, how you keep yourself open to bad news before it's news.

And what is going on in Salomon there, the compensation plan, et cetera? How do you think that, culturally, is going to work out?

WARREN BUFFETT: Charlie and I are always — we're more interested in bad news, always, than good news. We figure good news takes care of itself. And one — we only give a couple of instructions to people when they go to work for us.

And one of them is to think like an owner. And the second one is to just tell us the bad news immediately, because good news takes care of itself. And we can take bad news, but we don't like bad news late.

So, I would say, in connection with Salomon, that there is, and has been, some culture clash. And there probably almost always would be a culture clash in a business where there is that amount of tension.

Whether it be the entertainment business, or the investment banking business, or the sports business, there's going to be a certain amount of tension when — between compensation to the people that work there and compensation to the owners.

And I think there's been some — that strain has existed at Salomon from the day I was first there and far before that. I mean, I — that was no surprise. It's understandable.

You're seeing a tension, actually, in the airline business between the people that work there and capital. And it's produced terrible results in the airline business. And the people that work there have been able to — and I'm not talking about USAir specifically, although that's a case. But it goes beyond that.

They have had contracts, which were, as I pointed out in the report, were executed in an earlier age, which, essentially, will not allow — in many cases — capital to receive any compensation. And that produces a lot of tension.

You don't have contracts like that in the investment banking business or Wall Street, generally. But you have that same sort of tension.

And changing a culture around, A, takes time and, B, probably takes some change in people. I mean, I don't think that's a great surprise if you expect to do it.

I have — I don't think you can find two better people than Bob Denham and Deryck Maughan. They're smart, they're high-grade, they're willing to work very hard. And there will be people that buy into the arrangements they want to have. And there are people that won't.

Not all of the people that have left, by a long shot, are leaving of their own volition, but most of them are. But some aren't. I mean, there — Salomon lost a lot of money last year. And many of the people that have left were not responsible for some of those losses, but some of the people were.

So, that is not something where you announce names in the paper. But some people are leaving because they can make more money elsewhere. And some people are, maybe, leaving because we think we can make more money without them. (Laughter)

Charlie?

CHARLIE MUNGER: Yeah, I don't think the tensions that have been commented on within Salomon are all that unusual. I think they pretty well exist everywhere on Wall Street. And even in the banks, which have tried to imitate Wall Street. I just think it comes with the territory.

WARREN BUFFETT: I don't know what percentage of the Goldman Sachs partners left this year, but they had tensions that were produced, obviously, when they had a bad year. And they're going to have a bad year from time to time. Everyone's going to have a bad year.

But it — the partners — the general partners — of Goldman Sachs, in the year ended November 30th, 1994, did not do well. They may have not done anything at all. And they'd made some very big money in prior years. And they'll probably make some very big money in subsequent years.

But in the year when they didn't make any money, it was a lot of turnover. And maybe some of that turnover, also, was not all at the volition of the general partners that you read about leaving. I don't know the facts in that case.

But there's a certain amount of tension that exists in Wall Street under any circumstances. And when you aren't making money, there's a lot of tension.

29. Best edition of Ben Graham's "Security Analysis"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Yeah. My name is Michael Johnson. I'm a native to Omaha, and however, my family and I are Americans living abroad in Dhahran, Saudi Arabia.

My question is related to intrinsic value and Ben Graham's "Security Analysis."

I read a book earlier this year by Janet Lowe, who said that you were more toward the first or second editions of "Security Analysis" and not so much toward the fourth.

Yet, the fourth edition seemed to move more toward growth and value being kind of joined at the hip, like you've said in your last few annual reports.

And so, if I'm a person who's always studying security analysis like I do — I think I spend more time with that — do you think I need to get those first editions? Or is the fourth edition kind of more of what you've moved toward, with your comments such as value and growth are joined at the hip?

WARREN BUFFETT: Janet Lowe is here, incidentally, today. She wrote a very good book on Ben Graham. I recommend that any of you that haven't read it, go out and buy a copy.

The — I still prefer the — I think the second edition is cheaper to buy than the first edition, by some margin. And I think it's basically the same book. So, I — that's the one I would recommend. I — it isn't because of differences on value and growth.

I just think that the reasoning is better and more consistent throughout the second edition, which is really the last one that Ben was the hundred percent — along with Dave Dodd helping him in various ways — was responsible for writing.

So, I think that the book has gotten away, to quite an extent, from both Graham's thinking and from his way of expressing himself. So I really — but I have no quarrel with anybody that wants to read later editions at all.

I do think, probably, the second edition, if you're a real student of security analysis and you read and understand that, you'll — you should do all right.

In terms of — a lot of the mistakes that were made, in terms of junk bonds and accounting and all of that sort of thing, were covered in 1934 in that first edition, and subsequently in 1940 in the second edition. There's a lot of meat in there.

Later on, you know — I must admit, I didn't read the last edition as carefully as the earlier ones. But it struck me, it was — it — what was said was not as important and it wasn't said as well. And it was more expensive. (Laughter)

Charlie, you have any thoughts on that?

CHARLIE MUNGER: No.

30. Why Berkshire doesn't sell businesses

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Yes, Jeff Peskin (PH) from New York City.

And I was — I have a question on the annual report where you say that, obviously, going forward, due to the size of Berkshire, the returns going forward probably won't match the returns of the past.

And then you go on to state that one thing that may hinder that is the fact that you don't really like to sell companies that you own.

And I would just like to know what the reasoning is in that, if you've got a company or investment that you don't think is going to do as well as where you can put the money going forward. What really the reasoning is for holding on and not redeploying the money elsewhere?

WARREN BUFFETT: Yeah. I'll just correct you just slightly. A, I didn't say we'd probably do worse than the past. I said we will do worse than the past. I mean, there's no way we can match percentage numbers of the past.

That, you know, we would — in a period that would not take that long, we would — assuming we paid out nothing — we would gobble up the whole GDP, which is something we may think about, occasionally, but — (laughter) — we don't really expect to accomplish. The —

But — and the second point, that relates to size. That does not relate to our unwillingness to sell businesses, because that unwillingness has existed for decades. But the size has not existed for decades.

The size is — you know, doubling 12 billion or so is harder than doubling 1 billion-2, which was harder than doubling 120 million. I mean, there's no question about that.

So, eventually — well, already it will be a drag on performance. It doesn't mean that the performance will be terrible, but it does mean that 23 percent is an historical figure. It has no predictive value.

The unwillingness to sell businesses, like I say, goes back a long way. That is not what — that —

If that hurts performance, it's peanuts. That's simply a fact — a function of the attitude Charlie and I have, is that if we want to live our lives, we find it a rarity when we find people in the business that we want to associate with. When we do find that, we enjoy it.

We don’t see any reason to make an extra half a percent a year or 1 percent a year — don’t try us on higher numbers. But the — (laughter) — we don’t see a reason to go around ending friendships we have with people, or contact, or relationships. It just doesn’t make any sense to us. It —

We don’t want to get committed to that sort of activity. We know we wouldn’t do it if we were a private company.

Now, in Berkshire, we feel we’ve enunciated that position. We want to get that across to everybody who might join with us because we don’t want them to expect us to do it.

We want them to expect us to work hard to get a decent result, and to make sure that the shareholders get the same result we get, and all of that sort of thing.

But we don’t want to enter into any implicit contract with our fellow shareholders that will cause us to have to behave in a way that we really don’t want to behave.

If that’s the price of making more money, it’s a price we don’t want to pay.

There’s other things we forgo also, but that is the one that people might disagree with us on. So, we want to be very sure that everybody understands that, going in. That’s part of what you buy here.

And it may — I don’t think it’ll hurt performance that much anyway. But to the extent that it does, it’s a limitation you get with us.

Charlie? (Applause)

CHARLIE MUNGER: I don’t think there’s any way to measure it, exactly. But my guess is that, if you could appraise something you might call the character of the people that are running the operating businesses in Berkshire, many of whom helped create the businesses in the first place, and are leading citizens in their community, like the Helzbergs —

I don’t think there’s any other corporation in America that has done as well as we have, if you measure the human quality of the people who are in it.

Now, you can say we’ve collected high-grade people because we sure as hell couldn’t create them. But one way or another, this is a remarkable system. And why would we tinker with it?

WARREN BUFFETT: If you want to — (applause) — attract high-grade people, you probably ought to try and behave pretty well yourself.

I mean it’s just — besides, it wouldn’t be any fun doing the other. I mean, it — I was in that position, a little bit, when I ran the partnership back in the ’60s.

And I really — you know, people were coming into partnership with me. And my job was to turn out the best return that we could. And I found that if I got into a business, that presented certain alternatives that I didn't like. So, Berkshire's much more satisfactory in that respect.

31. Focus on Graham's three principles

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: John Rankin (PH), Fort Collins, Colorado. Thanks for having us.

In the book, "Warren Buffett Way," the author describes the capital growth model that you've used to evaluate intrinsic value in common stock purchases.

My question is, do you also still use the formula Ben Graham described in "The Intelligent Investor," that uses evaluating anticipated growth, but also book value?

It seems to me that fair value is always a bit higher when using Mr. Graham's formula than the stream of cash discounted back to present value that is in "Warren Buffett Way" and also that you've alluded to in annual reports.

WARREN BUFFETT: Yeah, we've tried to put in the annual report pretty much how we approach securities. And book value is not a consideration — virtually, not a consideration at all.

And the best businesses, by definition, are going to be businesses that earn very high returns on capital employed over time. So, by nature, if we want to own good businesses, we're going to own things that have relatively little capital employed compared to our purchase price.

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

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

But I don't look at the primary message, from our standpoint, of Graham, really, as being in that — in anything to do with formulas. In other words, there's three important aspects to it.

You know, one is your attitude toward the stock market. That's covered in chapter eight of "The Intelligent Investor." I mean, if you've got that attitude toward the market, you start ahead of 99 percent of all people who are operating in the market. So, you have an enormous advantage.

Second principle is the margin of safety, which again, gives you an enormous edge, and actually has applicability far beyond just the investment world.

And then the third is just looking at stocks as businesses, which gives you an entirely different view than most people that are in the market.

And with those three sort of philosophical benchmarks, the exact — the evaluation technique you use is not really that important. Because you're not going to go way off the track, whether you use Walter's approach — Walter Schloss's — or mine, or whatever.

Phil Carret has a slightly different approach. But it's got those three cornerstones to it, I will guarantee. And believe me, he's done very well.

Charlie?

32. Don't believe projections

CHARLIE MUNGER: Yeah. To the extent that the method of estimating future cash flow requires projections, I would say that projections, while they're logically required by the circumstances, on average, do more harm than good in America.

Most of them are put together by people who have an interest in a particular outcome. And the subconscious bias that goes into the process, and its apparent precision, make it — makes it some — well, it's fatuous, or dishonorable, or foolish, or what have you.

Mark Twain used to say a mine is a hole in the ground owned by a liar. And a projection prepared in America by anybody with a commission, or an executive trying to justify a particular course of action, will frequently be a lie.

It's not a deliberate lie, in most cases. The man has gotten to believe it himself. And that's the worst kind.

So, I don't think we should — projections are to be handled with great care, particular when somebody has an interest in misleading you.

WARREN BUFFETT: Charlie and I, I think it's fair to say, we've never looked at a projection in connection with either a security we've bought or a business we've bought. We've had them offered to us in great quantities.

Now, the fact that we voluntarily turn them away when people try to thrust them upon us — I mean, it — the very fact that they are prepared so meticulously by the people who are selling the businesses, or by the executives who are presenting to their boards and all of that sort of thing, you know, I mean, either we're wrong or they're wrong.

It’s a ritual that managers go through to justify doing what they wanted to do in the first place, in about nine cases out of ten.

I have never, you know, I have never met an executive who wanted to buy something that said, “Well, I had to turn it down because the projections didn’t work.” I mean, it’s just — it’s never happened.

And there will always be somebody that will come up with the projections that will satisfy the guy who’s signing his paycheck or will sign the deal that provides the commissions.

And they will pass those along to whomever else they need, the bankers or the board, to approve it.

It is total nonsense. I was recently involved in some — in a situation where projections were a part of the presentation. And I asked that the record of the people who made the projections, their past projections also be presented at the same time. (Laughter)

It was a very rude act. (Laughter)

CHARLIE MUNGER: It was regarded as apostasy.

WARREN BUFFETT: It — but believe me, it proved the point. I mean, it was a joke, I mean. So, we’ll leave it at that.

33. First question when looking at an investment

WARREN BUFFETT: We’re going to have another — one more question, maybe. And then we’ll take a break.

And Charlie and I will be eating up here. The ones who want to stick around can stick around. And the ones who are in the other room, undoubtedly there will be seats in here to fill.

So, we’ll sort of regroup in 10 or 15 minutes. And then we’ll go on as long as that group lasts.

So, let’s take one more from zone 6. And then we’ll take a break.

AUDIENCE MEMBER: Hello, my name is Peter Bevelin from Sweden.

What is the absolutely first question you ask yourself when you look at a potential investment? And do you and Mr. Munger ask yourself the same first question?

WARREN BUFFETT: Yeah. Well, I think — I don’t ask myself whether Charlie’s going to like it because — (laughter) — that will be a tough one.

No, the first question is, can I understand it? And unless it's going to be in a business that I think I can understand, there's no sense looking at it.

There's no sense kidding myself into thinking that I'm going to understand some software company, or some biotech company, or something of the sort. What the hell am I going to know about it? I mean, you know, I can — so that's the first threshold question.

And then the second question is, you know, does it look like it has good economics? Has it earned high returns on capital? You know, does it strike me as something that's likely to do that? And then I sort of go from there.

How about you, Charlie?

CHARLIE MUNGER: Yeah. We tend to judge by the past record. By and large, if the thing has a lousy past record and a bright future, we're going to miss the opportunity. (Laughter and applause)

Afternoon Session - 1995 Meeting

1. Banks are in our circle of competence

WARREN BUFFETT: OK, we're ready to start here with a question from zone 1, if you'll take your seats, please. We've got to —

AUDIENCE MEMBER: Mr. Buffett, I'm Brian Murphy (PH) from Clearwater, Florida.

I'd like to ask you a question concerning your present thinking behind your acquisitions of banks, such as PNC and SunTrust, particularly in light of the fact that banks were selling so cheaply in 1990 and now many have tripled in price.

And it would appear from recent publications and the financial literature that you've become much more interested in banks at these higher prices, relative to the 1990 valuations. Could you comment on your thinking there?

WARREN BUFFETT: Yeah, we really have no different — there's no difference in the criteria we apply to banks than to other businesses. And a couple of publications have, maybe, made a little more of that than is warranted, because I doubt if there's more than a couple percentage points difference in —

And we don't think of it that way, incidentally. And we do not have a lot of sector — we don't have any sector allocation theories whatsoever.

So, we simply apply the same criteria when looking at banks that we would at any other business that —

There — incidentally, there — sometimes, you should know, that there's — I would say that maybe half, or maybe even a little more, of the reports about our activities are — in the press are erroneous. Now, some are accurate, too.

And then, of course, some are way out of date. I mean, we get confidential treatment on our — on the filings we make with the SEC as to our holdings, so they're published well over a year after we've filed them.

And therefore, there have been a couple of stories in the last month or two as to something we've bought. And of course, if you read the story carefully, we bought it a year and a half ago, maybe. And we may have sold it, we may have bought more, all kinds of things.

So that, I'd be careful about press reports, generally.

We've — we actually — we bought a bank for Berkshire in 1969, the Illinois National Bank and Trust of Rockford. We've had an interest in the banking business.

We feel it's something that we can — that falls within our circle of competence to evaluate. That doesn't mean we'll be right every time, but it — we don't think it's beyond us to understand the banking business. And so, it's — we look at businesses in that area.

Charlie?

CHARLIE MUNGER: Nothing to add.

2. Buffett always plans to write a book "six months from now"

WARREN BUFFETT: OK. And do we have zone 2?

AUDIENCE MEMBER: Larry Myers from Omaha.

Warren, two quick questions, the first one very brief. Do you have any timetable regarding when you will write your own book about your career and philosophy?

WARREN BUFFETT: Yes, my timetable's always been six months from now. (Laughter)

The answer on that is I've thought about doing it a few times, and I think about it. It always seems to me there's way more interesting things yet to happen than have happened so far, and I don't want to — I know I won't write a second one, so I keep postponing it. That's my rationale on it, anyway.

3. Coca-Cola "doing exactly the right thing" with its cash

AUDIENCE MEMBER: Thank you. Second question concerns dividends. Last Friday night, by coincidence, on Louis Rukeyser's weekly television show, the special guest was Philip Carret.

And Mr. Carret made the statement that his favorite American stock is Berkshire Hathaway. And one of the major reasons he stated was that, "Berkshire has never paid a dividend, as we all know," and consequently, you had superior utilization of the extra cash.

Now, if you extend that reasoning, could it also be a beneficial policy if Coca-Cola and Gillette stopped paying dividends and utilized the cash in other ways?

WARREN BUFFETT: Well, it depends what they could use the — how they would use — utilize the cash, what they could use it for. Those are more focused enterprises than Berkshire, at least in terms of products.

And they — I think — I commend managements that have a wonderful business for utilizing cash in those wonderful businesses, or in businesses that they understand and that will also have wonderful economics, and for getting the rest of the money back to the shareholders.

So, Coca-Cola, in my book, is doing exactly the right thing with its cash when it both — when, A, it uses all the cash that it can, effectively, in the business to expand in new markets and all of that sort of thing.

But then beyond that, it pays a dividend which distributes cash to shareholders, and then it repurchases shares in a big way, which returns cash on a selective basis to shareholders, but in a way that benefits all of them.

So, we — you will benefit from us not paying dividends just as long as we can use the — every dollar we retain — to produce more than a dollar of value, and of market value over time.

Whether we can continue doing that, you know, how long we can continue doing that, I can't promise you, but that is the — that's the yardstick by which the decision is made.

And that is the yardstick, I think, by which Coca-Cola's making the decision, too. And I think that they deserve great credit for exercising the discipline to quit when they — using cash — when they've run out of the opportunities to use it well, and then to use it — then to further deploy it advantageously by repurchasing shares.

I think one of the things I admire about my friend, Bill Gates, he's got 4 1/2 billion of cash in Microsoft, and very few managements can stand having 4 1/2 billion of cash and not doing something unintelligent with it.

So far, it's made sense for us to retain everything we earn, and I think it'll make sense for a while longer, but it may not make sense indefinitely.

Charlie?

CHARLIE MUNGER: I hope it lasts a long time. (Laughter)

4. Why is Wall Street compensation so high?

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: My name is Dan O'Neil from Santa Fe, New Mexico.

And I would ask — like to ask you a more specific question about Salomon Brothers, which is, why do we pay our employees there so much?

WARREN BUFFETT: Why what?

AUDIENCE MEMBER: Why do we pay our employees there so much money? The conventional theory seems to be that there's just a different pay scale on Wall Street than the rest of the world.

And it's based on the idea that traders are smarter than — that some traders are smarter than others, and, in some supernatural way, are able to receive signals that the future is sending back to the present. And how do we know that that isn't just an urban legend like alligators in the New York City sewers?

Another theory would be that the large amount of shareholders' capital allows the traders to capture inefficiencies that are in the market in the same way that the house does in Las Vegas.

I mean, if we owned a casino, it wouldn't make any difference if we hired Albert Einstein or Forrest Gump to run the blackjack table, and we would pay them the same. And I wonder which theory you think is closer to the truth.

WARREN BUFFETT: Well, you put it well. (Laughter and applause)

In the end, of course, you end up paying at a, what you think, at least, is a market rate. And to some extent, the market tests you out by whether people leave because they can get a higher rate.

But the limiting factor on that should be that you pay them a market rate as long as you are getting a market rate on capital. But it's harder to measure the market rate on capital in a short period than it is to measure the market rate on compensation.

So, the — a good many of the people that have left — but far from all — have left because they felt that they would obtain — presumably — because they would obtain greater compensation elsewhere.

The market was working in that way, just as it works in entertainment that way and it works in the athletic field that way.

And whether it — when it works that way, it leaves a return for capital that's adequate, is an open question. I mean, I haven't looked at the figures on all the baseball teams, but I've seen some of them. And certainly, in some of the smaller markets, I mean, the books were not phony.

I mean, it is very hard to pay market rates for ballplayers in Kansas City and still make money running a ball team, where you've got a smaller television market and all of that of the big cities.

So, in the end you're going to have to pay market rates to retain people, but part of that will also depend upon the period over which they measure their — what they are going to be paid.

I mean, if you want to look at Goldman Sachs last year, they were paid nothing. Does that mean that everybody will leave because they can get paid something someplace else? No, because 80 percent of the partners, or 90 percent of the partners, have a longer time horizon than that. And they have an anticipated earnings figure in mind when comparing it with what they're being offered elsewhere.

If you have a situation where market rates, you know, exceed the earning capacity of the business, then at some point, capital will flow away from the business.

In the airline industry, which I use as an example, the market rate — most — well, the — in terms of the bigger airlines, people are not being paid market rates, they're being paid contractual rates. Well, you can't blame anybody for that.

If you have a contract that entitles you to X and the current market is a half of X, you're going to hang onto that contract very aggressively. And like I say, you don't blame anybody for that, it's just if you end up in that condition, though, you've got a real problem.

And if you have the same problem that you have if the market is higher than — or a similar problem — the one you have if the market is higher than one that you can sustain in your own business.

My guess is that there — that, in effect, Salomon has put in a more Goldman Sachs-like system because, essentially, it created, to a degree, a partnership within it. That —

To have that work, A, over time, the partners have to earn good money or it won't work, but, B, you have to have people that have a partnership mentality in it. And if you change from one culture to another, you are not going to get a hundred percent acceptance of any new system.

Charlie?

CHARLIE MUNGER: Yes, it was kind of a bad break to put in a new compensation system and then have a very bad year. In the very nature of things, people are going to blame the compensation system subconsciously.

And then, two, I think that Wall Street generally has more envy-jealousy effects than are typically present elsewhere.

5. Buffett on the "real" advantage of being rich

I have a friend whose grandmother used to say that she couldn't understand why people got into envy-jealousy, because it was the only one of the sins that you could never possibly have any fun at. And — (Laughter)

But generally speaking, on Wall Street I think a lot of people have had the wrong kind of grandmothers. (Laughter and applause)

WARREN BUFFETT: Yeah, I've commented from time to time that — what's his name? Robin Leach has it all wrong on "Lifestyles of the Rich and Famous," because he's presenting all these wonderful things that will happen to you if you get rich.

But they really aren't that all that wonderful, these fancy houses and boats and all that. The real advantage of being rich, as I explain to people, is that it enables you to hate so effectively.

That if you're terribly rich, you know, and — but your brother or whomever, cousin or somebody, is getting a little more attention in the world or something of the sort, you can hate in a very major way.

You can hire accountants and lawyers to cause him all kinds of trouble. If you're poor, you just snub him at Thanksgiving and don't show up or something of the sort. (Laughter)

But I've noticed that these rich people, particularly when they inherit great amounts of money, sooner or later they start — frequently — they get very antagonistic toward siblings, or cousins, or whatever it may be.

And they really can — they can hate in a way that — or get envious in a way that the rest of us really can't really aspire to. So, that's the benefit that hasn't appeared on Robin Leach lately, but I —

But you see that — you see a little of that in the athletic field and the entertainment field, and perhaps even on Wall Street, that making a million dollars a year looks great until this guy that sits next to you that can't possibly be as smart as you is making a million-two. And then the whole world, it turns into a very unfair place. (Laughter)

6. "It's never a policy of ours to hold a lot of cash"

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Good afternoon. My question is simply about the cash and cash equivalents that are shown on the balance sheet this year versus last year.

In my thinking, cash equivalents is always something good to have around in case of a big market drop, being able to make opportunistic buys, as I know you've referred to "Mr. Market" getting manic-depressive at times.

Is there something that is less than obvious here that I'm not seeing? Or is the position not there now, should that happen in the marketplace?

WARREN BUFFETT: Cash at Berkshire is a residual. I mean, we would like to have no cash at all times. We also don't want to owe a lot of money at any time.

But we — if we have cash around, it's simply because we haven't found anything we like to do, and we hope — always hope —- to deploy it as soon as possible.

We never are thinking about whether the market's going to go down or something of the sort, or whether we might buy something even cheaper. If we like something, we'll buy it.

And when you see cash on our balance sheet of any size, that's an acknowledgement by Charlie and me that we have not found anything, in size anyway, attractive at that point. It's never a policy of ours to hold a lot of cash.

7. Newspaper business is "exceptionally good," but not as good

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: David Winters, Mountain Lakes, New Jersey. I'll stand up.

David Winters, Mountain Lakes, New Jersey.

Years ago, you said you loved the newspaper business and then, over time, I guess, it — said it declined a bit in how much you loved it. And I'm kind of wondering how you feel about it now, and if you can prognosticate a little bit for us at all?

WARREN BUFFETT: Well, I used to love it in two respects. I loved the economics and I loved the activity, both. The activity — the love of the activity has not diminished.

The economics are still exceptionally good compared to virtually any business in the world. They aren't quite as good as they were 15 years ago.

So, they have — I wrote about that a couple of years ago, whereas what was — seemed almost the most bulletproof of franchises is still an exceptionally good business, but it isn't quite as bulletproof as might've been the case 10 or 20 years ago.

I still think it's about as interesting a business as there is in the world I'm in. But if you're talking pure economics, the — I can't think of many other businesses that, if I just owned one asset over my life, that I would rather own than a newspaper in a single-newspaper town.

But I wouldn't have quite the feeling of absolute certainty that I had — that I would've had 10 or 15 years ago.

Charlie?

CHARLIE MUNGER: Yeah, I think it's obvious, I — the newspaper proprietors are getting a touch of paranoia for the first time.

I mean, they worry about the electronic revolution, they worry about the fact that young people, you know, don't read. It's not as much fun going to newspaper conventions as it used to be.

WARREN BUFFETT: They're still making exceptional money. I mean, that's the interesting thing.

CHARLIE MUNGER: Ah, but they — I've heard you say a dozen times, "People don't seem to care what floor they're at, just whether the elevator is going up or down."

WARREN BUFFETT: That's right, that is true. (Laughter)

People feel better when they're on the second floor of an elevator that's just come from one than they do when they're on the 99th floor coming down from a hundred, there's no question about that.

They have this projection. And of course, it's particularly the case where they've been in a business where the money — the profits — were automatic, because they start thinking about, you know, questions of whether they really have the ability to make a lot of money, absent this favored position.

And that's not something they've had to dwell on before. So, it can make them uncomfortable.

They're all screaming about newsprint prices. We'd probably scream about them a little bit, too.

I mean, if you compare being in the newsprint business over time to being in the newspaper business, I mean, it's a joke.

And newsprint prices, if you — you can graph them from any point, you know, 15 or 20 years ago, or 10 years ago, and the price of the newspaper, the price of advertising has gone up more.

I mean, it is interesting to hear them yelling foul, because they have moved a lot in the last 12 months and they'll move some more in the next six months. But believe me, it's better to be in the newspaper business than the newsprint business.

8. Buffett's semi-hostile takeover of Berkshire

WARREN BUFFETT: Zone 6?

AUDIENCE MEMBER: Mr. Buffett, my name is Liz Pruce (PH), I'm from New York City.

I was wondering, on your acquisition criteria — I know part of that is that Berkshire Hathaway won't participate in unfriendly takeovers. I wondered how that philosophy may or may not apply to your role as a member of the board of several other companies.

WARREN BUFFETT: That's an interesting question. And I haven't been on the board of any company where the CEO has brought to the board the question of a hostile takeover.

Can you think of anything I'm forgetting? No, and — but there's no rule that that can't happen.

So, I don't know exactly what I would do if that came along. That's a very good question.

I used to be — I used to have a whole different attitude on that. I mean, in effect — we actually — if you go back 40 years, we bought, in effect, control of companies.

Well, in the case of Berkshire, Malcolm Chace, the chairman, was all in favor of us buying our stock in Berkshire. But Seabury Stanton, the president, would not have been in favor of it, and Seabury was the — was managing the business.

So, it wasn't hostile, but Seabury would not have been in favor of it. It would — but Malcolm would've been.

So, I don't know what the situation would be today if somebody walked in Gillette or Cap Cities, or someplace like that.

I don't think it's going to happen, but I have not — I don't have any policy on it at this point.

What do you think we'd do, Charlie?

CHARLIE MUNGER: I don't think our behavior is totally predictable. (Laughter and applause)

WARREN BUFFETT: And he's right. (Laughter)

9. Comparing investing styles of Ben Graham and Phil Fisher

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Yes, Neil McMahon (PH), New York City, also a Sequoia shareholder.

Ben Graham investing encouraged turnover. Looking at Berkshire's holdings, concentration and long-term, are you still a 15 percent Phil Fisher and 85 percent Graham?

WARREN BUFFETT: I don't know what the percentage would be. I'm a hundred percent Ben Graham in those three points I mentioned earlier, and those really count.

I am very — I was very influenced by Phil Fisher when I first read his two books, back around 1960 or thereabouts. And I think that they're terrific books, and I think Phil is a terrific guy.

So, I think I probably gave that percentage to — I think I first used it in Forbes one time when Jim Michaels wrote me. And I think I, you know, it was one of those things. I just named a number.

But I think I'd rather think of myself as being a sort of a hundred percent Ben Graham and a hundred percent Phil Fisher in the points where they don't — and they really don't — contradict each other. It's just that they had a vastly different emphasis.

Ben would not have disagreed with the proposition that if you can find a business with a high rate of return on capital that can keep using more capital on that — that that's the best business in the world. And of course, he made most of his money out of GEICO, which was precisely that sort of business.

So, he recognized it, it's just that he felt that the other system of buying things that were statistically very cheap, and buying a large number of them, was an easier policy to apply, and one that was a little more teachable.

He would've felt that Phil Fisher's approach was less teachable than his, but his had a more limited value because it was not workable with really large sums of money.

At Graham-Newman Corp — Graham-Newman Corp was a closed-end fund — oh, it was technically an open-end fund, but it had $6 million of net worth. And Newman and Graham, the partnership that was affiliated with it, had 6 million. So, you had a total pool of 12 million.

Well, you could go around buying little machine tool companies — stocks in machine tool companies, whatever it might be, all statistically cheap. And that was a very good group operation.

And he had — you have — if you own a lousy business, you have to sell it at some point. I mean, if you own a group of lousy businesses, you better hope some of them get taken over or something happens. You need turnover.

If you own a wonderful business, you know, you don't want turnover, basically.

Charlie?

CHARLIE MUNGER: What was interesting to me about the Phil Fisher businesses is that a very great many of them didn't last as wonderful businesses.

One of his businesses was Title Insurance and Trust Company, which dominated the state of California.

It had the biggest title plant, which was maintained by hand, and it had great fiscal solvency, and integrity, and so forth. It just dominated a lucrative field.

And along came the computer, and now you could create, for a few million dollars, a title plant and keep it up without an army of clerks.

And pretty soon, we had 20 different title companies, and they would go to great, big customers like big lenders and big real estate brokers, and pay them outlandish commissions by the standards of yore, and bid away huge blocks of business.

And in due course, in the State of California, the aggregate earnings of all the title insurance companies combined went below zero — starting with a virtual monopoly.

WARREN BUFFETT: From what looked like a monopoly.

CHARLIE MUNGER: So, very few companies are so safe that you can just look ahead 20 years. And technology is sometimes your friend and it's sometimes your bitter enemy.

If Title Insurance and Trust Company had been smart, they would've looked on that computer, which they saw as a cost reducer, as one of the worst curses that ever came to man.

WARREN BUFFETT: You can — it probably takes more business experience and insights, to some degree, to apply Phil Fisher's approach than it does Graham's approach. If you —

The only problem is, you may be shut out of doing anything for a long time with Ben's approach, and you may have a lot of difficulty in doing it with big money.

But if you strictly applied, for example, his working capital test to securities, you know, it will work. It just may not work on a very big scale, and there may be periods when you're not doing much.

Ben really was more of a teacher than a — I mean, he had no urge to make a lot of money. It did not interest him. So he was — he really wanted something that he thought was teachable as a cornerstone of his philosophy and approach.

And he felt you could read his books sitting out here in Omaha and apply — buying things that were statistically cheap, and you didn't have to have any special insights about business or consumer behavior, or anything of the sort.

And I don't think there's any question about that being true, but I also don't think you can manage lots of money in accord with it.

10. Munger's sales of Berkshire shares

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Hi, Rob Pitts, shareholder from New York City.

This is a question for Mr. Munger. I've noticed, in the insider sales activity sheets, that you've been a rather consistent seller of your Berkshire stock over the last few months.

Wondered if you would comment on why you're doing this, especially in light of the prospective tax change in capital gains, where it might be reduced, which would obviously be beneficial to you and beneficial to Berkshire by reducing its deferred tax liability?

CHARLIE MUNGER: I've given away a fair amount of Berkshire in the last couple of years and I've also sold some. I gave away the Berkshire because I thought it was the right way to behave, and I sold some because I had uses for the money. (Laughter and applause)

WARREN BUFFETT: He doesn't know anything I don't know. I (Inaudible) it's selling, I'd checked that, but — (Laughter)

11. When a company's accounting is confusing, stay away

WARREN BUFFETT: Zone 3?

Charlie has a very high percentage of his net worth in Berkshire, as do I.

Go ahead. I'm sorry, go ahead. I don't think it's working, quite —

AUDIENCE MEMBER: Hello?

WARREN BUFFETT: OK.

AUDIENCE MEMBER: Hi, Gorem Pulich (PH) from New York City.

I have a two-part question, first part very short. I think a lot of people have difficulty valuing businesses because of some convoluted accounting schemes that are out there.

Do you have any suggestions, in terms of books, or something you can read, where you can sort of make sense of some of the accounting stories that are going around?

WARREN BUFFETT: Well, that's a good question. Abe Briloff used to write for Barron's quite frequently on various accounting machinations, and Barron's has continued that somewhat.

But you're right that there are people out there who will try to paint pictures with accounting that are something far from the economic reality. And sometimes, the rules of accounting themselves lead to that.

I would say that when the accounting confuses you, I would just tend to forget about it as a company. I mean, it's probably — it may well be intentional, and in any event, you don't want to go near it.

I — we have never had any great investment results from companies whose accounting we regarded as suspect. I can't think of a one. Can you, Charlie?

CHARLIE MUNGER: No.

WARREN BUFFETT: It's a very bad sign.

CHARLIE MUNGER: I made a short sale once that worked out well — (laughter) — in a case like that.

WARREN BUFFETT: It really — accounting can be a — accounting can offer you a lot of insight into the character of management.

And I would say there's a lot — you know, there's a — you run into a fair amount of bad accounting. I used to call it creative accounting. And you'd probably run into a lot more, if it was allowed.

But some companies have been able to push their auditors pretty far, and I would be very skeptical of anything that looks suspicious to you.

I think there have been — there've been a couple of things written, but I can't think of where they've appeared, where people talk about the questions of, you know, what —

Obviously, if some prepaid expense, deferred asset accounts start building up suspiciously high, and inventories look out of line, you know, with sales and, particularly, the trend of them and all that, you want to look twice at companies like that.

Life insurance, you know, frequently, you know, we see weak accounting in. You can — when you don't have a product where revenues and expenses are being matched up on something close to cash in the short-term, you have the opportunity for people playing games with numbers.

And some people have learned how to do that very well, and they've sometimes created long-lasting stock manipulation or promotion schemes that have enriched themselves, or they've enriched the managers or the creators of it, at the expense of the public, over time.

If you ever get suspicious about accounting, just go onto the next company.

12. Lloyd's of London has slipped in recent years

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Yes. Miss Wasserman (PH) from Chicago.

In order to understand the reinsurance business a little better, can you explain your relationship with Lloyd's of London in the marketplace, how you — which is probably the leader in the field?

How often do you compete directly, or if you've ever done reinsurance business for them, since they've had losses in recent years, and how you see the industry changing as their economics changes?

WARREN BUFFETT: Well, Lloyd's, which is not an insurance company, as you know, but a — well, originally it was a place — it was a coffee house, but people think what — it's a place where a large number of syndicates operate and congregate in a given physical location. And it's had a history for larger, more exotic risks over time.

Lloyd's has lost its relative position to a fairly significant degree in the last 10 or so years, partly because — well, in significant part, because of bad results, which had the other effects of causing capital to withdraw and people who backed the syndicates to become unhappy.

So, Lloyd's is still an important competitive factor in the reinsurance business and in certain specialized kinds of primary insurance. It's a very — you know, it's very important factor.

But it's not the factor it was 10 or 15 years ago. And I'm not sure how Berkshire's capital compares with the capital of all those syndicates at Lloyd's, but it's certainly changed in its relative importance in the last five or 10 years.

And the ability of Lloyd's to attract capital with the problems they had has been diminished, although they're working on that problem.

But we regard Lloyd's as a competitor just like we would regard any one of a number of reinsurance companies as competitor.

But we also do business with a number of syndicates at Lloyd's, and we'll probably do a lot of business over the next 10 years with various syndicates.

Charlie?

CHARLIE MUNGER: Yeah, Lloyd's is a very interesting institution because it had this reputation for integrity, what they paid off in — what, the San Francisco fire, and so on, and so on.

But I would argue that 10 or 15 years ago, a lot of slop and folly got into Lloyd's, in certain syndicates particularly.

And too many commissions coming off the top as the same risks circulated around the system. Too much fine tailoring and three-hour lunches with fine wines. And it wasn't right, and they got in a lot of trouble.

WARREN BUFFETT: Actually, in the history of Berkshire, the most significant insurance problem we ever had was in connection with Lloyd's almost — or certain syndicates of Lloyds — almost 20 years ago.

And as Charlie said, they had this terrific reputation — behavioral reputation — over centuries. And I think that they coasted for a while on that. And we had a behavioral problem with — in one situation. And it was very expensive to us. So, we may have gotten an early lesson in what was coming.

There are a lot of different syndicates at Lloyd's, and there are different people running them, and they have had different standards of behavior, to some extent. And people who assumed that, because they were dealing with Lloyd's, that they would have no problems of any kind have found out otherwise.

But they will continue to be a major force in insurance, and they will get by their present troubles, and they'll probably come out of it better structured than they went in.

13. We'll keep a dollar if we can make more than a dollar of value

WARREN BUFFETT: Was that zone 5 that we did there?

AUDIENCE MEMBER: Christopher Jones (PH) from Scottsdale, Arizona. I had a couple of questions for you.

You've mentioned several times today about the difficulty and the frustration that you both have in trying to find capable companies to acquire, or acquire parts of, in the United States.

And I realize that, of course, when we own Coca-Cola and Gillette we are a part of the global environment.

But it's surprising to me that there haven't been any global franchises or global managements that have been interesting to either of you that — and I realize, in the past we've owned some pieces of some.

So, I was — questioned, because of the size of Berkshire now, might we see something more of a global flavor to the portfolio?

And second question, you've also addressed the intelligent use of cash as something that you look for in management.

Many management teams now are buying back their own shares because they can't find anything cheaper or better in the marketplace.

Does your current philosophy of not buying back your own shares suggest that maybe you think Berkshire's overpriced at these prices?

WARREN BUFFETT: Well, we have never bought back shares. I — we actually bought a few back in the '60s — but we basically have never bought back shares, although there were plenty of times when we thought it would be quite attractive to do it.

But we've also felt that if we could create more than a dollar of market value by — and maybe well over a dollar of market value — by retaining a dollar, that on balance that that would work out better over time.

As long as we can find ways to use the cash, which, overall, we feel will turn dollar bills into something larger than dollar bills, we will — we'll keep retaining the money.

And we won't measure that on whether we can find anything this week or this month, but we'll certainly measure it based on whether we can find anything in a couple of years, always.

We've had dry spells. Actually, right now, there's a little more going on than usual. But we've had dry spells a lot of times over a 20-odd year period. And you know, as I said, I wound up the partnership during one dry spell.

So that — it will be measured — it's measured partly on what's going on now, and it's measured partly on the expectancy.

And I don't think, whether our stock was selling at X or three-quarters of X right now, would make a lot of difference. But it would make a difference if we thought we couldn't find things to do with the money externally.

14. "Not too likely" we'll buy a business outside the U.S.

WARREN BUFFETT: The question about nondomestic operations, as you mentioned, we've got almost $8 billion in Coca-Cola and Gillette combined, and Coke has 80 percent-plus of their earnings from non-U.S. sources, and Gillette has maybe two-thirds or thereabout.

So, you can argue that almost 40 percent of the net worth of Berkshire — 35 to 40 percent — is operating outside the United States, just in those two investments alone.

In terms of buying a business outright, we don't preclude buying a non-U.S. domicile business. But it's not too likely that it'll happen.

We'd like to do it, particularly if it were large and if we understood it. But are we as likely to get a fix on a Helzberg's of Europe as we would a Helzberg's in the United States? You know, I doubt it.

I just don't know whether we would develop as much confidence in understanding the scene in which they operated, and understanding the management, and all that. But we might.

It would have to be a pretty simple business, and it would have to be a business where we thought we really understood the moat for a long time.

And it would have to be a business where we could establish a rapport with the management, despite coming from somewhat different backgrounds. It's not impossible, but I would say it's, you know, it's less than likely.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

15. Buffett: my growing fame isn't a distraction

WARREN BUFFETT: Zone 6?

AUDIENCE MEMBER: Hi there. My name is Lee Debroff (PH) from Morgantown, West Virginia.

Ever since the Salomon debacle, it appears that you have attracted more and more media attention.

In this regard, there have been numerous displays that would appear to be distractions from the actual business of investing. To wit, we have watched as you attended Bill Gates' wedding in Hawaii, and bought a personal computer, and now wear striking designer ties. (Laughter)

And yesterday —

WARREN BUFFETT: Bill would've invited me to the wedding even if I hadn't have been at Salomon. (Laughs)

AUDIENCE MEMBER: Yesterday, we got those pennants during the rainout.

A very serious question, now that you've become this media darling, how can you assure us that you're still keeping your eyes concentrated on the proverbial ball? (Laughter)

WARREN BUFFETT: Well, I do get more mail than I used to, so we've developed a little more of a system on that. But I just — I do what I like to do.

Just take speeches, I probably get asked to make, maybe, 20 times as many speeches as I would've been asked to make 10 years ago, but I make the same number. You know, I've got the — I've got my own selection process for what I do on that.

And it's the same way, you know, I'm invited to, you know, I don't know how many dinner tributes, et cetera. And you know, they basically — I don't change the way I — what I do, because I don't want to change the way —

If I wanted something else — if, while I was building Berkshire, that was being done to end up in some other spot, I'd have been there by now. And it just doesn't change anything.

It does change the volume of mail, but I've got that so that that is not a big distraction.

Pardon me?

WARREN BUFFETT: Oh, I'll remain in Omaha. Yeah, there's no question about that. I mean, I — if I hadn't wanted to be in Omaha, I would have figured out ways to change, and it would have been very easy to change decades ago.

I think it's — we've got a lot of people here who aren't from Omaha, but that's their problem. I mean — (Laughter)

CHARLIE MUNGER: I have been watching Warren for a long time, and people who are concerned that he will change have a huge appetite for needless worry. (Laughter)

WARREN BUFFETT: The odds that I will change are about as good as the odds that Charlie will change. (Laughter)

The mail thing is a, you know, you wish you didn't — that there was an easier way to handle it.

But you essentially can't answer all the letters you get, it's that's simple. And that's about the — once you get past that and get a form letter that takes care of it, that takes care of it.

16. Decline in GEICO's return on equity

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Yes. I'm Samuel Park (PH) from Tulsa, Oklahoma.

My question is regarding GEICO. I noticed that, for the last five years, their return on equity has come down every year. Is this something that signifies change of a business, or just temporary things?

WARREN BUFFETT: Question is about GEICO's return on equity?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yes. Well, it's true, it has come down to some extent. The — GEICO's growth is, more or less, a function of, basically — I mean there's a natural rate of growth there.

And the growth in capital has been greater than the growth rate in premium volume and in invested assets, so that achieving the same success on underwriting and achieving the same success on investments will produce a lower return on capital unless they buy in stock, which they have done fairly significantly. But that's limited by availability, too, but —

It's a very good business. But it's not a business where, if you double the capital, you can double the earnings easily.

Charlie?

CHARLIE MUNGER: I have nothing to add.

17. No comment on Guinness investment

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: My name's Mark Hake (PH) from Scottsdale.

And I think your question — my question — about foreign equity investment was pretty much answered by the other gentleman.

But I noticed that you had made an investment in Guinness in the past. And can you comment on that? Do you — is it still owned? And if not, why not?

WARREN BUFFETT: We don't comment on purchases and sales of securities or ownership, unless either we're legally required to, or they hit this threshold level where we report annually.

And we move the threshold level up as our assets move up. We don't move it up as a percentage of assets. So that we used, as a cutoff this year, 300 million, I believe, of market value as to where we reported.

Now, if we'd owned the same amount of Guinness — which I'm not saying that we did — but if we owned the same amount of Guinness on December 31st, 1994, it would not have hit that threshold as we had on December 31st, '93. It would not have hit that threshold.

And we really don't want to get in the business where we are talking at all about what we're buying or selling. We get a lot of speculation on that, but it's of no use to Berkshire to be talking about purchases or sales.

If we were acquiring a piece of land downtown and we bought a quarter of what we intended to buy, for example, we would not feel we were benefitted by a front-page story in the paper saying that we were acquiring land.

And it — we are not in the business of giving investment advice, basically. We'll talk about our principles.

So, the only conclusion you can come to about Guinness, or anything else that does not show up on our list at year-end, is that we did not own $300 million's worth at market value at that time.

18. Buffett's Berkshire shirt isn't available

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Yes, Mr. Buffett. My name is Don Bresca (PH), I'm from Boston, Massachusetts.

Recently I've noticed you wearing an IZOD shirt with Berkshire Hathaway in the middle — there was a fist grasping cash. Is that the new insignia?

And the second question is, is that shirt available to stockholders? (Laughter)

WARREN BUFFETT: The shirt is not available. That shirt was a gift from someone, and the shirt is not available to stockholders. But you can draw your own conclusions, the meaning of it. (Laughs)

19. No matchmaking for Mrs. B and Phil Carret

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Yes. I'm Lyle McIntosh from Missouri Valley, Iowa, about 25 miles up the road.

And Warren, recognizing this is corn country, and I farm, and there's several other farmer shareholders, this meeting hits right in the middle of corn planting.

Could you move it back about three weeks? (Laughter)

And also, I noticed [mutual fund pioneer] Phil Carret was on "Wall Street Week" Friday night. I'm sorry I don't know his marital status, but if he is available have you thought about introducing him to Mrs. B. [Nebraska Furniture Mart founder Rose Blumkin]? (Laughter)

WARREN BUFFETT: Well, Mrs. B., incidentally, was out working yesterday. I went out and dropped by to see her about 4 o'clock, and she was doing fine.

She will be 102 late this year, and my guess is she will be working on her 102nd birthday as well. But I'll let Phil and Mrs. B. handle their own affairs, in that respect. (Laughter)

CHARLIE MUNGER: He's probably a little too young for her. (Laughter)

20. "We're open to buying anything"

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Well, I'm Ken Donovant (PH), a Cincinnati investor.

You've addressed the subject of your feelings about buying entire foreign corporations.

I wonder if you'd say something about, or is Berkshire looking for opportunities to buy, we'll call them near-franchise companies, that might be based overseas — buying a stock interest or a part interest? And also, how do you feel about fixed-debt investments of overseas companies?

WARREN BUFFETT: Debt investments, was that?

AUDIENCE MEMBER: Yes. Well, the first part was buying a stock investment rather than a whole company.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: And the second part was debt investments.

WARREN BUFFETT: Yeah. Well, we're open to buying anything. When you say, are we looking at them, I've never been quite sure how we look at things anyway. I mean, they just seem to sort of pop up from reading or something of the sort.

But we're — it's less likely we end up doing it, for some of the reasons I've given earlier. But we have bought stock in companies that — aside from Guinness, that are domiciled outside of the United States. And we would have — we could conceivably buy debt instruments.

We don't buy a lot of debt instruments anyway, so it'd be very unlikely.

But we will do anything we think makes sense at Berkshire, that's compatible with the way we want to operate. And certainly, we don't care where — the domicile is not that important.

Charlie?

21. Helzberg has unusually good sales for jewelry retailer

WARREN BUFFETTL OK, zone 5, is it?

AUDIENCE MEMBER: Scott Spilcovich (PH), New York City.

My question is regarding the Helzberg acquisition. Can you comment on things such as the acquisition price, your sales and profit expectations, and how much debt was on the books at the time of the acquisition?

WARREN BUFFETT: This is in reference to which acquisition?

AUDIENCE MEMBER: Helzberg.

CHARLIE MUNGER: Helzberg.

WARREN BUFFETT: Well, we have not put out the figures on Helzberg's, and we won't be.

But we evaluate — the sales have been published at about 280 million for the year that ended in February, and there'll be considerably more in the current year.

But we have not put out the figures. I can tell you that, obviously, that we think that, in terms of the amount we are laying out in terms of shares and/or cash — we think, over time, that it's going to be a very decent acquisition.

It's the same line of reasoning we've applied in other businesses. Retailing, as I mentioned earlier, is the kind of business where you have to stay smart over time, and we have a terrific manager, a fellow named Jeff Comment, who's going to be running it.

And his record is extremely good, and I would bet the record would stay good.

It earns good returns on invested capital or we wouldn't be buying into it. We always look for good returns on capital.

And a lot of companies in the jewelry business do not get good returns on capital. I mean, it's not an industry that — where most of the participants are prosperous.

It takes unusual sales per square foot compared to competitors to succeed in that, and we have one operation that does that in spades at Borsheims, and then a different type of operation that does it at Helzberg's.

The typical jewelry store operation is not a very good business, but we think we've got two good operations.

Charlie?

CHARLIE MUNGER: Yeah, we frequently find that owners of entire businesses have schizophrenia. They want to sell their business for a little more than it's worth, taking stock, so they don't have to pay taxes.

And they want the stock to be the kind of — to be in a kind of business that will make just one dumb acquisition — theirs, and thereafter will guard the stock like gold, making no more dumb acquisitions. (Laughter)

Needless to say, the world is not that easy. And I think over time, we've made acquisitions that were fair on both sides, and averaged out, they've worked well for Berkshire.

And I think a company that behaves that way is giving the best long-term value to the private owner who wants to sell. You do not want to sell your business for stock to a firm that likes issuing stock.

22. Insurance float important in estimating intrinsic value

WARREN BUFFETT: Zone 6?

VOICE: That was six.

WARREN BUFFETT: Where do we have the mic? Oh, there. I don't think it's on.

AUDIENCE MEMBER: Can you hear me now?

WARREN BUFFETT: Yeah, sure.

AUDIENCE MEMBER: Jack Glanding (PH) from Knoxville, Tennessee.

I have a question which may not be appropriate for the officers of Berkshire to answer, but I think I'll ask it anyway.

You focused on intrinsic value in your annual report, and you suggested that by reviewing the grey pages in the back that one could come up with a — possibly come up — with a value of intrinsic value for Berkshire.

I've made an effort to do this, and I think I come up with a price-to-earnings ratio somewhere around 21, which seems to be a little overvalued.

I'd like to ask you, Mr. Buffett, if you would care to divulge what you believe is the intrinsic value of Berkshire?

And if you're not willing to do that, do you consider the price of Berkshire at this level to be fair?

WARREN BUFFETT: I — every year I get asked that, in one form or another, and I always say that I don't want to spoil the fun for those of you who are working out the intrinsic value for yourself.

You have all the numbers that we have that are key to it.

And I would say that there are some important factors besides P/E. I mentioned earlier that I thought that the page where we describe float, for example, is probably as important a page as there is in the report.

And then the question is, you know, what do you do with the capital as you allocate it over time? And obviously, that makes a difference in intrinsic value, too.

But I would say in a general way that I — and this has been true virtually all of the time that — I think — I would say that the intrinsic value of Berkshire in relation to its — actually, I'll put it the other way.

The price of Berkshire in relation to its intrinsic value, I think, probably offers as much value as, or more, than the majority of stocks that I see. But I don't want to go any further than that.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

The — your story about the fun of working it out, though, there's a famous English headmaster who used to say to each graduating class, he said, "Five percent of you are going to become criminals, and I know just who you are.

"But I'm not going to tell you, because I don't want to deprive your lives of a sense of excitement." (Mild laughter)

WARREN BUFFETT: We'll explain that later on. (Scattered laughter and applause)

There is a lot more to — there's more to intrinsic value, as we've discussed earlier, than just adding up what you think you can sell the pieces for at any given time, because it is a prospective figure. It is future cash discounted back to the present. And capital allocation is a good part of that.

What you expect the float to do, for example, over time, would not — that would lead to a large swing in possible numbers relative to value.

I mean, if — when we bought National Indemnity in 1967, when it had whatever it had, 15 or 20 million in float, we didn't see it then.

But if we could have foreseen the eventual development of float over time, it might have turned out that the intrinsic value of National Indemnity was many multiples of what most people might have thought at the time, and probably what we thought at the time.

23. Hagstrom book had "some effect" on Berkshire's stock price

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: Richard Ducheck (PH) from Melbourne, Florida.

I have a two-prong question, first on the stock. As we all know, the first month this year we ramped up about 25 percent and then we pulled back, I guess, about 20.

Just wondering your thoughts on that, if specifically you attribute that to the books perhaps, or institutional buying or, you know, what explanation you might have for that. And second —

WARREN BUFFETT: I would say — I'll answer that first. I would say [Robert] Hagstrom's book ["The Warren Buffett Way"] undoubtedly had some effect on that. It's impossible to measure, but that book sold a lot of copies. And my guess is that that had some effect.

AUDIENCE MEMBER: OK. More so than institutional buying? Because I've heard rumors like Fidelity and whatever were buying —

WARREN BUFFETT: I can't — I just don't know the — I don't know how to separate out the variables, but I would say that the book was certainly a factor at that time, and it's unreasonable to assume that it had no effect.

CHARLIE MUNGER: Well, a lot of the buying came in in odd lots, so —

WARREN BUFFETT: A lot of odd lot activity, yeah.

CHARLIE MUNGER: Certainly looked like book buyers. (Laughter)

24. Buffett doesn't understand Microsoft, despite his friendship with Gates

AUDIENCE MEMBER: Secondary question, I'm an electronics engineer by profession. So, the technology sector is of prime interest to me, and I think we'll all agree, at least the last six to eight months has been phenomenal for the technology sector.

And I also see that you're somewhat befriending Mr. Gates, inviting him into your house, et cetera.

Is there a possibility down the road apiece of you doing some type of purchase of Microsoft, or acquiring that? Or is there something — (laughter) — you two could work out together?

WARREN BUFFETT: I bought a hundred shares one of the day — first day — I met Bill, and that was the end of it. I just want to be sure I got his reports from that point on. This is personal, not in the — not in Berkshire.

There's no chance we'll be in businesses we don't understand, and I won't understand it.

AUDIENCE MEMBER: No, you're quite clear on that. I just thought maybe there'd be an exception, because apparently —

WARREN BUFFETT: Well, if you made an exception, he would be a good guy to make — a very good guy — to make an exception with. But I don't think I'll make an exception.

25. Business schools should study Mrs. B's success

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: My name is (inaudible) from Arlington, Texas.

Mr. Buffett and Mr. Munger, what possibility to use these two great minds for a long term in life, by either taking apprenticeship in Berkshire or open a school?

CHARLIE MUNGER: I didn't follow that one. Warren, you handle it.

WARREN BUFFETT: Is it a question of what —?

AUDIENCE MEMBER: What the possibility of using these two great minds of yours to educate a new generation as a long-term investment in this country, either through apprenticeship in Berkshire for young people or open a business school?

CHARLIE MUNGER: Well, let me try that one because I have a demonstrated record of nonperformance. (Laughter)

I have had great difficulty enabling my children to know what I know. (Laughter)

And Warren, maybe you have failed less. (Laughter)

WARREN BUFFETT: My children, in many ways, are a lot smarter than I am. So, I've had different experience, Charlie. (Laughs)

No, I think you can — you know, I've mainly learned by reading myself, so I don't think I have any original ideas that — I've certainly got a lot —

I mean, I've talked about reading Graham, I read Phil Fisher, and I've gotten a lot of ideas myself from reading. And in my own case, I mean, talk about your parents having influences, you know, my parents had an enormous influence.

So, I think you can learn a lot from other people. In fact, I think, if you learn reasonably well from other people, you don't have to get any new ideas or do much on your own. You can just apply the best of what you see.

CHARLIE MUNGER: Generally speaking, I think we always get a group of wise people after sifting millions. But I don't think anybody's invented a way to teach so that everybody is wise.

It's extraordinary how resistant some people are to learning anything. (Laughter and applause)

WARREN BUFFETT: Really, what is astounding is how resistant they are when it's in their self-interest to learn.

I mean, I was always astounded by how much attention was paid to Graham — I mean, he was regarded 40 years ago as the dean of security analysts —but how little attention was paid, in terms of the principles he taught. And it wasn't because people were refuting them, and it wasn't because people didn't have a self-interest in learning sound investment principles. It's just this incredible resistance to thinking or change.

I mean, I quoted Bertrand Russell one time as saying — who said that, "Most men would rather die than think. Many have." (Laughter)

In the financial sense, that's very true. It's not complicated. I mean, human relations, you know, usually aren't that complicated, but — and certainly it's in people's self-interest to develop habits that work well in human relations, but an amazing number of people seem to mess it up one way or another.

CHARLIE MUNGER: How much has Berkshire Hathaway been copied, either in investing America or corporate America? I'm not saying we deserve to be, necessarily. But people don't want to do it differently than they're presently doing it.

WARREN BUFFETT: You might argue that Mrs. B. [Nebraska Furniture Mart founder Rose Blumkin], having started what you may have seen out there this weekend, with $500 in 1937, you know, without a day in school in her life, and building that into a great enterprise, you might say, "Well, that is something to study."

I mean, is it because she couldn't speak English when we got — you know, she got over? Maybe we can explain to people — I mean, what is there to learn from seeing somebody create an incredible success like that in a competitive business?

She didn't invent something that the world had never seen before. She didn't have a lock on some piece of real estate that protected her from competition.

You know, all of these — and yet, she accomplished something that virtually no one has accomplished.

Now, why aren't business schools studying her? You know, why are they talking about EVA, you know, economic value added, as we talked about earlier? I mean, here is a success. Something has made her a success.

You know, is it something — is it a 200 — and she's very smart — but is it a 220 IQ? No, it isn't. It's a very smart woman, but it's not something that's incapable of being replicated in the habits and the way of thinking. But who is studying her?

I mean, they present her as a curiosity. But if you go to any of the top 20 business schools, you know, there's not one page that's being given to anybody to study what is an incredible success. And I just — I find that very interesting that — and to some extent, you know, I've seen it in the investment world.

There's this — for one thing, the high — you know, it's probably a little discouraging to a professor of management at some major business school that has gone on to get his doctorate and everything, to think he has to come and hang around the Furniture Mart — (laughter) — study a woman in a golf cart, I mean — (Laughter)

But you could — they'd be better off if they did.

26. Do what you like now, not later

WARREN BUFFETT: Where were we on that? What zone are we on, four, are we? Wherever it is. Zone 3 maybe, huh?

AUDIENCE MEMBER: Yes, thank you. I'm Jim Ludke (PH) from Phoenix, Arizona.

And I haven't been to one of your annual meetings for about 10 years now. The last one was down at the Red Lion Inn by the water. And I congratulate you on your popularity.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: I wish I had bought more stock then. (Laughter)

But like Charlie, I too, have been giving mine away for charitable purposes. So, your beneficial effects have reciprocated and rippled throughout the economy. I congratulate you.

WARREN BUFFETT: No, I congratulate you.

AUDIENCE MEMBER: What do you think has changed — well, one thing is that Ben Graham — commenting on what you just said — I'm a student of Ben Graham, and he said it never ceased to amaze him how widely read he was and least followed.

But how have you changed in the last 10 years? Much, if any? Or none at all? Or —

WARREN BUFFETT: Well, we'll let Charlie — he's been watching me. (Laughter)

CHARLIE MUNGER: I'd say about one stone. (Laughter)

Takes one to know one. (Laughter)

WARREN BUFFETT: If we'd wanted to change, we would have changed a long time ago.

I mean, I've never believed much in this theory of, you know, if I have 2X instead of X that I'm going to do this or that, or I'll take this job I don't like now, and I'll get one I like later on, or —

It doesn't make that much sense to me. I mean, there aren't that many years around, so you ought to be doing what you like at the present time, and Charlie and I have always followed that pretty well.

27. "We let .400 hitters swing the way they want to swing"

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Peter Borma (PH), Chicago.

Every year, you have your operating companies send a check back to Omaha. What percentage do the heads of the operating companies keep as a bonus, and how do you set that figure?

WARREN BUFFETT: Well, we have different bonus arrangements at different companies. It would be a big mistake, with businesses with as many different economic characteristics, or as varying economic characteristics existing, as they do at Berkshire, to try and have some formula approach that paid managers in all of these different businesses based on a simple formula of one kind.

So, we have, I think, four businesses where they own a part of it. And we have varying arrangements with the various businesses.

Some businesses, capital employed is unimportant. There simply isn't a way to employ a lot of capital. So, we do not have a capital charge, even, at those businesses. We don't believe in going through a lot of machinations if it's going to involve peanuts at the end.

So, some businesses have a capital charge, some businesses don't have a capital charge. If they use a lot of capital, they're going to have a capital charge, is what it amounts to.

Some businesses are easy businesses, some businesses are tougher businesses. So, we have different thresholds where things kick in based on that.

We simply sit down and try and figure out, in the case of each business, what makes sense. And that usually isn't very hard to figure out.

I mean, we want something that's fair. The best managers, we aren't going to change their behavior much by the compensation thing. We may a little bit, in terms of teaching them how we think about capital employed.

But in terms of their enthusiasm for the business, imagination, and marketing, and all that, basically we usually buy businesses with those people in place.

But it would be — A, it'd be wrong not to treat people fairly, and they would resent it if they weren't treated fairly, too, understandably.

So we try to have a system that rewards the things that we want to have rewarded, and treats them fairly in a way that they understand they're treated fairly.

And I don't think we have any two businesses that have the same arrangement. They're different in each case.

Incidentally, that applies in their policies, too. We don't get into — very seldom, I should say, maybe once or twice — but they have different arrangements in terms of compensating their employees.

Some of our businesses have budgets, some of them don't. We don't have any budgets that come up to headquarters. We let .400 hitters swing the way they want to swing. And some of them, you know, have a little different swings than others, but overall, they're extremely effective.

And they feel, and we want them to feel, like they own their own business. If they felt — if somebody that's independently wealthy sold us a business and we started telling them how to swing, they would tell us what we could do with it very quickly, because they don't need that in life.

So, what we have to do is create a situation, or maintain a situation, where they are having more fun doing what they're doing than anything else they can do in life, and that's what's we're designing for. And then we have to treat them fairly in respect to that.

Charlie?

CHARLIE MUNGER: Nothing to add.

28. "Foreign exchange baffles me, frankly"

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Roger Hill from Racine, Wisconsin.

Gentlemen, a little change of pace. Could we get your opinion on the present situation with international exchange? Do you think we have a dollar problem, or is — the Japanese have a yen problem?

WARREN BUFFETT: Well, I'm going to let Charlie answer that. (Laughter)

CHARLIE MUNGER: I have no comment. (Laughter)

WARREN BUFFETT: That's probably — that's a very good question, but the trouble is anytime I say, "That's a very good question," it's probably because I don't know the answer.

And I — you know, I don't know the answer to that. Foreign exchange baffles me, frankly.

I mean, you know, I think in terms of purchasing power parity, because that's a natural way to approach it. But purchasing power parity does not work very well as a guide to how exchange values will behave in any shorter, medium, or maybe even long term, because the world adapts in different ways.

Sometimes it adapts by high rates of inflation to a sinking currency. Usually it does. It hasn't done that in respect to ours, but we're only sinking relative to a couple of other important currencies.

I don't have a great answer for you on that, sorry.

29. We don't look for small stock bargains anymore, but they exist

WARREN BUFFETT: Zone 6?

AUDIENCE MEMBER: Hi, I'm Howard Winston (PH) from Cincinnati, Ohio.

First, I wanted to thank you and Charlie for sharing your time with us today.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: My question is, you've repeatedly said that you see many wonderful stock ideas but can't invest because they're too small.

Given that many in the audience today have a lower dollar investment threshold — (Laughter)

WARREN BUFFETT: "Do these stocks have names?" (Laughter)

AUDIENCE MEMBER: Yeah. Well said. (Laughter)

WARREN BUFFETT: Well, the answer to that is that we don't look anymore. We assume that there are a reasonable number of opportunities as you work with smaller amounts of capital because it's always been true.

I mean it was — over the years, as I looked at things, clearly, you run into companies that are less followed as you get smaller. And there's more chances for inefficiency when you're dealing with something where you can buy $100,000 worth of it in a month, rather than 100 million.

But that is not because I am carrying around in my head the names of 25 companies that we could put 100,000 in. I just don't look at that universe anymore. I —

Sometimes, people send me annual reports, or I get letters from managers and they say, you know, "I've got this wonderful thing." I look — I usually know ahead of time, but I mean, I would first look at the size. And if the size isn't right — and it isn't going to be virtually any time — I don't look any further, because there's just no time to be looking at all kinds of smaller opportunities.

I do think, if you're working with very small amounts of money, that there almost always are some significant inefficiency someplace — to find things.

I've mentioned to some people, when I started out, I actually went through all of the Moody's manuals and the Standard and Poor's manuals page by page.

And you know, it was probably 20,000 pages, but there were a lot of things that popped out, and none of them were in any brokerage report or anything of the sort. They were just plain overlooked, and you had to —

You could find out about them, but nobody was going to tell you about them. And my guess is that continues to be true, but not on anything like the scale it was then.

Charlie?

30. Early Buffett cigar butt: Delta Duck Club

CHARLIE MUNGER: Well, I can remember when you bought one membership in some duck club that had oil under it, when you were young.

WARREN BUFFETT: Yeah, that was a company called Atled —

CHARLIE MUNGER: When you get down to one duck club membership, well, you're really scavenging for cigar butts. (Laughter) But —

WARREN BUFFETT: Not a bad cigar butt. There were 98 shares outstanding. It was the Delta Duck Club. And the Delta Duck Club was founded by a hundred guys who put in 50 bucks each, except two fellows didn't pay, so there were only 98 shares outstanding.

They bought a piece of land down in Louisiana, and one time somebody shot downward instead of upward, and oil and gas started spewing forth out of the ground. (Laughter)

So, they renamed it Atled, which is Delta spelled backwards, which was — sort of illustrated the sophistication of this group. (Laughter)

And a few years later, they were taking up — at $3 a barrel oil — they were taking about a million dollars a year in royalties out of the place. And the stock was selling at $29,000 a share, and it was earning $10,000 a share —

No, it was earning about $7,000 a share after-tax, about 11,000 pretax, and it had about 20,000 a share in cash. And it was a long-lived field.

So, you know, I use that sometimes as an example of efficient markets, because somebody called me and offered me a share of it, and those things, you know — is that an efficient market or not?

You know, 29,000 for 20,000 of cash, plus 11,000 of royalty income at 25 cent gas and $3 oil? I don't think so.

You can find things out there. I'll give you hunting rights on all my duck clubs in the future. (Laughter)

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

WARREN BUFFETT: Zone 1.

Don't think the mic —

AUDIENCE MEMBER: How do Berkshire and Berkshire companies protect themselves against lawsuit-happy lawyers? And is it possible for American businesses to survive the financial and time-consuming costs of dealing with lawyers?

WARREN BUFFETT: Well, that's a good question and we've probably had less litigation than any company, you know, with a $25 billion market value in America.

But it's, you know — we were sued one time at Blue Chip Stamps — what was it for, Charlie, and how many billion by some guy?

CHARLIE MUNGER: Lots.

WARREN BUFFETT: Yeah. It was — you know, there — you cannot protect yourself against lawsuits, and there are certainly a lot of frivolous ones we've — like I say, we have — it's not been a drain on our time or money — but particularly time — to date.

And I think one thing you'd have to do is, if you ran into anything of that sort, you would not pay and you would make life as — try to make life comparably difficult for the other party as they made it for you. But that has not been our experience so far.

Charlie?

CHARLIE MUNGER: Yeah. Well, I can tell an Omaha story on that one which demonstrates the Berkshire Hathaway technique for minimizing lawsuits.

When I was a very young boy, I said to my father, who was a practicing lawyer here in Omaha, “Why do you do so much work for X,” who was an overreaching blowhard — (Laughter) — “and so little work for Grant McFayden,” who was such a wonderful man?

And my father looked at me as though I was slightly slow in the head. And he said, “Charlie,” he said, “Grant McFayden treats his employees right, his customers right, everybody right.

“When he gets involved with somebody who’s a little nuts, he gets up from his desk, and walks to where they are, and extricates himself as soon as he can.” And he says, “Charlie, a man like Grant McFayden doesn’t have enough law business to keep you in school. (Laughter)

“Ah, but X,” he said, “he’s a walking minefield of continuous legal troubles, and he’s a wonderful client for a lawyer.”

Now, my father was trying to teach me, and I must say it worked beautifully, because I decided that I would adopt the Grant McFayden approach.

And I would argue that Warren independently reached the same approach very early in life. Boy has that saved us a lot of trouble. That is a — it is a good system.

WARREN BUFFETT: You can’t — yeah, we basically have the attitude that you can’t make a good deal with a bad person. And you can — that means we just forget about it.

I mean, we don’t try and protect ourselves by contracts, or getting into all kinds of, you know, due diligence, or —

We just forget about it. We can do fine over time, dealing with people that we like, and admire, and trust.

So we have never — and a lot of people do get the idea, because the bad actor will tend to try and tantalize you in one way or another, and —you won’t win. It just pays to avoid them.

We started out with that attitude, and you know, maybe one or two experiences have convinced us, even more so, that that’s the way to play the game.

32. Why there’s just one Borsheims store

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: I’m Clarence Cafferty from Long Pine, Nebraska.

I’d like to know if we can get another .400 hitter by starting another Borsheims store someplace in this United States.

WARREN BUFFETT: Well, it's an interesting question about both the Borsheims and the [Nebraska Furniture] Mart. I mean, they — and of course, they're owned — as you probably know — historically, by the same family. I mean, it was Mrs. B.'s sister's family that bought Borsheims, but, in effect, started it virtually from scratch.

And the — both of those institutions offer this incredible selection, low prices brought about by huge volume, low operating costs, and all of that.

Operating multiple locations, you would get some benefit, obviously, from the name and the reputation.

But you would lose something, in terms of the amount of selection that could be offered. There's $50 million-plus at retail of jewelry at Borsheims' one location.

Well, when someone wants to buy a ring, or a pearl necklace, or something of the sort, they can see more offerings at a place like that than they possibly could at somebody who is trying to maintain inventory at 20 or 50 locations.

Similarly, that gives us a volume out of a given location that results in operating costs that, again, can't be matched if you have an enormous number of locations.

So, I think those businesses tend to be more successful in that particular mode as one-location businesses.

Now, a Helzberg's will be bringing merchandise to people all over the country at malls. And they will do — through that mode of operation, they perform that exceptionally well.

But Borsheims can't be Helzberg's, and Helzberg's can't be Borsheims. They're both going for two different — in a sense, two different customers, to some degree.

Sol Price, Charlie's friend who started the Price Club, the first big wholesale club, said that part of his success was due to figuring out the customer he didn't want. I think that's right, isn't it, Charlie?

CHARLIE MUNGER: Right.

WARREN BUFFETT: You have to figure out what you're good at and who you really can offer something special to. Borsheims offers something very special to people, but in part, it comes about through being at one location.

You can see more of almost any kind of jewelry you want there than you're going to see virtually any place in the world. And that will bring people there, or it will bring male people there.

And that gives you operating costs that are many — oh, 20 percentage points — off of what somebody else will be doing without that pulling power.

And that, in turn, enables you to offer the lower prices, which keeps the circle going. I mean, it's very hard to replicate something like that. And trying to do it in 10 spots probably wouldn't work well.

But it's a question you ask yourself as you go along, obviously, when you — McDonald's certainly did well by deciding to open a second store. I mean — (Laughter)

33. Factors boosting reported return on equity

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Warren, I'm Frank Martin from Elkhart, Indiana.

You have written extensively on the subject of the immutability of return on equity for American industry, as a whole, being stuck in the 12 to 13 percent range.

What forces do you see, since we're above the mean, to cause that number to regress to the mean over time?

WARREN BUFFETT: Yeah, it's true, it has been higher in the last few years. Although Fortune's got some interesting figures in the current issue, on the 500, that shows decade by decade what the return has been on the Fortune 500 group — which is a shifting group, of course.

And it's tended to stick, although I would say it was more between 12 and 13 than 11 and 12, probably, in that one.

The return, to some extent, in certain business has gotten a big kick because they finally put the health liabilities on the balance sheet, and therefore reduced equity.

So if you — anything you do that tends to pull down equity, if it doesn't change your ability to do the same sales volume — it's leveraged American business, in effect, by putting the health liabilities on the balance sheet.

It may be wrong. It may be that business can earn 15 percent or so. But I think competitive factors tend to, over time, keep pushing that number down, somewhat.

And 12 or 13, when you think about it, is not bad at all. I mean, it's a level, with 7 percent interest rates, that allows stocks and equity to be worth much more when employed in equity than elsewhere in the world.

But if I had to pick a figure for the next 10 years, I would pick some figure between 12 and 13, but that doesn't mean I'd be right on it.

Charlie?

CHARLIE MUNGER: Yeah. I think all of those published averages overstate what's earned anyway. They're the biggest companies, they're the winners, they're the ones whose stock sells at high multiples, so they can issue it to other people for high-earning assets.

And many of the low-return people are constantly being dropped out of the figures. Now, you can say that was true in the past, too. But it would be remarkable to me if, on average, American business earned 13 percent on capital after taxes.

WARREN BUFFETT: Those figures, incidentally — it isn't a huge item, but it's not totally insignificant. They don't show as a cost, for example, the cost of stock options.

And the American shareholders pay that, so the American shareholder has not gotten the returns on equity shown by those numbers, although it's not a huge factor.

But I wouldn't be surprised if it was, you know, two or three-tenths of a percent just for that one cost that's omitted.

If you let me omit my costs, I can show a very high return on equity. (Laughter)

34. Return on capital at Berkshire subsidiaries

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Jeff Peskin (PH) from New York. And I have a question for you.

It's really more of an observation, in that you've written about when you look at acquiring a business, you look a lot at how they allocate capital.

And my question is, once you acquire a stake in a company, do you find that, just by the fact that you are helping doing the allocation of capital and doing the compensation, that that alone makes a company have a lot higher return?

Or is there some benefit by the fact that you own, or some major shareholder, owns a big slug of the company that also allows a company to increase its return on capital?

WARREN BUFFETT: Well, that's a good question. The answer is sort of, some of the time, some of the places. It's the —

There's no question, in a business that earns a high rate on capital, that doesn't have natural ways to employ that money within the business, that we actually may contribute significantly to the long-term results of that business by taking the capital out.

Because if they don't have a place to use it, nevertheless, they might well use it someplace. And we have the whole universe to spread that money over.

So we can take the money that's earned in some operating business and we can buy part of the Coca-Cola Company with it, and buy into another wonderful business, whereas very few managements probably would do that. So, there's an advantage there.

Now on the other hand, Helzberg's, for example, will probably grow very substantially. They'll probably use all the capital they generate. Maybe they'll even use more. Well, they don't really need us for that. I mean, they would've done that under any circumstances.

We may actually give them the ability to grow even a little faster because if a company — and this is not the — these are not the Helzberg's figures — but if a company is earning 20 percent on equity but can grow 25 percent a year, you know, they're going to feel equity strains at some point. And we, obviously, would love the idea of supplying extra capital that would earn 20 percent on equity.

So, there can be some advantage to having us as a parent, in terms of sending capital to the business, as well as taking capital from the business.

We also, I think, can be helpful in some situations, in that once we are there, a lot of the rituals — particularly in a public company — but a lot of the things that people waste time doing in business, they don't have to do with us.

I mean, there's an awful lot of time spent in some businesses just preparing for committee meetings, and directors meetings, and all kinds of things like that, show-and-tell stuff. And none of that's needed with us. We won't go near them.

And so, we really free them up to spend a hundred percent of the time thinking about what is good for the business over time. If they have extra money, they don't have to worry about what to do with it.

If they need extra money for a good business, it'll be supplied. So, there are some advantages that way. And I guess —

Charlie, can you take it any further?

CHARLIE MUNGER: Yeah. I think our chief contribution to the businesses we acquire is what we don't do.

(BREAK IN RECORDING)

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

AUDIENCE MEMBER: — it's hard to continue to grow at the rate you've grown in the past because the company has gotten so big. And I'm wondering if you could elaborate a little bit on that.

And my second question, which is totally unrelated, but I've also read where you're very good with numbers, with working things in your head. And I'm totally a rookie when it comes to economics and accounting and things like that, but I'm very good with numbers and keeping things in my head.

And I'm wondering if there's some way a mathematician who knows very little about the business world, what I could read or what I could do to learn how better to invest and how you did that.

WARREN BUFFETT: Well, going to the first question, when you say it's going to be hard — it's going to be impossible. I mean, now that's the answer. We cannot compound money at 23 percent from a $12 billion base.

We don't know how to do that, and it would be a mistake for anybody to think that we could come close to that. We still — we think we can do OK with money, but we did not start with a $12 billion base.

And we've never seen anybody in the world compound numbers like that, at that rate. So, we'll forget it — that part of it, but there are intelligent things we can be doing.

The second part of the question, I don't think any great amount of mathematical aptitude is — not aptitude, but mathematical knowledge is a — advanced math is of no use in the investment process.

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

But that doesn't really require any great mathematical ability. It really requires sort of a mathematical awareness and a numeracy. And I think it is a help to be able to see that.

I mean, I think Charlie and I probably, when we read about one business, we're always thinking of it against a screen of dozens of businesses — it's just sort of automatic, and —

But that's just like a scout in baseball thinking about one baseball player against an alternative. I mean, you only have a given number on the squad and thinking, you know, "One guy may be a little faster, one guy can hit a little better," all of that sort of thing. And it's always in your mind, you are prioritizing and selecting in some manner.

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

Charlie?

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

WARREN BUFFETT: I'd agree with that.

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

WARREN BUFFETT: And, if you sort of have in your head how all of that looks in different industries and different businesses, then you've got a backdrop against which to measure.

I mean, if you'd never watched a baseball game and never seen a statistic on it, you wouldn't know whether a .300 hitter was a good hitter or not.

You have to have some kind of a mosaic there that you're thinking is implanted against, in effect. And the Value Line figures, you know, they cycle it every 13 weeks. And if you ripple through that, you'll have a pretty good idea of what's happened over time in American business.

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

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

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

WARREN BUFFETT: Yeah, but I save the old ones. (Laughter)

CHARLIE MUNGER: Yeah. But you know, I wish I had that in the office, but I don't.

WARREN BUFFETT: Yeah, we — Charlie and I — maybe even, I do it more — we tend to go back. I mean, if I'm buying Coca-Cola, I'll probably go back and read the Fortune articles from the 1930s on it or something.

I like a lot of historical background on things, just to, sort of, get it in my head as to how the business has evolved over time, and what's been permanent and what hasn't been permanent, and all of that. I probably do that more for fun than for actually decision making.

But I think it is — I think if you think about if — we're trying to buy businesses we want to own forever, you know, and if you're thinking that way you might as well see what it's been like to own them forever, and look back a ways.

36. Management made the difference for Wells Fargo

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: I'm Stewart Horejsi from Salina, Kansas.

When you first bought part of Wells Fargo a few years back, I looked at it and I couldn't tell it was any better than any of the other banks. I think, now, anybody that would look at it can tell it's better than almost any bank.

Now you've bought PNC Bank, and again, I can't see how it's distinguished from any of the other banks. (Laughter)

What did you see in PNC Bank that made you select it over all the other banks that were available?

WARREN BUFFETT: (Laughs) Well, we're not going to give any stock advice on that. So, I think that going back to Wells, it was very clear that, if you —

I knew something about Carl Reichardt, and to a lesser extent at that time, Paul Hazen, from having met them and also from having read a lot of things they said.

So, they were different — they were certainly different than the typical banker. And then the question was, is how much did that difference make, in terms of how they would run the place?

And they ran into some very heavy seas, subsequently. And I think, probably, the difference — I probably think those human differences that were perceived earlier are what enabled them to come through as well as they did. But that's about all I can say on banks.

CHARLIE MUNGER: You know, you might add to that slightly, because that Wells Fargo thing is a very interesting example. They had a huge concentration of real estate lending, a field in which people took the biggest —

It was the biggest collapse in 40 or 50 years in that field, so that if they had been destined to suffer the same sort of average loss per real estate loan that an ordinary bank would've suffered, the place would've been broke.

So, we were basically betting that their real estate lending was way better than average. And indeed, it was. And they also handled it on the way down, way better than average.

So, you can argue that everybody else was looking at this horrible concentration of real estate loans and this sea of troubles in the real estate field, and in bankers to the real estate field. And they just assumed that Wells Fargo was going to go broke.

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

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

37. Nothing "magic" about a positive shareholders' equity

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: David Carr, Durham, North Carolina.

Tambrands and U.S. Tobacco are two companies which are primarily single-focus product companies, that seem to possibly have some barriers to growth in unit sales and pricing, and have employed a strategy of returning cash to shareholders through stock repurchases.

Both companies have, at times — when they thought the stock was at a discount to intrinsic value — used debt to accentuate the repurchases.

Those companies recently have talked about problems with going into a negative shareholders — a negative stake to shareholders' equity position — through the use of additional debt to repurchase more shares, at a time when both companies believe their stock's very cheap. And they appear to have the type of long-term cash flow that would at least allow that.

Would you comment on the, at least, accounting treatment and the stated shareholders' equity, and if you think that should be a real concern for management in those areas?

WARREN BUFFETT: What was the first company, besides U.S. Tobacco?

AUDIENCE MEMBER: Tambrands.

WARREN BUFFETT: Do you want to?

CHARLIE MUNGER: Tambrands?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yeah, I don't think there's anything magic about whether shareholder equity is positive or negative. The — Coca-Cola has a shareholder equity of $5 billion. It has a market value of 75 billion or so.

Now, they're not going to do it and I'm not going to recommend it, but if they were to spend $10 billion buying in their stock they would have a negative shareholders' equity of 5 billion. They would — their credit would be sound.

I mean, if somebody else were to buy the company for 75 billion, they'd have 5 billion of tangible assets and 70 billion of intangible assets.

And there is nothing magic about a company having a positive shareholders' equity. And it isn't done very often. And I can't even think of a case where it's been done, but it may have been.

But I see no — I see nothing wrong with a company having a negative shareholders' equity, although it may be prohibited by the state in which they're incorporated, in terms of repurchasing shares at a time that would produce that. You'd have to look at the state law on that.

But anytime a company in an LBO, or something, is bought out at some very large number over book value, in effect, they're creating a negative— if they borrow enough money on it — they're creating a negative shareholders' equity, in terms of the previous shareholders' equity. And it's just a fiction, as to the numbers between the two organizations.

You should buy in your stock when you don't have a use for the money. And that could be management specific. I mean, some managements might have a use for the money if their field of capital allocation were large enough, whereas another management that was more specialized in their own business might not.

But once a company has attended to the things that are required or advantageous for the present business, we think reacquisition of stock is a very logical thing to consider, as long as you don't think you're paying more than the intrinsic value of the business in doing it.

And obviously, the bigger the discount from intrinsic value, the more compelling that particular use of money is.

Charlie?

CHARLIE MUNGER: I've got nothing to add. Generally speaking, maybe Coca-Cola can have a negative equity, but I don't think it would be a good idea for General Motors. I think there is something to be said for a positive shareholders' equity.

38. Looking for winners in competitive credit card business

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Edward Barr, Lexington, Kentucky. I had a two-fold question.

Number one, you mentioned American Express earlier. And I was curious as to whether the fact that credit card usage is only 10 percent of all transactions, and that may continue to grow for some time going forward, was a factor in your decision?

And the other part of the question pertains to the durability and permanence of the banking franchise with regard to alternative delivery channels that may appear over the next few years, including the possibility of the Microsoft/Intuit merger.

WARREN BUFFETT: Well, the specific number you mentioned about credit card usage and so on, that's not a big factor with us. We think credit cards are both here to stay and likely to grow, to some extent.

Although at some point you start reaching limits, at least in terms of outstandings [outstanding credit card debt] that people are — that make any sense.

But the credit card field is a very big field. The question is, is who's got the edge in it? Because everybody is going to want to be in it, and they already are. And there are a lot of different ways you can play the game if you're in the credit card business.

And you better have some way of playing one part of the game, preferably a large part. But you better have some way of playing one part of the game better than others or natural capitalistic forces are going to grind you down.

I mean, it's a business that people are willing to change their minds about what they do in. I mean, if you offer somebody a credit card that gives them some advantages that don't exist on their earlier card, people are quite willing to shift cards.

So, you need some kind of an edge in some particular segment of the market. So, the growth aspects overall of the market were not a big — are not a big factor with us.

It's really a question of figuring out who's going to win what game, and who's going to lose what game.

And what was the second question again on that?

39. Expect big changes in banking over next 20 years

AUDIENCE MEMBER: The second question pertained to the permanence and durability of the banking franchise.

WARREN BUFFETT: Oh yeah, sure.

AUDIENCE MEMBER: And whether alternative delivery channels over the next few years may erode the durability of that, including the Microsoft/Intuit merger.

WARREN BUFFETT: Well, that's a good question. You're certainly seeing the value of bank branches diminish significantly. It used to be a point of enormous pride with managements, in how many branches they had.

And it was, you know, often political influence and everything else was called into obtaining branch permits.

The world will change in banking, probably in some very major ways, over a 20 or 30-year period. Exactly what players will benefit and which ones will be hurt, you know, is a very tough question.

But I would expect — I would not — I don't think I'd expect really significant change in banking over the next five years, but I'd certainly expect it over the next 20 years.

And there are a lot of people that have their eye on that market, including Microsoft, as you mention.

It may be to their advantage to hook up with the present players. I mean, I know it's certainly something that gets explored. But they may figure out a way to go around the present players, too. And that's one investment consideration.

Charlie?

CHARLIE MUNGER: Yeah. The interesting player that went around the rest was Merrill Lynch. Merrill Lynch went heavily into banking with its cash management accounts. And I don't think it's the only innovation that'll come along.

WARREN BUFFETT: What's the name of that book?

CHARLIE MUNGER: You know, I'd forgotten, that's a marvelous book.

WARREN BUFFETT: Yes, there's a great book.

CHARLIE MUNGER: Maybe Molly remembers. What was that book you gave me? It was the history of the credit card.

WARREN BUFFETT: Was it Joe Nocera's? Yeah, Joe Nocera was the author. I don't remember the title ["A Piece of the Action: How the Middle Class Joined the Money Class"]. But it came out about six months to a year ago. It's a terrific history of the credit card business.

And if you read that you will get some idea of the amount of change that can occur in something like, you know, the movement of money. And my guess is that if there's another edition of it in 20 years, there'll be plenty more to write about. So —

CHARLIE MUNGER: By the way, that is a fabulous book. Most of the people who are here will not be able to put it down. I mean, for a book about an economic development, it captures the human background in a very interesting way.

40. No comment on SunTrust and PNC moats

WARREN BUFFETT: Is it zone 4? That seems far away for zone 3. Yeah.

AUDIENCE MEMBER: I was — Adam Engel (PH) from Boulder, Colorado.

I was wondering if you could comment on the moat you see around the castles of SunTrust and PNC.

WARREN BUFFETT: Well, I don't think I should comment on specific holdings like that. But — so I would say you would look at those in a general way very much as you'd look at banking operations first.

And then you'd try and figure out what are the specific strengths or weaknesses of both organizations. But there, again, I don't want to spoil the fun for you.

Charlie?

CHARLIE MUNGER: Nothing to add.

41. "Wiseass" comment on Salomon that Munger wishes hadn't occurred

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: My name is Bob McClure (PH). I'm from the States but I live in Singapore.

About a week ago, in the Asian Wall Street Journal, a remark was attributed to Mr. Munger, specifically that owning Salomon Brothers was like owning a casino with a restaurant in the front. (Laughter)

The casino, eluding to the proprietary trading, and the restaurant, to the so-called client-driven business. If that attribution is correct or accurate can you —

Charlie Munger: Well, I don't think —

AUDIENCE MEMBER: — elaborate on why you view the business in that way?

CHARLIE MUNGER: I don't think it's entirely correct, but I have a pithy way of speaking on occasion. (Laughter)

And I frequently speak in a way that works with an in-group, but wouldn't necessarily work everywhere else.

And every once in a while, when you take one of those wiseass comments — (laughter) — out of context — why, I very much wish that it hadn't occurred. (Laughter)

This was such a case. (Laughter and applause)

WARREN BUFFETT: It won't stop him in the future, though. (Laughter)

Or me.

42. National debt isn't scary now, when compared to GDP

WARREN BUFFETT: Zone 6? Or are we in 5? Which one are we in? Kelly? Or —

AUDIENCE MEMBER: Mr. Buffett, I'm Randall Bellows (PH) from Chicago.

And the two questions I have, since you're answering questions so far afield, are, if you were to look at the balance sheet of the United States of America, is the national debt as frightening as — that it appears to be?

And secondly, in terms of redeployment of capital, if Coca-Cola is such a wonderful investment, as it returned so much, why not redeploy some capital in purchasing additional shares of Coca-Cola?

And finally, thank you for letting Jane do that portrait of you. And if it's good, we'll do Mr. Munger next. Thank you.

WARREN BUFFETT: First question about the U.S. balance sheet, it — the net national debt is about — it would be about 60-odd percent of GDP.

CHARLIE MUNGER: Without counting unfunded pensions.

WARREN BUFFETT: Yeah, but that's — but also with a claim on the income, in effect, of future citizens, which was an asset, too, that you could set up the —

But that figure, I think, at the end of World War II, may have been — I know it was around at least 125 percent, may have been 150 percent or so, of GDP. So we have sustained —

Now, the interest rate on that debt was much lower. A lot of it was at 2.9 percent because that's what savings bonds paid.

But that level of debt, which I don't advocate in relation to GDP, turned out to be quite sustainable. And as a matter of fact, it drifted down year after year for a long time until the early '80s, when it started rising again. And now it's actually fallen a little bit in the last few years, the ratio of debt to GDP.

There are a lot of measurements of how much debt is too much and all of that. But, probably, I think that if I had to look at one single statistic, I would look at that ratio, just like I would look at a ratio of debt to income for an individual.

Then you'd get into the question of the stability of the income and to whom it is owed.

But I do not think that the level of debt, relative to the economy, is of anything that's of a frightening nature. I like the idea of it trending downward a little bit over time rather than trending upward. And if it keeps trending upward, it can get awkward.

Although, it's — I think, in Italy, I think it's close to 150 percent now. And you start getting to 150 percent, and talk 8 percent interest rates, and you're talking 12 percent of GDP essentially going to interest.

If you were to put a balance sheet of the country together, it's kind of interesting, because you would have this 4 billion of net debt on the liability side, and you'd also have a lot of pension obligations, as Charlie mentions, on the liability side.

But you've got a lot of assets, too. You've got a 35 percent interest — profits interest — in all the American corporations. I mean, the government, if it has a 35 percent tax rate, really owns 35 percent of the stock of American business. They own a significant part of Berkshire Hathaway.

We write them a check every year. We don't write you a check every year, but we write them a check. We plow your earnings back to create more value for their stock, in other words, the taxes they get.

CHARLIE MUNGER: Are you trying to cheer these people up? (Laughter)

WARREN BUFFETT: But what would you pay to have the right, today, to receive all the future corporate tax payments made by all the companies in the United States, the discounted value? You'd pay a very big number.

What would you pay to have a right to take a percentage of the income of every individual that makes more than X in the United States, and also the right to change your percentage as you went along? That's a very big number, too. (Laughter)

So, you've got a very big asset there that — and you've got some very big liabilities, too. But the country is very solvent.

And I would not like to see debt rise at any rapid rate. I wouldn't like to see it rise at all, but I wouldn't like to see it, particularly, rise at a rapid rate, because that sets a lot of things in motion, if it's rising as a percentage of GDP.

But if you tell me that 20 years from now the national debt will be $10 trillion, but that it'll be the same percentage of GDP, does that alarm me? Not in the least. I mean, I expect it to increase and I think there's some arguments why — even, why it may be advisable to have it increase.

But I don't think it's a good idea to have it take up more and more of your income, because that sets a lot of other things in motion.

So, I welcome what's happened in the last couple of years, which is to see it decrease modestly from the trend that existed the previous 10 or 12 years.

Charlie?

CHARLIE MUNGER: Well, generally I think that you're right, that it isn't all bad. And to the extent that it is bad, a great nation with a capitalistic economy will stand quite a bit of abuse on the political side. It's a damn good thing, too, because — I don't think we should be terribly discouraged.

If there's anything that's really going to do the country in it'll be what I call a "Serpico effect," where you start rewarding what you don't want more of, and it then just grows, and grows, and grows. But I don't think that's necessarily a bad fiscal result, it's just a bad result.

WARREN BUFFETT: Berkshire owes 7 or 800 million — or whatever it is now, in debt, and we owe another 3 billion-some of float. You know, those numbers would've sounded very big to me 25 years ago, but — and yet we're one of the most conservatively financed operations you'll find.

Ten years from now we may owe more money, and it may be a smaller percentage still. I mean, you can't talk about debt levels without relating it to the ability to pay debt. And this country is probably in better financial shape now than it was in 1947.

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

Zone 1. What, there was a second — was there a second question that I didn't answer on that? Or —

AUDIENCE MEMBER: (Inaudible)

WARREN BUFFETT: Oh, in terms of repurchasing shares. Right.

CHARLIE MUNGER: No, you said, "Why don't we buy more?"

WARREN BUFFETT: Well, we think about it.

CHARLIE MUNGER: We did, not long ago —

WARREN BUFFETT: Yeah, we did. We bought more last year, and it's not a bad measuring stick against buying other things.

But there's — I would not rule out Berkshire buying more. I don't have any plans to do it right now, but I wouldn't rule that out at all because it's — if I'm going to look at another business I will say, you know, "Why would I rather have this than more Coca-Cola?"

CHARLIE MUNGER: Well, there he is saying something that is very useful to practically any investor, when he said, "Use this as a measuring stick," in terms of buying other things. For an ordinary individual the best thing you have easily available is your measuring stick.

If it isn't — if the new thing isn't better than what you already know is available, it hasn't met your threshold, then that screens out, you know, 99 percent of what you see, and it's an enormous thought conserver. And it is not taught in the business schools, by and large.

WARREN BUFFETT: No, and that's why we think it's slightly nuts when big institutions decide, because everybody else is doing it, to put 4 percent of their money in international equities or 3 percent in emerging growth countries — some damn thing like that.

I mean, the only reason to put the money in there is if they've measured against what they're already doing.

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

But it’s what committees are talked to about and what keeps investment managers going to conferences and everything, so —

CHARLIE MUNGER: They’re deliberately using a technique that takes away the best mental tool they have. And you can say this is nuts, and you’re right.

And I think {German philosopher Friedrich] Nietzsche said it pretty well when he said he laughed at the man who thought he could walk better because he had a lame leg.

I mean, they literally are blinding themselves and then they’re teaching our children how to do this in our own business schools. Very interesting, don’t you think?

And all Warren says is, deciding whether to do something, just compare the best opportunity you have. If that one is better and you’re not taking it, why would you do this just because somebody tells you you need 2 percent in international equities?

44. Buy Berkshire or let your money manager loose?

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Hi, my name is Mark Wheeler (PH), I’m from Portland, Oregon. And I have a few eggs in your basket. My grandmother always said, “Don’t put all your eggs in one basket.”

I have a question, and I think you answered this a couple of years ago in one of your reports about Little Abner’s investment approach.

Suppose I had $100,000 and I decide to buy four or five more of your shares, and that was sort of a buy and hold thing for four or five years.

And also I have a money manager — I’ve already got one — and he does pretty well – 10, 15 percent.

But he churns the assets all the time. You know, every time I turn around all this mailbox full of paperwork. And I guess my question is, how can I arrive at which is a better deal for me?

In other words, to buy Berkshire, which I like, and obviously I’m here, so I’m interested in it, or hang onto my money manager, who just seems to be churning the hell out of the account?

WARREN BUFFETT: Well, it’s better than having a broker churning the hell out of the account. (Laughs)

He had a little less incentive if he’s getting a management fee.

But I can’t answer your question as to which decision you should make in that case.

But I would say that if — you're right, in the sense that, if you buy Berkshire, you should only think about buying it for a very long period of time.

We have no idea what Berkshire is going to do, either intrinsically or in the market, in the next year. And you know, we care about the intrinsic part of it. We don't care about the market aspect. We do care about building intrinsic value.

And you know, in the end, we don't think — well, when we own Berkshire, we don't think of all our eggs being in one basket, I mean, because we have got a lot of good businesses.

But if you're talking about some, you know, lightning from someplace, the huge liability suit or something like that hitting one corporate entity, we're one corporate entity. But if you think about it in terms of the business risk implicit in an entity, we have a lot of different good businesses.

In fact, we probably have as decent a collection of good businesses as any company I can think of.

But your money manager will also undoubtedly have the advantage of working with, probably, with smaller sums, too, and that gives him a bigger universe of opportunity.

We're not set up, taxwise, perfectly, as compared to an individual working with their own capital. We're set up, taxwise, fine for somebody that's going to sort of own it forever. But we're not set up, taxwise, as well for somebody that's going to own it a year or something of the sort.

Charlie? Anything?

CHARLIE MUNGER: Nothing to add.

45. "We like people who are candid"

WARREN BUFFETT: Zone what? Oh, back there. I don't think it's on. OK.

AUDIENCE MEMBER: I'm Jeff Johnson (PH). I'm grateful to be here from Tulsa, Oklahoma.

I have two questions. First, I was hoping you could explain, or offer an opinion as to why investors in property-casualty insurance companies are willing to accept traditionally below-average type of returns.

Second question relates to an answer you gave me yesterday, that being that intuition or gut feeling has nothing to do in your — in making investment decisions.

I was wondering if there is anything subjective in yours and Mr. Munger's assessment of whether or not you like someone, and how it is that you determine whether or not you like the lord of the castle?

WARREN BUFFETT: Well. I don't know. Charlie, do you want to answer that second part?

CHARLIE MUNGER: Well, we spoke about agency costs. And there are two different kinds of agency costs. One, the guy favors himself at the expense of the shareholders, and the other is he's — he does foolish things. Or he's not trying to favor himself, he just is foolish by nature.

Either way, it's very costly to you, as the shareholder. So, you have to judge those two aspects of human character, and they're terribly important.

And on the other hand, there are some businesses so good that they'll easily stand a lot of folly in the managerial suite. And I — much as we like perfect people, I don't think we've always invested with them.

WARREN BUFFETT: No. But generally, we like people who are candid. We can usually tell when somebody's dancing around something, or where their — when the reports are essentially a little dishonest, or biased, or something. And it's just a lot easier to operate with people that are candid.

And we like people who are smart, you know. I don't mean geniuses. But that — and we like people who are focused on the business.

It's not real complicated, but we generally — you know, there may be a whole bunch of people in the middle that we don't really have any feeling on one way or the other, and then we see some that we know we don't want to be associated with, and some that we know we very much enjoy being associated with.

CHARLIE MUNGER: Averaged out, we've been very fortunate.

WARREN BUFFETT: Very lucky.

46. Difficult to get capital out of a sub-par business

CHARLIE MUNGER: And your other question, you said, why is it that these investors accept below-average results? Well, in the nature of things, approximately half the investors are going to get below-average results. They didn't exactly accept it in advance. It's just the way it turned out.

WARREN BUFFETT: And the money tends to be fairly captive, once it's in a company. I mean, it takes a lot — if you have a business that gets subnormal returns over time, there's a big threshold in terms of either a takeover, or a proxy fight, or something like that to unleash the capital.

So, money that's tied up in an unprofitable business, or a sub-profitable business, is likely to stay tied up for a good period of time.

Eventually something will probably correct it. But capitalism does not operate so efficiently as to move capital around promptly when it's misallocated.

We are in a better position to do that when Berkshire owns a company. And obviously, we're in no position to do it — because it involves something we don't want to do — if we own it through some other enterprise. We just sell to somebody else who takes another — who takes our chair — at the table, in effect.

47. Focus on future, not current, earnings

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Hi, Philip King (PH) from San Francisco.

I've got another question about valuation — more specifically, the relation of P/Es to interest rates.

I understand that you don't want to lay down a rigid formula for valuation, but I also know that you don't want people to think that a multiple of 20 times earnings is cheap, or a multiple of five times earnings is expensive.

So, Benjamin Graham, he devised a central value theory that valued the average stock at an earnings yield that's about a third above bond yields.

In other words, that would work out to maybe 11 times earnings, currently. And I know that you've compared the average business to a 13 percent bond that's worth roughly book at 13 percent interest rates, and worth perhaps roughly twice book at 6 percent interest rates.

So, given current interest rates of 7 to 8 percent, as they are now, that would tend to imply that stocks are worth perhaps 12 to 13 times earnings.

And yet, the acquisitions that I've seen in the private market have gone out at more like 17 to 20 times earnings. And I'd like to know, what do you think is the rough range of multiples that make sense?

WARREN BUFFETT: Yeah. Well, it isn't a multiple of today's earnings that is primarily determinate of things. We bought our Coca-Cola, for example, in 1988 and '89, on this stock, at a price of $11 a share. Which — as low as 9, as high as 13, but it averaged about $11.

And it'll earn, we'll say, most estimates are between 230 and 240 this year. So, that's under five times this year's earnings, but it was a pretty good size multiple back when we bought it.

It's the future that counts. It's like what I wrote there, what Wayne Gretzky says, to go where the puck is going to be, not where it is.

So, the current multiple interacts with the reinvestment of capital and the rate at which that capital's invested, to determine the attractiveness of something now.

And we are affected in that valuation process to a considerable degree by interest rates, but not by whether they're 7.3, or 7.0, or 7.5. But I mean, we'll be thinking much differently if they're — long-term rates are 11 percent or 5 percent. And — but we don't have any magic multiples in mind.

We're thinking — we want to be in the business that 10 years from now is earning a whole lot more money than it is now, and that we will still feel good about the prospects of the business at that time.

That's the kind of business we're trying to buy all of, and that's the kind of business that we try and buy part of. And then sometimes we buy others, too. (Laughs)

Charlie?

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

WARREN BUFFETT: There's a general framework, that you can call a formula, in our mind. But we also don't kid ourselves that we know so much about the specifics that we would actually make a calculation, in terms of the equation.

When we bought Coke in '88 and '89 we had this idea about what we thought the business would do over time, but we never reduced it to making a calculation.

Maybe we should, but I mean, it just — we don't think there's that kind of precision to it.

We think it's the right way to think in a general way. And we think, if you try to — if you think that you can do it to pinpoint it, you're kidding yourself.

And therefore, we think that when we make a decision, there ought to be such a margin of safety that it ought to be so attractive that you don't have to carry it out to three decimal places.

We'll take a couple more and then we'll have to leave. We've got a directors — we have one directors meeting a year and we don't want to disappoint them.

48. USAir was mistake, despite five years of dividends

WARREN BUFFETT: Zone 4? (Laughs)

AUDIENCE MEMBER: Yes, I'm Roy Christian from Aptos, California.

I wanted to ask one question about USAir, which has not been questioned much at this meeting.

When you were on television talking about the losses there, it was funny how so many of my friends or, maybe, acquaintances came forward to tell me this piece of startling news. And, you know, I tried to stand up for you, a little bit. And at least —

WARREN BUFFETT: It was a mistake. (Laughter)

You should've just taken a dive. (Laughter)

AUDIENCE MEMBER: Well, at least I wanted to point out to them —

WARREN BUFFETT: No —

AUDIENCE MEMBER: — that you did have dividends over a period of —

WARREN BUFFETT: Right.

AUDIENCE MEMBER — about five or six years, and that that money was reinvested, maybe at a better return than USAir.

So, that it wasn't quite the disaster that was pictured on television when you spoke about it, or the impression that all my friends — or I should call them acquaintances — pointed out to me.

Just a comment, I guess, is what I'm asking for.

WARREN BUFFETT: Yes. Well, you're right, it could've been worse. But it was a mistake. But we received five years, I guess — yeah, it'd be five years of dividends at a good rate while we got it.

But it's like somebody says, "It isn't the return on principal that you care about, it's the return of principal." And we —

But we're better off — we're a lot better off, obviously, than if we'd bought the common [stock], and we're even better off than if we bought some other stocks.

But it was still a big mistake on my part. But keep standing up for me. I need all the help I can get on this one. (Laughter)

49. Charlie's and Warren's book recommendations

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Hi, I'm Chris Stabru (PH) from New York.

Charlie, in addition to the book that you mentioned on credit cards, are there any other books you have been reading that you'd recommend to us?

And Warren, are there any books that you have been reading that you'd recommend? I know you're a fan of Bertrand Russell. Any favorite one or two of his books?

WARREN BUFFETT: Been a long time since I've read those, though. I mean, I read a lot of Russell, but I did that a — he hasn't written much in the last 10 or 15 years. (Laughs)

Charlie?

CHARLIE MUNGER: There's a textbook which is called, I think, "Judgment in Managerial Decision Making." And it's used in some of the business schools, and it's actually quite a good book.

It's not spritely — it's not written in a spritely way that makes it fun to read, but there's a lot of wisdom in it. It's something like Braberman [Max Bazerman]. But it's "Judgment in Managerial Decision Making."

WARREN BUFFETT: Since taking up computer bridge, which is 10 hours a week, it's really screwed up my reading. (Laughter)

It's a lot of fun, though.

50. Despite "awkward to disadvantageous" per share price, Berkshire won't split stock

WARREN BUFFETT: Zone 6? We'll take a couple more and then we'll —

AUDIENCE MEMBER: Yes. I am Dick Leighton from Rockford, Illinois.

This is the first annual meeting that I've attended and it's been very beneficial to me. I've been extremely impressed with the number of people here, but even more so with the number of young people who have come.

And I would like very much to be able to bring my grandchildren as shareholders, but I find it difficult to get shares into their hands with the current per unit value.

WARREN BUFFETT: That's the nicest introduction to the stock split question we've had. (Laughter)

It really is, too.

AUDIENCE MEMBER: I thought you would appreciate that. (Laughter)

Obviously you understand the question. I understand the position you've taken over the years and the fact that it adds no value to make the split.

In this case, however, it could be a tax savings to many of us who would like to get stock shares into the hands of other family members.

Should I just go to work on my congressman to change the tax code, or would you consider a change? (Laughter)

WARREN BUFFETT: Well, that's a very valid question. And there's certainly a couple of areas, one of which you've just mentioned.

And I had someone else mention to me that they had their Berkshire in an IRA account. And now they were getting into the mandatory payment arrangement, and it didn't work well, in terms of using the Berkshire — although I think they could sell it and then pay out a percentage of it.

There are certain aspects, primarily of gifting, where it is anywhere from awkward to disadvantageous to have the price per share on a stock that exists with Berkshire.

And you know, we're aware of it, we've thought about it, and we've got our own personal situations even, sometimes, that are involved in that. I've got one in the family, which we've worked — figured out ways around.

The disadvantage, of course, is that you saw a little even earlier this year of what a book ["The Warren Buffett Way"] can do.

We want to attract shareholders who are as investment-oriented as we can possibly obtain, with as long-term horizons.

And to some extent, the publicity about me is negative, in that respect. Because I know that if we had something that it was a lot easier for anybody with $500 to buy, that we would get an awful lot of people buying it who didn't have the faintest idea what they were doing, but heard the name bandied around in some way.

And secondly, to the extent that ever created a market that was even — that was stronger — you then would have people buying it simply because it was going up. We got a little bit of that going on this year.

There are a lot of people that are attracted to stocks that are going upward. It doesn't attract us, but it attracts the rest of the world to some degree.

So we are almost certain that we would get — we don't know the degree to which it would happen — we are almost certain we would get a shareholder base that would not have the level of sophistication and the synchronization of objectives with us that we have now. That is almost a cinch.

And what we really don't need in Berkshire stock is more demand. I mean, that is not — we don't care to have it sell higher, except as intrinsic value grows.

Ideally, we would have the stock price exactly parallel to change in intrinsic value over time because then everybody would be treated fairly among our shareholders.

They would all gain or lose, as the company gained or lost, over their ownership period. And anything that artificially stimulated the price in one period simply means that some other period's shareholders are going to be disappointed.

I mean, we don't want the stock to sell at twice intrinsic value, or 50 percent above intrinsic value. We want the intrinsic value to grow a lot.

And I don't think there's any question, but that we would get a worse result in that aspect if we introduce splits in, because then people would think about other possibilities that might give the stock a temporary boost.

We — they had a tabulation in Businessweek a couple of months ago on turnover on the exchange. We were at 3 percent, and I don't think anybody was, that I saw on the list, was under double digits and bigger numbers.

But those are people who are simply, you know, their shareholders leaving frequently, and new shareholders coming in with shorter-term anticipations. We have wanted this to be as much like a private partnership as we can have, with everybody having the ability to buy it.

We don't think the minimum investment is too high to — in this investment world. I mean, there are all kinds of investment opportunities that are limited to 25,000 or 50,000, and that sort of thing.

But the problem of making change, you know, in terms of gifts or — you know, that I wish I had a better answer for, because I think that is a —

CHARLIE MUNGER: My grandchildren pay me the difference between $20,000 and the current price. And I think that's a very reasonable way for them to behave, particularly when they are, sometimes, they're only six weeks old. (Laughter)

WARREN BUFFETT: You need a spouse's consent to make it — to work with 20, obviously.

But most of the things can be solved, but I'll admit it isn't as easy to solve as if we just had a stock denominated in lower dollars per share.

I do think that once you get a shareholder base that is — has got — that has different objectives or expectations or anything, you can't get rid of it. I mean, you can keep a shareholder base like Berkshire, but you can't reconstruct it if you destroy it in some way.

And it's important to us who we're in with. I mean, it enables us to — I think it helps us in our operation. I think it even may — in some cases, it may even help us in acquisitions, in terms of who we attract.

It may — for all I know, it may hurt us someplace, too, that I don't know about. But I don't think so, because I think we can design — particularly with a preferred stock — we can design something to satisfy somebody who might have in mind a different denomination of security.

CHARLIE MUNGER: Look around you. Are we really likely to do a lot better? This is a good bunch.

Morning Session - 1996 Meeting

1. Welcome

WARREN BUFFETT: Just a little early, but I think everyone's had a chance to take their seats.

I must say, this is the first time I've seen this program. They told me they'd surprise me, and they certainly did. (Laughter)

Marc Hamburg, our chief financial officer, who is now known around the office as CB, was in charge of putting all this together. And we — I want you to know, we have no multimedia (inaudible). (Applause)

This entire meeting is handled by a regular staff. We have no public relations department, or investor relations, or multimedia department, or anything of the sort. So, everybody just pitches in. And Marc will, forevermore, be in charge of the pregame ceremonies. (Laughter)

We have a very large crowd today. I hope everybody has found a seat, either in this main room or in the three overflow rooms. I think we can handle around 5,400. And historically, 62 percent or just about exactly 62 percent, every year, of the people who request tickets have come to the meeting.

And if that percentage holds true today, we have just filled the rooms. And we will have a problem in the future, which we haven't figured out the answer to yet. But we've got another year.

The way we'll run the meeting is that we'll get the business out of way — out of the way — at the start. And we'll talk about the Class B issuance, then, too. So, it'll take a little longer than historically has been the case.

And, then, we'll have Q & A for — until about noon. We'll have a short break at noon. There'll be sandwiches outside, which you can buy. (Laughter)

And Charlie and I will have a couple of sandwiches up here at the podium.

And, then, we will stay around until about 3 o'clock to answer more questions. And at that time, after noon, I'm sure everybody in the overflow rooms will be able to find a seat here in the main room.

But people have come from great distances to attend this meeting. So, we really want to get a — give everyone a chance to get their questions asked. And Charlie and I are delighted to — but we'll have to break it up at three, no matter what. But we'll be delighted to stick around.

You can leave anytime, obviously. As I've explained in the past, it's much better form to leave while Charlie is talking. (Laughter)

But the — feel free to do that. And then at noon you'll get a chance to do it en masse.

We have buses available to take you to — if you have any money left at all after yesterday — to take you to other business establishments of Berkshire, locally.

So that will be the plan. I hope everyone does get their questions answered.

We've got a system where we break this room into six zones. And we have a couple of zones in other rooms. And then this afternoon, everybody will be able to be here in the main room. So, that is the procedure.

I'm sure you recognize Charlie Munger, the vice chairman of Berkshire Hathaway, who also had not seen that movie before. (Laughs)

And showed — we were — I think Marc was afraid to show it to us. But in any event — (laughter) — we will go on.

I thought you might be interested. This is a list of people that came in for tickets. And we had, in addition to 99 from Canada and, of course, the U.S., we had Australia, the Channel Islands, England, Greece, Hong Kong, Israel, Portugal, Puerto Rico, Singapore, Sweden, and Switzerland.

I'm not sure all of those people are with us today. But they did send for tickets. And I've met a number that did come in from a distance.

2. Election of directors

WARREN BUFFETT: So, with that introduction, I will call the meeting to order.

I'm Warren Buffett, chairman of the board of the directors. And I do welcome you to this meeting. I hope everybody has a good time this weekend.

And I'd like to introduce the directors, in addition to myself and to Charlie.

Now, you don't get quite your money's worth this year from our directors. They've — collectively, they've lost 100 pounds since last — our last meeting. I think they've been trying to live on the director's fees. (Laughter)

We have with us Howard Buffett — let's stand. (Applause)

Susan T. Buffett. (Applause)

Malcolm G. Chace III. (Applause)

And Walter Scott Jr. (Applause)

Along with us today are partners in the firm of Deloitte & Touche, our auditors, Mr. Ron Burgess and Mr. Craig Christiansen (PH). They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Mr. Robert M. Fitzsimmons has been appointed inspector of elections at this meeting. He will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg. Proxy cards have been returned through last Friday representing, it says "number to come." (Laughter)

VOICE: There's another script.

WARREN BUFFETT: Ah, OK, there's another — oh, yeah. Here's the script on that one: 1,041,567 Berkshire shares to be voted by the proxy holders, as indicated on the cards. That number of shares represents a quorum. And we will therefore proceed — directly proceed — with the meeting.

We will conduct the business of the meeting, then adjourn the formal meeting. After that, we will entertain questions that you may have.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott Jr. who will place a motion before the meeting.

WALTER SCOTT JR.: I move that the reading of the minutes of the last meeting of shareholders be dispensed with.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions? We will vote on this motion by voice vote. All those in favor say, "Aye."

VOICES: Aye.

WARREN BUFFETT: Opposed? Motion's carried.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

ROBERT M. FITZSIMMONS: Yes. I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent by first-class mail to all shareholders of record on March 8, 1996, being the record date for this meeting, there were 1,193,512 shares of Berkshire Hathaway common stock outstanding with each share entitled to one vote on motions considered at the meeting.

Of that number, 1,041,567 shares are represented at this meeting by proxies returned through last Friday.

WARREN BUFFETT: Thank you. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the two items of business provided for in the proxy statement, he or she may do so.

Also, if any shareholder that's present has not turned in a proxy and desires a ballot in order to vote in person on those two items, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish two ballots to you, one for each item.

Will those persons desiring ballots please identify themselves, so that we may distribute them?

First item of business at this meeting is to elect directors. And I'll recognize Mr. Walter Scott Jr. to place a motion before the meeting, with respect to election of directors.

WALTER SCOTT JR.: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace III, Charles T. Munger, and Walter Scott Jr. be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: Are there any other nominations? Is there any discussion?

I learned a lot in China. We did so — (Laughter)

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Will the proxy holders please also submit to the inspector of elections a ballot on the election of directors, voting the proxies in accordance with the instructions they have received?

Mr. Fitzsimmons, when you're ready, you may give your report.

ROBERT M. FITZSIMMONS: My report is ready. The ballot of the proxy holders received through last Friday cast not less than 1,040,667 votes for each nominee. That number far exceeds the majority of the number of all shares outstanding.

The certification required by Delaware law regarding the precise count of the votes, including the votes cast in person at this meeting, will be given to the secretary to be placed in the minutes of this meeting.

WARREN BUFFETT: Thank you, Mr. Fitzsimmons.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcom G. Chace III, Charles T. Munger, and Walter Scott Jr. have been elected as directors.

3. Why Class B shares were created

WARREN BUFFETT: The second item of business of this meeting is to consider the recommendation of the board of directors to amend the company's restated certificate of incorporation.

The proposed amendment would add a provision to the restated certificate of incorporation authorizing the board of directors to issue up to 50 million shares of a new Class B common stock, with each Class B share having economic rights equivalent to 1/30th of a share of the current common stock, and with 1/200th of the vote, and to re-designate the company's current common stock as Class A common stock and to make each share of Class A common stock convertible into 30 shares of the new Class B stock at the option of the holder.

I think, before we get into moving that motion — I think this would be a good time to have discussion and take your questions regarding the issuance of the Class B. And I should give you a little background.

I think many of you know the background on this. But over the years, we've had probably half a dozen people, one time or another, propose that the creation of an all-Berkshire investment company or unit trust.

In other words, an entity that would hold nothing but Berkshire stock, and then would parcel out its own shares in smaller denomination pieces to the public.

And we have generally discouraged that because we felt that there was considerable potential for abuse in such an arrangement.

And our discouragement has been successful up until last fall, when there was one — there were two proposals — that went as far as submission to the SEC for clearance, that involved unit trusts.

And these unit trusts would've owned nothing but Berkshire shares and, then, been sold to the public in small denominations, probably with a minimum investment of around a thousand dollars or so.

And holders of those trusts would've bought into an entity that had a defined life, but that had considerable, in the way of costs and some tax consequences, that they might not anticipate when they came in.

And Charlie and I were worried that a combination of Berkshire's past record — which cannot be repeated — and high sales commissions, and a low denomination, and a lot of publicity about Berkshire and myself, which, as you've seen this morning, we attempt to discourage (Laughter) —

The — that the — a great many people would end up buying these unit trust holdings without any idea, really, of what they were buying, and with unrealistic expectations as to the future.

And that that would, in turn, create a considerable demand — because these unit trusts would go out and buy Berkshire shares — that would create a considerable demand against a fixed supply, much of which is almost unavailable because people have a low tax basis and are reluctant to sell, and I hope they're reluctant to sell for other reasons.

And that the very action of the creation of these, and that push on the demand, would — might very well create some speculative spurt in the stock, which in turn, would induce people who had been approached about the trust to feel they were missing even more of a good thing by rushing in.

Rising prices in certain kinds of markets create their own kind of demand. It's not a sustained demand. And it's a demand that the reversal of which, later on, when people become disillusioned, can cause a lot of problems.

But that potential was there with a flood of buyers with unrealistic expectations, high commissions, and a fixed supply. So, we attempted to dissuade both of the promoters.

One backed away and then came out a few months later with something that was a combination of Berkshire and some other securities, which were at least thought to be in our portfolio.

And we started hearing from people that it was clear had no understanding of what they were buying, or the costs involved, or the potential tax implications, or anything of the sort.

So, at that time, we faced — we had to make a decision, and we had to make it rather quickly, as to what would be the best solution to this problem that, in turn, wouldn't create the same sort of thing that we felt had potential harm when being done by these promoters.

Obviously, we considered a split of the stock. But we were worried that a split would send out signals to all kinds of people who want to believe in things that may not be too believable about future performance and that they would look at it as some grand chance to buy in at a lower price.

Of course, it wouldn't really be a lower price in relation to value. But it would be a lower denomination.

And that, again, against a fixed supply, might very well have created the same kind of problem, maybe even a greater problem, than would occur with the unit trusts.

So, we came upon the idea of the Class B shares, which would create a supply that would match the demand for, in effect, split shares, and that would be offered in a way that did not create special inducements, or to create false inducements to people thinking of buying.

And one of the things we did was we stuck a commission on it, on the issuance of the Class B shares, that was about as low as any I've ever seen in many years in Wall Street, because we did not want salespeople to have a great inducement — we — to go out and sell the shares.

We wanted anyone that was interested to read the prospectus, and think about it, and make their own decisions.

And we did another thing, which is quite counter to the normal commercial approach, which is that we said we would issue as many shares as people wanted to buy.

And, you know, you do much better in this world if you're selling something, to say "only one to a customer," and "you have to get in early," or "you have to know somebody in order to get shares." And many new issues are sold that way, and it's very effective.

I mean, you know, it's like those old stories in Russia where there'd be lines, and people would get in them without knowing what they were going to buy when they got to the front of the line.

And that's a very effective selling tool. And it's one that Wall Street is not unfamiliar with.

But we decided that, to reduce any of that feeling that you have to get in early, or only the big guy's going to get it, or something of the sort, that we would announce loud and clearly that we would have shares available for everyone that wanted.

So, there was no reason to assume that — it couldn't be a hot stock, in effect. And we've done various other things.

So, I — our hope is that the Class B shareholders that we attract are of the same quality as the people in this room, that they have an investment attitude where they feel they are buying into part of a business, that they expect to stay with it for the indefinite future, maybe the rest of their lives.

And they do not think of it as a little piece of paper that may be hot because it's a new issue or something of the sort.

It lets the people who are happy with the present shares stay in exactly the same position, which is what I'm going to do, what Charlie will do.

We have made the B very slightly disadvantageous, in two respects, to the A. It has a lower vote, and it will not participate in the shareholder contributions programs.

There were reasons for both of those, but in addition to the — the explicit reasons, there also is the desire that the B not be made fully — it's just a slight bit inferior —but it's not fully as attractive as the A, because we did not want to do anything that pushed everybody into converting into the B.

If that started in a big way, the B would then enjoy the better market, and it would create its own dynamic where it made sense for everybody to do it.

So we have left it so there's no reason for you, if you own the A, to convert to the B, unless you wish to sell or give away some portion of your holding that would be less than a full A share.

And it will be convenient for that reason. But beyond that, there should be no incentive.

If the B should trade slightly above 1/30th of the price of the A, there will be arbitrage activity that will keep that from being anything other than a negligible amount.

It, of course, could trade well below 1/30th because the B is not convertible into the A.

Charlie, would you like to add anything before we start taking questions on this? And I —

CHARLIE MUNGER: No. (Laughter)

WARREN BUFFETT: — I encourage everyone to ask.

Charlie, as you will note during the meeting, does not get paid by the word. (Laughter)

But we — I encourage every — anyone to ask any question. There are no bad questions about this. I mean, it — last year, we talked about a preferred issue. And people had very valid questions.

I might take those two points of difference between the A and B, just to start with, on the shareholder-designated contributions program, which was $12 a share last year.

In addition to wanting the A to have a very small edge over the B, which would be a reason for not having the B participate, it also would get very impractical, in terms of taking $12, and dividing it by 30, and soliciting the names of charities and to designate contributions.

We can handle the present program fairly efficiently. But we would not want to be sending out checks for a dollar or two, and it would get very inefficient.

So, we have told prospective B holders that that's not going to happen. And so, they're fully informed coming in.

In connection with the vote, the issuance of the B does create more votes outstanding. So, absent any change in the situation, through the issuance of shares which we are not particularly eager to issue, the vote — my vote — will be diluted, somewhat, by this.

And, frankly, I had no desire to create a lot more shares which would dilute the vote of the Buffett family. It will be diluted, somewhat, by this action because we will have all the present votes outstanding, plus some votes from the B.

If there is a lot of conversion to the B, it is true that our holding will go up, percentage-wise. But I see no reason why people really should convert. So, I don't think that's likely. I think, in the end, it'll stay very much the same.

And as I mentioned earlier, we want there to be a slight disadvantage to the B.

In all other respects, we will treat the B just as the A. We have a problem with numbers at this annual meeting. We're going to have to do something next year. And we haven't figured it out yet, either.

But the suggestion was made by someone that maybe the B would get second-class seating or something. We're not going to have any of that. (Laughter)

But from this point forward, with the point — with the exception of two things we put in the prospectus, the B shares will be treated, in every way, as equivalent to A. There —

So, with that, and with Charlie's reluctance to elaborate, we have a six-zone system in here. And then we have another two zones in the overflow rooms.

So, if there are any questions in zone 1, somebody — just raise your hand and somebody will bring a microphone.

Zone 1 is over there. Two is back in the corner. Three, four, five, and six. So it just goes right around clockwise. Just raise your hand and somebody will bring a microphone to you.

4. Class B IPO price is the same for everyone

WARREN BUFFETT: We've got a question, I think, in zone 1.

AUDIENCE MEMBER: Good morning. I'm Marshall Patton (PH) from Bandera, Texas.

And when the price is struck on the Class B shares, those of us who buy our shares through computer programs, do we have assurance that, whoever we buy from, that that will be the price that we pay for these shares?

WARREN BUFFETT: Yeah, the — well, the price — there'll be a price established, probably, Wednesday night or thereabouts of this week. And everybody will pay the same price. And a very high percentage of that price, incidentally, will come to Berkshire.

I mean, there is a very, very low underwriting spread, compared to any other offering.

Now, once the initial offering is — everybody will pay the same price: large institutions, the buyer of one share will pay the same price.

Subsequently, the stock will, we expect, will be listed on the New York Stock Exchange, probably, Thursday morning. And we have the world's greatest specialist here, I believe, Jimmy Maguire, who handles the trading, now, of the common and will handle the trading of both the A and B.

Jimmy, are you here? Do you want to stand up? Just so — there he is. The world's greatest specialist, Jimmy Maguire. (Applause)

I think he leads the singing of "Wait 'Till the Sun Shines, Nellie," too, annually. You can see him on CNBC occasionally, and the Nightly Business Report. I want to give equal time here. The —

But Jimmy will be trading both classes of stock starting Thursday. As I say — as I said, the — it will be impossible, after the first few days, it would be impossible for the B to sell much above 1/30th of the A, because people would buy the A and sell the B if more than a very small — with even the smallest of arbitrage differentials.

But there will be markets in two shares and — in two classes. They will both trade in 10-share lots. That will be the round lot — so-called round lot. Usually the round lot on the New York Stock Exchange is 100 shares. But in the case of both Berkshire shares, the round lot will be ten shares.

Now, I read one or two press accounts that said, therefore, the minimum purchase is ten shares. That's not true. The minimum purchase of each stock — each class of stock — is one share. I mean, you can buy one share or two shares. Or you can sell one share or two shares.

And you have an odd lot differential, just as you would if you were working with less than 100 shares of a company whose stock traded in 100 share round lots. But there's no minimum size in the case of either share.

And you will see, when they get mechanics straightened out, and they may have a little bit trouble with it, but you will see Berkshire A and Berkshire B in — quoted in the papers. And I think that you're — that it'll be quite clear after Thursday what is going on, on that.

I don't know about the computer purchases. But I don't that — certainly, in terms of the initial offering, that will be through one of, I think, 137 people — or brokers — in the selling group. And it's the same, no matter who you deal with.

5. Downside of Berkshire unit trusts

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: My name is David Hendel (PH). I'm from Boca Raton, Florida.

To your knowledge, will this program effectively discourage the unit trusts?

WARREN BUFFETT: Well, it's certainly designed to. And I think the answer to that is yes, because I see no way that a unit trust — either in connection with the initial offering or with the subsequent trading — I see no way that the unit trust could offer people as an efficient and inexpensive way of participating in Berkshire as direct purchase of the B.

Bear in mind, if a unit trust were established, it would have to buy Berkshire shares in the market. So, it would have the costs that people have in buying shares. And, then, on top of it, it would superimpose these other costs. And in addition to the initial commission, they even had a valuation fee.

That was a job I wanted to have because every — (laughter) — three months or however often, maybe every day, somebody, their job was to evaluate this trust value which involved the great skill of being able to locate it alphabetically — (laughter) — in the newspaper.

The figure was left blank as to what the evaluator's fee would be. But I had a feeling that it was one of the more cushy jobs available. (Laughter)

There was an added problem, too. I mean, if these unit trusts started and did not get off the ground very far, they could've become something in the way of orphans. And they certainly would've become expensive to operate.

And, then, with Berkshire paying nothing in the way of dividends, but with the trust incurring expenses, including this evaluator's fee, among others — but with the trust incurring expenses, they would have to sell small amounts periodically to pay the expenses. And that would create tax consequences for every unit trust holder.

I mean, people would not know what — we felt they would not know what they were getting into.

The more serious problem is that somebody would flash our past record in front of them or show them some chart on Berkshire's stock price and say, "You know, this is your chance to do the same thing." And it, obviously, isn't — wouldn't have been.

And — but based on what we have seen, right now, we anticipate the offering being 350,000 shares. But the extent to which the number of tickets involved, that even seeking out informed purchasers only, there's very substantial demand.

So I think if you widen that circle to include uninformed, it might have been quite an experience.

I think the answer is that we will not have a problem with the unit trusts in the future.

6. No plans for Class B secondary offering

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: I'm Adam Ingle (PH) from Boulder, Colorado.

In terms of the number of shares that you're going to issue, B shares, do you plan to just look at the book on Wednesday and issue enough to totally satisfy the demand? And do you have any plans to do a secondary if it starts becoming a hot number?

WARREN BUFFETT: Yeah. Well, I think what we plan is to tailor the size of the offering to fit the demand that appears Tuesday night or Wednesday morning, or whenever the exact moment will be on that. But the offering will be designed to do that.

Like most offerings, I would anticipate that the underwriter will — and this is a supposition at the moment — but I — it's frequently done — would sell some more shares than the initial offering with the intention of creating some short position in the security.

And, then, they have an option to take — from the company — for 30 days up to 15 percent of whatever we initially sell, which protects them on their short position. But the short position also helps in terms of having an orderly market in the stock, subsequently.

But we will, essentially, tailor the size of the issue to the demand as it appears to us midweek.

We have no plans for any secondary offering. I think this has been sufficiently publicized. There's a large network of selling group members. So that people that are interested, but wanted to buy in a smaller denomination, will have had their chance.

I think there will be a — well, present indications, there'd be 350,000 shares out. There would be a fairly large — a large — number of holders based on what we're seeing.

So, the market should, starting Thursday morning on the exchange, there should be, in my opinion, a reasonable market based on that kind of quantity and the number of people buying. And so, I anticipate nothing subsequently.

7. We don't think Berkshire shares are "undervalued"

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Can you hear me?

WARREN BUFFETT: Yep.

AUDIENCE MEMBER: My name's Tom Conrad (PH). I'm from McLean, Virginia, and I (inaudible) to this meeting and tell all my friends and family members to buy it last week. But I've been reading in some publications that you said that you would not advise your friends and family members to buy it at its current pricing.

And I'm just concerned, if I go out and run and tell them why you're saying — what your feeling would be, should I go tell my friends and family members? — (Laughter)

WARREN BUFFETT: I think I'll leave that one up to you. What I said — (laughter) — I said, at present prices, Charlie and I do not think Berkshire stock is undervalued. And that, now that is not what's gotten reported sometimes. I mean, sometimes people have said we thought it was overvalued.

We did not — if you look at the prospectus or if you look at the — if you look at the prospectus, you will see that what we said was we do not think it's undervalued.

Now, I find it somewhat entertaining that people regard that as kind of an amazing statement by somebody making a public offering.

But if you think about it a bit, can you imagine a management that goes out and says to the world, "We are selling you something — in a new stock — and it's way undervalued."

What do you say to your present shareholders if you go out and say to the public, "We're selling you something that's worth a dollar, and we're going to sell it to you for 80 cents?" Now, that would leave me very unhappy.

So, I feel that any management that is talking about selling their stock and they say it's very undervalued, either doesn't know what's good for their present shareholders or they may have their tongue in cheek.

We would not be selling — we would not sell a part of your interest in Berkshire at a price which we did not feel was adequate for the present shareholders. It's that simple.

If we sell 1 percent of the company, and 350,000 shares is close to that figure of B, we are selling 1 percent of your ownership in See's Candy. We're selling 1 percent of your ownership in GEICO. We're selling 1 percent of your ownership in The Buffalo News. Those are all valuable assets.

We have no intention of selling 1 percent, or 10 percent, or the hundred percent of any of those entities at a price that is not fair to present shareholders.

That doesn't mean it's unfair to new shareholders, but we're not going to — we would not be selling the stock if we thought it was undervalued.

I'm not sure what we would've done if we'd had that position when the unit trust came along. But we have — and put in the prospectus — but we are not selling any of our shares. Frequently, on a new offering you see present holders. But, you know, I have very close to 100 percent of my net worth in Berkshire and it leaves me quite happy.

I've got a trust I run set up in 1964. I'm the sole trustee. I can do anything in that trust I want. And I'm freed by the person who set up the trust of responsibility for a concentration of investments. And I have some members of my family who are beneficiaries of that trust.

That trust owns nothing but Berkshire Hathaway stock. That doesn't bother me at all. That — I'm not recommending purchase. But I'm perfectly happy owning Berkshire.

But we do not want — (applause) — we do not want people to think, when they buy into Berkshire, that they're buying something that's undervalued, because it's not.

And we say in that fourth caveat on the prospectus that we want people to buy it only if they expect to be holders for a very long time.

Charlie and I expect to be holders for a very long time. And, in fact, you may see us up here sometime where we don't know who the guy next to us is. (Laughter)

But we'll put on an act, though. (Laughter) The — we —

You know, that is our attitude toward Berkshire. We do not want people to come in who think it's going to be a hot stock or selling for more a year from now, because we don't have the faintest idea whether it's going to be selling for more or less a year from now. Never have had.

We do think that to the extent that Berkshire attracts a special class of shareholder that really looks at themselves as owning a part interest in a business, like they'd own a part of a farm or part of an apartment house, and they expect to hold it, really, for the rest of their lives, we think that it's a perfectly sensible thing to do because we're doing it ourselves. But we don't want to go beyond that.

8. No plans for the Class B proceeds

WARREN BUFFETT: I'm not sure whether we got zone 4. Can we go back there?

AUDIENCE MEMBER: My name is Gordon Shepherd (PH) from Montreal.

I wondered whether you had any plans for what to do with the money? (Laughter)

WARREN BUFFETT: Well, the answer to that is in the prospectus, but the — we have no immediate plans for the money. But we've faced that situation a number of times.

I mean, the money — the inflow of money and outflow of money should not be, in our view, attempted to be matched too carefully in this world, because you get investment and business opportunities at times that differ from the times that funds come in.

And one of the most important disciplines in running a business or managing investments is that — is to not get your — not to try to coordinate your actions simply with the availability of cash.

Over time, we found a way to use money. It's much tougher for us to run 17 billion than it was when we had 20 million in the business. There's no question about that. And we pointed that out many times. And it'll get tougher still if we get larger, which I hope we do.

But the fact that, if 400 million comes in on this offering or whatever, that's really no different than 400 million coming in in some other manner.

And when our float grows, we take in more money. When our earnings are retained, we take in more money. When we have — I forget what the check would've been on the Cap Cities transaction, but it was certainly well over a billion dollars that came in on a single day.

So, money's fungible, and we have to keep looking for bigger and bigger things as we go along. And that's what we do focus on.

But it doesn't bother me to take it. It wouldn't bother me if we weren't taking it. It wouldn't bother me if we took in three times as much. It doesn't make a lot of difference.

And we will have — we — the constant challenge for Charlie and me is to allocate capital is we go along. And it's a nice challenge. (Laughter)

9. Discouraging buyers with unreasonable expectations

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Hi there. Lee Debroff (PH), long-time shareholder, I think, going back a number of years now to when it was a little more intimate affair. Not quite sure whether I should look at you in the TV here or in real life, on stage. But anyway, I'm on the very right of you.

And I see all the guards around you, and I see all the security and that sort of thing. And then, I see this offering of the Class B. And I sort of wonder whether, from your perspective, you feel you might be in the same boat that the pope and the president are?

And I mean this absolutely sincerely, because I don't think that you have, perhaps, as good a handle as some of us do on the renown that you carry outside of Omaha, Nebraska. People who have no idea what investments are about are fully aware of who you are.

And when they see this offering, I think you may find that there are substantially more people who are interested in just having a piece of you for the sake of saying they have a piece of you than having absolutely any idea what they're doing.

And I notice that on — I try to read the fine print here — on page 14, first paragraph, second line, that you indicate some 50 million shares of Class B common stock may be offered.

And so, I'd like you to comment on this situation that you find yourself in, where you may be, perhaps, out of touch with the popularity that you have.

WARREN BUFFETT: Well, my first reaction: maybe I should tell my barber we could save the clippings and sell them. (Laughter)

The — I don't think it's quite as extreme as you say.

But, you know, I — in relation to the 50 million first, we have to authorize enough shares, because we are going to allow every share of class A — or present common stock — but the class A, to convert to B.

So we have to have the shares authorized to take care of 30 times the present one point almost two million shares. So, 36 million shares, in effect, are reserved for the present common stock. And, as long as we were authorizing it —

Well, we need that much, or we wouldn't have the shares actually available if everybody came around to convert. That's not going to happen. But we still have to be prepared for it.

We have no plans to issue a lot of shares. The — but the point you mention, which I think you stressed a little more than I would've, but the — that is what we were worried about, in terms of the unit trusts.

There are people that think that it can all happen again from this kind of a base which, you know, is mathematically a joke. And Charlie and I would settle for one whole lot less, you know, right today.

And we have done everything we can — I mean, if we hadn't done this, the unit trusts would've moved forward. And I think they would've cashed in on that phenomenon you suggested.

And in a few years, you know, it would not — I would've been in a somewhat different position because people can get very disillusioned if they have hopes that aren't realized.

And we have done everything possible, I think, to filter out those who might have an unrealistic belief.

And everyone should read a prospectus before they buy shares, and —

I think we have tailored — we've designed what we're doing about as well as we can to moderate that phenomenon you're talking about. There may be a few come in but not too many.

Charlie, do you have any thoughts on that?

CHARLIE MUNGER: Well, if we only issue the amount we're now talking about, it's sort of a non-event around Berkshire. It'd be 1 percent —

WARREN BUFFETT: Yeah. It's 1 percent.

CHARLIE MUNGER: — or something like that of the —

It solves the problem of these disreputable followers — (laughter) — and 1 percent, what does it matter? (Applause)

WARREN BUFFETT: Wait, you heard that remark, referring to Charlie earlier, about all I want to know is where I'm going to die, so I'll never go there. (Laughter)

Well, we think about that, in terms — we believe in reverse engineering.

And how do we keep people from buying it, who really are going to be unhappy, you know, a few years later?

You know, it's a little like singing country songs. You all — you should sing them backwards. That way, you get your home back and your auto back and — (laughter) — your wife back, and —

10. Almost like buying direct from Berkshire

WARREN BUFFETT: Zone 6? Have we got —?

VOICE: There was a hand over here, wasn't there? Here. Right here.

AUDIENCE MEMBER: Good morning. I'm Rena Lowie (PH) from Chicago, proud to be here. At mic —

WARREN BUFFETT: Where are we? Oh, over here. OK.

AUDIENCE MEMBER: I have a question that's been asked me, and I really don't know. Several people wanted to know if they could buy directly from the company.

WARREN BUFFETT: The answer to that is no. But Salomon Brothers is the underwriter of the issue. They have a hundred and, I think, 37-or-something broker-dealers, all — virtually all — the major ones in the country, in the selling group.

The cost to the company of doing this are really very, very low compared to any issue I've seen. When AT&T had their spinoff — or sale of Lucent — which was close to a $3 billion deal — you know, their percentage costs were more than double what our costs will be, for example, on this offering of Berkshire.

So, it's almost as if you're buying it — a Class B holder — is buying it from us, in terms of the, what I would call the frictional costs involved of getting the issue done. In fact, if we handled it ourselves, it might cost more.

But the company, itself, is not a broker-dealer. And it's — it would require a whole group of different hoops to jump through in order to have a direct issue. It will be sold only through broker-dealers.

11. All-Berkshire mutual fund for retirement plans?

WARREN BUFFETT: Zone 7?

This will come in from another room. Here we are.

VOICE: There aren't any questions in zone 7.

WARREN BUFFETT: No questions in zone 7. Zone 8?

VOICE: No questions from zone 8.

WARREN BUFFETT: OK. Then, we'll go back to zone 1.

AUDIENCE MEMBER: Mike Rocker (PH) from Flint, Michigan, God's country.

I noticed in the press, when this issue of the unit trust was going on, that there apparently also were some people trying to form mutual funds to carry Berkshire stock, which I kind of thought was a good idea, because there's one potential class of Berkshire owners that could only own Berkshire stock via either an open-end mutual fund or a closed-end mutual fund.

And that is those thousands of teachers and hospital employees whose future retirement money is in 403(b) plans that are limited to investing in mutual funds only. And so, I wonder if, first of all, if you were aware of that? And if so, if you considered that? And if not, if you might?

WARREN BUFFETT: Well, the answer is I wasn't aware of that. So it wasn't considered.

There are, of course, some mutual funds that own Berkshire shares. But there's no all-Berkshire fund, outstanding.

I would say this: that if the law was set up to, in some way, to restrict investments of this group you're talking about to options that involve mutual funds but that don't involve individual stocks, I would think it might even be regarded as a way around it, if a fund owned nothing but one stock.

Because, if you can't buy General Motors directly under, I assume, the relevant rules or statutes on that, it would seem that a fund that owned nothing but General Motors might be regarded as a way of getting around that.

But the answer is that it was not considered. I don't know where the rules are derived, whether there — whether they can be changed by some organization or they're part of some statute.

But if they're part of some organization, by a vote of their directors, they might be able to allow purchase of individual stocks within those plans that you describe. But if not, it does seem to me that an all one-stock fund is — might be regarded as simply a way around the rules.

12. Suggestion for Class B symbol

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Alan Rank, Pittsburgh, Pennsylvania.

Have you determined what the symbol will be for the Class B?

WARREN BUFFETT: The symbol? No, we haven't.

AUDIENCE MEMBER: May I make a suggestion? As a broker, the stocks that have come out and given theirselves Class A and Class B cause massive confusion.

If there'd be any way to make symbol something like BRB and just keep it a simple, three-letter symbol, it aids people both in following it on the tape on CNBC. As brokers, four-letter symbols on the New York restrict a lot of things we can do as far as punching them in.

If there's any way you could keep the symbol for the B a simple one, two or three-letter symbol, it would be greatly appreciated.

WARREN BUFFETT: Well, thanks for the suggestion. Now, the exchange has generally been exceptionally cooperative in trying to work with us. I mean, a 10-share trading unit is no piece of cake for them.

And I'm sure, at times, that they have wished we were a little more like some of the other companies that list on the exchange. But they've been very cooperative and helpful. And we are — they'll — they listen to things we suggest. We listen to things they suggest.

So, we will try to do whatever facilitates things at the exchange and the reporting of prices. And it's nothing we will try to impose on them, believe me.

I have no favorite name that I'm looking for. So, we'll see what they — what ideas they have. And we'll include that suggestion.

13. Not expecting big change in Class B offering size

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Paula Finster (PH) from Tulsa, Oklahoma. Very glad to be here. I'm one of those few second generation, finally finagled a ticket out of my dad. (Clears throat)

Three years ago —

WARREN BUFFETT: Her dad has a soda fountain, incidentally. If you're ever in Tulsa, be sure to see him. (Laughter)

AUDIENCE MEMBER: He certainly does. And you're certainly invited to come back. (Laughter)

I was here three years ago for the movie theater. And considering the growth — I know you won't leave your beloved Omaha — but maybe you could build a stadium with — that's covered — (laughter) — considering the growth — (Buffett laughs) — with adequate parking. (Laughter)

Here's my question. You said there's going to be unlimited offering, as much as they want. This question is not designed to get a rise out of Mr. Munger, however —

WARREN BUFFETT: That's not easy to do. (Laughter)

AUDIENCE MEMBER: Understood, considering the bridge game of yesterday.

Anyway, my question is, you're authorizing up to 1 percent. What happens if it goes bananas, as zone 5 suggested, and it goes greater?

You said this 1 percent is yours. Is the next 1 percent yours? Is the next 1 percent ours? Do — I know we are limited partners. And you're a controlling partner. But how far does this ballgame go?

WARREN BUFFETT: Well, in terms of the size of the offering, it — whatever the size of the offering, it affects everybody economically the same. I mean, our shares are no different than the ones than the people in this room.

So, we do not care, from an economic standpoint, whether the issue turns out to be approximately 1 percent or whether it was 1 1/2 or 3/4 of 1 percent.

It simply — as long as we're not selling the stock below its true value, we are not going to be hurt by it. So, that —it's inconsequential to us. We're not going to be helped in any significant way by a large sale.

The — it would appear, to me —we're just a few days away from the offering, and it's been out there awhile.

So, I would doubt if there's huge changes. But I don't know the answer to that. I mean, that could depend on what happens in the general stock market.

But I don't think you'll see any huge change in the offering. If there were a big change, we, obviously, would very promptly let the SEC know. The SEC has wanted us, as we have seen changes in demand as we've gone along, promptly change the size of the offering. And the covering page gets modified.

And we've done that. Every day as indications come along, we've tried to be responsive to their instructions on that. And the 350,000 shares is our best estimate, as of last Friday, and —

We'll look at it the next day or two. But I don't think it's going to change dramatically. I don't know, though. I don't want to — I'm giving you a definitive answer on that. But it's just my — it's a strong impression. Thank you.

14. Only Class B questions

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Mike Assail (PH) from New York City with a question for Charlie —

WARREN BUFFETT: Good.

AUDIENCE MEMBER: — about his investment models.

I'd like to know the most useful models on industry consolidation, vertical integration, and models which explain the special cases when it makes sense to invest in retailing stocks —

WARREN BUFFETT: Ah, well, I think —

AUDIENCE MEMBER: — and if —

WARREN BUFFETT: — I don't want to interrupt you now, but I think we'll save those to the general question and answer. This is only on the issuance of the Class B right now.

AUDIENCE MEMBER: Oh. Sorry, sorry.

WARREN BUFFETT: But we're glad to have that question later on.

AUDIENCE MEMBER: Sorry.

WARREN BUFFETT: It'll give Charlie time to figure out the answer for one thing. (Laughter and applause)

We'll go through all of the questions regarding the Class B. And, then, we'll have a vote on the class —authorization of the Class B. And, then, we'll get into general questions and answers.

15. Do B shares penalize Class A shareholders?

AUDIENCE MEMBER: Sir —

WARREN BUFFETT: Somebody over there — we'll take another one from zone 4 if there's somebody — monitor.

AUDIENCE MEMBER: Mark Findidi (PH) from Connecticut. I'll apologize ahead. This isn't meant to be an impudent question or — in any way, shape, or form.

Do you think that the issuance of the B, in any way, might — in an effort to protect the folks who might be out there suckered in by the trust, if you will — in any way penalizes the A shareholders, either, one — or might penalize them — either, one, financially or, two, philosophically in the BRK experience?

I don't mean that in any kind of elitist fashion, because I don't think you've ever propagated that. BRK doesn't propagate that. But clearly, there's a room full of people — or rooms full of people — who have made a commitment financially to show that their philosophy is with you. Does that get diminished?

The other part of the question is the trusts, as you portrayed them, didn't sound terribly attractive. In a longer term, would they, perhaps, have ultimately failed as folks realize that they hadn't gotten into what they thought?

WARREN BUFFETT: Well, they might've. But I think the rub off would've been on us rather than the promoters of the trust — might've been on the promoters, too. But in terms of the failure of the trust, I don't mean failure in an absolute sense, but in terms of disappointing their investors.

I really think if tens of thousands or hundreds of thousands of people had come into something that was sold as being an all-Berkshire-type trust, if people came away disappointed in some years, I think they would tend to project that disappointment upon Berkshire fully as much as the promoter who sold the trust, who they might not even be able to find at that time.

The first question, you know, this — I don't think — we wouldn't be doing this if we thought it would hurt present shareholders, we — as much as we might detest something else that was going on. And we designed it so it — we felt that it wouldn't hurt present shareholders.

In terms of them having a philosophy — the new shareholders having a philosophy similar to the present ones — we've tried to filter those out coming in.

But I intend, after the offering, to send out a booklet, you know, kind of like freshmen at college, you know, orientation, greetings to Siwash U.

And we'll send it to everybody, new shareholders and the old shareholders, explaining our philosophy, just as an orientation course on the company. And we'll get that out, probably, in a month or so after the offering settles down.

I don't see any reason that — you know, Berkshire has evolved over a long period of time. We had 12 shareholders at the annual meeting 15 years ago. And it — we seem to be able to retain the same class and group of shareholders, in terms of people who really understand the business. It's a different group than you find at other companies.

And I think we can — as long as we've had this filter in effect, operating as new people join us, I think we can keep it.

Charlie?

CHARLIE MUNGER: Yeah. If the offering went wild and you issued 3 percent of the company, new, you're also taking in a billion-odd dollars. It is a — it's a non-event for us. (Laughter)

WARREN BUFFETT: He's very excitable. Don't say anything to him. (Laughter)

16. Berkshire can't match previous gains

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Ed Johnson (PH) from Park City, Utah.

As you receive the proceeds of the Class B sale and generate other cash, are you seeing opportunities out in the marketplace to continue to provide the kinds of returns that we've been fortunate enough to experience in the past?

WARREN BUFFETT: With or without the sale of the B, we don't see things to do that can maintain anything close to the average returns of the past. We've tried to convey that.

And it becomes a mathematical absurdity. Money just won't compound at that rate in this world, absent extraordinary inflation. It certainly won't compound in real terms.

So, absent the issue of the B, we are not looking at them. We're not seeing things. We're not hoping to find things that match some of the things that we have found in the past, relative to the capital base we've had in the past.

But we have that problem with or without the B. And it has not changed in any, even very minor degree, by the issuance of the B.

We are looking for things all of the time. Anytime we find anything that makes sense to us, we will do it.

The harder part is to make sure that we don't do something when we don't find something that makes sense. I mean, that's the bigger worry.

And when we find them, you know, they'll come along. And you never have — you never know when it's going to happen.

We run into businesses — I described a little bit of that in the annual report — almost by accident that we've had — contracted to make one purchase this year. The people who run it are here today. And it came about because I was attending a birthday party. And, you know, I'll go to more in the future. (Laughter)

So, things have not ended around here. We'll find interesting things to do over time. But they can't remotely be as profitable as the things we've found in the past, simply because of the large capital base.

17. Not expecting volume spike for B shares

WARREN BUFFETT: Zone 6?

AUDIENCE MEMBER: Hi. I'm Matt Zuckerman from Miami.

I don't know, I think Charlie is the same class as Ev Dirksen. You know, $3 billion, we'll soon be talking about real money. (Laughter)

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: The two questions I have, basically, are, one — number one, referring to the gentleman over here before who commented on your popularity, which will definitely affect the stock, don't you think —?

And the second part of that is that even my wife's beautician has put in for some shares of this stock, and he represents a small tip of a large group who are probably doing the same thing on the one hand, so that there's going to be a large popular demand for the stock, which probably is not reflected in the numbers that the selling brokers are getting from institutions.

And number two, mutual funds themselves, in order to lend some panache or glamour or whatever to their portfolios will certainly be sucking up Berkshire stock after this.

And have you taken all of this into consideration when you decided upon the number of shares to go — that you're sending out, number one?

And number two, that the reaction, at least in the first 14 days, of the public to the shares, which will probably be in the range of $1,100, might not send the B shares up high enough to make a very, very interesting spike in the price of the A stock.

WARREN BUFFETT: Well, I — we've considered what you're talking about. I think that the issue has been well enough publicized that the demand will largely be reflected on the books of the underwriter in a day or two.

And I see no reason at all for a spike in the stock. I mean, the way we've designed it should really prevent that. We — and we tell people not to expect it.

If any institution wants to buy it, if any individual wants to buy it, they're going to have a chance to do it.

And I don't see any reason why there should be some huge influx of people immediately subsequent to the offering that didn't hear about it during the offering period.

It's interesting. I think most of the demand will be retail and smaller holdings, not so much institutional.

The — most new offerings are done in a manner where the idea is to have far more demand than supply, and therefore cause people to, maybe, order stock they didn't even want, and just on the idea that this restricted supply will cause a big jump the first day, whether, you know — you've seen Yahoo or a number of other offerings.

I think — I don't personally like that sort of distribution arrangement because you'll find that 30 to 40 percent of the issue will, perhaps, trade the first day. Well, I think — and, perhaps, at a lot higher price.

I think there's something a little wrong with that kind of an offering, because the company obviously isn't getting the proceeds that are equivalent to what people are willing to pay. And favored customers get the chance to flip the stock and really are getting paid an exorbitant underwriting fee themselves, even though they're called purchasers, because they sell it the first day.

We will be very interested in seeing the volume in the B stock the first couple of days, relative to the amount of the issuance.

And I will be disappointed and I'll be surprised if the trading volume in the B stock the first couple days, related to whatever the size of the issue is, turns out to be anywhere near as high as with most new issues.

I think that we will have a better success in finding people who really want to own it and who did not buy it to flip it, I think, by this method of distribution. But we'll have a test of that. We will see what happens in trading volume.

And I invite you to look at the volume and compare it to the amount we issue and, then, look at that relative to other new issues this year and just see how successful we were in finding real investors rather than people who were buying it to sell it to somebody else the next day.

18. Buffett's visibility and safety concerns

WARREN BUFFETT: Let's see, was that zone 6? I guess we go to zone 1.

(Long pause)

CHARLIE MUNGER (quietly to Buffett): Maybe we can vote.

WARREN BUFFETT (quietly to Munger): Yeah, but I don't want to cut off —

VOICE: Uh —

WARREN BUFFETT: Charlie says maybe we can vote, but I do — I want people to have their questions — (Applause)

It just encourages him when you do that. (Laughter)

I want to be sure people get their questions answered on this. I don't want to prolong it beyond —

If you feel your question has been 95 percent answered by an earlier question, I hope you'll skip asking it.

But we do want to have people that have questions about it answered, because I can tell by commentary and letters I've received that some people have genuine concerns. Yes?

AUDIENCE MEMBER: My concern — oh, my name is Jan Anglin (PH). I'm from Southern Indiana. And this is my first Berkshire meeting.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: I did have a concern about the B shares that's less business and more — I guess it would be concerned with your and Mr. Munger's personal safety.

I often see your picture in the newspaper. And I certainly don't mind seeing it on financial magazines, but now, it's kind of, like, proliferating. I don't like the idea that you are so visible. (Laughter)

That bothers me. It's — I mean, do you understand what I'm saying?

WARREN BUFFETT: No. I understand exactly.

AUDIENCE MEMBER: This isn't —

WARREN BUFFETT: It's occurred to me. (Laughter)

I appreciate that, and I — but the answer is there's no other way, I mean, if —

AUDIENCE MEMBER: OK.

WARREN BUFFETT: — over time

AUDIENCE MEMBER: But can —

WARREN BUFFETT: — in terms of what happens. And —

AUDIENCE MEMBER: So —

WARREN BUFFETT: — as it grows, you get more visible, basically.

AUDIENCE MEMBER: Oh, I know. But along with the B shares and things, can you, kind of, like, be quotable but less available for photos? (Laughter)

WARREN BUFFETT: Well, I normally am. I — if you've noticed, in terms of interviews or anything of the sort, I do not do them. I've been invited to go on all of the news shows. And I, basically, don't do it.

Frankly, with the shareholders, I feel differently about this group. I'm delighted to see everybody come here. And I enjoy getting together with the shareholders. (Applause)

I think the real protection is, if we'd done something that had caused the stock to balloon way up and then come way down, I might have had to be a little more careful. (Laughter)

CHARLIE MUNGER: I think she has a very good idea. Having seen that acting — (Laughter)

I think hereafter, maybe you should be the voice of Mickey Mouse. (Laughter)

WARREN BUFFETT: I do appreciate the sentiment out of everybody. And there is a — it is unavoidable, to a fair degree. Although, Charlie may have thought I wasn't pushed into those acting jobs.

19. Class A "forever" convertible to Class B

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: This Joe Greer (PH) from Omaha, Nebraska of all places. (Laughter)

Regarding the conversion privilege, is there a time limit on the converting from the A to a B?

WARREN BUFFETT: No. That's a good — I'm glad you asked that question.

The first five days or so after issuance — business days — there's no conversion. But after that, you'll be able to convert until judgment day. It's forever convertible from A to B. But it's not convertible from B to A.

So there's no need to convert it until you have a reason to do so. It — and as I've pointed out, there's a very slight disadvantage in converting. And I wouldn't — until I had a need, I would not convert it.

20. How to convert Class A shares to B

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Scott Dowling from Redmond, Washington.

Kind of related to this question, as an A shareholder, I can only see really two reasons to convert A shares into B shares, one of them being gifting reasons.

In regard to that, how does one convert A shares into B?

WARREN BUFFETT: Yeah. That — yeah, there are instructions on that in the proxy statement as to how that — I guess it's in the annual report, too, that it describes how to do it.

But, basically, you get in touch with the Bank of Boston to do that and proceed from there. Or if you have your shares with a broker, you would instruct your broker to do it.

21. Class B price meant to discourage unreasonable expectations

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Good morning. I'm Ruth Owades from San Francisco.

I wondered, how did you decide that the ratio of the Bs should be 30-to-1 instead of 300-to-1 or something in between?

WARREN BUFFETT: Yeah. We wanted to have something that was roughly — would trade, initially, at least, in the thousand-dollar range.

We thought it very unlikely that anyone would find it commercially feasible to set up a trust that offered units that were denominated much below that.

So, that's as low as we felt we had to go. And we did not want to signal, in any way, that, you know, some sort of last chance, or something like that, to get in for some very low sum for people that, you know, just had some wishes that they could turn a hundred dollars into 100,000 or something.

I get letters from people that, you know, think that somehow that can be done. It can't be done.

And we don't want to appeal subliminally or any other way to people who harbor those hopes.

I'm sympathetic with them. But we don't have the answer to that. So, we went down to the level to match the unit trusts.

22. B shares will increase book value, but not intrinsic value

WARREN BUFFETT: Zone 5?

We'll try and do — we'll try to end the questions on the B fairly soon. But I don't want anybody that feels that they've got a — got some reservations about this — not to have a shot at asking their question.

AUDIENCE MEMBER: My name is Bob McClure (PH). I live in Singapore.

And the way I figure it, the sale of the B shares at the price they will probably be sold, will give an immediate boost to the book value of Berkshire Hathaway. So, as far as I'm concerned, the more the merrier.

Can you give us your thinking on that, the accounting treatment, how this will affect the book value of Berkshire?

WARREN BUFFETT: Well, any sell — shares we sell at the equivalent per A share of in the range of 33,000 or thereabouts, where the stock is selling now, will increase the book value per share.

But that does not mean it increases the intrinsic value per share.

I've said many times in the report, we use book value as a proxy in tracking movement of intrinsic value. But it does not represent anything like intrinsic value per share.

And the key is not what it does to book value per share, but what it does to intrinsic value per share. And, you know, we believe the intrinsic value is materially higher than the book value.

We don't spoil your fun by ever giving you a number. But — (laughter) — we do not regard the fact that it increases the book value per share as being any kind of a determinant in deciding to issue the shares.

But it will have that consequence mathematically. The key is the relation to intrinsic value.

23. "The facts are out on what we do"

WARREN BUFFETT: Zone 6?

VOICE: I think there was a question over here.

WARREN BUFFETT: Any questions in six?

VOICE: Behind you.

AUDIENCE MEMBER: Your problem seems to be that you've attracted a fair number of potential shareholders that don't have a way of estimating intrinsic value or developing expectations about what Berkshire's future prospects are.

Now, do you have any suggestions about how they might do that, short of the general guidance that you can't continue to compound your intrinsic value at the same high rate that you have in the past because of your asset base, and that you don't believe the share is undervalued?

WARREN BUFFETT: Yeah. Well, we'll probably talk more in the general question and answer period about our various businesses, but we simply try to give you all of the information about our businesses in a large, general way that Charlie and I consider important and that we would want if our positions were reversed.

I can assure you that if all Charlie and I knew about our businesses, what we've publicly disclosed, it would not change our estimates from what they might be from being intimately involved with the businesses. The facts are out regarding what we do.

So, you are in the same position to the extent that you have followed our kind of businesses and understand industry conditions and all of that.

And we'll continue to do that. We essentially regard you as our partners. And we tell — we try to tell you exactly what we, as partners, would want to know if you were running the place. And we'll continue to do that.

We won't tell you a number because we don't know the number. We have a range in our mind. Things change that range over time. And we'd probably get in all kinds of trouble if we tried to put out that range.

And Charlie and I would not come up with exactly the same range. But they'd be pretty close. We'll talk more about that a little later.

24. Shareholders approve Class B shares

WARREN BUFFETT: We do have questions now from zone 7 and 8 in the other room. So, we'll take on zone 7, please.

VOICE: I guess you've answered our questions in seven.

WARREN BUFFETT: Oh, took care of zone 7. How about zone 8?

VOICE: No questions from zone 8.

WARREN BUFFETT: Oh, OK. (Applause)

I think, at this point, we can move on to general questions after we have this vote.

And then, if you have another question or two that comes up during the general question and answer period, I'll be glad to — we'll be glad to work those in at that time.

So, we are now at the point: is there a motion to adopt the board of directors' recommendation?

WALTER SCOTT JR.: I move the adoption of the amendment to the fourth article of the restated certificate of incorporation that's set forth in exhibit A of the company's proxy statement for this meeting.

VOICE: I second the motion.

WARREN BUFFETT: The motion has been made and seconded to adopt the proposed amendment to the certificate of incorporation. It says here, "Is there any discussion?" but I'm not going to say that. We are ready to act upon the motion.

If there are any shareholders voting in person, they should now mark their ballot on the proposed amendment to the certificate of incorporation and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the proposed amendment, voting the proxies in accordance with the instructions they have received?

Mr. Fitzsimmons, when you're ready, you may give your report.

ROBERT M. FITZSIMMONS: My report is ready. The ballot of the proxy holders received through last Friday cast not less than 970,495 votes in favor of the proposed amendment. That number far exceeds the majority of the number of all shares outstanding.

The certification required by Delaware law regarding the precise count of the votes, including the votes cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Mr. Fitzsimmons.

The amendment to the certificate of incorporation, as set forth in exhibit A to the proxy statement for this meeting, is approved.

After adjournment of the business meeting, I will respond to questions that you may have that relate to the business Berkshire but do not call for any action at this meeting.

Anyone have any further business to come before this meeting before we adjourn? If not, I recognize Mr. Walter Scott Jr. to place a motion before the meeting.

WALTER SCOTT JR.: I move this meeting be adjourned.

VOICE: I second the motion.

WARREN BUFFETT: The motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say, "Aye."

VOICES: Aye.

WARREN BUFFETT: All opposed say, "No." The meeting's adjourned. (Applause)

25. Berkshire is more than its breakup value

WARREN BUFFETT: Now we'll to move to a — to general questions. And we'll do it by the same zone system.

As I said earlier, any of you are free, obviously, to leave at any time. We will break formally at noon and reconvene about 15 minutes later, after you've all had a chance to buy a sandwich, and you can — (Laughter).

Those in the other rooms can come in here. And we will go from then until about 3 o'clock.

So, we'll start in with zone 1.

AUDIENCE MEMBER: I'm Will Jacks (PH) from Chicago. I'm sort of representing Benjamin Graham today, the question he might ask.

You talked earlier about how you — about the value of your shares, the A shares, let's say, because the B is tied to the A.

But — and I know it — I don't expect a complete answer, but generally, how would you go about placing a value on the A shares?

WARREN BUFFETT: Yeah. Well, that's obviously a key question. As I've said, we try to give you the information.

But I think people, to the extent they've made a mistake in the past in valuing Berkshire — and they have made this mistake over time, including many commentators, including some institutions — is to look at it as simply a breakup value to our businesses.

I mean, you know, you can — you could do the same with General Electric, we — a magnificently run operation by Jack Welch. But I don't think the way you should look at a business like General Electric is to think about what would happen if they sold each division today, paid the taxes, and then distributed the proceeds.

And that has tended to be the case with many people looking at Berkshire, looking at it on a static basis. And that is not the way that Charlie and I have looked at it over time.

It lends itself a little more to that kind of analysis because we have a lot of money in marketable securities. But we have a lot of money in other things, too.

And the question of Berkshire, in valuing the intrinsic of any business, of course, is what is going to be the stream of cash over many years in the future — in fact, all of the years in the future, discounted back at an appropriate interest rate. I've talked about that in the past in the annual report.

Berkshire is a collection of businesses. And some of which we own in their entirety, some of which we own part of. And some of those businesses have very interesting dynamics to them.

And they — the value of our insurance business, for example, if you go back 26 — what was it? Twenty-eight years or so since we — 29, I guess — since we bought it from Jack Ringwalt. We paid 8.7 million, I believe, 8.4 — 8.7 million for two companies that Jack controlled.

If you had the foresight at that time to — and I didn't, but — if you had the foresight at that time to see what that would develop out of that insurance business, you would've come to the conclusion that their value to us was going to be far, far greater than the value at which they were then carried on our balance sheet. They were part of a business which had enormous potential.

And that's been, probably, the most significant asset that's been developed at Berkshire. But right now, we have over seven — right at 7 billion — over 7 billion — of float that's been developed from our insurance business.

We couldn't foresee that 25 or 30 years ago. But it would've been a big mistake to think in terms of the book value of that business being representative of its actual value to us over time, if it was run right.

And that situation probably prevails today.

So, it's a — Berkshire is a group of, on balance, very fine businesses to which we hope to add.

The intrinsic value will be affected by the job we do in allocating capital. It'll be affected by the job our managers do in running their businesses. It'll be affected by some items that we don't foresee now and, perhaps, have no control over.

But it is not measured, essentially, by what we could sell each separate business for and pay the tax on now. We haven't run it that way. We've run it so that we get the use of a lot of capital at very low cost.

Between deferred taxes and our insurance float, we have some 12 billion or so on the liability side that we think will be a very low cost. And that's — doesn't show as an asset, but it can be quite valuable.

Charlie, you want to —?

CHARLIE MUNGER: No. I don't think I've got anything to add to that.

WARREN BUFFETT: Oh. I was all set to write it down, too. (Laughter)

26. Buybacks at what appear to be high stock prices

WARREN BUFFETT: Zone 2, please.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, I'm Tim Medley from Jackson, Mississippi.

My question is an allocation of capital one. You've indicated that one thing you like in companies is a willingness on the part of management to repurchase its own shares.

I wonder if you would talk for a minute about your own frame of reference on repurchases when it appears that the current price of the stock is rich in relation to its intrinsic value.

And some have said that, with the right company, ongoing repurchases of stock should be made, irrespective of the price.

So, would you speak for a moment, as to how you think it pencils out when the current price of the stock is rich in relation to its intrinsic value?

WARREN BUFFETT: Yeah. If you're repurchasing shares above a rationally calculated intrinsic value, you are harming your shareholders, just as if you issue shares beneath that figure, you are harming your shareholders.

That's a truism. Now, the tough part of that, of course, is coming up with the intrinsic value.

And, for example — a good example might be Coca-Cola.

I think a number of people might have thought Coca-Cola was repurchasing shares at a very high price, because they'll look at book value or P/E ratios. But there's a lot more to intrinsic value than book value and P/E ratios. And anytime anybody gives you some simplified formula for figuring it out, forget it.

You have to understand the business. The people who understood that business well, the management, have understood and been very forthright about saying so over the years, that by repurchasing their shares, they are adding to the value per share for remaining shareholders.

And like I say, people who didn't understand Coca-Cola, or who thought mechanistic methods of valuation could — should take precedence, really misjudged the value to the Coca-Cola Company of those repurchases.

So we favor — when you have a wonderful business — we favor using funds that are generated out of that business to make the business even more wonderful. And we favor repurchasing shares if those shares are below intrinsic value.

And I would say that if it's a really wonderful business, we probably come up with higher intrinsic values than most people do.

We have great respect, Charlie and I with — I think it's developed over the years — we have enormous respect for the power of a really outstanding business. And we recognize how scarce they are. And if a management wishes to further intensify our ownership by repurchasing shares, we applaud.

We own — we just went over 8 percent of the Coca-Cola Company, probably, in the last three or so months, by a very tiny fraction. But we had a second purchase one time.

But our percentage interest in the Coca-Cola Company has gone up significantly through their repurchases. And we are better off because they have bought those shares at what looked like, to some people, perhaps, high prices. And we thought they were wrong at the time, and I think now it's been indicated or proven.

So, I urge you, if you're trying to decide on the wisdom of repurchases, or of share issuances, that you don't think in terms of book value. You don't think in terms of specific P/Es. You don't think in terms of any little model.

But you think in terms of what would you really, A, pick businesses you can understand and, then, think what you really would pay to be in those businesses. And that's what counts over time, is whether the repurchases are made at a discount from that figure.

And I would say with the companies that we own shares in, we — our interest in GEICO went from 33 or so percent to 50 percent over a 15-year or so period, simply through repurchases. And we benefitted significantly.

So, did every other shareholder, I might add, that stayed with the company. And we benefited in no way disproportionate to them.

But that was a very wise action on their part. And there too, they were all — usually buying that stock at at least double book value. And you could compare it to other insurance stocks and say, "Well, that's too much to pay."

But GEICO wasn't an insurance company that was comparable to other insurance companies. It was a very different sort of business. And they were very wise, in my view, to be following that course of action.

Charlie? No?

27. B shares won't dilute value of A shares

WARREN BUFFETT: Zone 3?

VOICE: That's you.

AUDIENCE MEMBER: Oh, sorry. I'm Elaine Cohen (PH) from San Diego.

I'm a little confused about how the B shares are going to be moving if they're at 1/30th of the A shares when they get out on the market.

Are they always going to be 1/30th of the A shares? And if they are, is that going to dilute the earnings of the A shares? Could you just explain that?

WARREN BUFFETT: Yeah. It won't dilute the earnings or value of the A shares as long as we use the money reasonably effectively that is produced.

As I mentioned earlier, if it happens to be 1 percent, you'll own 1 percent less of all these other things — on the other hand, will have close to $400 million more of cash. So, it will not — in our view, it will not dilute the value of the A.

I expect, over time, that the B, a very large percentage of the time, will be selling very close to a 30th. But it could sell for less than that ratio. It can't sell for any significant amount more than that ratio, or arbitrage will eat away at any slight premium. I think that takes care of that.

28. No "secret formulas" for Wells Fargo

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Mr. Buffett, my name is Hugh Stephenson. I'm a shareholder from Atlanta, Georgia.

My question involves the company's interest in Wells Fargo. As you know, Wells Fargo, like most banks, has a very expensive branch system for deposit-gathering and servicing their customers.

As I guess you know, they also have moved more into branches in supermarkets and in online banking that seems to have the potential to very significantly reduce their costs, relative to the branch system.

Would you comment on how you think that might play out and how significant it might be?

WARREN BUFFETT: Well, the question — you're right. Wells Fargo has been a leader in moving into supermarkets. They've got a couple different formats they've used. And they've been a — they've certainly been a leader in the online banking services.

Unfortunately, in banking, you know, it's a little hard to have any secret formulas. Coca-Cola has 7X down there in the vaults of the, what used to be the Trust Company of Georgia, now SunTrust. But in the banking business, anything you do, your competitors can copy.

Nevertheless, there's a — there is an advantage. And sometimes it can be a quite — a significant advantage in being first and learning more about different distribution methods. And I think Wells Fargo has done a terrific job in learning that.

I think they've got some advantages. They — but they aren't advantages that other people can't work at copying and chipping away at.

But it's a good management. They've done a very good job of seizing on that particular trend in supermarkets.

And as such, they are — they have the potential, perhaps, for having a relatively low-cost deposit-gathering operation. And every other bank in the world will be looking, noticing how that works, not only there but at other banks, to figure out whether they can copy it.

Charlie? OK.

29. GEICO benefits from being entirely owned by Berkshire

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: My name's Alan Parsow from Omaha.

Berkshire has increased the rate of growth in its insurance float in excess of 20 percent a year since 1967.

In regards to GEICO, its rate of growth, what is its historic rate of growth been in its insurance float? And what impact will it have on the rate of growth in the overall Berkshire insurance float?

WARREN BUFFETT: Well, I would say that GEICO is a huge plus to Berkshire. Now, we owned 50 percent of it before. I mean, we've had a — we've benefitted from our GEICO investment in a big way, ever since 1976. So, it's not entirely a new benefit that's coming in.

We paid a good price for GEICO, but it is a terrific company. It has outstanding management. It has a low-cost method of distribution, which is very difficult for people to — I mean, everybody wants to have that. But they — very few come close to it.

The management is focused on bringing costs down even further and widening that competitive moat.

GEICO — I personally think that, just from what I see, that GEICO — I would think GEICO's growth rate is likely to be greater, at least, in the future, that I can see, over where it has been in the past. But it's been perfectly satisfactory in the past.

I think there are some advantages to it being part of Berkshire, in that there are costs attached to bringing new business on the books. And we care not at all about reported quarterly earnings.

GEICO was relatively insensitive to those before. And that's a compliment when I say that. But they had some more pressure on them in respect to reported earnings than they will have, as part of Berkshire.

And I think there's some really big opportunities, in terms of what can be done with GEICO as part of Berkshire.

So, I think five years from now, you'll be very happy with the fact that we own a hundred percent of GEICO.

And I think you will see that as marvelous a company as GEICO was independently — as an independent company — it will flourish maybe even a bit more as being part of Berkshire.

Not because we bring anything to the party. I mean, the management will continue to run it autonomously. But there's — there are some advantages for it in being part of a larger enterprise.

30. Berkshire businesses worth more than book value

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Mr. Buffett, my name is Steven Tuchner. I'm a shareholder from Toronto, Canada. And my question concerns the valuation of Berkshire shares.

Given the large number and dollar size of the private businesses recorded at historic cost, which Berkshire owns, shouldn't the multiple to book that the stock trades at, essentially, expand over time to reflect the increases in intrinsic value of the private holdings?

And I cite Buffalo News on the books at, essentially, I think around zero. And even GEICO now will be on the books at, probably, between 3 and 4 billion — worth more than that — as examples of the disparity between intrinsic value and book value?

WARREN BUFFETT: Most of the businesses that we own all of, or at least 80 percent of, are carried on the books at considerably less than they're now worth.

And with some of them, it's dramatic, although it's not dramatic compared to a $40 billion total market valuation for Berkshire. It's dramatic relative to the carrying price.

Because when we bought See's Candy for an effective $25 million in 1972, it was earning 4 million, pretax. It earned over 50 million, pretax, last year. When we bought the Buffalo News, it was making nothing. Paid 30 and a fraction million. And it's now earning, maybe, 45 million. And we've got a number of businesses. And GEICO's worth more than we carry it for because of the accounting peculiarities of the first 50 percent.

So, it is true that, overwhelmingly, our businesses are worth something more than intrinsic value — than book value — and, in many cases, very substantially more, although that's reflected in the market price of our stock.

I don't think you can go from year to year and trace the intrinsic value precisely by changes in book value. We use changes in book value as a very rough guide as to movement, and sometimes I comment.

There have been certain annual reports where I've said our intrinsic values grew more than the proportional change in book value, and there's been others where I've said I thought it was roughly the same.

So, I don't think you can use it as a — stick some multiplier on it and come up with a precise guide — a precise number. But I do think it's a guide to movement.

Our insurance business, though, is the most dramatic case of dollar difference between book value and intrinsic value. I mean, the number has gotten very big over time there. I personally think it will tend to get bigger, because I think GEICO will grow, and I think our other businesses will do well.

The trick, of course, is to take the new capital as it comes along — and not from the issuance of the B, because that's relatively small compared to the amount of capital we will just generate from operations.

Our float will grow from year to year. Our earnings will be retained. And we've got to go out and find things to do that three or five years from now that people say, "Well, that's worth more than the book value." And that's a job. It's a tougher job than it was. But it's kind of fun.

31. Not expecting B shares to affect price of A shares

WARREN BUFFETT: Zone 7?

AUDIENCE MEMBER: Yes. My name is Jim Elliot (PH). I'm from Minneapolis.

I wonder if you could help me with an upside scenario where the B shares, after they're issued, are limited and there's not a significant reissue afterwards. The A shareholders are somewhat reluctant to convert. And you have a run on the B shares where, let's say, it goes to $2,000 a share.

Do we then have the tail wagging the dog, where the 2,000 command a $60,000 price on the A shares? And, you know, what — does the — this arbitrage take care of that? Or —

WARREN BUFFETT: Well —

AUDIENCE MEMBER: — what do we do in that case?

WARREN BUFFETT: If there is demand for the B that pushes the price up somewhat, it will produce conversion from the A. I mean, the only way the B will be able to get — we'll just pick a figure — if it were to get to $1,200 — there is no way that the A could be selling appreciably below 36,000.

And I don't think — I think that introducing the B into the equation, may mean — it will mean — that there will be some people who like a lower denomination stock and come in.

But it takes a lot of that to, in an appreciable way, affect $40 billion worth of what is now A stock.

So, you know, if there were incremental demand of a hundred million dollars a year or something like that, that's a little more than the demand that might otherwise go into the A. But I do not see it producing anything in the way of a big movement.

But you're quite correct in that there's no way that the B stock can go up and not really force some conversion from the A. It'll — I think it'll be minor.

32. World Book Encyclopedia business won't be sold

WARREN BUFFETT: Zone 8?

AUDIENCE MEMBER: Hello. This is Rick Merliof (PH) from Oakland, California.

I wanted to ask you about World Book Encyclopedia. World Book seems to me to be an example where Berkshire has invested in technology without necessarily intending to.

I would expect that in five or 10 years it's going to be real tough to sell a paper encyclopedia, because at that time, you'll probably be able to buy the computer and the electronic encyclopedia for less than the paper encyclopedia.

Up till now, I haven't had the impression that World Book has been as aggressive as its competitors in marketing and developing its electronic product.

It's been the highest price that I have seen of the competition. It's — it asked at least — a year ago, its list price was 600 and the competition was 8,200.

You sold as low as a hundred on special promotions. But it — I don't think that was the list.

A year ago, you were still selling by direct sales. I have not yet seen it in a mass market software store. I've never seen it bundled with a computer.

And I have seen one newspaper review of electronic encyclopedias that mention the World Book print version but didn't seem to be aware that a World Book electronic version was available, which it was at that time.

In terms of the product itself, we have both the World Book and the Grolier's at our house. The Grolier's came with the computer. And both encyclopedias, in this last year, solicited us to buy an upgrade. World Book was asking $85. Grolier's was asking 30.

But in addition, I ended up buying only the Grolier's, because it addressed my biggest disappointment on the original version of both of them, which — it's sort of a — in a way, a minor issue. But I thought it was relevant for kids doing school reports.

Neither one allows you to print out a very big percentage of the pictures in the encyclopedia. They have a lot of pictures. But you can't print them. And you can get a color inkjet printer for under 200 bucks these days, so it's real practical to print things out.

The World Book made no mention of having any improvement in this area. The Grolier's said you can print out almost all the pictures. And I have found — since we got the upgrade — I found that to be true.

So, I'm concerned that — I'm not an expert on this, but I don't think World Book is as aggressive in either developing or marketing its electronic encyclopedia.

So, my question is, do you plan to become aggressive in this area and a leader in the electronic technology? Or have you considered selling your electronic business and just getting out of it?

WARREN BUFFETT: Yeah. We won't sell the electronic business. That, I can tell you.

You're quite correct. Some of the technical stuff I'm not very good at. I have a little trouble turning on the light switch.

But the — (laughter) — in terms of the bundled product, which is the encyclopedia that is offered with the purchase of a new computer, there's no question that that's become a large business in units.

It's not so large in terms of dollars, because those units, bundled with an original equipment sale, are very low. Actually, Encarta's probably — well I'm sure has sold, you know, many, many millions of units bundled with a new encyclopedia. It doesn't necessarily produce a lot of dollars. But it produces a lot of units out there.

We, at World Book — Encyclopedia — some of you may not have noticed, but Encyclopedia Britannica has, within the last couple of weeks, announced the cessation of direct distribution of the print product.

And unit sales of encyclopedias — print encyclopedias — in the country have gone down very significantly in the last few years, as they have at World Book.

We changed the — we are in the process of changing, and have already changed in some parts of the country — the distribution system because we are going to see what can be made to work, if anything, in the direct distribution.

There are some indications that we may be able to make money in that business but with a different cost structure than before. And it — well, we'll know more about that. We're not that far along, because we changed the distribution within the last — or partially changed it — within the last few months.

We — it's not easy to figure out how to make money in either the electronic or print encyclopedia end of the business. And we have some ideas in the electronic end that we'll know a lot more about in about six months or so, but I can't really — I don't want to go into any detail on those at present.

I've got the electronic product myself. It's a first-class product. We've got ideas about how to make it an even better product. And we have taken a lot of costs out of the print end of the business. We'll be putting some of those into the electronic end. But we've taken a lot of costs out.

It may well be that it'll be a workable business for us, even though it isn't for anybody else, but the jury's still out on that.

It is not the business it was five years ago. And I don't think it will be the business that it was five years ago, because the world is changed in some ways on that.

But we're — we will not sell World Book. That I can just — I'll state that unequivocally. We will not sell electronic World Book. We are in the business to stay.

But we are groping a bit in terms of figuring out a configuration that will produce decent profits for us and sell a lot of World Books in the process.

Charlie?

CHARLIE MUNGER: We don't have any way of avoiding declines in some of our businesses some of the time.

Blue Chip Stamps once sold stamps at the rate of $120 million year. Now, it's about $200,000 a year. So, we lose some. (Laughter)

WARREN BUFFETT: We were in the windmill business many years ago. (Laughter)

We try to make — you know, we think plenty about the problems. But there are industry problems.

I was in anthracite coal at one time, too. Street railways. I've seen them all.

But World Book is a first-class product. It's a product I use, a product Charlie uses. And there is — through an electronic means, you can deliver information at costs far, far less than — I mean, unbelievably less — than was the case not that many years ago.

And the world, in many forms, will be adjusting to that, not just in encyclopedias. And it affects some of the businesses we're in. And it's something we think about. But it's very unlikely that Charlie and I are going to be smarter than the rest of the world, in terms of the electronic world.

I mean, we are looking at it as something where we're looking for the obvious, and something that is within our capability of doing something about. But we're not trying to beat people at their own game, where we're not very good at the game.

33. Protecting public shows "tremendous integrity"

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Mr. Buffett, Richard Charlton from Canada. One of the highlights of — good afternoon, Mr. Munger, also. (Laughter)

One of the highlights, for me, in coming to the annual meeting for the past seven or eight years was the way that you dealt with the question that was inevitably asked by a new shareholder as to why you will not split your shares.

I know how much it has meant to you to keep the shares trading in an exclusive way. And you have been my mentor for the last 17 years.

And I think that what you're doing in splitting these shares in order to protect the public, and indirectly, Berkshire shareholders, but mostly to protect the public, is just another expression of your and Mr. Munger's tremendous integrity.

And you're setting a fantastic example for corporate America. And I salute you, sir. And I thank you very much. (Applause)

WARREN BUFFETT: Thank you. Thank you.

34. "The fairer, the better" for Berkshire's stock price

WARREN BUFFETT: Well, I hate to leave zone one after that, but we'll go on to zone 2. (Laughter) Thank you.

AUDIENCE MEMBER: Wesley Jack from Oklahoma City, Oklahoma.

As a stock broker, I can say I definitely don't like UITs and I appreciate your plan for the B shares.

But as long — with the rest of the shareholders, what we hope — that the shares go up in value in the future. Don't you see a problem with them coming back with this idea in the future?

WARREN BUFFETT: On the unit — you mean on the issuance of unit trusts?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Oh, I don't see any problem because the B will be out there. And it is a superior product, whatever its absolute merits may be. On a relative basis, it is a superior product to anything that is going to carry a big commission to a salesperson and a lot of annual costs.

So, I think — my guess is we've taken care of that problem. I wish it hadn't come up, but it — I would think that it would be very difficult for anyone to honestly offer a product — a derivative-type product — through a unit trust that would be superior to buying the product that will be available.

CHARLIE MUNGER: I think he's afraid that the B will go up to the place where the whole story comes again. And I must say that if that were to happen, we'd like it. (Laughter)

WARREN BUFFETT: Well, we'd like it, only if it reflected underlying values, but — (Laughs)

CHARLIE: Yeah.

WARREN BUFFETT: Yeah. We have a very strange attitude on that. I mean, most managements feel that the — on the price of their shares — that the higher, the better. And that's an understandable feeling. But the trouble is the game isn't over at any time.

We really feel the fairer, the better. Our goal is that every shareholder participates in the progress that Berkshire makes, during — as a business — during their holding period. In other words, we don't want one party getting wealthy off the other. We want them to share based on the gain in value of the business.

And to the extent that the stock got way overvalued or way undervalued, you know, that may make one party — in the first case, the seller, in the second case, the buyer — very happy. But there's somebody on the other side of the transaction.

In economics, you know, the most important question — maybe important beyond economics, too — but whenever somebody tells you something, you know, the first question to ask yourself is, "And then what?" And we tend to do that around Berkshire.

And so, the stock going up is not an end of itself, because it's — the next question is, "And then what?"

And to the extent that the stock goes up because the intrinsic value goes up, everyone is getting their fair share of the pie as they go along.

To the extent it exceeds that in some way, the selling shareholder gets a benefit. But the entering shareholder is at a disadvantage. And we really like the idea of the price tracking intrinsic value over time.

And we think that, by having the right kind of shareholders and by communicating with them properly and following the right kind of policies, that we can come as close to that as is attainable in a world where markets, essentially, are fairly volatile. And so far, I think it's worked out pretty well that way.

But the intention is to — and the goal — is to keep it that way.

One thing to remember: in the end, the owners of businesses, in aggregate, cannot come out anyway better than the businesses come out.

I mean, you can — the businesses are the — and not just our businesses, I'm talking about all American business — the profitability of American business determines the profitability of what the owners of American business have, and you can forget all about the little ticker symbols and everything else.

The owners suffer to the extent that they have some extra costs imposed in broker's commissions, fees, all kinds of things. That diminishes the return from the business. But no one has figured out yet how to perpetually have owners do better than their businesses.

And our idea is to have them do it as they go long in proportion to the gain that occurs during their tenure as a shareholder. And that isn't easy to do. And it's not attained perfectly. But that's the goal as we go along.

35. Insurance float: "Above all, get it cheap"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Maurus Spence. And I have a serious question and, then, a less serious question first.

The less serious: you said that you and Charlie had lost, between you, a hundred pounds. I was curious who had lost more?

WARREN BUFFETT: No, no. I said the board had lost a hundred pounds. (Laughter)

I have some members of the board who would take umbrage of the fact that they weren't included in that total. (Laughter)

AUDIENCE MEMBER: OK, Who lost —?

WARREN BUFFETT: Charlie and I, we're pretty close at the moment, aren't we? Modesty prevents — (Laughs)

AUDIENCE MEMBER: I must say you're both looking very good, anyway.

WARREN BUFFETT: We're feeling good.

AUDIENCE MEMBER: I was wondering who lost the most and what your diet secrets were. (Laughter) And, then, the more serious question was about float.

You touched on this a little bit earlier. But you've often said that your insurance business is probably the most important business that you own.

On page 12 of the annual report, you said, "We have benefitted greatly to a degree that has not been generally understood, because our liabilities have cost us very little."

I was wondering if you could describe this a little bit better so we can understand it.

WARREN BUFFETT: Yeah, the — Charlie and I have lost about the same amount, at about 20 pounds each.

The insurance business provides us with float. And float is money that we hold that doesn't belong to us.

It's like a bank having deposits. A bank has deposits. The money doesn't belong to it. But it holds the money.

Now, when a bank holds deposits, on everything except demand deposits, there's an explicit cost, an interest rate attached to it. And, then, there are the costs of running the system and gathering the money which is — also must be attributed both to demand and time deposit.

So there's a cost to getting what they would call deposits and we could call float.

In the insurance business, a similar phenomenon takes place in that policy holders give us their money at the start of the policy period. And therefore, we get the money paid in advance for the product.

And secondly, it takes time to settle losses, particularly in the liability area. If you bang up a fender on your car, you — it's going to get settled very quickly, so there's — but if there's a complicated injury or something, it may take some years to settle. And during that period, we hold the money.

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

So, you're only making an estimate, as you go along, of what that float is costing.

To date with Berkshire, in the 29 years we've been in the business, it appears — never certain, because you don't know for sure what's going to happen — but it appears that our float has not cost us anything, in — on average.

There’s been years when we’ve had an underwriting loss when there’s a cost. There’s been years when we had an underwriting profit. And so, we had a reverse cost.

So we have obtained that float on very advantageous terms over the years. Far more than — fully as important as that— it’s important to get it at a low cost, in our case, no cost. But the other important thing is that we’ve grown it dramatically.

And so, we’ve gotten more and more money without having any cost attached to it. And if we still had our 16 — or 17 million, I guess — of float that we had in 1967 and it was no cost, it would be very nice.

But 17 million of free money is worth something, but it’s not worth a ton.

Having seven billion, if we can achieve that as free money, it’s worth a lot of money. And that growth has not, probably, generally, been appreciated fully in connection with Berkshire nor has the interplay of how having zero-cost money, in terms of affecting our gain in value over time.

People have looked at — always looked at our asset side, but they haven’t paid as much attention to the liability side. Charlie and I pay a lot of attention to that.

And, I mean, this — it’s not entirely an accident that the business has developed in this manner. And we have intentions of trying to make it continue to develop in this manner, and in that manner, in the future. But we’ve got competitors out there, too.

Float, per se, is not a blessing. We can show you many insurance companies that thought it was wonderful to generate float. And they have lost so much money in underwriting that they’d be better off if they’d never heard of the insurance business.

But, you know, the job is to get it, get it in increasing quantities, but above all, get it cheap. And that’s what we work at.

And you do that in the business through having some kind of competitive advantages. You won’t do it just by having an ordinary insurance company. The ordinary insurance company is not a good business.

We have it, in certain respects, because of our attitude toward the business. We have it because of our financial strength gives us certain competitive advantages, and we have it in the case of GEICO, because of a very low-cost operation.

And it’s us — up to us — to try and figure out ways to maximize each one of those competitive advantages over time.

We've built those advantages. I mean, in 1967, we were not looked at that way in the insurance business. We were — we've built a position of competitive strengths. And in the case of GEICO, they had it without us. But we have bought into it over time.

It's a very important asset. And you ought to pay a lot of attention over the years as to what is happening in — with that asset as to both growth and costs. And that will aid you in calculating intrinsic value.

Charlie?

CHARLIE MUNGER: Nothing to add.

WARREN BUFFETT: OK.

36. Intrinsic value isn't above current stock price

WARREN BUFFETT: Zone 4 is the next.

AUDIENCE MEMBER: Henry Neuhoff (PH), shareholder, Dallas, Texas.

My guess is that you consider the intrinsic value of the shares to be more than that represented by the price.

WARREN BUFFETT: By more than represented by what?

AUDIENCE MEMBER: More than represented by the current price of the shares.

If that be the case, what would be your thoughts about Berkshire repurchasing its own shares?

WARREN BUFFETT: Yeah, no. We have said we do not consider Berkshire undervalued at this price. We didn't say we thought it was overvalued. But we said we did not consider it undervalued.

So, a repurchase based on our estimate would not be in the interests of shareholders.

It's conceivable it could be at some time, but we do not think that's the case. We think intrinsic value far exceeds book value, but we do not think it exceeds present price.

We're not selling any shares, though, either. (Laughter)

(Break in tape)

37. Complications from "street name" shareholders

WARREN BUFFETT: Zone 6?

AUDIENCE MEMBER: My name is Carlos Lucera (PH). I'm from Idaho. And my question relates to street names.

Our stock at Berkshire Hathaway is in a family limited partnership. And in addition to that, it's in a street name.

Now, what is the reason, and the rationale behind the reason, for street name shares not being able to participate in the charitable contributions by Berkshire Hathaway?

WARREN BUFFETT: Yeah. We submitted a request for ruling to the IRS — I don't know, 15 or so years ago, in connection with the shareholder-designated contribution program.

And the ruling we received specifies record holders and not street name holders. Now, that doesn't mean that a different ruling might not be obtained.

But frankly, when we get into the multitude of indirect holdings and the problems we have with those indirect holdings in other respects, I think it would be a bit of a nightmare for us to attempt to get that program extended through — into street name holders.

I think the costs would far exceed the benefits. And I think that it is the situation, and anybody with it in street name can move it into their own name if they want to.

So I think, with very small amount of effort on the part of an individual shareholder, it would offset an enormous set of problems that we would encounter at Berkshire.

We can handle the present system. We've got 12 people there. And they run the annual meeting. They make movies. They do all kinds of things. (Laughter)

And it would be — it would be very tough and — you know, if an extra 10,000 shares participated, it'd be $120,000 of contributions. I just don't think it would be worthwhile.

Our ruling doesn't presently cover the subject, in any event. It's something we've thought about.

Charlie?

CHARLIE MUNGER: Yeah. I think even if they changed the ruling, we wouldn't change the policy. It would be, administratively, very difficult.

WARREN BUFFETT: We run into other problems, in terms of people getting their material — just the material on the annual meeting.

And we've heard from a number of shareholders that they can't get it from their broker, and they're — they don't know what the B is all about because they didn't get their proxies. And it just — street name posed more problems.

Although, we have a — now we have — probably have more than — forget about the B. We have more than twice as many, I believe, holders in street name as in direct ownership. Although, the number of shares is far, far — I mean it's — it'd be less than 20 percent of the shares. But it's probably double the number of holders.

38. No "look-through earnings" in annual report

WARREN BUFFETT: Zone 7?

AUDIENCE MEMBER: Good afternoon. My name is Bill Guerra (PH). I'm from the San Francisco Bay area. I've owned your shares for many years and appreciate the good job you've done.

However, in this year's chairman's letter — you developed a concept a few years ago called look-through earnings.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: And I failed to see that this year. And I'm wondering if that no longer is a valid concept or why you refrained from showing the data?

WARREN BUFFETT: Yeah. That's a good question. I should have actually covered that in the annual report, in terms of mentioning — because I've talked about it, and we'll talk about it in the future.

And we do have a goal on look-through earnings of $2 billion in the year 2000. And that's going to be adjusted upward to allow for the fact there are more shares outstanding. It'll be the same basic goal.

But there were two reasons that it was skipped this year. And like I said, I should've mentioned it.

One was it was the longest letter we've ever had. And having that section in there would've elongated it even a bit more. And that, coupled with the fact — and this is the important part of it — we had major changes in our — the composition of the company — immediately after the end of the year.

So, our Capital City stock disappeared. At the time it disappeared, we didn't know whether it was going into cash, or all Disney stock, or a combination.

We had the acquisition of the other half of GEICO where, even now, the accounting treatment isn't clear. And I felt that —

The look-through earnings last year were fine. But I felt that, by the time I got through explaining all of the adjustments you would have to make for the transactions then pending, that adding it to the — to already the longest letter I've written, would've slowed things down a lot and not been particularly helpful.

It will be back in this year, this upcoming report, and future reports, because it's a very important concept. And it's something that we're focused on.

It's just that last year's number — it would've been a mess by the time I got through trying to explain it.

You know, I normally — the accounting stuff, I know, puts a lot of you to sleep. But believe me, it isn't so much fun writing it either. (Laughter)

So, I skipped it this year. We'll have it next year. And the number would've been OK last year, but there would've been a lot of asterisks attached.

39. Discount rate for estimating intrinsic value

WARREN BUFFETT: Zone 8, please.

AUDIENCE MEMBER: Yes. Mr. Buffett, good morning. My name's Ed Walzak (PH) from New York. I'm a student and an admirer of your investment philosophy. I have a question.

In determining a company's intrinsic value, you seem to write or indicate that you project out a company's owner earnings for a number of years, and then discount that back by prevailing rates.

My question is, how much of a premium, if any, to prevailing risk-free rates do you demand when you discount back the owner earnings of a company?

Or stated differently, for example, today, with loan rates at about 7 percent, if you did the same exercise with Coca-Cola, at what rate of interest would you discount back their owner earnings?

WARREN BUFFETT: Yeah. We get asked that question a lot. And we've answered it to some extent in past annual reports about what discount rate to use.

We basically think in terms of the long-term government rate.

And there may be times, when in a very — because we don't think we're any good at predicting interest rates, but probably in times of very — what would seem like very low rates — we might use a little higher rate.

But we don't put the risk factor in, per se, because essentially, the purity of the idea is that you're discounting future cash. And it doesn't make any difference whether cash comes from a risky business or a safe business — so-called safe business.

So, the value of the cash delivered by a water company, which is going to be around for a hundred years, is not different than the value of the cash derived from some high-tech company, if any, that — (laughter) — you might be looking at.

It may be harder for you to make the estimate. And you may, therefore, want a bigger discount when you get all through with the calculation. But up to the point where you decide what you're willing to pay — you may decide you can't estimate it at all. I mean, that's what happens with us with most companies.

But we believe in using a government bond-type interest rate. We believe in trying to stick with businesses where we think we can see the future reasonably well — you never see it perfectly, obviously — but where we think we have a reasonable handle on it.

And we would differentiate to some extent. We don't want to go below a certain threshold of understanding. So, we want to stick with businesses we think we understand quite well, and not try to have the whole panoply with all different kinds of risk rates, because, frankly, we think that'd just be playing games with numbers.

I mean, we — I don't think you can stick something — numbers on a highly speculative business, where the whole industry's going to change in five years, and have it mean anything when you get through.

If you say I'm going to stick an extra 6 percent in on the interest rate to allow for the fact — I tend to think that's kind of nonsense. I mean, it may look mathematical. But it's mathematical gibberish in my view.

You better just stick with businesses that you can understand, use the government bond rate. And when you can buy them — something you understand well — at a significant discount, then, you should start getting excited.

Charlie? (Laughter)

CHARLIE MUNGER: Yeah. The discounts were once greater than we now see.

WARREN BUFFETT: That's all you're going to get, folks. (Laughter)

40. See's Candies not going fat-free anytime soon

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Hi. Warren, it's Peter Newman, Nick and Racky's son. You can't see me because I'm on your hard left over here.

And by the way, Racky says to send her love to you —

WARREN BUFFETT: Great.

AUDIENCE MEMBER: — and Susie.

I'm going to take a cue from something that the guy who asked the questions about the World Book —

I know you're loathe to, normally, interfere in the running of your individual corporations, because they do so well on their own. And I am particularly fond of See's Candy and their products. And you may or may not know that we have a chocoholic in our family, as you do in yours.

WARREN BUFFETT: Yeah. Makes good chocolate syrup, too. (Laughs)

AUDIENC MEMBER: Yeah, I won't mention who.

However, when I was in there this Christmas buying some gifts, I noted that, with the exception of the little candy canes, there's nothing in that store that is fat-free.

And we are facing a trend — (laughter) — in the world, especially in dessert items and ice cream and candy items, of fat-freeness.

And I just thought that, perhaps, it would be a word — worth a word to management to consider expanding the hard candy line.

WARREN BUFFETT: Well, we look at a lot of things. One of the problems, as you probably know, for example, in using aspartame is it doesn't interact well with heat. And so that's been sort of tough.

Now, Charlie and I have kept getting our regular boxes of candy during this weight loss-program. And we've — (laughter) — devoured them.

And candy, you know, it may be, on average, a hundred and — depends on whether it's a sugar product or not.

But, take the lollipop, it'd be about 110 calories per ounce. But there's — that's one and a half, or one and a quarter lollipops, or something like that.

Most things are, you know, in that hundred per ounce to 150 per ounce range. So, candy is not a specific no-no.

If we can find something that the customer likes, that makes them think they're getting skinnier by eating it — (laughter) — you know, that will be a breakthrough.

And we look forward — and we test everything that comes along. I can assure you. (Laughter)

In fact, Charlie and I may be the main testers.

Chuck Huggins is here today — and if you've got any ideas on it — who runs See's. Done a terrific job of running See's ever since we took over in 1972. He'd appreciate ideas.

But we are looking for things that appeal to the consumer that taste good and that they'll go for. I mean, just as is, you know, the Coca-Cola Company, in terms of carbonated soft drinks. So, it's a constant subject.

And, you know, there were high hopes on aspartame originally. But it just hasn't panned out in terms of candy. And I've read a few articles about the fat-free stuff.

Well, it should be the fat substitute, which didn't get me too excited about trying it. But I'm not sure whether some of you read those articles or not. We'll keep looking, Peter, I appreciate it.

41. GEICO's price: "We gulped a few times and paid it."

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger.

As an aspiring shareholder, I'm very happy and proud to be here. Maybe I can encourage Mr. Munger to respond to my question this morning.

In regards to your purchase of the other half of GEICO, would you comment on your reasoning behind paying the premium above market value and why you, instead, did not purchase shares in the open market?

CHARLIE MUNGER: Well, we couldn't have purchased very many shares in the open market at the quoted price. And the price we paid, with the large number of shares we got, we thought was a very satisfactory price.

WARREN BUFFETT: Yeah. We — what Charlie said is a hundred percent right. We also had a restriction that we agreed to many, many years ago — almost 20 years ago — as to the number of shares we would own without the consent — of the directors and, I believe, the Insurance Department.

So, we actually had some special restrictions on us in the case of GEICO. But if we hadn't have had those restrictions, we'd have behaved in exactly the same manner.

And we didn't think we could buy it any cheaper than that price. And we gulped a few times and paid it. And I think we will be happy that we did, as it's turning out.

GEICO is doing very well. It — I mean, I knew it would do well. But I feel very good about it.

42. Newspaper business is still good, but not as good

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Mr. Buffett, my name is David Lowe (PH) from Ventura, California.

My first Berkshire meeting, and I want to mention that I'm very intrigued at the influence you have over the shareholders here. I note that the first beverage they ran out of in the lobby was Cherry Coke. (Laughter)

My question is about The Buffalo News. You say, in the letter for the '95 report, that the newspaper industry has lost another notch in its economic attractiveness. Can you elaborate on that?

WARREN BUFFETT: Yeah. The — what you are seeing in newspapers is a circulation trend that has been prevalent for a long time, in terms of newspapers per household.

But that has been declining, and that — daily newspapers — and that I would say the trends of the last couple years are somewhat worse, in that respect.

I would say that the ability to price, both at the circulation and advertising level, is — has weakened a bit in recent years — not dramatically, but it's weakened a bit.

At one time, newspapers really — daily newspapers in single-newspaper towns were probably as attractive, economically, as any business you could find. I mean, it — a large percentage of advertisers had very little choice, in terms of using them as an advertising medium.

People had less options, in the way of learning what was going on around them other than the daily newspaper. So, the — they started from a position of extraordinary strength.

They still have a very strong position. And I've tried to emphasize that in the report. I mean, they're a bargain at the price they sell for. They give you all kinds of information with very low price. And they're a magnificent way for most merchants to reach their customers.

But they are not — they do not have the exclusive advantages, in many cases, that they had 15 or 20 years ago.

Third-class mail has become more of an option. People have more ways of obtaining information. As we talked earlier, information can be processed electronically and delivered at far lower cost than people dreamt of 20 years ago.

So, all of those things eat away a little bit. It's still a very fine business. But those — I don't see anything that will reverse those trends. I don't think that they will necessarily accelerate.

But I think that, if the only thing you owned in life was a daily newspaper in a single-newspaper town 20 years ago, you would feel slightly less secure today than you did at that time. But you'd still be a lot better off than owning virtually any other business.

Charlie?

CHARLIE MUNGER: Nothing to add.

43. "Outside information" in annual reports

WARREN BUFFETT: How about zone 4?

AUDIENCE MEMBER: Mr. Buffett, my name is Hutch Vernon. I'm from Baltimore, Maryland.

I know that you read lots and lots of annual reports. And I'm curious what you are reading for, if you would share that with us.

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

WARREN BUFFETT: Yeah. The main thing that they can't mandate in annual reports: I really like to have — I like to know as much as I can about the person that's running it and how they think about the business and what's really going on in the business.

In other words, I would like to have a report that would be identical to what — if I owned half of a company but was away for a year, and I had a partner who owned the other half — when I came back, that he would tell me about what had taken place during the past year and what he foresaw coming up and all of that.

I — that is what I think the purpose of the report is. Now, the SEC mandates a lot of information, and —

VOICE: — side on?

WARREN BUFFETT: — some of that is helpful. But there's an intent behind the report. I mean, if it's a sales document I'm, you know, I'm less interested. I'm — and —

I don't see any way to mandate what I'm talking about. But that's the kind of report I'm looking for.

What I'm trying to do as I read reports, A, I like to understand just generally what's going on in all kinds of businesses.

If we own stock in a company and in an industry, and there are eight other companies that are in the same industry, I want to own or be on the mailing list for the reports for the other eight, because I can't understand how my company is doing unless I understand what the other eight are doing.

I want to have the perspective of, in terms of market share, what's going on in the business or their margins or the trend of margins, all kinds of things that I can't get unless I know —

I can't be an intelligent owner of a business unless I know what all the other businesses in that industry are doing. And so, I try to get that information out of a report.

If I'm thinking about investing in a specific company, I try to size up their business and the people that are running it.

And over the years, I have found reading a lot of reports to be quite useful in terms of making business decisions at Berkshire.

If we own all of a business, I want to own shares in all of the competitors just to keep track of what's going on. And I want to be able to intelligently evaluate how our managers are doing that. And I can't do that unless I know the industry backdrop against which they're working.

It's amazing, you know, what — how well you can do in investing, really, with what I would call outside information. I find inside information — I'm not sure how useful that is.

But outside information — there's all kinds of information around, as to businesses. And you don't have to understand all of them. You just have to understand the ones that you're thinking about getting in. And you can do it, if you just — nobody will do it for you.

You can't read — in my view — you can't read Wall Street reports and get anything out of them. You have to do it yourself and get your arms around it.

I don’t think we’ve ever gotten an idea, you know, in 40 years from a Wall Street report. But we’ve gotten a lot of ideas from annual reports.

Charlie?

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

WARREN BUFFETT: Yeah. I would say that, on average, in a business we’re really interested in, even though we know what to skip, to some extent, and what to read, I mean, it’s going to be 45 minutes or an hour on a report.

And if there are six or eight companies in the industry, that’s going to be six or eight hours, perhaps, and then their quarterlies and a lot of other —

I mean, it — the way you learn about businesses is by absorbing information about them, thinking, deciding what counts and what doesn’t count, relating one thing to another. And, you know, that’s the job.

And you can’t get that by looking at a bunch of little numbers on a chart bobbing up and down about a — or reading, you know, market commentary and periodicals or anything of the sort. That just won’t do it. You’ve got to understand the businesses. That’s where it all begins and ends.

44. “Berkshire is not a one-man show”

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Mr. Buffett, my name is Hank Strickland (PH). I’m from Fairfax, Virginia, which, if it were a city, would be the tenth largest in the United States. I’m here as a stockholder. And my daughter, who’s also my broker, is here with me.

We were also out there Friday night when we watched you warming up for the beginning of the ballgame. And we noted that you didn’t drop the ball. You seemed to be able to get it to the guy that was warming you up.

We noticed your first pitch, which I had difficulty characterizing as either being a passed ball or a wild pitch.

WARREN BUFFETT: It was a premature sinker, actually. (Laughter)

Very hard to hit, I might add. (Laughter)

AUDIENCE MEMBER: And, then, you moved spritely into the stands, did a lot of picture taking, photo opportunities, signed autographs, vaulted over a rail or two. And we noted, with great enthusiasm, your fitness.

Now that all having been said, many people would characterize Berkshire as a one-man company, with all due respect to Charlie. And many of this audience here, I'm sure, are retired or semi-retired. It's not unthinkable that, perhaps, you might want to retire, or for good — God's sakes —

WARREN BUFFETT: It's unthinkable. I don't want that one to go by. (Applause)

AUDIENCE MEMBER: Or for something — something worse could happen. And for those of us —

WARREN BUFFETT: That would be the worst, I think — (Laughter)

AUDIENCE MEMBER: Well I —

WARREN BUFFETT: I think death would be second. (Laughter)

AUDIENCE MEMBER: I could think of some things some of us might want to do to protect our sizeable investments, say, having owned Berkshire since Blue Shamp — Blue Chip Stamp days. But anyway, we could put in a stop order, might take out an insurance policy.

We might ask Charlie to masquerade as Warren after you've moved on. Those don't seem like very attractive options. So, I'm very serious now.

How would you respond to the question of a stockholder that's really concerned about Berkshire being a one-man show?

WARREN BUFFETT: Yeah. Well, Berkshire is not a one-man show. It's a two-man show, in terms of capital allocation. There's no question about that, at present.

But it's run by many managers that are doing an outstanding job and that don't need any guidance from Charlie or me as they go along.

But I might say that, you know, I will die with all of my Berkshire stock, essentially. And that will — stock will be held, either in the family or in a foundation, depending on the order of death, for a long time thereafter.

So, there's no one that's more concerned about the subsequent management issue than I. I mean, this is not something that ends, at all, on my death. And it doesn't end for the Buffett family or The Buffett Foundation. So, it's a subject that Charlie and I have both thought about.

The most likely situation — you got to get away from the idea that it's a one-man show because, right now, we've got 33,000 people working for Berkshire out there, you know, as we speak.

And I'm sitting around, you know, watching movies about myself or something. I mean, you can see how vital I am to the place. (Laughter) So the — but the question —

And the other thing we do, besides allocate capital, is we do identify these managers. And hopefully, we make it attractive for them to stay and work for Berkshire.

But that — you know, that doesn't require 150 IQ or anything to do that. It does require a certain sensitivity to why people want to get up in the morning and do what they do.

And when I'm not around, the logical, at some point — it depends on exactly when it happens, again. But Charlie's a little older than I am. And it's likely that it will be broken into a two-person function again, but not exactly the way Charlie and I function.

And that is that there will be someone in charge of investments and capital allocation. I mentioned Lou Simpson's position, because he is younger than I am, in the annual report, and then someone in charge of operations. And we have that person in the organization now.

Now, I don't know what the situation will be when I die, because it could be in 20 minutes or it could be in 20 years. And when that — so, I can't specifically name the individuals.

We have the individuals now for both those functions. We'll have the individuals for the same functions 20 years from now. I don't know whether they'll be the same people.

But it's quite a logical way to run the business. GEICO was run that way and still is run that way and has been for some years.

It's always struck me as terribly illogical, the way property-casualty insurance companies are run, because they've been dominated by the underwriting side of the business. And here they have this important investment side, but it's always been — virtually every company's been subservient to the underwriting.

And GEICO, very logically, set up a co-CEO arrangement some years back where — originally Bill Snyder before that — but Tony Nicely ran the underwriting end of the business and Lou Simpson ran the investment side.

And those are two very different functions. Same person, logically, doesn't fit both functions in most cases. I mean, it's a rarity when the same person happens to hit for both functions.

So GEICO worked very well that way. Still works that way. Lou runs investments. Tony runs underwriting.

And Berkshire — slightly different — it's a variant on it. But, essentially, at Berkshire headquarters, you need someone overseeing and not meddling in them too much, but making sure you've got the right manager and you're treating him fairly.

You need someone on the operating side. You need someone on the investment/capital allocation side. We've got those people now. And we'll have them, you know, whenever it happens, too.

That's the — that is the structure. And we've got some very good businesses.

And, you know, nobody's buying See's Candy because they think I'm sitting in some office in Omaha. And no one's buying a GEICO insurance policy because, you know, my name is there as chairman or CEO. The businesses are marvelous businesses. They'll continue very well.

And there will be a capital allocation problem then just like there is now. And there will be the problem of keeping good managers in place and treating them fairly. And that's a solvable problem.

So, that's the future as seen from Kiewit Plaza.

Charlie?

CHARLIE MUNGER: Yes. If you just run your mind through all the assets, I think you will quickly decide that there are large momentums in place that would do very well without us.

I mean, is Coca-Cola going to suddenly stop selling because some manager's dead at Berkshire Hathaway?

You know, are the people going to stop using Gillette razor blades? Is GEICO suddenly going to stop being intelligently run? Are — is the Nebraska Furniture Mart going to try any less hard?

So, the existing assets, you can argue, have been lovingly put together, so as not to require continuing intelligence at headquarters. (Laughter)

And what — there would be a disadvantage in that I think it would be unreasonable to expect that a successor would be as good at making new investments as Warren has been in the past. Well, that's just too damn bad. (Laughter and applause)

WARREN BUFFETT: The sympathetic ear over here. (Laughter)

45. Buffett doesn't answer individual letters

WARREN BUFFETT: Let's see, where are we? Zone 6 now?

AUDIENCE MEMBER: Mr. Buffett, I'm indebted to Walter Schloss for introducing me to you some 40 years ago. And finally in the early '80s, I became a stockholder.

My question is, now that you've expanded headquarters 9 percent from 11 people to 12 people — (laughter) — do you now more frequently answer letters from stockholders?

As a specific, had you looked at my letter from January 1986? (Laughter)

WARREN BUFFETT: We haven't gotten to January yet. (Laughter)

AUDIENCE MEMBER: Relating to Cap Cities/ABC and talk radio, the problem that occurred last month at cape — Cap Cities might have been prevented.

WARREN BUFFETT: You should get a form letter from us. But the — we do not — A, we do not get into the activities of our investee companies.

I mean, it — if people are unhappy about Coca-Cola or Gillette, and they shouldn't be — (laughs) — but if they happen to be, they should talk to the companies themselves. I don't interject myself into the management or operations of the investee companies.

In terms of questions about Berkshire — I put in the annual report a few years back — just running Berkshire takes up a fair amount of time, in terms of keeping track of a lot of businesses.

And it doesn't need to take up as much time as it does with me. But I enjoy it. But the — I feel that the annual report, the annual meeting, are the time to take up everything on shareholder's minds. And so, I don't answer one-on-one questions.

I get all kinds of letters. They want career guidance. They want advice on their business. I mean, there's a million letters that come in.

And it would really be — it would take a significant amount of time, that otherwise would be spent on Berkshire, to reply to that sort of thing. I may note them, in terms of what I address in subsequent annual reports.

But the annual meeting and the annual report, I feel, are the best ways to communicate with shareholders. And I really don't do it the rest of the year, although you will get some form reply or you should get some form reply on it.

AUDIENCE MEMBER: Thank you.

WARREN BUFFETT: Thanks. It's noon now. And I'd like to give everybody a chance to visit our other stores and everything. But we will be back here at 12:15.

Afternoon Session - 1996 Meeting

1. Investing with "the two wealthiest guys"

WARREN BUFFETT: OK, if we've got a monitor over in zone 1, we're ready to start.

AUDIENCE MEMBER: Yes. Thank you very much. My name is Maria Nicholas Kelly (PH). I'm from Tacoma, Washington.

And my husband and I have rather different investment approaches. And in 1988, he bought me one share of Berkshire, so that I could learn something about investing. We both started about that same time.

And he has chosen to invest in, let's say, about 40 different stocks and buying and selling, and doing rather well for us, frankly.

My approach is more simple. And basically, I finally figured out last year that I should invest in the companies of the two wealthiest men in the world.

So — (laughter) — I decided we should buy, monthly, more Berkshire and Microsoft. So, then this year — and so, we've been able to do that.

This year, we read in your report that Berkshire is selling "at a price at which Charlie and I would not consider buying it," so my husband has challenged my investment strategy. (Laughter)

I know that you are an honest man. And while you may not — (laughter) — you may not recommend to "my partner, Charlie," to buy more Berkshire at this time, do you recommend that I continue — (Buffett laughs) — my rather automatic investment buying of Berkshire?

And I wanted — I think I know the answer. But I wanted my husband to hear it from the horse's mouth. (Laughter)

WARREN BUFFETT: I think you're using me here. (Laughter)

AUDIENCE MEMBER: But —

WARREN BUFFETT: Well, I — we don't recommend selling it, but we don't recommend buying it, either. We are neutral on that subject.

And I hope you continue to be in with the two wealthiest guys. I like the other fellow, too. (Laughter)

AUDIENCE MEMBER: Thank you.

WARREN BUFFETT: Yeah.

2. American Express has "slipped" in credit cards

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Mr. Buffett, I am Harriet Morton from the Emerald City [Seattle], the same area, the land of Microsoft. And I have a couple small questions.

The first one is, recognizing your lack of interest in technology or sense of familiarity with it, I'm wondering if you'd give a few comments on Bill Gates as a manager.

But the second one, dealing with a business that you're familiar with, has to do with American Express.

Would you comment on American Express' strategy to deal with their declining market share in the credit card industry and the rising importance of debit cards? Thank you.

WARREN BUFFETT: I'm not sure I got that entirely, Charlie. Did you? I mean, I got the part about American —

CHARLIE MUNGER: She wanted you to comment on Gates as a manager and American Express as — with the problems in declining in market share.

WARREN BUFFETT: Well, the first part is very easy. You know, Bill Gates is, you know, one of the great managers of all time and is an exceptional business talent who loves his business.

And when you get that combination and a high energy level and, now, an heir to leave it to, I don't think you do much better than that.

American Express has, you know — has slipped over from where they were 20 years ago, obviously, in the credit card business. And I think they may have taken their customer a little bit for granted for a while.

I think [CEO] Harvey Golub is very focused on correcting that and has made some progress. But the credit card business is a very different competitive struggle now than it was 20 or 25 years ago.

Interestingly enough, American Express, itself, backed into the business. Because they were worried about what was going to happen to their traveler's check business, originally.

And they saw Diners Club come along. A fellow named Ralph Schneider and — started it. And they saw the inroads that were being made. So, the credit card was a reactive move. And for a while, they really dominated the field. And of course, they still dominate the travel and entertainment part of it.

But credit cards are going to be a very competitive business over time. And you need to establish — American Express needs to establish — special value for its card in some way, or it gets more commodity-like.

It's not an easy business. But their franchise — they've got a strong franchise. It is not what it was 20 years ago, relative to the competition.

3. "A lot of mediocrity" among CEOs

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Good afternoon. My name is John Weaver. I'm a shareholder from Bellingham, Washington.

You have discussed what a wonderful business is. One of the criterias in your acquisition, page 23 of your annual report, is management.

Could you discuss how you decide what good management is and how you decide whether you have a good manager?

WARREN BUFFETT: The really great business is one that doesn't require good management. I mean, that is a terrific business. And the poor business is one that can only succeed, or even survive, with great management. And —

But we look for people that know their businesses, love their businesses, love their shareholders, want to treat them as partners. And we still look to the underlying business, though. We —

If we have somebody that we think is extraordinary, but they're locked into one of those terrible businesses, because we've been in some terrible businesses, and you know, the best thing you can do, probably, is get out of it and get into something else.

But there's an enormous difference, frankly — there's an enormous difference in the talent of American business managers.

The CEOs of the Fortune 500 are not selected like 500 members of the American Olympic track and field team. And it is not the same process. And you do not have the uniformity of top quality that you get with the American Olympic team in any sport. You do not get that in top management in American business.

You get some very able people, some terrific people, like a Bill Gates, that we just mentioned. But you get a lot of mediocrity, too.

And the test — I think, in some cases, that it's fairly identifiable, who has done an extraordinary job. And we like people that have batted .350 or .360, in terms of predicting that they're going to bat over .300 in the future.

And some guy says, you know, "I batted .127 last year. But I've got a new bat or a new batting coach," you know, some management consultant has come in and told them how to do it, supposedly.

We're very suspicious of that. So we don't like banjo hitters who suddenly proclaim that they can become power hitters.

And then we try to figure out what their attitude is toward shareholders. And that isn't uniform, either, throughout corporate America. It's far from uniform.

We still want them to be in a good business, though. I would emphasize that.

We feel that — I mean, I gave the illustration of Tom Murphy in the annual report.

I mean, no one had either the ability — no one could top his ability or integrity, in terms of the way he ran Cap Cities for decades. I mean, and you could see it in 50 different ways.

I mean, he was thinking about the shareholders. And he not only thought about them, he knew what to do to forward their interests, and —

In terms of building the business, he only built it when it made sense, not when it did something for his ego or to make it larger alone. He did it when it was in his shareholders' interests.

And they're not all Tom Murphys. But when you find them, and they're in a decent business, you want to bet very heavily and not make the same mistake I made by selling out once or twice, too. (Laughter)

4. "Diversification is a protection against ignorance"

WARREN BUFFETT: Zone — was that zone 3 or —? Yeah, zone 4.

AUDIENCE MEMBER: Yeah, my name is Mark Hake (PH). I'm from Scottsdale, Arizona.

And I am very interested in your policies on diversification and also how you concentrate your investments.

And I've studied your annual reports going back a good number of years, and there's been years where you had a lot of stocks in your marketable, equitable securities portfolio. And there was one year where you only had three, in 1987.

So, I have two questions. Given the number of stocks that you have in the portfolio now, what does that imply about your view of the market in terms of, is it fairly valued, that kind of idea?

And second of all, whenever you — it seems that, whenever you take a new investment, you never take less than about 5 percent and never more than about 10 percent of the total portfolio with that new position. And I wanted to see if I'm correct about that.

WARREN BUFFETT: Yeah. Well, on the second point, that really isn't correct.

We have positions which you don't even see, because we only listed the ones above 600 million in the last report. And obviously, those are all smaller positions.

Sometimes, that's because they're smaller companies, and we couldn't get that much money in. Sometimes, it's because the prices moved up after we'd bought them. Sometimes, it's because we may be selling the position down, even. So there's nothing magic.

We like to put a lot of money in things that we feel strongly about. And that gets back to the diversification question.

You know, we think diversification is — as practiced generally — makes very little sense for anyone that knows what they're doing.

Diversification is a protection against ignorance.

I mean, if you want to make sure — (laughter) — that nothing bad happens to you relative to the market, you own everything. There's nothing wrong with that. I mean, that is a perfectly sound approach for somebody who does not feel they know how to analyze businesses.

If you know how to analyze businesses and value businesses, it's crazy to own 50 stocks or 40 stocks or 30 stocks, probably, because there aren't that many wonderful businesses that are understandable to a single human being, in all likelihood.

And to have some super-wonderful business and then put money in number 30 or 35 on your list of attractiveness and forego putting more money into number one, just strikes Charlie and me as madness.

And it's conventional practice, and it may — you know, if you all you have to achieve is average, it may preserve your job. But it's a confession, in our view, that you don't really understand the businesses that you own.

You know, I base — on a personal portfolio basis — you know, I own one stock. But it's a business I know. And it leaves me very comfortable. (Laughter)

So you know, do I need to own 28 stocks, you know, to have proper diversification, you know? It'd be nonsense.

And within Berkshire, I could pick out three of our businesses. And I would be very happy if they were the only businesses we owned, and I had all my money in Berkshire.

Now, I love it — the fact that we can find more than that, and that we keep adding to it. But three wonderful businesses is more than you need in this life to do very well.

And the average person isn't going to run into that. I mean, if you look at how the fortunes were built in this country, they weren't built out of a portfolio of 50 companies. They were built by someone who identified with a wonderful business. Coca-Cola's a great example. A lot of fortunes have been built on that.

And there aren't 50 Coca-Colas. You know, there aren't 20. If there were, it'd be fine. We could all go out and diversify like crazy among that group and get results that would be equal to owning the really wonderful one.

But you're not going to find it. And the truth is, you don't need it. I mean, if you had — a really wonderful business is very well protected against the vicissitudes of the economy over time and the competition.

I mean, you know, we're talking about businesses that are resistant to effective competition. And three of those will be better than 100 average businesses.

And they'll be safer, incidentally. I mean, there is less risk in owning three easy-to-identify, wonderful businesses than there is in owning 50 well-known, big businesses. And it's amazing what has been taught, over the years, in finance classes about that.

But I can assure you that I would rather pick — if I had to bet the next 30 years on the fortunes of my family that would be dependent upon the income from a given group of businesses, I would rather pick three businesses from those we own than own a diversified group of 50.

Charlie?

CHARLIE MUNGER: Yeah, what he's saying is that much of what is taught in modern corporate finance courses is twaddle. (Laughter and applause)

WARREN BUFFETT: You want to elaborate on that, Charlie? (Laughter)

CHARLIE MUNGER: You cannot believe this stuff. I mean, it's modern portfolio theory and — yeah, it's —

WARREN BUFFETT: It has no utility. But you know, it will tell you how to do average. But, you know, I think anybody can figure out how to do average in fifth grade. I mean, it's just not that difficult, and —

It's elaborate. And you know, there's lots of little Greek letters and all kinds of things to make you feel that you're in the big leagues. But it — (laughter) — there is no value added. (Laughs)

CHARLIE MUNGER: I have great difficulty with it because I am something of a student of dementia — (laughter) — and I have —

WARREN BUFFETT: And we hang around a lot together. (Laughter)

CHARLIE MUNGER: And I get ordinarily — classified dementia, you know, on some theory, structure of models. But the modern portfolio theory, it involves a type of dementia I just can't even classify. (Laughter)

Something very strange is going on. (Buffett laughs)

WARREN BUFFETT: If you find three wonderful businesses in your life, you'll get very rich. And if you understand them — bad things aren't going to happen to those three. I mean, that's the characteristic of it.

CHARLIE MUNGER: By the way, maybe that's the reason there's so much dementia. If you believed what Warren said, you could teach the whole course in about a week. (Laughter)

WARREN BUFFETT: Yeah, and the high priests wouldn't have any edge over the laypeople. And that never sells well. (Laughter)

CHARLIE MUNGER: Right.

5. Downsizing is sometimes needed to correct excessive hiring in the past

WARREN BUFFETT: OK, zone — what, 5, are we over there?

AUDIENCE MEMBER: Yes. Good afternoon, Mr. Buffett, Mr. Munger, board of directors.

Wanted to ask, in looking ahead, do you see the trends of extensive outsizing, the offshoring, the downsizing, the expendable workforce, the rightsizing, the diminished commitment to company loyalty, and the greater emphasis on the short term, quick buck, bottom line versus your commitment to the long-term investment affecting your pool of investment possibilities and your decision processes?

And do you possibly think of creating new companies on your own?

WARREN BUFFETT: Well, I think that the trends you talk about, and the attention devoted to them, could have some effect, just in terms of how the public and Congress may feel toward business.

Historically, you know, every industry, at all times, is interested in downsizing or becoming more efficient.

Now, if the industry is growing, you can achieve efficiency by doing more work, or turning out more output, with the same people.

But you know, if you go back 150 years and look at the percentage of people in farming, for example, farming has downsized from being a very appreciable percentage of the American workforce to a very small percentage. And essentially, that's released people to do other things.

So, it's in the interest of society to get as much output in anything as it can per unit of labor input. It's very difficult on the individual involved.

And you know, it's no fun — I guess it's no fun being a horse when the tractor comes along, or a blacksmith, and when the car comes along. But the —

So, I don't quarrel with the activities. I quarrel, sometimes, with how it's done. And I do think there's been a certain lack of, in certain cases, some empathy or sensitivity in terms of the way it's being done.

You should try to make your businesses more efficient. We hope we're not in businesses that will require us to lay off people over time, because we hope that physical output grows, and that we become more productive and can keep the same number of people to get greater output.

Dexter Shoe has done a great job of that over time. They've become more and more productive. But they've sold more shoes instead of selling the same number of shoes and letting people go. But sometimes, industry trends —

I mean, at World Book, we have fewer people than we had a year or two ago. And we didn't — we don't have any answer to that.

Over time, we got out of the textile business. I wish we didn't have to. But we did not know how to run a textile company in New England and compete effectively.

Like I say, I would — I love avoiding those businesses. And to the extent we can, we will.

I mean, GEICO is going to add people over time. And I think Berkshire Hathaway's going to add people over time.

But I can't — but it is in the interest of society to do jobs more effectively. It's also in the interest of society, it seems to me, to take care, in some way, of the people that are affected by that activity. And either — in some cases, it may be retraining.

But in other cases, you know, it doesn't work so well if you're 55 years old, and you've been working in a textile mill all your life, and all of a sudden the guy that runs the place can't make any money out of selling your output. I mean, that's not the fellow's fault that's been working at the textile mill for 30 years.

So, there's a balance in that. I think that the attention that's come about lately, I think there's — to some degree, it was a media fad based on some particularly dramatic examples at a couple of companies.

I don't think there is more displacement going on now, as a percentage of the labor force, annually, than there was 10 years ago, in terms of reconstituting what people do. But it's gotten a lot of attention lately.

There could be a backlash on that, in terms of corporate tax rates or a number of things. And we might feel it in that direction.

We want, at Berkshire, to do everything as efficiently as we can. Part of that, in a big way, is not taking on a lot of people we don't need.

A lot of the mistakes that are being corrected now are because people got very fat. And their businesses got very fat in the past and took on all kinds of people they don't need. We see that in a lot of businesses that we're exposed to.

And as long as they're very prosperous, really, no one does very much about it. And then when the time comes, they all of a sudden find out they can get way more output.

The oil companies are a classic example. You know, the people, probably, actually needed to produce, refine, and market oil probably hasn't changed that much. But if you look at the employment relative to barrels produced, refined, and marketed, it's gone down dramatically over 20 years ago.

To me, it just means that they weren't being run that well 20 years ago. And it never should've occurred in the first place.

We don't want to take on more people than we need in any of our businesses, because we don't want to lay people off, either.

Charlie?

CHARLIE MUNGER: Well, if you put it in reverse, you'd say, name a business that has been ruined because it was over-downsized. I cannot think of a single one.

But if you asked me to name businesses that were half-ruined, or ruined, by bloat, I mean, I could just rattle off name after name after name.

It's gotten fashionable to assume that downsizing is wrong. Well, it may have been wrong to let the business get so fat that it eventually had to downsize.

But if you've got way more people than are needed in the business, I see no social benefit in having people sit around half employed or unemployed.

WARREN BUFFETT: You're very likely to compete against some guy, at some point, who doesn't have more people around than needed in the business, too. But it doesn't change. For the people involved, they've got real problems, and —

CHARLIE MUNGER: Warren, can you name one that has been ruined by over-downsizing? There must be one, but —

WARREN BUFFETT: Well, it's like Eisenhower said about Nixon. Give me a week, and I'll come up with something. (Laughter)

6. No layoffs at insurance operations due to reduced volume

WARREN BUFFETT: How about zone 6?

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, I'm Walter Kaye of New York City.

WARREN BUFFETT: We're glad to have you here, Walter.

AUDIENCE MEMBER: What?

WARREN BUFFETT: We're glad to have you here. Walter's been a good friend of ours.

AUDIENCE MEMBER: Thank you very, very much. You just make me more of an egomaniac, a humble egomaniac, by saying that.

I don't know if Mr. Munger's wife is here and Mrs. Buffett is here, but back East, where I come from, in New York, they say, "When people — when men are successful, it's their wife's doing. But if they're a failure, it's because they're lazy." (Laughter)

But anyhow, I just wanted to, again, thank you very much. You've done such great things for our family. It's absolutely incredible.

And to those of you who don't know these two gentlemen, besides being financial geniuses, and you all know Mr. Buffett and, somewhat, Mr. Munger, too, they're the finest human beings you'll ever meet. I mean, just the way they explained this downsizing is the most intelligent thing that I've ever heard.

And eventually, like, you know, these people eventually find work. They have to be reeducated and everything like that.

But one point of business I'd like to ask you, if you don't mind. I have been noticing that there has been a tremendous amount of new capital going into reinsurance carriers.

And I was wondering if you could make a few comments about that, if you think that will affect the reinsurance business — have any effect on the insurance business in general, because, as you know better than I, we're still in a very soft market.

And there isn't a month that goes by that I don't hear of some new reinsurance carrier, whether in Bermuda or London or somewhere. Thank you.

WARREN BUFFETT: OK. Walter knows more about insurance than I do. But I'll, nevertheless, comment on that.

There has been a fair amount of capital. And there was a rush of it about, I'd say, maybe three years ago into the reinsurance business.

But there has been capital come in, and that is negative for our business. I mean, because any capital that's brought in, basically, will get employed.

We are willing, at Berkshire — and we do it — we are willing to sit on the sidelines in the reinsurance business.

We'll offer quotes. But somebody that — will cut those prices substantially, if they've got a lot of capital and want to keep busy. And if you've got a lot of capital in this business, or if you attracted a lot of capital, you will do something. You might like to do something smart, but if need be, you'll do something dumb.

You'll rationalize it, so you think it's smart. But you will do it. You won't just sit there and write the shareholders at the end of the year and say, you know, "We asked you for $300 million last year. And we'd like to report that it's all safely in a bank account at Citicorp." It just doesn't work that way.

So they will go out and do something. People don't like to sit around all day and do nothing.

And that means that prices will get cut under certain circumstances. And those circumstances — that's happening now.

We will — at Berkshire, we do have a rule about downsizing on that. We have promised people, at all of our insurance operations, that we will never have layoffs because of a drop in volume. We do not want the people who run our insurance business to feel they have to write X dollars in order to keep everybody there.

We can afford some overhead around that's costing us a little money for lack of using it at full capacity, because it isn't that much, relative to the size of our insurance operation.

What we can't afford are people feeling some internal compulsion to keep writing business in order to keep their job. So, we have a strong policy on that.

And if the business falls away, in terms of price, we won't be doing business. But we will be around to do business in a big way when the circumstances reverse.

They reversed in the casualty business for a while in 1985 or thereabouts. And we did a terrific amount of business.

They reversed in catastrophe reinsurance four or five years ago, and we became very active in that, and —

We will have times that are very good for us in insurance. It's a lot like investments. If you feel you have to invest every day, you're going to make a lot of mistakes. It just — it isn't that kind of a business. You have to wait until you get the fat pitch.

And in insurance, it's similar. You do not — if we had a budget for premium volume for our insurance companies, it would be the dumbest thing we could do, because they would meet the budget.

They could meet any budget I set out. I could tell some operation that wrote a hundred million last year to write 500 million this year, and they would meet it, you know, and I would be paying the bills for decades to come, so —

It's a very illogical way to try and plan 8 or 10 percent-a-year growth.

Now, GEICO is a different story in that GEICO is a business that is the low-cost operator and can attract, from a huge pool, business at, I think, a very good rate of growth simply by letting people know what's available out there. So that is a business that I see growing under almost any circumstances.

But our reinsurance business will swing around enormously, in terms of volume, based on what the competitor is doing. And what the competitors are doing depends, to a great extent, on how much money they've got burning a hole in their pocket.

And right now, it's going one direction. But it will change, I mean, just like investment markets change, you know. I've been through at least a half a dozen periods where people think, you know, they're never going to get a chance to buy securities at intelligent prices. And it always changes.

In the insurance business, people that misprice their policies will pay the price for it. And the world will still need insurance. And we will still be there.

7. International expansion for GEICO would be dangerous distraction

WARREN BUFFETT: Zone 7? Oh, we don't have any. I guess we have everybody in here now, so we'll go back to zone 1.

AUDIENCE MEMBER: Mr. Buffett, salutations from Portugal. I am from Portugal. My name is Herculano Fortado (PH). I have been a shareholder of your company since it was traded on the NASDAQ.

And I hold the shares and went on accumulating year after year, whenever funds were available and were at my disposal.

Now, a little bit about my history. As a student, I am from India. I was born in India, of Indian parentage. And my parents were very modest and could not afford me higher education. I started my school —

WARREN BUFFETT: I think maybe you'd better just get to the question, though, if you will, please.

AUDIENCE MEMBER: Yes. And then started writing insurance, life insurance, for a company which was a subsidiary of American Life.

My question now is this. I am now living in Portugal, and I see that the European market is developing and Berkshire Hathaway is having a very big slice of insurance investments.

They don't seem to be operating in the new markets that are emerging in Europe, and as well as in countries like India or the Pacific area, where the human — two-thirds of human beings are living.

Is there a policy or a plan, on the part of Berkshire Hathaway, to diversify and internationalize their insurance business? This is my only question.

WARREN BUFFETT: Thank you.

The reinsurance business of Berkshire Hathaway is totally international. I mean, we deal with risks all over the world. We deal with companies all over the world.

And that's the nature of the reinsurance business, generally, although there might be some that would be more specialized to this country, but —

We are quite willing to take on risks around the world, although they have to be risks with a large premium. I mean, that's the nature of our reinsurance business. We're not in the retail end of the business.

But we do that worldwide. And we'll continue to do that worldwide, because there are huge risks that exist for primary insurers around the world. And they need somebody to lay them off on.

Now, whether they will pay the proper price is another question. And it may be a little more difficult, in a few jurisdictions, to do business than in others. But that's an international operation.

GEICO has two-and-a-fraction percent of the U.S. auto market. We have about 2 1/2 million policyholders. There are over a hundred million in the country.

And there is such an opportunity here that it would be diversionary to go into other countries with GEICO.

There's been a firm that was very successful over in England that introduced a somewhat GEICO-like operation about 10 years ago. And they did very well. They are now encountering more competition. And their results are falling off somewhat, but —

There's a huge potential for GEICO in this country. And I would not want the management of GEICO to be going off in other directions now, when there's so much to be done here.

I mean, three percentage points on our growth rate here, for example, you know, would be 75 million or so of volume. And that, in turn, would keep compounding over time. Well that — there's too much to do here before we set up some startup operation around the world.

And there are actually various problems in a lot of jurisdictions in — to run a GEICO-like operation — although I wouldn't say that that prevails every place. I mean, there could be opportunities. But the opportunity here in this country is huge. And the management of GEICO is focused.

I love focused management. The management of — if you read the Coca-Cola annual report, you will not get the idea that Roberto Goizueta is thinking about a whole lot of things other than Coca-Cola.

And I have seen that work time after time. And when they lose that focus — as, actually, did Coke and Gillette both, at one point 20 to 30 years ago somewhat — it shows up.

I mean, it — two great organizations were not hitting their potential 20 years ago. And then they became refocused. And what a difference it makes. It makes tens of billions of dollars' worth of difference, in terms of market value.

GEICO actually started — they started fooling around in a number of things in the early '80s, and they paid a price to do it. They paid a very big price.

They paid a direct price, in terms of the cost of those things, because they almost all worked out badly. And then they paid an additional price in the loss of focus on the main business.

That will not happen with the present management. Tony Nicely thinks about nothing else but doing — carrying the GEICO message to people who — that 97 1/2 percent or so that are not policyholders. And that will work very well for us over time.

Charlie?

CHARLIE MUNGER: We are indirectly in all of these emerging markets through Coca-Cola and Gillette. So, it isn't true that we're totally absent.

WARREN BUFFETT: No. Well, at Coca-Cola the international markets are 80 percent of profits — actually, a little more.

Gillette, I think they're about 70 percent or so. So, the — we love the international aspects of the Coca-Cola or Gillette businesses. And that's a very major attraction.

But the management of those companies is focused on that. But they are doing — they have distribution systems, and they have recognition, and they've got a lot going for them over there. But the beauty of it is that they're maximizing what they do have going for them, which was not the case 20 years ago.

They just sort of let it go more by default, and they started fooling around with a lot of diversification. And you know, basically, that has not worked that well. So, we like focus. We love focus.

CHARLIE MUNGER: Yeah, and doing it indirectly, as we've done, one can argue that we, thereby, do it a lot better. (Laughter)

WARREN BUFFETT: We won't explore the implications of that. (Laughter)

8. Shareholders boost Borsheims sales

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: My name's George Olson (PH). I'm from Atlanta, Georgia. I have a couple quick questions for you.

First of all, I'd like to have your comments on the USAir preferred that were — they're several quarters in arrears on.

And secondly, I was wondering about the Borsheims report from yesterday. You usually comment on that. (Laughter)

WARREN BUFFETT: Well, Susan Jacques, who runs Borsheims, called me this morning. And her voice was hoarse but happy, and — (Laughs)

Borsheims — that comparable day last year was the biggest day of the year. And it was about 60 percent up this year, so — I'm — you've done your part. (Applause)

CHARLIE MUNGER: We are starting a new custom at Berkshire Hathaway's annual meetings. A shareholder came up to me and asked for my autograph on his sales slip from Borsheims — (laughter) — which was a $54,000 watch.

Now, that is the kind of autographs we like to give. (Laughter and applause)

And so our message to you all is, "Go thou and do likewise." (Laughter)

WARREN BUFFETT: It wasn't a member of Charlie's family, incidentally. (Laughter)

9. USAir investment has improved, but was still a mistake

WARREN BUFFETT: The USAir preferred, as I mentioned in the annual report, it looks considerably better than it did 18 months ago or thereabouts.

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

And the — you know, their costs are out of line. Their costs are those that are relics of a regulated, protected environment. And they are not in a regulated, protected environment. And so far, they have not had any great success in correcting the situation.

Knowing Mr. Wolf, I'm sure he is, you know, focused entirely on getting that changed. And he will need to get it changed. And he — his record has been pretty successful at that.

So, we're a lot better off with our US Air preferred than we were 18 months ago, but it still is a mistake I made.

And we would've been a lot better off if I'd just, as Charlie says, gone out to a bar that night instead. (Laughter)

You got any comments, Charlie, on USAir? He doesn't want to comment. It may sound like it's his deal. (Laughter)

CHARLIE MUNGER: It's, plainly, worth a lot more than it was last year. (Laughter)

10. Newspapers may evolve, but won't disappear entirely

WARREN BUFFETT: And with that, we'll move to zone 3. (Laughter)

AUDIENCE MEMBER: Hi, David Winters, Mountain Lakes, New Jersey.

Without ruining my fun, can you give me a few hints about how I should think about calculating the intrinsic value — (Buffett laughs) — of the insurance businesses?

And secondly, I'm wondering about, not that you can foretell the future, either one of you, but with regards to newspapers, is there any concern that it goes the way of the printed World Book and Blue Chip Stamps?

WARREN BUFFETT: It could — I think it's very — I'll answer the second part first.

I think it's very unlikely — very, very unlikely, you know, down to a few percentage points, that newspapers will go the way of Blue Chip Stamps.

World Book is a different story. World Book has got — they have a reasonable shot at a decent future. But it's not automatic.

But the newspaper, it may be configured somewhat differently. It may get a different percentage of its revenue from circulation and advertising than it does. I mean, there may be some evolutionary-type changes in it. But it's still a bargain.

It is a bargain to anybody that is interested in their community. It's still a bargain to a great many advertisers.

We spend a lot of money advertising in newspapers in our various businesses. And we feel we are getting our money's worth, obviously. And it works.

But it just doesn't have the lock that it used to have on the business.

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

WARREN BUFFETT: Now, what was the other question about?

Did you want to repeat the first one?

AUDIENCE MEMBER: (Inaudible)

WARREN BUFFETT: Oh, yeah, the question about the insurance business, the intrinsic value.

I would say this. We have — I'm not going to give you a precise answer, but I will tell you this.

We have 7 billion, presently, of float. That's the money we're holding that belongs to someone else but that we have the use of.

Now, if I were asked, would I trade that for $7 billion and not have to pay tax on the gain that would result if I did that, but I would then have to stay out of the insurance business forever — total forever non-compete clause of any kind in insurance — would I accept that? And the answer is no.

Now, that is not because I would rather have 7 billion of float than 7 billion of net proceeds of free money. It's because I expect the 7 billion to grow.

And if I'd made that trade — that I'm just suggesting now — if I'd made that 27 years ago and said, "Will you take 17 million for the float you have, no tax to be paid, the float for which you just paid 8-million-7 when we bought the companies, and gotten out of the insurance business," I might've said yes in those days, but it would've —

CHARLIE MUNGER: Oh, you would've?

WARREN BUFFETT: Yeah. (Laughter) Yeah.

CHARLIE MUNGER: No, he keeps learning. That's one of his tricks. (Laughter and applause)

WARREN BUFFETT: That's probably true in this case. I'm not sure about other cases.

But it would've been a terrible mistake. It would've been a mistake to do it 10 or 12 years ago with 300 million.

It is not worth $7 billion to us to forego being in the insurance business forever at Berkshire Hathaway.

Even though it would all be, you know, it would be — if it were nontaxed profits, so we got the full 7 billion, pure addition to equity — we would not take it. And we wouldn't even think about it very long. So as Charlie says, that is not the answer that we would've given some time back. But it's a very valuable business.

It has to be run right. I mean, GEICO has to be run right. The reinsurance business has to be run right, National Indemnity, the Homestate Company. They all have to be run right. And it's not automatic.

But they have the people, the distribution structure, the reputation, the capital strength, the competitive advantages. They have those in place. And if nurtured, you know, they can become more valuable as time goes by.

12. Keeping more mortgages has increased Freddie Mac's risk a "tiny bit"

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Yes. I'd like to ask the chairman and Mr. Munger about Freddie Mac.

A few years ago, I think they were earning most of their money from the guarantee fees and the float. Now, they've got the huge balance sheet, a lot of short-term liabilities.

Do you think that's a more risky business now and that the spread might go away in some, you know, less-than-foreseen event?

WARREN BUFFETT: Charlie, I think he aimed that one at you. (Laughter)

CHARLIE MUNGER: It's probably slightly more risky, but I don't think they're taking horrible risks. It's still a very good business.

WARREN BUFFETT: Yeah, what the question referred to is that, formerly, Freddie Mac emphasized, normally, just the guarantee of credit and then passed all interest rate risk onto the market.

Now, they've retained, for their portfolio, a greater percentage of the mortgages that come through their hands.

I think they've structured the liabilities quite intelligently to handle what they call in the investment world "the convexity problem," but — which is that the borrower has the option of calling off the deal tomorrow or retaining it for 30 years. And that is a very disadvantageous contract to enter into, if you lend money.

They have done quite an intelligent job of attacking that by callable debt and various things. But you can't address a problem like that totally. There is no way to set up some model that satisfies that entire risk.

They've done a good job. But as Charlie says, the larger the portfolio, as compared to guarantee fees — because you've still got the — you got the credit risk on the portfolio, and you've added a little interest rate risk at the extremes.

And it doesn't keep us up nights, but it's a tiny bit riskier than it used to be.

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

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: (Inaudible) — I'm the guy who asked you my question, my family last year — (inaudible) — my mom. This guy said fine, so I — (inaudible) — (laughter).

I know you said do what you want. I just wanted to let you know that —

WARREN BUFFETT: Well, you did what you wanted. I mean, you followed my advice. (Laughter)

I'm batting 1.000. We'll see what you're batting next year. (Laughter)

AUDIENCE MEMBER: I had one quick question — (inaudible) — you said, if you have three great companies, wonderful businesses, they could last you a lifetime.

And I have — one thing that struck me in a way that — (inaudible) — great businesses get pounded down. And then you bet big on them, like American Express and Disney at one time.

And my question is, I have capital to invest, but I haven't yet invested it. I have three great companies, which I've identified: Coca-Cola, Gillette, and McDonald's.

And my question is, if I have a lifetime ahead of me, where I want to keep an investment for more than 20 or 30 years, is it better to wait a year or two to see if one of those companies stumble, or to get in now and just stay with it over a long time horizon?

WARREN BUFFETT: Yeah. Well, I won't comment on the three companies that you've named.

But in general terms, unless you find the prices of a great company really offensive, if you feel you've identified it —

And by definition, a great company is one that's going to remain great for 30 years. If it's going to be a great company for three years, you know, it ain't a great company. I mean, it — (Laughter)

So, you really want to go along with the idea of something that, if you were going to take a trip for 20 years, you wouldn't feel bad leaving the money in with no orders with your broker and no power of attorney or anything, and you just go on the trip. And you know you come back, and it's going to be a terribly strong company.

I think it's better just to own them. I mean, you know, we could attempt to buy and sell some of the things that we own that we think are fine businesses. But they're too hard to find.

I mean, we found See's Candy in 1972, or we find, here and there, we get the opportunity to do something. But they're too hard to find.

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

I mean, it may be great if you inherit. You know, Paul Getty inherited the money at the bottom, in '32. I mean, he didn't inherit it exactly. He talked his mother out of it. But — (laughter) — it's true, actually.

CHARLIE MUNGER: Close enough.

WARREN BUFFETT: Yeah, close enough, right?

But he benefitted enormously by having access to a lot of cash in 19 — in the early '30s — that he didn't have access to in the late '20s. And so, you get some accidents like that.

But that's a lot to count on. And you know, if you start with the Dow at X, and you think it's too high, you know, when it goes to 90 percent of X, do you buy?

Well, if it does, and it goes to 50 percent of X, it gets — you know, you never get the benefits of those extremes anyway, unless you just come into some accidental sum of money at some time.

So, I think the main thing to do is find wonderful businesses.

Is Phil Carret here? We've got the world —there's the hero of investing. Phil, would you stand up?

Phil is 99. He wrote a book on investing in 1924 ["Buying a Bond"]. (Applause)

Phil has done awfully well by finding businesses he likes, and sticking with them, and not worrying too much about what they do day to day.

There's going to be — I think there's going to be an article in the Wall Street Journal about Phil on May 28th, and I advise you all to read it. And you'll probably learn a lot more than by coming to this meeting, but —

It's that approach of buying businesses — I mean, let's just say there was no stock market. And the owner of the best business in whatever your hometown is came to you and said, "Look it, you know, my brother just died, and he owned 20 percent of the business. And I want somebody to go in with me to buy that 20 percent.

"And the price looks a little high, maybe, but this is what I think I can get for it. You know, do you want to buy in?"

You know, I think, if you like the business, and you like the person that's coming to you, and the price sounds reasonable, and you really know the business, I think, probably, the thing to do is to take it and don't worry about how it's quoted. It won't be quoted tomorrow, or next week, or next month.

You know, I think people's investment would be more intelligent, you know, if stocks were quoted about once a year. But it isn't going to happen that way, so —

And if you happen to come in to some added money at some time when something dramatic has happened — I mean, we did well back in 1964, because American Express ran into a crook.

You know, we did well in 1976, because GEICO's managers and auditors didn't know what their loss reserves should've been the previous couple of years.

So, we've had our share of flu epidemics. But you don't want to spend your life — (laughs) — waiting around for them.

14. "Change is likely to work against us"

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: I'm Joe Condon (PH) from London.

Both Mr. Buffett and Mr. Munger have addressed my question in annual reports and at previous meetings here. This is my first time. It has to do with investment in a few great, high-technology stocks.

I know your answer has been that, if you don't understand it, and I can't, after this performance, can't really believe that both of you don't understand most of the high-technology questions. But I'm thinking about not only Microsoft but, say, Pfizer and J&J.

All three companies, which have already proven that not only do they have a great product, proven management over 10 to 15 years, great market share positions, which are not easy to get into.

And I, frankly, don't see a big difference in the P/E ratios, for example, you could say, Coca-Cola, or, you know, against Johnson & Johnson or Pfizer, which are very powerful companies. I wonder if either or both of you would address that question again.

WARREN BUFFETT: Charlie, why don't you? (Laughter)

CHARLIE MUNGER: If you have something you think you understand that looks very attractive to you, we think it's smart to do what you understand. If — we've been unable to find companies that fit our slender talents.

We well might have been in the Pfizers and Microsofts and so forth. But we've never had to revert to it.

We don't sneer at it. Other people with more talent have found that a wonderful course of action.

WARREN BUFFETT: We generally look at businesses — we feel change is likely to work against us. We do not have great ability — we do not think we have great ability to predict where change is going to lead.

We think we have some ability to find businesses where we don't think change is going to be very important.

Now, at a Gillette, the product is going to be better 10 years from now than now, or 20 years from now than 10 years from now. You saw those earlier ads going back to the Blue Blade and all that. The Blue Blade seemed great at the time. But they keep — the shaving technology gets better and better.

But you know that Gillette — although they had that little experience with Wilkinson in the early '60s — but you know that Gillette is basically going to be spending many multiples the money on developing better shaving systems than exist now, compared to anyone else.

You know, they've got the distribution system. They've got the believability. If they bring out a product, and they say, "This is something that men ought to look at," men look at it.

And they found out here a few years ago that the same thing happened when they said to women to look at it in the shaving field. They wouldn't have that same credibility someplace else. But in the shaving field, they have it.

Those are assets that can't be built. And they're very hard to destroy.

So change — we think we know, in a general way, what the soft drink industry or the shaving industry or the candy business is going to look like 10 or 20 years from now.

We think Microsoft is a sensational company run by the best of managers. But we don't have any idea what that world is going to look like in 10 or 20 years.

Now, if you're going to bet on somebody that is going to see out and do what we can't do ourselves, I'd rather bet on Bill Gates than anybody else.

But that — I don't want to bet on anybody else. I mean, in the end, we want to understand, ourselves, where we think a business is going. And if somebody tells us the business is going to change a lot, in Wall Street, they love to tell you that, you know, that's great opportunity.

They don't think it's a great opportunity when Wall Street itself is going to change a lot, incidentally. (Laughter)

But they — you know, it's a great opportunity. We don't think it's an opportunity at all. I mean, we — it scares the hell out of us. Because we don't know how things are going to change.

We are looking, you know — when people are chewing chewing gum, we have a pretty good idea how they chewed it 20 years ago and how they'll chew it 20 years from now. And we don't really see a lot of technology going into the art of the chew, you know? (Laughter) So, that —

And as long as we don't have to make those other decisions, why in the world should we? I mean, you know, if I — all kinds of things, we don't know. And so, why going around trying to bet on things we don't know, when we can bet on the simple things?

Zone 1? (Applause)

I can see the shareholders like us sticking with the simple ones. They understand us, yeah.

15. We don't reveal more about our stocks than we have to

AUDIENCE MEMBER: Good afternoon, Warren. Jerry Zucker (PH), Los Angeles, California.

In the annual report, the second-largest holdings of unsecured securities are labeled, "Others."

Could you please expand on some of the holdings there? Like, do we still own PNC? And are we supposed to be buying Big Macs, as the press has reported?

WARREN BUFFETT: Yeah, well, actually, it's a very descriptive title, "Others." (Laughter)

We do that for several reasons. But one is that we have no interest in people buying Berkshire or looking at the Berkshire report or anything else, in order to generate investment ideas for themselves. Some people may do it, but we are not in that business.

Berkshire Hathaway shareholders are not being paid for that. There is no way it benefits the owners of the company.

So, we will not disclose, in the way of our security holdings, more than we feel we have to disclose in order to be fair about things that can be material to the company.

And we certainly have no interest in disclosing them to people who, essentially, want to use the information to try and figure out where our buying power may be, subsequently, or something of the sort.

So, we will keep raising the cutoff level. And you may see more and more in others.

And I will say this. There's a lot of speculation about what we do, in the press, and I'd say about half of it's accurate and about half of it's inaccurate.

And again, we leave to you the fun of figuring out which half is right. (Laughter)

Yeah, we hope you get a lot for your money in buying a share of Berkshire. But we don't want to act as an investment advisory service.

16. Buffett isn't worrying about the Y2K computer problem

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: David Coles, Appleton, Wisconsin.

Earlier, you made reference to the vicissitudes of time. What are the plans to ensure that all the computer systems and companies in which Berkshire has an interest will function correctly with dates of January 1st of the year 2000 and beyond?

And what will you do to reassure shareholders that we will not suffer serious business loss or failure due to incorrect handling of these dates by computer systems?

WARREN BUFFETT: Well, actually, I've got a friend that's quite involved in the — (laughter) — question of — no, I'm serious about that — the 2000 question with computers. But that's the kind of thing I don't worry about.

I mean, I will let the people who run the operating businesses work on that. And I'll work on capital allocation. And I have a feeling, one way or another, we'll get through it.

But like I say, we have — there are a lot of things at Berkshire we don't — (applause) — we don't spend a lot of time on a lot of things at the headquarters that other companies have whole departments on.

And our managers have not let us down. I mean, I must say that we've got a group at one business after another. And they focus on their business. And they mail the money to us in Omaha. And we're all happy. (Laughter)

Charlie?

CHARLIE MUNGER: I have the feeling that our people will be quite good at keeping the computer systems in order and with backups. I also have the feeling that few companies could handle a big computer snafu better than we could.

I have the feeling the Coca-Cola stock would be there. The Gillette stock would be there. The Nebraska Furniture Mart would be full of furniture and know the customers.

I don't think a computer crash is going to do us in.

WARREN BUFFETT: Yeah. You're correct, though, that that is a problem for the computer world. But as Charlie says, it'll hit other people a lot harder than it hits us.

Most of the things — we try to be in businesses that are fairly simple and that can't get all messed up.

And by and large, I think that we've got an unusual portfolio of those. And when it gets to our investees, you know, they're going to worry about those problems themselves.

We really worry about allocating money around Berkshire and having the right managers in place. That — if we can do those two right, everything else'll take care of itself.

17. Berkshire businesses are "way easier to predict"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: My name is Peter Bevelin from Sweden.

You have said that you like franchise companies, companies that have — that are castles surrounded by moats, companies that are possible to — you can have some prediction five, 10 years down the road.

But aren't businesses like See's Candy, the furniture business, the jewelry business, the shoe business, businesses that are hard to predict the future, five, 10 years down the road?

WARREN BUFFETT: What was that on the last part of that?

CHARLIE MUNGER: Aren't these businesses hard to predict five or 10 years down the road?

WARREN BUFFETT: Yeah, I think —

CHARLIE MUNGER: Things like shoe business and —

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

I think ours are way easier to predict. There are fair — they tend to be fundamental things, fairly simple. Rate of change is not fast, so I feel pretty comfortable.

I think, when you look at Berkshire five years from now, the businesses we have now will be performing pretty much as we've anticipated at this time.

I hope there are some new ones, and I hope they're big ones. But I don't think that we'll have had lots of surprises in the present ones.

My guess is we'll have had one surprise. I don't know what it'll be. But I mean, you know, that happens in life. But there won't be a series of them.

Whereas, if you — if we were to buy — if we owned a base metals business or many retailing businesses I can think of, or an auto business, I'm not sure I'd know where we would stand in the competitive pecking order five or 10 years from now.

I would not want to try and come in and displace See's Candies, for example, in the business it does, or the Furniture Mart. It's not an easy job.

So, I don't think you'll get lots of surprises with the present businesses of Berkshire, but the key is developing more of them.

18. Eisner is "most important factor" in Disney's success

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: My name is Stafford Ordahl. I'm from Morris, New York.

I was just wondering if the surprise could be coming from Disney. Because it seems to me they've been coasting, up until very recently, on the efforts of a person that's no longer with the company, [Jeffrey] Katzenberg, who is one of those rare geniuses, like [filmmaker Steven] Spielberg, that has his finger on the pulse of the American people.

And that — they don't come along every day, even in Hollywood.

They might be a very different company now that all of his efforts are, so to speak, out of the pipeline.

WARREN BUFFETT: Yeah. Have you finished, or —?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yeah, I — Katzenberg is a real talent. I would say that, by far, I mean, by far, the most important person at Disney in the last 12 years, or whatever it's been, has been [CEO] Michael Eisner.

I mean, if you know him and what he has done in the business, there's no one — [former President and Chief Operating Officer] Frank Wells did a terrific job in conjunction with Eisner.

But Eisner has been the "Walt Disney," in effect, of his tenure. He knows the business. He loves the business. You know, he eats and lives and breathes it. And he has been, in my view, by far, the most important factor in Disney's success.

Now, they face competition. The money is in — you know, the big money is in the animated films and everything that revolves around that, because you go from films to parks to character merchandising and back. And I mean, it's a circular sort of thing, which feeds on itself. There's going to be plenty of competition in that.

I mean, they've — you know, you've seen what MCA and Universal's going to do in the parks in Florida. And you know what DreamWorks is going to do in animation. And now, you've got new technology in animation, you know, through [Pixar CEO Steve Jobs.] And there's a lot of things going on in that field.

So the question is, 10 years from now, what place in the mind — because it's a share of mind. You know, they call it share of market, but it starts with share of mind — and what place in the mind of billions of children around the world, and their parents, does Disney itself have, and their characters, relative to that owned by other organizations and other characters?

And it's a competitive world, so there will be people fighting for that. But I would rather start with Disney's hand than anyone else's, by some margin. And I would rather start with Michael Eisner running the place than with anyone else, by some margin.

So that does not mean that it can't become a much more competitive business. Because people look at the video releases of a "Lion King," and they salivate.

You know, you sell 30 million copies of something at whatever it may be, 16 or $17, and you can figure out the manufacturing cost. And you know, it gets your attention. And it gets your competitors' attention.

But going back, if I had to — if I thought the children of the world were going to want to be entertained 10 or 20 years from now, and I had my choice of betting on who is going to have a special place, if anyone has a special place, in the minds of those kids and their parents, I think I would probably rather bet on Disney.

And I would feel particularly good about betting on them, if I had the guy who has done what Eisner has done over those years presiding in the future.

Charlie?

CHARLIE MUNGER: Well, I think it helps to do the simple arithmetic. Suppose you have a billion children of low-middle income 20 years from now. And suppose you could make $10 per year per child, after taxes, from your position. It gets into very large numbers.

And — (laughter) — I don't know about your children and grandchildren, but mine want to see Disney. And they want to see it — (applause) — over and over and over again. They don't want to see Katzenberg. (Laughter)

WARREN BUFFETT: Well I —

CHARLIE MUNGER: I mean, in terms of the trade name. (Laughter)

WARREN BUFFETT: It's a pretty good trade name. I mean, when you think about names around the world, it's interesting that, you know, it's very hard to beat the name Coca-Cola. But Disney's got a — it's very, very big name.

And Charlie's point that they want to see them over and over again, and it's kind of nice to be able to recycle Snow White every seven or eight years. You hit a different crowd.

And — (laughter) — it's kind of like having an oil field, you know, where you pump out all the oil and sell it. And then it all seeps back in over seven or eight years. (Laughter)

19. Why Wall Street businesses are "tough" to manage

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: I'm Randall Bellows (PH) from Chicago. Thank you for this marathon question-and-answer period.

WARREN BUFFETT: We enjoy it. Thanks.

AUDIENCE MEMBER: Thank you. My question is on the security business, Wall Street firms, in general, and specifically, what you feel about Salomon at this time. Thank you.

WARREN BUFFETT: Well, we know more about the security business than we knew 10 years ago. (Laughter)

And it, you know, it is a tough business to manage.

There's a lot of money made in the business and then — throughout Wall Street, I'm talking about. There's, you know, there's very big sums of money made. And then the question is, how does it get divided up between the institution and the people there?

And you get to this question — I've often used the analogy of, you know, would you rather — if you're an investor, and you get a chance to buy the Mayo Clinic, you know, that is one sort of an investment. And if you get a chance to buy the local brain surgeon, that's another one.

You buy the local brain surgeon and his practice for X millions of dollars. And the next day, you know, what do you own?

And if you're buying the local brain surgeon, you would not pay any real multiple of earnings because he's going to have this revelation, several days later, that it's really him and not you there, with your little stock certificate, that's producing the earnings. And it's his reputation. And he doesn't care.

Can you imagine Berkshire Hathaway advertising brain surgery, you know, how much business we would do?

So — (laughter) — he owns the business, even though you've got the stock certificate.

Now, if you go to the Mayo Clinic, no one can name the name of anybody at the Mayo Clinic, unless you live within 10 miles of Rochester [Minnesota].

And there, the institution has the power. Now, it has to keep quality up and do all the things that an institution has to do. But whoever owns the Mayo Clinic has an asset that is independent of the attitude of any one person in the place the next day.

Wall Street has a mix of both. And there are some businesses that are more — where the value resides more in the institution. And there are some where the value resides more in the individuals.

We've got a couple of sensational people running Salomon. And they wrestle with this problem as they go along. And they seem to be wrestling considerably more successfully currently than was the case close to a year ago.

But it is not an easy business to run. And it's not an easy business to predict, unless you have a business that's very institutional in character, and there aren't many of those in Wall Street.

20. Not important if part of the market is "kind of screwy"

WARREN BUFFETT: Zone 6?

Sorry we got a — the microphone's over here.

CHARLIE MUNGER: (Inaudible)

WARREN BUFFETT: Yeah. Just raise your hand and the monitor will supply the microphone.

AUDIENCE MEMBER: Thank you. Howard Winston (PH) from Cincinnati, Ohio.

One question. Are you concerned about the rising valuations on the NASDAQ market, where companies trade at multiples of revenues instead of multiples of earnings?

WARREN BUFFETT: The rising value of what, did you say?

AUDIENCE MEMBER: The NASDAQ market —

WARREN BUFFETT: Oh.

AUDIENCE MEMBER: — where they trade at 10 times revenues or more, 30 times revenues, instead of 10 times earnings?

WARREN BUFFETT: Yeah. Well, we don't pay much attention to that. Because throughout the careers Charlie and I have had in investing, there have always been hundreds of cases, or thousands of cases, of things that are ridiculously priced, and phony stock promotions, and the gullible being led in to believe in things that just can't come true.

So that's always gone on. It always will go on. And it doesn't make any difference to us.

I mean, we are not trying to predict markets. We never will try and predict markets. We're trying to find wonderful businesses. And the fact that a part of the market is kind of screwy, you know, that's unimportant to us.

We tried, a few times, shorting some of those things in our innocence of youth. And it's very tough to make money shorting even the obvious frauds. And there are some obvious frauds.

It really is — it's not tough — it's not so tough to find the obvious frauds, and it's not tough to be right over 10 years. But it's very tough to make money being short them, although we tried a few times way back.

It's — we don't look at indicia from stocks in general, or from P/Es, or price-sales ratios, or what other things are doing.

We really just focus on businesses. We don't care if there's a stock market. I mean, would we want to own Coca-Cola, the 8 percent we own of Coca-Cola, or the 11 percent or Gillette, if they said, you know, "We're just going to delist the stock and we're never — you know, we'll open it again in 20 years?"

It's fine with us, you know. And if it goes down on the news, we'll buy more of it. So we care about what the business does. Yeah.

21. A business is more important than where it's based

WARREN BUFFETT: Norton, did — why don't you give him the microphone there?

AUDIENCE MEMBER: Thank you, Warren, for including me — (Buffett laughs) — out of order.

WARREN BUFFETT: It's good to have you here. Norton [Dodge] represents a family that came in nineteen-fifty —

AUDIENCE MEMBER: Six.

WARREN BUFFETT: Six! Yeah, that joined up with the partnership and has been with us ever since. (Applause)

AUDIENCE MEMBER: A very, very fortunate connection. (Laughter)

WARREN BUFFETT: Both ways, Norton, both ways.

AUDIENCE MEMBER: And —

CHARLIE MUNGER: Careful, Norton. We don't want you mobbed on the way out. (Laughter)

AUDIENCE MEMBER: But I might say that it all began with my father [Homer Dodge] discovering — thanks to a professor of finance that was also at the University of Oklahoma — Ben Graham, back in 1940.

And then later, when Ben Graham was about to retire, we were trying to find his protégé. And clearly, that was Warren. And so he belongs to that long tradition.

But the question I wanted to ask was, you've mentioned the very strong companies that Berkshire has that are really international companies, like Coca-Cola and the — Gillette.

But are you considering, or have you ever thought of considering, the foreign companies that are undervalued? Or have you, for some reason, not included that in your universe of companies to consider?

WARREN BUFFETT: We've looked at companies domiciled in other countries. And we continue to look at companies domiciled in other countries.

We wouldn't — you know, we're happy for the U.S. and for Atlanta that Coca-Cola's domiciled in Atlanta. But would we pass on it if it happened to be domiciled in England? No, we'd love it, if it were domiciled in England, too.

And we feel that the important thing is the business, not the domicile. Although, it's — A, we're more familiar, in a general way, with domestic companies that are domiciled here, although they make — they may make their money internationally.

And we feel a tiny bit more comfortable, just a tiny bit, in terms of understanding the nuances of taxes, and politics, and shareholder governance, and all of that in something where we've been reading and thinking about it daily than someplace where we've had a little less experience.

But we would love to find a wonderful business that is domiciled in any one of 30 or so countries around the world.

We look some. We don't look as hard as we look at domestic companies. We're not as familiar with them.

But I have read hundreds of annual reports of companies spread around the world. And we've owned a few, just a couple.

They're usually not as big, so just getting the kind of money in, in many cases, is more of a problem. But some of them are big.

And we do not have such a surplus of ideas that we can afford to ignore any possibilities. And if we can find something with a market cap, probably, of at least $5 billion or greater, that strikes us as having our kind of qualities, and the price is right and everything, we will buy.

22. We never reach "for an extra eight of a percent"

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Good afternoon, Mr. Buffett. I'm Nelson Coburn (PH) from Silver Spring, Maryland. I have one question I want to ask that hasn't come up here yet.

Where does the money sit that comes in, say, from dividends and whatever other income that comes into Berkshire, that you're waiting to invest someplace else? Is it get — someplace where it's taking in a profit? Or is it just sitting, gathering dust? (Laughter)

WARREN BUFFETT: Well, we only have about four or five commercial paper names we accept. We're very picky about where we put — the money all gets invested. We do not have anything sitting around in a safe or anyplace else. So it's all invested.

But we do not get venturesome, in the least, in terms of where our short-term money goes. So we only have, like I say, maybe four or five approved names on commercial paper, all of which I approve. I mean, if anything ever goes haywire on this, it's my fault.

Right now, we have, maybe, a billion and something in relatively short-term Treasurys. And we have a little extra in some commercial paper, maybe.

But you will never see us reaching for an extra eighth of a percent on short-term yields.

Some of you may remember the fiasco in the — in Penn Central, in the commercial paper market. And Penn Central, around 1970 or thereabouts, was paying a quarter of a point, as I remember, more than other commercial paper issuers.

And of course, they, one day, despite showing a positive net worth, I think, of a billion and a half or so, they said they had a lot of net worth but no cash. Turned out cash was more important. And so they defaulted.

Now, the interesting thing about doing that is, if you're getting a quarter of a point extra, and you came over on the Mayflower, and you landed, and you said, "Well, I'm going to apply myself to getting a quarter of a point extra on short-term money," and you didn't make any mistake until you got to Penn Central, you would — aside from the compounding aspect — you would be behind at that point.

And I don't like a business that you can do right for 300 years and then make one mistake and — (laughter) — be behind.

So we are very picky about short-term paper. But it is all invested. And when it's large amounts, it probably will be in Treasurys. A couple firms' commercial paper, we take.

23. Volatile earnings to be expected at Salomon

WARREN BUFFETT: Zone 2, please?

AUDIENCE MEMBER: My name is George Gotti (PH) from Zurich, Switzerland. I've got a question with respect to Salomon.

Salomon experienced quite a large volatility in profits and even revenues in the past years. What are your views on how this will develop in the future with respect to volatility in profits and revenues?

WARREN BUFFETT: I didn't get a hundred percent of that, Charlie. Want to —?

CHARLIE MUNGER: Yeah, well —

WARREN BUFFETT: I can see, he can hear. We make a great combination. (Laughter)

CHARLIE MUNGER: Well, you can see we aren't wasting much around the joint. (Laughter)

Salomon's earnings have always been volatile, at least all the time I've been around the place. And I don't think that that volatility will — is likely to disappear.

All that said, we very much like the people at Salomon. And they've done a ton of business with Berkshire over the years and in a whole lot of different capacities. And they've done it very well.

So we're high on the firm, as a customer. And the firms we like, as a customer, we think, maybe, other people will like, as a customer. And generally, we love it, volatile or no.

WARREN BUFFETT: If you — at Salomon, as well as other firms of that type, they mark their securities to market. And so the changes in those marks go through earnings daily, actually, but you see them quarterly.

Interestingly, if you took Berkshire over the last 30 years, and marked to market, as we do now for balance sheet purposes, but not for income statement purposes, because the rules are different in that case — if you did that, you would see enormous volatility, quarter to quarter, in Berkshire's figures.

You would — I don't think you'd necessarily have seen any down year. But you would've seen swings between a few percent and, perhaps, 50 percent or something.

And if you looked quarterly, you'd have seen a number of quarters of losses. And you would've seen some great upsurges, too.

The volatility would be extreme, if it had all been run through the income account. But accounting convention does not call for running it through the income account, in the case of Berkshire. And it does, in the case of Salomon.

But the nature of their business is volatile earnings. The nature of most Wall Street businesses is going to be volatile earnings. Some may follow policies that tend to make it look a little less volatile than it might actually be, even.

The real thing that counts is two things, really. I mean, it's running it so that the volatility never kills you in any way, and the second is having a decent return on equity over time. And I think that the people at the top of Salomon are very focused on that.

CHARLIE MUNGER: I think it's illogical for the credit rating agencies to mark down Salomon as much as they do because the earnings are volatile. But they're in a style business. And it's their game.

24. Very little interaction between Berkshire subsidiaries

WARREN BUFFETT: Zone — what are we? Zone 3 now? Yeah, zone 3.

AUDIENCE MEMBER: Yes. I have three quick questions.

Do you have any formal or informal way where the managements — I know that you don't interfere with the managements of the holdings — but where they can cross-pollinate ideas, for instance, you know, selling World Book through the GEICO channel or something like that?

WARREN BUFFETT: I'll answer that right now. There's very, very, very little of that, I — you know, maybe once in two or three years, maybe some idea might strike me as worth passing along. But I — they're doing fine running their own operations.

We don't do it within Berkshire, either. They really go their own way.

Now, they know what businesses we're in. And so they can always go directly to somebody else. But they don't need me to communicate.

25. Lloyd's of London reputation problems have helped Berkshire

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: My name is Mike Macey (PH) from Las Vegas, Nevada.

My question is this. There have been some recent news articles on the problems at Lloyd's. What effect, if any, do you see the problems at Lloyd's having on an increase in the Berkshire insurance or reinsurance business?

WARREN BUFFETT: Well, I think, probably, I think it's fair to say that the problems of Lloyd's have helped us because Lloyd's had a terrific reputation. It was the first stop and, usually, the last stop for all kinds of unusual risks and large risks 20 years ago.

And the fact that they have lost some of their luster in that period has helped us. And, you know, we didn't do anything to contribute to it, but it obviously benefits us, as a competitor, when questions develop about an organization which has been a premier player in the industry.

So, Berkshire probably possesses more capital than all of Lloyd's put together, and it has established a reputation for being willing to quote on very large risks very quickly and to do exactly what it says. And it might very well be that, in many cases, we would get a call before they would get the call now.

So we've been a beneficiary and, probably, in a fairly good-sized way, from their problems. And it's more difficult for them to make inroads on us now than would've been the case 10 years ago.

We have a — I don't like to lay it on too strong — but we do have a preeminent position in a certain area of really large-scale reinsurance that will be difficult for anyone else to replicate.

Now, they may not like our prices. There may not be demand for some of the things we can do. But if there is demand, we are very likely to get some very significant business out of that position. And we've seen it some in recent years. And we'll see it more in the future.

26. "We assume we'll be around forever"

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Mike Assail (PH) from New York City with a question for Charlie about the hundred or so models we ought to have in our head —

WARREN BUFFETT: Here we go.

AUDIENCE MEMBER: — mentioned at the end of the excellent "Worldly Wisdom" speech.

I'd like to know the most useful models on industry consolidation, on product extension, on vertical integration, and any models which explain the special cases when it makes sense to invest in retailing stocks. And if Warren has anything to add or subtract, I'd love to hear it. Thank you very much.

CHARLIE MUNGER: Well, I'm glad to answer such a modest question. (Laughter)

I spoke about having a hundred models in your head. But those are all great, big models of considerable generality that are useful over and over again.

Now, you're down into very complex sub-modeling when you get into a separate model for what's going to happen in industrial consolidations and retail and so on, and I'm not up to all those sub-models. (Laughter)

WARREN BUFFETT: The truth is, you know, we're up to a few. But we take the general models and, you know, plug them in. And sometimes, the light goes on. And sometimes, it doesn't. But if it does, they could be quite useful.

If you focus, you do see repetition of certain business patterns and business behavior. And Wall Street tends to ignore those, incidentally. I mean, Wall Street really doesn't seem to learn, for very long, business lessons.

It may not be to their advantage to learn it. Charlie would — that would probably plug right in to Charlie's model. It's —

CHARLIE MUNGER: You bet.

WARREN BUFFETT: Yeah. It's better, if you're out selling the future, it may be better to forget the past, if you're getting paid on selling it and not on betting your life on it in some way.

One situation at Berkshire that really is somewhat different than many companies: we assume, and unfortunately, it's in error, but we assume we'll be around forever.

So when we — in our insurance business, we assume we're going to be here to pay every claim. And we're not going to retire at 65 and hand over something to someone else. And there wouldn't be any sense paying games on accounting because it would catch up with us later on.

And whereas, in many businesses, I don't think they have quite the same horizon on things. They do at a Coca-Cola, or they do at a Gillette.

But many companies are thinking about what kind of — I think, I'm afraid that, more than you'd like — are thinking about what little pictures they can paint for the next four quarters or so. And that's easy to do.

But our problem is we're going to be around a lot longer, we think, than four quarters, so that's not an option available to us. And we have to — we really run it as if, in the year 2050 or something, somebody's going to look and say, "Did — how'd it work out?"

27. Compensation plans must include cost of capital

WARREN BUFFETT: Zone, where are we, 5 or 6? Wherever the microphone is.

Zone 5, we got a mic over there? Maybe that was — 6! OK, we'll go to 6.

AUDIENCE MEMBER: You state, in your letter —

WARREN BUFFETT: Could you have the microphone? Or do we have one in the — yeah. Want to bring him the microphone? Particularly for the people behind you, it's a little difficult.

AUDIENCE MEMBER: Glen Rollins (PH), Atlanta, Georgia.

You state, in your letters to shareholders, that with your wholly owned companies, you reward them at a higher rate when they release capital to you. And you, likewise, charge them a higher rate when they need capital. Could you elaborate on that?

WARREN BUFFETT: Well, we — some of our businesses don't need capital at all, or need so little that it doesn't make sense to build it into a formula.

So we have certain businesses, those are the best businesses, incidentally, that take — to take, essentially, no capital because it means that, if you double the size of the business, you don't need any more capital. And those are really wonderful businesses. And we've got a few of those.

But where our businesses do produce capital, we could have all kinds of complicated systems and have capital budgeting groups at headquarters and do all kinds of things.

But we just figure it's simpler to charge people a fair amount for the money and then let them figure out, you know, whether they really want to buy a new slitter or whatever it may be in their business.

And it varies a little bit. It varies on the history of when we came in. It varies on interest rates that they — but we generally will be charging people something in the area of 15 percent, in terms of working out compensation arrangements for capital.

Now, 15 percent pretax, depending on state income taxes, is only 9 to 9 1/2 percent after-tax. So you can say that isn't even enough to charge people, but we find that 15 percent gets their attention.

And it should get their attention, but it shouldn't be such a high-hurdle rate that things that we want to do don't get done.

Our managers expect to be running their businesses for a long, long time. So we don't worry about them doing something that works for them in the next year but doesn't work five years out or vice — you know, where they don't make longer plans, because they see themselves as part-owners of the business. But we want them to be owners with a cost attached to capital.

We think it's awful, frankly, the way businesses reward executives with absolutely no regard for the cost of capital. I mean, a fixed-price option for 10 years — you know, imagine giving somebody an interest-free loan for 10 years. You're not going to do it.

And if a company is retaining a significant part of its earnings, and you give out a fixed-price option for 10 years, you know, they can do nothing with it but put it in a savings account, and they'll make some money off of it. So it — we like attaching a cost to the capital.

If we had options for me and Charlie at Berkshire, which would not — it's not going to happen, but it would not be illogical. We have responsibility for the whole place.

You could have some kind of a compensation arrangement that worked in respect to how the whole enterprise fared, and it would make sense for the two of us.

It wouldn't make sense for the rest of our managers because they work on specific units. And you should have compensation arrangements that apply to those units.

But assuming you had it for the two of us — which we're not going to have, I want to assure you — but we would say the fair way to do that would be to have an option at not less than present intrinsic value.

Forget what the market price is. Because, believe me, it — the idea of having the more depressed your market price be, the better your option price be, does not make any sense.

So we would have it at not less than intrinsic value. And then we would have it step up yearly based on something relating to a cost to capital. Because we would say, "Why should we get free use of the shareholders' capital?" And we could work out a fair stock option.

That would be perfectly appropriate. We won't do it, but it'd be a perfectly appropriate way to have us compensated that involved an issuance, then an initial price of not less than intrinsic value, and involve carrying costs.

And then we would be in a position, still, not totally analogous to shareholders, because we wouldn't have a downside that you have, but we would at least have the carrying cost that you have of ownership.

And we work that through into our unit compensation plans by having a cost of capital that, like I say, tends to run about that 15 percent area.

And if people can give us money, we should be able to figure out a way to do something better than 15 percent pretax with it. That's part of our job, too. So we will pay them to give us back money.

CHARLIE MUNGER: Well, we really invented a more extreme system. And that is the executives can buy Berkshire Hathaway stock in the market for cash.

This is a — (laughter) — very old-fashioned system, but most of them — it doesn't take any lawyers, or compensation consultants, or — and most of them have done it. And most of them have done very well with it. I don't know why it doesn't spread more. (Laughter)

WARREN BUFFETT: People say they want their management to think like shareholders. Management, you know, they're compensating them. We're going to have them think like shareholders. It's very easy to think like a shareholder. Become one, you know? (Laughter)

And you'll think exactly like a shareholder.

CHARLIE MUNGER: Right, right.

WARREN BUFFETT: It's not a great — it's not a huge psychological hurdle to get over, if you actually write a check. (Laughter)

28. Unlike many movie companies, Disney makes money for shareholders

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: John Lichter from Boulder, Colorado.

Are there some worthwhile books that you could recommend to us?

And secondly, with respect to Eisner and Disney, how would you define Michael Eisner's circle of competence? And are you concerned that he might step outside it?

WARREN BUFFETT: Well, I would say that he has proven himself very good at understanding what Disney is really all about.

And you can look back to the predecessor management, between Walt and Eisner. And they didn't really do much with that, if you look at those years.

What is special about Disney? And how do you make it more special? And how do you make it more special to more people? I mean, those are the things that you want to — and you've got wonderful ingredients to work with when you're working with something like Disney.

I mean, it — you know, one of the advantages — we were talking about the Mayo Clinic and brain surgeons. The nice thing about the mouse is that he doesn't have an agent, you know. I mean, the mouse is yours. (Laughs)

He is not in there renegotiating and, you know, every week or every month and saying, you know — (laughter) — "Just look at how much more famous I've become in China," you know, or something. (Laughter)

So if you own the mouse, you own the mouse. And Eisner understands all of that very well. I would say he's been very skillful, in terms of how he's thought about it.

I worry about any manager. It has nothing to do with Michael Eisner. But Charlie and I worry about ourselves in terms of getting out of our circle of competence.

And we've done it. It is very tempting. And it's probably part of the human condition, in terms of hubris or something, that if, you know, that if you've — as Charlie would say, if you've — you know, if you're a duck floating on a pond, and it's been raining, and you're going up in the world, after a while, you think it's you and not the rain.

You know, that there — that you're some duck. (Laughter) But —

CHARLIE MUNGER: Right, right.

WARREN BUFFETT: And we all succumb to that a little bit.

But I think that Disney, Coca-Cola, Gillette — I think those companies are very focused. I think our operating units are very focused.

And I think that gives us a huge advantages over the managers that are getting a little bored and decide that they'd better fool around with this or that to show just how talented they really are.

Charlie?

CHARLIE MUNGER: Yeah. Eisner is quite creative. And he also distrusts projections. And that is a very good combination to have in the motion picture business. (Laughter)

WARREN BUFFETT: Yeah, Charlie was a lawyer for, what, 20th Century in the old —

CHARLIE: Yes.

WARREN BUFFETT: — days? Yeah, and he saw a little bit of how Hollywood operated. And it kept us out of buying any motion picture stocks for about 30 years. Every time I'd go near one, he'd regale me with a few stories of the past.

So it's a business where people are — can trade other people's money for their own significance in their world. And that is a dangerous combination, where if I can buy significance in my world with your money, you know, there's no telling what I'll do. (Laughter)

CHARLIE MUNGER: Part of the business reminds me of an oil company in California. And it was controlled by one individual. And people used to say, about it, "If they ever do find any oil, that old man will steal it." (Laughter)

The motion picture business, it's only about half of it that has normal commercial morals.

WARREN BUFFETT: Yeah, we're not applying that to Disney.

CHARLIE MUNGER: No.

WARREN BUFFETT: Disney is really — Disney's done an extraordinary job for the shareholders.

And they make real money out of movies. Most movie companies have — they make money for everybody associated with it, but not a lot has stuck to the shareholders.

Zone 2?

AUDIENCE MEMBER: I —

29. Book recommendations

WARREN BUFFETT: What? Oh, the books! Charlie, what are you reading these days? (Laughs)

CHARLIE MUNGER: Well, I'm almost ashamed to report because I've gone back and picked up the part of biology that I put up — should've picked up 10 or 15 years earlier. And if any of you haven't done it, it's a total circus, what they figured out over the last 20 or 30 years in biology.

And I — if you take [evolutionary biologist Richard] Dawkins, "The Selfish Gene" and "The Blind Watchmaker", I mean, these are marvelous books. And there are words in those books that are entering the English language that are going to be in the next Oxford Dictionary. I mean, these are powerful books. And they're a lot of fun.

I had to read "The Selfish Gene" twice before I fully understood it. And there were things I believed all my life that weren't so, and I think it's just wonderful, when you have those experiences. We always say, "It isn't the learning that's so hard. It's the unlearning."

WARREN BUFFETT: Yeah. I made the mistake of taking Charlie up to Microsoft in December. And he became friends with [Chief Technology Officer] Nathan Myhrvold.

And they are corresponding back and forth with increasing fervor and enthusiasm about mole rats. And they copy me on all these communications. So I'm getting to see this flow back and forth on the habits of mole rats.

I really haven't found a way to apply it at Berkshire. But I'm sure Charlie — (laughs) — has got something he's working on, on that. He's gotten very interested in biology lately.

I like — you know, I've always liked reading biography, but since the — the computer has changed my life. I now find myself playing bridge on the computer about 10 hours a week. And unfortunately, I didn't want to give up sleep or eating or Berkshire. So the reading has been kind of light.

On investment books, if you're asking about that, I would recommend the first two books that Phil Fisher wrote back around 1960, "Common Sense [Stocks] and Uncommon Profits" and the second one ["Paths to Wealth Through Common Stocks"]. They're very good books.

You know, I obviously recommend, first and foremost, [Benjamin Graham's] "The Intelligent Investor," with chapters eight and 20 are the ones that you really should read.

Two of the — well, all of the important ideas in investing, really, are in that book, because there's only about three ideas. And those — two of them are emphasized in those two chapters.

Actually, I think John Train's "Money Masters" is an interesting book.

I don't know. Can you think of any others, Charlie, that we want to tout? (Laughs)

CHARLIE MUNGER: I don't know. We have such a fingers-and-toes style around Berkshire Hathaway. (Laughter) So you sort of count.

WARREN BUFFETT: The three —

CHARLIE MUNGER: I've never seen — you know, Warren talks about these discounted cash flows. I've never seen him do one. (Laughter and applause)

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: If it ever —

WARREN BUFFETT: There are some things you only do in private, Charlie. (Laughter)

CHARLIE MUNGER: If it isn't pluperfect obvious that it's going to work out well, if you do the calculation, he tends to go on to the next idea.

WARREN BUFFETT: Yeah, it's sort of — it is true. You don't — if you have to actually do it on — with pencil and paper, it's too close to think about. I mean, it ought to just kind of scream at you that you've got this huge margin of safety.

I mentioned the three ideas. The three ideas, I should elaborate on. One is that — to think of yourself — to think of investing as owning a business and not buying something that wiggles around in price.

And the second one is your attitude, which ties in with that, the attitude toward the market, that's covered in chapter eight. And if you have the proper attitude toward market movements, it's an enormous help in securities.

And the final chapter is on the margin of safety, which means, don't try and drive a 9,800-pound truck over a bridge that says it's, you know, "Capacity: 10,000 pounds." But go down the road a little bit and find one that says, "Capacity: 15,000 pounds."

30. We'll do more in insurance, but we don't know what

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Yes, Chip Tucker (PH), Minneapolis.

Mr. Buffett and Mr. Munger, what market share does Berkshire have in super-cat insurance business? And what's your outlook for both the market growth in that business and the potential market share growth with — from Berkshire?

You answered a related question regarding GEICO's auto opportunities. Are there other insurance businesses potentially worth expanding into? Or is your focus on super-cat and autos opportunity enough?

CHARLIE MUNGER: You know, Warren can answer that question a lot better than I can.

WARREN BUFFETT: I — we don't — there wouldn't be any good market share figures in something like super-cat.

We know that, a couple years, and last year, I think, too, we had to be the biggest in terms of premium volume.

We simply take on so much more than anyone else will. And we were getting the calls on the big risks, you know, 400 million here or something of the sort. We had a quote we put out on a billion dollars on the New Madrid fault here a little while ago. Nobody else will be doing that.

So we got market share by our willingness to do large volume, by the fact that people knew we would pay subsequently, but we don't — while we know we were the largest, we can't give you any precise figures.

We also know we're slipping in that now, but that makes no difference to us. We'd only be interested if we were slipping in profitable markets.

And what was the second part of the question on that, Charlie?

AUDIENCE MEMBER: What other opportunities —

WARREN BUFFETT: Oh, what other opportunities in the insurance business?

We — just this year, we bought a very, very small company [Kansas Bankers Surety], the managers of whom are here, a very fine insurance company. It has a little niche.

It — I mean, it will never be huge or anything of the sort, but it's the kind of business that we can understand. And we like the people that run it. And we like the position they've achieved in the market. So we're delighted to be in it.

We are willing to think about a whole variety of things to do in insurance. But most of them, we find, make no sense. We'll be — we'll do other things in insurance over the next 10 or 15 years. It's just bound to happen, but I can't tell you what they will specifically be.

The biggest single thing we will do in terms of value, though, probably, is grow GEICO. But we will do other things. And who knows what they might be?

We have expanded some in the — it's a small business — the structured settlement business, from when we talked a year or two ago. And we are the preferred provider of structured settlements. Those are annuities, essentially, that are payable to people who are usually the victims of a very bad accident.

So they're very severely injured people, with injuries that will probably last for life. And so we will be making payments to people who are incapable of earning a living, may incur substantial medical bills, for many decades, sometimes, 50 or 60 years.

Those annuities are provided by our companies to other insurance companies and to these injured people, usually, with the approval of the injured person's attorney.

And when the advisors to the injured person think, "Who is going to be around in 50 years to pay money to this person who's been incapacitated," they frequently, and in our view, logically, think of Berkshire. So we have become much better known in that over the last couple of years.

It's not a big business. And it won't be a big business. But it's a perfectly decent business. And it's one where we have a competitive advantage over time.

We don't obtain the competitive advantage by price. We obtain the competitive advantage from the peace of mind that the injured party obtains from knowing that that check will be in the mail 50 years from now.

And that's the kind of business where we have some edge. And we'll find other things to do over time, but can't — I can't —

It isn't like we're looking at some specific area and saying, "We're focusing on this." We're aware, generally, of what's going on in the insurance business. And we're very ready to move when the time comes, so that we can do something intelligent.

31. People rewarded by capitalism need to help those who aren't

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my family's been associated with Berkshire since 1968. So I ask this question with a great deal of respect for your integrity and your wisdom.

I work as an inner-city schoolteacher, where there is a rising and pervasive sense of hopelessness.

When I ask my students, "What would make you happy?" their predominant response is, "A million dollars." As some of the richest men in the world, I wonder what your response to them might be.

And as a second part of this question, the philosophical underpinnings of capitalism have largely ignored a systemic perspective involving issues of ongoing depletion of limited global resources exploited to sustain a market economy, widening gaps between the very wealthy and the severely impoverished, and an international view of America as a country whose primary values are greed and imperialism.

As we move into the 21st century, do you see a need to re-envision capitalist premises towards original notions of democracy, justice, and humanitarian concerns?

WARREN BUFFETT: I didn't get all of that.

CHARLIE MUNGER: Well — (laughter) — I will say this. I am higher on the existing social order than you are. (Applause)

I — there's always plenty wrong with a social order. And certainly, there are places where ours is a lot more broken than it used to be.

I don't think Warren and I have any wonderful solution to all the problems of the world. But wishing for a million dollars instead of some more tangible short step is the wrong frame of mind. That isn't the way we got our million dollars.

WARREN BUFFETT: But I don't — (Applause)

CHARLIE MUNGER: Warren might give a different answer, by the way. He's a —

WARREN BUFFETT: No, I would agree with the — I, you know — wishing for a job makes a lot of sense to me and figuring out how to get one and then going from there. But it —

There is and always has been — that doesn't mean it always should be — but there is a tremendous amount of inequality.

What you don't want is an inequality of opportunity. There will be a lot of inequality in ability.

A market system, like we have, churns out what people want. If they want to watch a heavyweight fight, and they want to watch Mike Tyson, they're going to pay him $25 million for getting in the ring for a few minutes.

And it produces what people like. And it produces it in abundance. And it's done very well in terms of production.

It is much better to be in the bottom 20 percent in this country now than it was 50 years ago. And it's better to be in the bottom 20 percent of this country than in any other country. But it still isn't very satisfactory.

The market system does not reward — it does not reward teachers, does not reward nurses — I mean, it does not reward all kinds of people who do all kinds of useful things in any way comparable to how it will reward entertainers, or people who can figure out the value of businesses, or athletes, or that sort of thing.

A market system pays very big for something that will entertain them. People want to be entertained a good bit of the day. And it pays better for people that will entertain than educate.

I think — I don't want to tinker with the market system. I don't think I should be telling people what they should want to do with their lives.

But I do think that it's incumbent on the people that do very well under that system to be taxed in a manner that takes reasonable care of anybody that is not well adapted to that system, but that is a perfectly decent citizen in every other regard.

And that is — you know, I don't want to start getting into comparable worth in terms of how I tax. But I do think that somebody like me, that happens to just fit this system magnificently, but wouldn't be worth a damn in Bangladesh or someplace, you know, because what I have wouldn't pay off there — their system would not reward that.

I think that we get from society — society provides me — this society provides me — with enormous rewards for what I bring to the game. And it does the same with Mike Tyson. And it does the same with some guy whose adenoids are right for singing or whatever it may be.

And I don't want to tamper with that. But I do think those people who are getting all kinds of claim checks on the rest of society from that — I think there should be a system that people — where people who are not well adapted to that system, but that are perfectly decent citizens in every other respect, do not really, you know, fall through the slats on that.

And I think progress has been made on that over the last 50 years. But I think we're far from a perfect society in that respect. And I hope, you know, more progress is made in the next 50 years.

I don't think the wishing for the million dollars, though — you know, it doesn't work that way. I think —

But if you are lucky enough to have something that the market system rewards, you do very well here. And if you're unlucky enough to have something it doesn't reward, you do better now than you would've 30 or 40 years ago. And you do better than in other countries.

But I can see where it seems very unjust to look at somebody else who has just a little different mix of talents that can achieve claim checks in a way that keeps them and the next five generations of their family in a position where they don't have to do very much.

CHARLIE MUNGER: I would say that I like a certain amount of social intervention that takes some of the inequality out of results in capitalism.

But I hate, with a passion, rewarding anything that can be easily faked. Because I think then people lie, and lying works, and the lying spreads. And I think your whole civilization deteriorates.

If I were running the world, the compensation for stress under workman's compensation would be zero, not because there isn't real stress. Because there's no way to keep the fakery out, if you reward stress at all.

WARREN BUFFETT: There was a great article, and this applies — (applause) — to an earlier question.

There was a very good article in Forbes about one issue ago that showed the occupational profile of the U.S. at a couple of different intervals, going back to 1900.

And one problem you can see, just by looking at that profile, is that, if you assume 20 percent of the — the bottom 20 percent — however you measure it, in terms of employability — whether it's measured by IQ, or interest in working, or energy level, or whatever you want to do — they fit, very well, most of the jobs that were available a hundred years ago.

In other words, you could do most of the jobs, of which there were many, with relatively unimpressive mental abilities. And as jobs have changed, the profile of people hasn't changed. So there are more people that end up on the short end.

Now, the good part of that is the society produces so much more that it can take care of those people, one way or another. Now, the trick is to take care of them and make them not only feel, but be productive and be part of the act, and —

We've got enough product to do that. But the country turns out way more output than 50 or a hundred years ago.

We don't have — we're not perfect at figuring out how to make the bottom 20 or 30 percent, in terms of abilities, fit a new, changing job profile.

I really recommend you look at that Forbes magazine. Because if you think through the implications of those charts, I think you'll see what social problems have to be attacked.

32. "No magic" to running a bank — just don't do "something foolish"

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Edward Barr, Lexington, Kentucky.

Earlier, you led us through a discussion of the competitive position of Disney. And you also discussed share repurchase.

I wondered if you could also lead us through a discussion of the competitive position of Wells Fargo, since they just effected such a large combination [with First Interstate], in addition with, perhaps, some discussion of their share repurchase, which is probably as large, in percentage terms, as any company I can think of at the present time.

WARREN BUFFETT: Well, Wells should repurchase their shares, if they feel that they're repurchasing them below intrinsic business value. And that's a calculation that they make.

And you should — have to ask the question of them what their calculus is of that. But that will determine whether that share repurchase program makes good sense or not.

The advantages of an in-market merger are — can be dramatic. Sometimes, it just causes a bank to do what they should've done anyway.

I mean, I'm not so — I'm not always as convinced that the economies come about through — totally through scale, as they are just from taking a hard look at how they run their business.

We may have in the audience today — he was here earlier — the CEO of the Bank of Granite, which is in Granite, North Carolina. And that bank earned 2.58 percent on assets, I believe, in the most recent quarter, annualized, and had a 33 percent efficiency ratio.

Now, that bank is 400 million or 500 million of assets. You know, it doesn't need to be 5 billion in order to get more efficient or anything of the sort.

It's got — it's so much more efficient than any of those larger banks that had to be put together to get those ratios that it makes you kind of wonder about the underlying rationale.

But I'm sure that Mr. [John] Forlines, who runs that bank, just focuses on — and he's been focusing on it for a lot of years — just doing the right things day after day. And it didn't take any in-market merger or anything of the sort to cause him to do that.

I recommend any of you in the banking business to get his report because there is nothing magic about the community of Granite, North Carolina.

Nor does he work under laws that are way different than the rest of bankers or anything of the sort. He just gets a record that — achieves a record — that makes all the rest of the records look silly.

We had a fellow over in Rockford, Illinois, in the bank we owned back in the '70s, Gene Abegg, whose brother is going to be 104. There was a fellow from Rockford here that got me to sign a note to Ed Abegg, who will be 104 soon. I wish Gene had lived to 104.

But Gene ran a bank in Rockford that, when banks — the best banks were earning one percent on assets, he earned two percent on assets. And he did it with way less leverage than anyone else and lower loan losses and big investment portfolio.

And there wasn't any magic about it. He just didn't do anything that didn't make sense.

And there's a lot of room for improvement in the banking business with or without mergers.

But I would say that Wells, on the record, has done an exceptionally good job of running their bank compared to other big banks. And I would say that those two operations put together will be run a whole lot more efficiently than if First Interstate had been run by — run on its own.

It's a business that can be a very good business, when run right, as the Bank of Granite or Illinois National Bank in Rockford proved. There's no magic to it. You just have to stay away from doing something foolish.

It's a little like investing. You know, you don't have to do anything very smart. You just have to avoid doing things that are ungodly dumb when looked at about a year later and — you know, airlines and that sort of thing. (Laughter)

And you know, that's the trick. It is not some great crystal ball game where you look into the future and see all these things that other people can't possibly see. I mean, what's complicated about Coca-Cola or Gillette or Wells Fargo, for that matter?

And that's — we like businesses like banking, if we've got somebody in charge of them that is going to run them right. We've got a — I don't know whether Bob Wilmers is here. But he runs First Empire, which we have a good-sized investment in. Bob just runs it right, you know?

I do not worry about surprises from Bob or First Empire. And he'll do things — if he can grow, and it's logical, he'll grow. And if it isn't logical to do something, he'll pass. He has no ego compulsions forcing him into some sort of action. And he runs a terrific bank.

Charlie?

33. We do "whatever comes along that makes sense"

WARREN BUFFETT: OK. Zone 5.

AUDIENCE MEMBER: Dorothy Craig (PH) from Seattle.

And I noticed, in the annual report, that your recent acquisitions doubled the revenue for Berkshire Hathaway. And it seemed astounding for me. I'm wondering how that's possible.

WARREN BUFFETT: Well, it's — for one thing, we started from kind of a small base. The — but we — the GEICO acquisition, you know, added 3 billion or so of revenues, and — actually more than that, a little more than that, but not much more. And RC Willey and Helzberg's probably added 600 million or so in the current year.

And since we were working off a base of 3 1/2 or so billion, those three acquisitions did double the revenues. We won't have many years when that happens. It's not any goal of ours to double the revenues or increase them 20 percent, even, or anything.

We just — we try to do whatever comes along that makes sense. And if there's a lot that comes along in one year that makes sense, we'll do a lot. And if there's nothing that comes along that makes sense, we'll do nothing.

So it's — there's a lot of accident in it. But last year, you know, a fair amount happened. And I'd love to see a lot happen next year. But we don't know at this point.

Charlie?

CHARLIE MUNGER: Nothing.

34. GEICO's Lou Simpson has more investing options now

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Oh me? Yes, my name is Victor Lapuma (PH). And I'm from the Virgin Islands. And my question is on the GEICO asset side.

One of the things that makes Berkshire unique is the high percentage in equity as opposed to fixed assets. And GEICO, as of the end of the year, looked like a typical insurance company with four times the fixed assets as equity assets.

And my question is, over time, will they have the same composite as Berkshire on the asset side?

And the second part of that question is, how are the asset allocations decisions being made at GEICO after the merger as compared to before the merger?

WARREN BUFFETT: The decisions at GEICO, which, as you say, is about 5 billion of marketable securities, have been made, and are being made, and will be made, by Lou Simpson. Lou has done a fabulous job of running the investments of GEICO since about 1979. And we're lucky to have him.

There are very few people that I will let run money running businesses that we have control over. But we're delighted, in the case of Lou. I mean, that's one in a thousand or something. But Lou has done a terrific job, will do a good job.

And the one thing we offer him, he has the ability to do whatever he wants to do with those assets now. He did not have that ability before GEICO became part of Berkshire. Because at that time, there were certain ratios that were necessary for — which were understandably necessary, that made sense.

With GEICO as a standalone entity, with its own net worth of a billion and a half or 2 billion, and doing 3 billion of business, it would've been inappropriate for him to take on a different configuration, beyond a certain point, in equities.

So he was constrained by the nature of the business he was in and its capitalization. That constraint no longer applies. So he, with that 5 billion, can do whatever he wants.

Now, if he does certain things, we would need to provide backup to GEICO, so that their policyholders would be protected under the most adverse of circumstances. But that's no problem for us.

We could do it by quota share reinsurance. We could do a lot of things. We could just guarantee their obligations. And we are in a position to do that.

We haven't done it yet because it's not — hasn't been necessary yet. But if it made sense — if Lou wanted to be 5 billion in equities and it made sense, we would arrange things so that the GEICO policyholders would be every bit as secure as under the most conservative of investment portfolios.

So Lou has another string to his bow now. And there may be a time when it gets used. He's been great under the old system. And he may be better under this system.

CHARLIE MUNGER: That's a very shrewd question. You're to be complimented.

WARREN BUFFETT: That means it's something we thought about — (laughs) — before, but you are to be complimented, right.

35. "Permanent holdings" probably won't be sold even if market overvalues them

WARREN BUFFETT: Let's see. Zone 1?

AUDIENCE MEMBER: Neil McMahon (PH), New York City.

Berkshire owns several companies — stock in several companies — which are called permanent holdings.

In the early '70s, we had a two-tier market, the one-decision stocks, high P/Es — 50, 60 times earnings.

If that were to reappear again, would Berkshire's companies still be permanent? Or is there a price for everything?

WARREN BUFFETT: Well, there are things that we think there's no price for. And we've been tested sometimes and haven't sold them, but —

You know, my friend, Bill Gates, says, you know, it has to be illogical at some point. The numbers have — at some price, you have to be willing to sell something that's a marketable security, forgetting about a controlled business.

But I doubt if we ever get tested on — there's only a couple of them in that category.

Actually, there — you know — I won't comment on that. (Laughs)

We really have a great reluctance to sell businesses where we like both the business and the people. So I don't think I'd count on seeing many sales. But if you ever attend a meeting here, and there are 60 or 70 times earnings, keep an eye on me. (Laughs)

Charlie?

CHARLIE MUNGER: The so-called two-tier market created difficulties, I would say, primarily because a lot of people or companies were called tier one when they really weren't. They just had been, at some time, a tier one. If you're right about the companies, you can hold them at pretty high values.

WARREN BUFFETT: Yeah, you can really hold them at extraordinary levels if you've got — it's too hard to find. You're not going to find businesses that are as good.

So then you have to say, "Am I going to get a chance to buy back the same business at a lot lower price? Or am I going to buy something that's almost as good at a lot lower price?"

We don't think we're very good at doing that. We'd rather just sit and hold the business and pretend the stock market doesn't exist.

That actually has worked out way better for us than I would've predicted 20 years ago. I mean, that mindset is — or 25 years ago — that mindset is — there's been a fair amount of good fortune that's flowed out of that that I really wouldn't have predicted.

CHARLIE MUNGER: But there, you're demonstrating your trick again, you know? Still learning. A lot of people regard that as cheating. (Laughter)

36. Buffett doesn't expect Gates will join Berkshire's board

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Yeah, Alan Rank, Pittsburgh, Pennsylvania.

Knowing your aversion to technology but your close affiliation with Bill Gates, Microsoft, have you ever considered either inviting him to be part of the Berkshire through the board, or being involved to maybe solve some of the problems with World Book and taking it to the new technology and expanding it?

And on the other end, you also love insurance and the float. Have you considered the other businesses that would have that similarity, such as cemeteries and funeral homes with their pre-need and their large cash reserves?

WARREN BUFFETT: The — Bill and I talked about the encyclopedia business some years ago. But he was pretty far down the line at Encarta, quite far down the line at Encarta, actually, before I even met him. So it wasn't — my guess is, if we had met earlier, that there might have been something evolve in that.

But he had put a lot of chips on Encarta and had done a good job with it. So it really wasn't — it wasn't a real option to work with him on World Book.

Bill also is very focused on his business. And I believe he's on the board of some biotech company in which he's got a significant investment.

But you will not see him on the boards of, at least I don't believe that you will, of American corporations — I think, if you look at the boards in the, say, up in the Pacific Northwest, where he had a lot of friends and knows the companies well and maybe grew up with some of the people.

But I don't think you'll see him on anything which really doesn't — which is just a business that doesn't grab him intellectually on something. I do think there's one biotech company that he's involved in that way. And you know, he'd be a terrific asset.

But he really focuses on Microsoft. He has his board meetings, as I remember, on Saturday. They last, you know, all day. And then he goes after the business that way. He's not —

I don't think he'd be interested on being on a bank board or an insurance company board because he just figures he's got other things to do with his time. And I think he's probably right. (Laughs)

37. Not all "float" businesses are attractive

WARREN BUFFETT: Zone 3? Oh, the question was about other kinds.

We've always had an interest in float businesses of one sort or another, but —

You know, Blue Chip Stamps was such a business, until it disappeared — (laughs) — one day, and we couldn't find it. We went — looked in the closet. We looked everywhere, out in the backyard. (Laughs) Where was it?

So we like that sort of business. But most of the float businesses, the costs are pretty explicit. And like I say, we don't like most insurance companies as float businesses. We are not interested in buying the typical insurance business, because we think the float will end up costing us too much.

We'd rather borrow money with an explicit cost attached to it rather than have the implicit costs of an underwriting loss with most companies.

But we're always — we are interested in businesses that provide cash rather than use up cash. We're willing to have them use cash, if the — if what they use will produce high enough returns. But we've got this bias toward things that throw off cash.

Charlie?

CHARLIE MUNGER: Well, if we go into the pre-need funeral home business, that'll be the day. (Laughter)

38. Expect a "better" market for Class A than Class B

WARREN BUFFETT: Zone 3. (Laughter)

AUDIENCE MEMBER: Charlie is a difficult act to follow. I'm Robert Keeley (PH) from Washington, D.C.

I have a brief comment and a brief question. The comment is that I think you may be considerably underestimating the interest there will be in purchases of Class B stock later this week and next week.

I have at least 10 friends in Washington who are aware that I'm a Berkshire shareholder and that I was coming to this meeting. And they've insisted that I report back to them tomorrow on just what happened with the Class B stock because they're very interested in buying some of it.

Now, that's anecdotal, to be sure. But if you take that ratio of 10 people to even the shareholders who are present here today, you're talking about tens of thousands of people who are going to be in that market.

And my question relates to liquidity. On page 18 of your annual report, you say, and I quote, "The prospect that most shareholders will stick to the A stock suggests that it will enjoy a somewhat more liquid market than the B."

Could you explain that? It seems to me that if most shareholders keep their A stock, do not convert it or sell it, that the B stock will be much more liquid. Maybe I don't understand liquidity.

WARREN BUFFETT: No, I think you do. You understand it. And I'll elaborate just a bit.

The — certainly, in the first week, I would expect the B stock to trade far more, although I hope it doesn't trade like most new issues trade in relation to the amount sold.

It's just the nature of a new offering that there's usually — there's always some flurry of activity. Sometimes, I think it's quite excessive. And I don't think it will be with Berkshire. But there will be some flurry of activity.

But longer range, let's just assume that there's $400 million worth of B stock. There will be 40 billion of A.

Now, admittedly, you know, I'm not going to do anything with my stock. And many people in this room have a very low tax basis and, except under very unusual circumstances, have no intention of doing anything with their stock.

So of that 40 billion, there's a very significant percentage that you might say is almost inoculated against reaction to market changes.

But there still is a very significant dollar value. There's a fair amount held by funds, for example.

And so the market value of what I would call the potentially tradeable A is likely to far exceed the market value of the potentially tradeable B. Now, it may be that all of the B is potentially tradeable, whereas, only a small portion of the A is.

But that 40-billion-to-400-million ratio, I think, almost ensures that, after the initial flurry, that the better market — and when I say, "better market," I mean the ability to move large dollar amounts in both directions with minimal movement of price — the better market — not by a huge margin — but the better market is likely to be in the A. And frankly, we hope that it is. We still hope there's a good market in the B, obviously.

But if you're talking 10 shares of the A, which is a $300,000 or so investment, I think that, two months from now — that it's likely to be that buying or selling $300,000 worth of A will have slightly less of a percentage impact than buying or selling $300,000 worth of B, but not by a significant amount.

But that's what I meant by that comment of having a slightly better market in the A than the B. And that's important from our standpoint because, if that situation became reversed and the B became the better market, then people would have a real incentive to convert from A to B over time, and eventually the B market would dominate.

We don't anticipate that happening. And I think the way we've arranged it, it won't happen. But it could happen.

Charlie?

CHARLIE MUNGER: Yeah, well, I think we've also created arrangements in the way we've written the prospectus and rewarded the selling brokers that tend to dampen demand, both individual and institutional. And we sometimes accomplish what we try to do. (Laughter)

WARREN BUFFETT: Zone 4? Don't ask us for a list of those, what we've accomplished. (Laughter)

39. Corporate return on equity will probably drop

AUDIENCE MEMBER: Dan Pico (PH), Sioux City, Iowa.

In the mid-'70s, you wrote an article on how inflation swindles the equity investor and that the average return on equity for corporate America would be like 12 or 13 percent.

Last year, the average was more like 20. Have the laws of economics been repealed or modified? Or if not, what sort of calamities might occur as we revert to the mean?

WARREN BUFFETT: Well, I have been surprised by returns on equity. There was a good article in Fortune about two issues ago. Well, it was in the "Fortune 500" issue, whenever that was. And it discussed the question of return on equity.

And it made some good points about how the introduction of putting post-retirement health benefits on the balance sheet tends to swell equity returns subsequently. In other words, it moves down the denominator in terms of total equity employed.

And there's been a lot of big-bath accounting, where there have been write-offs, so that counting that, I don't think it has gotten to 20 percent. But it's higher than — it's certainly higher than I anticipated when I wrote that article.

And I would say that it would seem very extreme to me, in a world of — like we're living in now — to have equity cap — returns on equity — close to the 20 — average close to the 20 percent rate over time. But it has surprised me, how high returns have been.

Now, you have had situations like at Coke, for example, where 25 years ago, they would not have repurchased stock. And so, they'd have piled up more equity in the business. And Coke's return on equity, if it had been following the policies of 1970 or '75, would be far less than it is now.

Coke really doesn't need equity. And so, it can earn extraordinary returns and very large dollar sums. To the extent that impacts the figures, that has some impact on them.

To the extent that General Motors sets up many, many billions of a reserve for post-retirement health benefits, that tends to make the returns on GM look a lot better than it did in the past, when it wasn't even recognizing those costs and, therefore, had an equity that really was much larger than the true equity.

So there have been some things happen like that. But all in all, I don't think, under any system of accounting, the 20 percent returns for American industry are in the cards.

Charlie?

CHARLIE MUNGER: Well, I agree. And I think that this business of having way more consolidation and the successful companies, like Wells Fargo, buying in stock, I think that's had a huge effect, too.

I don't think it's actually gotten that much — obviously, we had a long period of real growth and so on. And I think that, on average, business has earned higher returns on equity. But I think a whole lot of things have combined to goose the results. And I don't see how it could go much farther.

40. Buffett's investment doesn't reflect any real estate insights

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Yes. My name is Ted Elliott (PH) from Connecticut.

The press reported a recent investment you made in the real estate business. And I wondered if you would comment as to your outlook for that business.

WARREN BUFFETT: Well, that's just sort of an asterisk. I've got virtually everything in Berkshire, and I own a few municipal bonds outside and a few other things, but I don't want to buy anything that Berkshire's involved in. It just complicates life. And all the best things I like — (laughs) — are in Berkshire.

So every now and then, some little thing happens to hit the radar screen that is too small, really, for Berkshire. And I'd bought a hundred shares of that company back when I — it's called Property Capital Trust — I'd bought 100 shares of that back when we owned NHP, which had done a couple of deals with them. So I — my policy of reading every annual report in sight that can further my knowledge about anything, I bought 100 shares.

And then I happened to see a year or so ago, where they said they were going to liquidate. So having some money around, I bought that. But it's not based on any feeling about the real estate business, any sophisticated analysis of the company, or anything else. It's a minor personal investment.

I have no insights whatsoever. We've done a few things in real estate at Berkshire. But they've been large things. And there was a brief period when there were a couple things that were intelligent to do.

If we'd started a little earlier, there might've been a lot more things. But we started a little late. So we're doing nothing now. But we listen to things, occasionally.

But we're looking. We're basically looking for big things at Berkshire. And we haven't found anything in real estate in a long time. And we may never.

But who can tell? I mean, we've got our oar in the water. And the couple things we're in are working out fine. But they're not significant relative to Berkshire's size.

41. Berkshire's past growth not a yardstick for new investments

WARREN BUFFETT: We'll go to zone 6. And this is the last question because it's going to be 3 o'clock. And let's have zone 6.

AUDIENCE MEMBER: Hi, my name's Mike Nolan from New Jersey. My wife and I have been shareholders since 1984, and happy ones. Thank you both. Two questions today.

In the retail store industry, in light of Berkshire's outstanding 23 percent annual growth in book value per share and the industry's roughly 8 to 9 percent growth in equity over the last several years, we wonder, why would Berkshire exchange stock for securities such as these, when the growth and the net worth of the acquired companies, if they're anywhere near the industry average that you've acquired this year, are one-third or less?

To quote Barnett Helzberg from the annual report, "The diamond business is a very competitive industry."

WARREN BUFFETT: Well, all retail is competitive. And both of those companies have averaged a lot better returns on equity than the numbers you cite for the industry.

And the second point, you know, we have no way of making 23.6 percent in the future. So we do not use our historical — if we used our historical average as a yardstick for new investments, we would make no new investments because we don't know how to make 23.6 percent in the future.

But we like — we regard the retail business as a very tough business. We like the records of those companies, their market positions, and their managements. And when we find a business like that, and we feel very comfortable with the people running it, we will make the deal.

But we won't expect to make 23.6 percent on our money over time doing that.

I'd like to thank everybody for coming. You've, you know — (Applause)

Morning Session - 1997 Meeting

1. Buffett is losing his voice

WARREN BUFFETT: Good morning. I'm Warren Buffett, the chairman of Berkshire Hathaway, as you probably have gathered by now. (Laughs)

I had a real problem last night. I was losing my voice almost entirely. I don't want you to think I lost it cheering for myself this morning here. I think I'll do all right, but we've always got Charlie here to — he's always done the talking. I just move my lips, you know. (Laughter)

So I'd like to tell you a little bit about how we're going to conduct things. And then we'll go through a script that was written by the speechwriter for Saddam Hussein. It has all the warmth and charm and participatory elements you'd expect.

And we'll get through the business of the meeting as promptly as we can, which is usually about five or six minutes. And then Charlie and I will answer questions, your questions until noon, when we'll have a break for about a half an hour.

There's food outside all the time. And then at 12:30 we'll reconvene, and we'll go till 3:30 or thereabouts. And I hope my voice lasts. We've got various non-Coca-Cola products here designed to keep it going.

We'll have a zone system where we have 12 microphones placed around, and — I believe it's 12 — and we'll just go around in order. And if you'll go to the microphone nearest you, there will be someone there who will try to arrange the people — get to ask questions in the order in which they arrived. And we'll make sure that everybody gets a chance to ask their questions before people go on to second questions.

Particularly in the afternoon, we'll make a special effort to answer the questions from people that have come from outside North America. We really got quite an attendance today. All 50 states — at least in terms of tickets — all 50 states are represented.

We had — I had it here somewhere. Yeah, we had ticket requests, at least, and I met a number of people from South Africa, Australia, Brazil, England, France, Germany, Greece, Hong Kong, Ireland, Iceland, Israel, Saipan, New Zealand, Saudi Arabia, Singapore, Sweden, Switzerland.

So when people have come from that sort of distance, we want to make sure that they — obviously we want to make sure that they particularly get their questions answered.

Interestingly enough, we have an increased percentage from last year who come from Nebraska this year. And you have to be a little careful in interpreting that, because some people say they're from Nebraska and really aren't, because for status reasons they, you know, like that. (Laughter and applause)

So make them produce their driver's license if they tell you they came from Nebraska.

2. Formal business meeting begins

WARREN BUFFETT: I think that's most of the preliminaries, so I'm going to get into this. We'll get the meeting over with here promptly with your cooperation.

And I will go through this little script that's been prepared for me, and it says, the meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company. I welcome you to this 1997 annual meeting of shareholders.

I will first introduce the Berkshire Hathaway directors that are present in addition to myself. I've introduced you to Charlie already.

And the other directors, I believe, are in the front row here. If they'd stand when I mention their names, you can withhold any applause until finished, and then it's optional. (Laughter)

Howard Buffett, Howie you want to stand up? Susan Buffett. Walter Scott. And Malcolm Chace III, "Kim" Chace. And that is our extensive directorate. (Applause)

Give them a lot of applause because they don't get much else for it. It's a rather low-paying board. (Applause)

Also with us today are partners in the firm of Deloitte and Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc B. Hamburg. Proxy cards have been returned through last Friday representing 1,012,050 Class A Berkshire shares and 645,940 Class B Berkshire shares, to be voted by the proxy holders as indicated on the cards. That number of shares represents a quorum, and we will therefore directly proceed with the meeting.

We will conduct the business of the meeting and then adjourn the formal meeting. After that we will entertain questions that you might have.

First order of business will be reading of the minutes of the last meeting of shareholders, and I recognize Mr. Walter Scott Jr. who will place the motion before the meeting.

WALTER SCOTT JR.: I move the reading of the minutes of the last meeting of shareholders will be dispensed with.

WARREN BUFFETT: Do I hear a second?

VOICES: (Inaudible)

WARREN BUFFETT: We got a second. The motion has been moved and seconded. Are there any comments or questions? We will vote on this motion by voice vote. Those in favor say “aye.”

VOICES: Aye.

WARREN BUFFETT: Opposed? Say, “I’m leaving.” (Laughter)

The motion is carried. Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated, a proxy statement that accompanied the notice of this meeting that was sent by first-class mail to all shareholders of record on March 7, 1997, being the record date of this meeting, there were 1,205,078 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 815,015 shares of Class B Berkshire Hathaway common stock outstanding with each share entitled to 1/200th of a vote on motions considered at the meeting. Of that number, 1,012,050 Class A shares and 645,940 Class B shares are represented at this meeting by proxies returned through last Friday.

WARREN BUFFETT: Thank you. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so. If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you.

Will those persons desiring ballots please identify themselves so that we may distribute them?

3. Berkshire board elected

WARREN BUFFETT: OK, the one item of business for this meeting is to elect directors. I now recognize Mr. Walter Scott Jr. to place a motion before the meeting with respect to election of directors.

WALTER SCOTT JR.: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace III, Charles T. Munger, and Walter Scott Jr. be elected as directors.

WARREN BUFFETT: It sounds good to me. Is there a second? (Laughter)

It has been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace III, Charles T. Munger, and Walter Scott Jr. be elected as directors. Are there any other nominations? Is there any discussion?

My kind of group.

The nominations are ready to be acted upon. If there are any shareholders voting and present, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections. Think we had one or two to collect there.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors, voting the proxies in accordance with the instructions they have received?

Miss Amick, when you are ready you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday cast not less than 1,015,697 and 2,300 votes for each nominee. That number far exceeds the majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as those cast in person at this meeting, if any, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace III, and Charles T. Munger, and Walter Scott Jr. have been elected as directors. After adjournment of the business meeting I will respond to questions that you may have that relate to the business of Berkshire but do not call for any action at this meeting.

Does anyone have any further business to come before this meeting before we adjourn? If not, I recognize Mr. Walter Scott Jr. to place a motion before the meeting.

WALTER SCOTT JR.: I move this meeting be adjourned.

WARREN BUFFETT: Second?

VOICES: (Inaudible)

WARREN BUFFETT: Motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say “aye.”

VOICES: Aye.

WARREN BUFFETT: Opposed, say “no.” The meeting is adjourned. (Laughter and applause)

You’re a very good group. You know, in that movie they said something about $350,000 an hour, and I see you’re conserving your money here by moving this thing right along. (Laughter)

4. Q&A session begins

WARREN BUFFETT: Now we’re going to answer questions. And if you’ll just go to the nearest microphone, and let’s see where we start here. I’m just orienting myself to a map here. And we have area 1 is right here.

I might describe this ahead of time. We have six areas on the main floor and we have six areas throughout the balcony. And they sort of work their way back one through six, and then seven starts over here, and then it works its way around to 12. And we look forward to having questions, the tougher the better. And if you always would just identify yourself and where you’re from, and that you’re a shareholder.

5. McDonald’s isn’t as “inevitable” as Coca-Cola and Gillette

AUDIENCE MEMBER: Yes, sir. My name is Tom Conrad (PH) and I’m from McLean, Virginia. And I’m a shareholder.

And I asked a question last year, Mr. Buffett, to you. I was struck with what you said, that it takes only three quality companies to be — to invest in to be set for a lifetime. And I asked you the question last year, “Should I wait until the market goes down, or should I get in now?”

And you advised to get in now, and the three companies that I chose were Coca-Cola, Gillette and Disney. And because of that advice I was able to afford the ticket to come back this year — (laughter) — to ask you a second question. (Buffett laughs)

And my question is this. I’m thinking of —

WARREN BUFFETT: You ought to quit while you’re ahead, but go ahead. (Laughter)

AUDIENCE MEMBER: I’m thinking of expanding to a fourth company. The fourth company that I’m thinking of is McDonald’s. And —

WARREN BUFFETT: I see.

AUDIENCE MEMBER: — I just wanted to ask you if you feel that McDonald's has the same ability to dominate the way Coca-Cola and Gillette has.

And secondly, do you feel that if the answer is yes, that I should wait until the price comes down a bit, or get in now? And that's my question.

WARREN BUFFETT: Would you it to the eighth of a point, or shall we round off? (Laughter)

In the annual report, we talked about Coca-Cola and Gillette in terms of their base business being what I call "The Inevitables." But that related, obviously, to the soft drink business in the case of Coca-Cola and the shaving products with Gillette. It doesn't extend to necessarily everything they do. But fortunately in both those companies those are very important products.

I would say that in the food business, you would never get the total certainty of dominance that you would get in products like Coca-Cola and Gillette. People move around in the food business, from where they eat, from — they may favor McDonald's but they will go to different places at different times. And somebody starts shaving with a Gillette Sensor Plus is very unlikely to go elsewhere, in my view.

So they do not — you just — you never would get in the food business, in my judgment, quite the inevitability that you would get in the soft drink business with a Coca-Cola.

You'll never get it again in the soft drink business. I mean, it took a hundred — I guess it'd be 1886, so it'd be about 111 years to get to the point where they are. And the infrastructure's incredible, and — so I wouldn't put it quite in the same class, in terms of inevitability.

That doesn't mean — it can be a better stock investment, depending on the price. But you're not going to get the price from me, and knowing Charlie I doubt if you'll get the price from him. But we'll give him a chance. (Laughs)

(Laughter)

He's breathing, folks. He's breathing. (Laughter and applause)

CHARLIE MUNGER: We've got this down to a routine. (Laughter)

No, I have nothing to add, Warren.

WARREN BUFFETT: OK. (Laughter)

I didn't have anything to say, either. I just took longer. (Laughter)

6. You can pay too much even if a business is "wonderful"

WARREN BUFFETT: How about area 2?

AUDIENCE MEMBER: Mr. Buffett, my name is Pete Banner (PH) and I'm from Boulder, Colorado, and I'm a shareholder.

Recently [Federal Reserve Chairman] Mr. [Alan] Greenspan made his comments about exuberance. And it wasn't long thereafter that you came out in the annual report and made your comments that you felt the market was fully valued or something of that nature.

Did you have, or have you had, any communication with Mr. Greenspan regarding the valuation of the stock market?

WARREN BUFFETT: No, the answer to that is no. The last time I — well, I can't remember precisely when the last time I saw Alan Greenspan was. It was a long time ago.

We had one conversation the day of the Salomon crisis, and he was formerly on the board of Cap Cities before he took his job with the Fed — Cap Cities/ABC — so I knew him then, but —

You know, it's very hard to understand what Alan says sometimes, so there's not much sense talking to him, I mean — (Laughter)

He's very careful about what he says.

But I should — I'm glad you brought up the subject of the annual report. Because what I was doing in the annual report is I had talked about Coke and Gillette as being "The Inevitables," and what wonderful businesses they were.

And I thought it appropriate, particularly — the report goes to a lot of people — that they would not take that as an unqualified buy recommendation about the companies, because they're absolutely wonderful companies run by outstanding managers.

But you can pay too much, at least in the short run, for businesses like that. So I thought it was only appropriate to point out that no matter how wonderful a business it is, that there always is a risk that you will pay a price where it will take a few years for the business to catch up with the stock. That the stock can get ahead of the business.

And I don't know where that point is with those companies or any other companies, but I did say that I thought that the risks were fairly high that that situation existed with most securities in the market, including companies such as "The Inevitables."

But it was designed to be sure that people did not take the remarks that I made about those companies, and just take that as an unqualified buy recommendation regardless of price.

We have no intention of selling those two stocks. We wouldn't sell them if they were selling at prices considerably higher than they are now.

But I didn't want — particularly — relatively unsophisticated people to see those names there and then think, "This guy is touting these as a wonderful buy." Generally speaking, I think if you're sure enough about a business being wonderful, it's more important to be certain about the business being a wonderful business than it is to be certain that the price is not 10 percent too high or 5 percent too high or something of the sort.

And that's a philosophy that I came slowly to. I originally was incredibly price conscious. We used to have prayer meetings before we would raise our bid an eighth, you know, around the office. (Laughter)

But that was a mistake. And in some cases, a huge mistake. I mean, we've missed things because of that.

And so what I said in the report was not a market prediction in any sense. We never try to predict the stock market.

We do try to price securities. We try to price businesses, is what we try to do. And we find it hard to find wonderful, good, average, substandard businesses that look to us like they're cheap now. But, you know, you don't always get a chance to buy things cheap.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that. (Laughter)

The one thing we can confidently guarantee is that real inflation-adjusted returns from investing in a standard collection of stocks will be lower in the long-term future than they've been in the last 15 years or so. This has been an unprecedented period, and there will be some regression toward the mean in average returns from investing in the stock market.

WARREN BUFFETT: American business has done extraordinarily well in the last decade-plus. And that's a huge plus for securities, because they just represent pieces of those businesses.

Interest rates over the last 15 years have fallen. That's a big plus for stocks. Anytime interest rates go down, the value of every financial asset goes up, in rational calculation.

Both of those factors have combined in recent years to produce conditions that enhance the true value of American business. But those are pretty widely recognized now, and after a while — Ben Graham always used to say you can get in more trouble in investment with a good premise than with a bad premise, because the bad premise will shout out to you immediately as being fallacious, whereas with a good premise it'll work for awhile.

You know, businesses are worth more money if interest rates fall and stocks rise. But then eventually the market action of the securities themselves creates its own rationale for a whole — for a large crop of buyers, and people forget about the reasons and the mathematical limitations that were implied in what they — in what got them excited in the first place. And after a while, rising prices themselves alone will keep people excited and cause more people to enter the game.

And therefore the good premise, after a while, is forgotten except for the fact that it produced these rising prices. And the prices themselves take over.

He wrote about that and the connection with the 1920s when Edgar Lawrence Smith in 1924 wrote a fine book on why stocks were better than bonds. And that was sort of the Bible of the bull market of the ’20s, and it made sense, if you paid attention to a couple of the caveats which were in Edgar Lawrence Smith’s little book, which related to price.

But people tend to forget about the importance of the price they pay as the experience of a bull market just sort of dulls the senses generally.

7. Berkshire discourages “street name” registrations of its stock

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Mr. Buffett, my name is Lola Wells (PH) and I come from Florida.

I’m a very minimum stockholder. And I’m curious why stockholders whose stock is held in street name aren’t eligible to make recommendations for your donations.

WARREN BUFFETT: The distinction really isn’t whether their stock is held in street — well, that’s one distinction. The Class B shareholders, as was pointed out in the prospectus originally for the B shares, do not participate in the program. The A shares that are held by the beneficial owner do participate.

We obtained a tax ruling — 1981 or thereabouts — that made sure that the — there would be no taxation as a constructive dividend of the amount that shareholders could designate. There always was that possibility that the IRS would take a position that by allowing shareholders to designate a contribution to a charity, that we were giving them something which first would be taxed as a dividend, and then they would later give away.

So we have a tax ruling, and that tax ruling applies to shares held by beneficial owners, or by record holders themselves. And we followed that ruling subsequently.

I might say it would be sort of a nightmare too, frankly, if we got into street name holders. We’re at the point now where we probably have 30 or 35,000 street name holders of the A, and with the B it's probably 60,000 or some number like that. And it would be quite a nightmare to do.

And anyone, you know, unless they have margin debt against their stock, they can put it in their own name and we encourage people to do it.

One reason we encourage people to do it is that they'll get their shareholder communications more promptly, too. We find that it's quite erratic — that the distribution of reports is quite erratic — when handled through brokerage houses to street name holders.

So we really do encourage you to have your stock registered in your own name. You'll get the communications promptly, and if you get the A shares you'll be able to participate in the contributions program.

And don't minimize your holdings, incidentally. Between the two of us we control the company, so I'm glad to have you here. (Laughter)

Charlie?

CHARLIE MUNGER: There's no ideological bias against the small shareholder. It's just not technically feasible to do it as a matter of administration.

WARREN BUFFETT: I should point out that the entire shareholder-designated contributions program, really, all of the work in relation to this meeting, I mean, and Ak-Sar-Ben has been terrific. They've helped out enormously.

But in terms of sending out 11,000-plus tickets to the meeting, the baseball tickets, the planning that goes into it and everything, it's all done by the people at Berkshire, basically. They pitch in to do all kinds of work.

So when you look at that 3,000-plus square foot office — we get help from an internal auditor who works — does not work — in the office.

But very few people just do all of their regular jobs, and then they do this on top of it. And they never thought they were getting into this. (Applause)

Thank you.

We could have a department of 50 people, you know, assigned to something like this. But, the same way — you know, we get thousands and thousands of requests for annual reports, and they all come in, and we've got just a few people, and they handle it with courtesy and cheerfulness and I really tip my hat to them.

8. Why Buffett hasn't written a book

WARREN BUFFETT: Now, let's go to Zone Four please.

AUDIENCE MEMBER: Good morning. I'm Marshall Patton (PH) from Bandera, Texas.

And first I'd like to thank you very much for not only giving us a good investment vehicle, but giving us a good education along the way. And thanks a lot for the two-volume set of the letters to stockholders over the years. It's required reading around our place.

And if you can contain your hostility, I'd like to thank Charlie Munger for — (Buffett laughs) — the copy of his speech to the University of Southern California Business School students back in 1994. It's also required reading.

And I want to ask you, when are you going to write your book?

WARREN BUFFETT: (Laughs) Well, first of all I'd like to comment on Charlie's talk here.

I think every investor in the world ought to read that talk before they invest. I think that's a classic. And we have copies available for — we mailed it out a year or so ago to the shareholders at that time. But anybody'd like a copy of that talk I'd be glad to supply it.

There doesn't seem to be any need for me to write a book. Everybody else is doing it. (Laughter)

We've got Janet Lowe here who just wrote the most recent one.

You know, at one time or another I said everything I know and a good bit more. So I've never felt compelled to do it. I really feel that the annual reports are sort of a book on the installment system.

Plus I think very few people write two books, and I have this kind of unwarranted optimism, I guess, that the best is always yet to come and there are a lot more interesting things that are going to happen, and I would hate to preclude commenting on those. So I think it's going to be a few years. But I may get around to it at some point.

But I think maybe it'd be a bad sign if it happened, because it might be that I really thought that what I was writing about was more important than what was going to happen next.

Charlie, are you going to write a book?

CHARLIE MUNGER: No, but your comment about why you are unable to write a book reminds me of the Middle Western fellow who left an unfinished manuscript. And he apologized for not finishing his book, which was entitled Famous Middle Western Sons Of Bitches. (Laughter)

And he said he was always meeting a new one — (laughter) — and therefore he could never finish the book. (Laughter and applause)

WARREN BUFFETT: As a courtesy, Charlie and I are leaving each other out of the book that we write. (Laughter)

Charlie was — Charlie grew up in Nebraska, and he's authentic. He has the credentials to prove it. We worked in the same grocery store at different times many years ago.

9. "Realistic" expectations

WARREN BUFFETT: Area 5, please.

AUDIENCE MEMBER: Mr. Buffett, my name is J.P. from Singapore. I flew 24 hours to get here.

Mr. Buffett, throughout your life you have repeatedly under promised and over delivered. For many recent years, for example, you've targeted Berkshire Hathaway's long-term book value growth at 15 percent. Yet you have come through at about 24 percent. That is a big gap of 9 percent between your modesty and the outcome. Perhaps the biggest dose of modesty in corporate history.

May I ask, why is there such a big gap between your modesty and the outcome? (Laughter)

WARREN BUFFETT: I don't think it was modesty. I think it was —

For one thing, we've had a terrific market that has reappraised all businesses in the last ten or 15 years. So when we really started worrying about future performance, the key factor was having larger amounts of capital. And there's no question that the larger the amount of capital you work with, the more difficult the job is.

Now, we were fortunate that that ascension in capital happened to coincide with things that just lifted all the boats substantially. And so we've had better luck than I would have guessed we would have had ten years ago, or five years ago.

But it's been aided by a huge tailwind. And absent that tailwind we would not have done as well. I think maybe we would have done relatively as well, but we would not have done as well in absolute terms.

And we won't have that tailwind in the future, I can assure you of that. But we will have a larger amount of capital, which is the anchor that works on it.

So, if Charlie and I could make a deal to increase the intrinsic value of Berkshire at 15 percent a year over the next ten years, we would sign up now. And I don't want you to even tempt us with lower numbers, because those numbers get astounding.

If we paid no dividend at all over a ten-year period, you can figure out where a 15 percent rate would take us. And we hope to get there, but we think that is absolutely the tops.

And I think it's very likely for a period when the market starts underperforming businesses, that the rate could be very substantially lower than that.

Charlie, do you want to expand on that?

CHARLIE MUNGER: Well, the questioner came from Singapore, which has perhaps the best economic record in the history of developing an economy. And therefore he referred to 15 percent per annum as modest. It's not modest, it's arrogant. (Laughter)

Only somebody from Singapore would call it modest. (Laughter)

WARREN BUFFETT: Yeah. Yeah. Be careful, Charlie, or they'll have a voice vote that we should move to Singapore, I mean —

This is the group that wants performance.

Large quantities of money are not going to compound at super rates — at super compound rates. Small sums probably aren't either, but large sums aren't.

And if anybody that manages large sums of money that promises or implies that they can achieve really outstanding returns, you know, I'd stay away from them.

The numbers just get too big. And you know, you've seen some of that with certain money management organizations in recent years. And you know, 15 percent on an intrinsic value which is substantially greater than our book value gets to be a very, very big number.

And we need huge ideas. We don't need thousands of ideas. I mean, we might need them, but we could never come up with them. So what we look for is the very large idea.

But we're not finding them now. And we'll keep looking, and every now and then we will find something.

But really, if you think we're going to have any chance of doing better than 15 percent, and believe me, that is no number that I'd want to sign my name to, but you really shouldn't — you're going to be disappointed in Berkshire. And we don't want to disappoint you, so that's the reason we try to be realistic about expectations.

10. Pre-Buffett Berkshire shareholders

WARREN BUFFETT: Zone 6?

AUDIENCE MEMBER: My name is Darrell Patrick (PH) from Dayton, Ohio.

How many shareholders do you have that have owned Berkshire longer than you and Charlie? And have you ever gotten together with them?

WARREN BUFFETT: How many shareholders have had it longer than we have? Well, we started buying in 1962. And it was seven and — I think the first ticket was at 7 5/8ths or thereabouts.

It was 2,000 shares. I've got the trading card on the wall, and I paid a dime commission. I can't believe I was paying a dime commission in those days. We pay a nickel now, on much higher-priced stocks. (Laughter)

It's a good thing I didn't have a fistfight with a broker about whether to pay it or not. I might have not had those 2,000 shares.

We have as a director, Kim Chace, and his family's holdings in Berkshire go back to, what? Kim, where are you down here? There we are. What year would you —?

MALCOLM CHACE: The '20s.

WARREN BUFFETT: The '20s, yeah. The Chace family has been in Berkshire since the '20s.

But I would say — we bought about 70 percent of the — Buffett Partnership, which was a partnership I ran in the '60s — bought about 70 percent of the company. So that means they were 300,000 shares roughly that were not owned by us.

Aside from the Chace family, I'm sure there are people that — I'm sure we've got, you know, 50 or 100 shareholders maybe from that earlier dates that are still around, and I'm glad they are.

Charlie?

CHARLIE MUNGER: Nothing to add.

11. Buffett's jet: "Indefensible" to "Indispensable"

WARREN BUFFETT: Area 7, up in the balcony over here.

AUDIENCE MEMBER: Maurus Spence from Omaha, Nebraska.

In light of recent stock market volatility, could you give us your definition of stock market risk, and how does your definition differ from the standard definition?

Finally, due to Charlie's recent counter-revelation about jets, are you going to rename "The Indefensible?"

WARREN BUFFETT: Charlie would like to make an announcement on that second point. (Laughs)

CHARLIE MUNGER: Prompted by Al Ueltschi, we are changing the name of the company plane from “The Indefensible” to “The Indispensable.” (Laughter and applause)

WARREN BUFFETT: Yeah, it was Chateaubriand, who, incidentally, was a writer and philosopher in addition to being the father of a piece of meat — Chateaubriand wrote one time, I believe I’m correct on my attribution here, that events make more traitors than ideas.

And if you think about that in terms of Charlie’s remark, that the purchase of FlightSafety caused Charlie to have this counter-revelation. It’s an experience that is duplicated many times in life where people flip over very quickly to a new view based on their new circumstances.

Now, what was that first question again? (Laughter)

CHARLIE MUNGER: I might add that I have a friend who’s a United Airlines pilot, and he has recently been promoted into the 747-400. Before he started carrying people like you around for hire, he had to train intensively for five weeks. One-hundred percent of his training was in a simulator. They’re that good. So —

WARREN BUFFETT: They better be that good. They cost us about 19 million.

I mean, but they’re fabulous. I mean, if you think about — I think it’s 85 percent of the problems that you can encounter in a plane, if you attempted to teach people by actually being in a plane, they wouldn’t be here anymore, so there’s —

You want to develop the instincts and responses that can react to 85 percent of the problems, the only place to learn them is in a simulator, and probably the other 15 percent the best place is.

12. “Volatility is a huge plus to the real investor”

WARREN BUFFETT: Now, let’s go back to your first question. Give it to me again.

AUDIENCE MEMBER: The first part was, would you define — give us your definition of stock market risk and how it differs from the standard definition.

WARREN BUFFETT: Yeah. We don’t think in terms of — well, we think first in terms of business risk, you know.

We — the key to [Benjamin] Graham’s approach to investing is not thinking of stocks as stocks or part of a stock market. Stocks are part of a business. People in this room own a piece of a business. If the business does well, they’re going to do all right as long as they don’t pay way too much to join into that business.

So we look at — we're thinking about business risk. Now, business risk can arise in various ways. It can arise from the capital structure when somebody sticks a ton of debt into some business, and so that if there's a hiccup in the business that the lenders foreclose.

It can come about just by the nature of the — certain businesses are just very risky. Back in — when there were more commercial aircraft manufacturers, Charlie and I would think of making a commercial airplane, a big airliner, sort of as a bet-your-company risk because you would shove hundreds and hundreds of millions of dollars out into the pot before you really had customers.

And then if you had a problem with the plane, you know, that company could go. There's certain businesses that inherently — because of long lead times, because of heavy capital investment — that basically have a lot of risk.

And commodity businesses have risk unless you're the low-cost producer, because the low-cost producer can put you out of business.

Our textile business was not the low-cost producer. And we had a fine management, and everybody worked hard. We had cooperative unions, all kinds of things. But we weren't the low-cost producer, so it was a risky business. The guy who could sell it cheaper than we could made it risky for us.

So there's a lot of ways businesses can be risky.

We tend to go into businesses that inherently are low-risk, and are capitalized in a way that that low risk of the business is transformed into a low risk to the enterprise.

The risk beyond that is that even though you buy — identify — such businesses, that you pay too much for them. That risk is usually a risk of time rather than loss of principal, unless you get into a really extravagant situation.

But then the risk becomes the risk of you yourself. I mean, whether you can retain your belief in the real fundamentals of the business and not get too concerned about the stock market.

The stock market is there to serve you, and not to instruct you. And that's a key to owning a good business, and getting rid of the risk that would otherwise exist in the market.

You mentioned volatility. It doesn't make any difference to us whether the volatility of the stock market, you know, is — averages a half a percent a day or a quarter percent a day or 5 percent a day. In fact, we'd make a lot more money if volatility was higher, because it would create more mistakes in the market.

So volatility is a huge plus to the real investor.

Ben Graham used the example of "Mr. Market," which is the — and we've used it. I've copied it in the report. I copy from all the good writers.

And Ben said, "You know, just imagine that when you buy a stock, that you — in effect, you've bought into a business where you have this obliging partner who comes around every day and offers you a price at which you'll either buy or sell. And the price is identical."

And no one ever gets that in a private business, where daily you get a buy-sell offer by a party. But in the stock market you get it. That's a huge advantage. And it's a bigger advantage if this partner of yours is a heavy-drinking manic depressive. (Laughter)

The crazier he is, the more money you're going to make.

So you, as an investor, you love volatility. Not if you're on margin, but if you're an investor you aren't on margin.

And if you're an investor, you love the idea of wild swings because it means more things are going to get mispriced.

Actually, volatility in recent years has dampened from what it used to be. It looks bigger because people think in terms of Dow points and so they see these big numbers about plus 50 or minus 50 or something. But volatility was much higher many years ago than it is now. And you had — the amplitude of the swings was really wild. And that gave you more opportunity.

Charlie?

CHARLIE MUNGER: Well, it got to be the occasion in corporate finance departments of universities where they developed the notion of risk-adjusted returns. And my best advice to all of you would be to totally ignore this development.

Risk had a very good colloquial meaning, meaning a substantial chance that something would go horribly wrong. And the finance professors sort of got volatility mixed up with a lot of foolish mathematics.

To me, it's less rational than what we do, and I don't think we're going to change. (Buffett laughs)

WARREN BUFFETT: Finance departments teach that volatility equals risk. Now, they want to measure risk, and they don't know any other way. They don't know how to do it, basically. And so they say that volatility measures risk.

And, you know, I've often used the example that the Washington Post stock when we first bought it had gone — in 1973 — had gone down almost 50 percent from a valuation of the whole company of close to, say, 180 or 175 million, down to maybe 80 million or 90 million.

And because it happened very fast, the beta of the stock had actually increased and a professor would have told you that the stock — company — was more risky if you bought it for 80 million than if you bought it for 170 million. Which is something that I've thought about ever since they told me that 25 years ago, and I still haven't figured it out. (Laughter)

13. University of Florida will teach Graham-style investing

WARREN BUFFETT: Incidentally, I should make an announcement on that, because I think that I've made a certain amount of fun of financial departments over the years.

A fellow named Mason Hawkins who runs Southeastern Asset Management just gave a million dollar gift to the University of Florida, and the state of Florida is matching that with 750,000.

So this million-seven-fifty is going to be used to have several courses in what essentially is the Graham approach to investing, I think, starting very soon. So that there will be at least — and there are more than this — but there will be a finance department in this case specifically devoted to teaching the Graham approach.

And I think they're even going to pick up on my suggestion that I stuck in the annual report about having a course on how to value a business and what your attitude toward the stock market should be.

So thanks to Mason, who's done very well managing money, I should add.

And there will be at least one university course that tackles what I think are the important questions in investing.

14. Compulsory reinvestment and "owner earnings"

WARREN BUFFETT: Zone 8, please.

AUDIENCE MEMBER: Gentlemen, my name is Richard Sercer from Tucson, Arizona.

WARREN BUFFETT: Let's give him a hand. This is the gentleman that led to the FlightSafety purchase. (Applause)

AUDIENCE MEMBER: My question relates to owner earnings. What guidance can you give us as to the calculation of item (c), which is maintenance capital spending and working capital requirements?

WARREN BUFFETT: Item (c)? Richard, I was going to ask you a question. How about another company? (Laughter)

Richard and his wife Alma have attended, what, maybe eight or so meetings, and what he did is covered in the annual report. But if it had not been for Richard we would not have merged with FlightSafety. And for that we owe him a lot of thanks.

Now, the item (c), I don't remember item (c).

CHARLIE MUNGER: He's talking about maintenance expenditures and working capital —

WARREN BUFFETT: Yeah, I know.

CHARLIE MUNGER: — and so forth. The compulsory reinvestment.

WARREN BUFFETT: Oh, oh, back on the — goes back some years on that description. Yeah.

In the case of the businesses that we're in, both wholly owned and major investee companies, we regard the reported earnings — with the exception of the — some major purchase accounting adjustment, which will usually be an amortization of intangibles item — we regard the reported earnings — actually the reported earnings plus — plus or minus, but usually plus — purchase accounting adjustments, to be a pretty good representation of the real earnings of the business.

Now you can make the argument that when Coca-Cola's spending a ton of money each year in marketing and advertising that they're expensing, that really a portion of that's creating an asset just as if they were building a factory, because it is creating more value for the company in the future, in addition to doing something for them in the present. And I wouldn't argue with that.

But of course, that was true in the past, too. And if you'd capitalized those expenditures in those earlier years, you'd be amortizing the cost of them at the present time.

I think with a relatively low inflation situation, with the kind of businesses we own, I think that reported earnings plus amortization of any — well, it's really amortization of intangibles. Other purchase accounting adjustments usually aren't that important. I would say that they give a good representation to us of owner earnings.

Can you think of any exceptions in our businesses particularly, Charlie?

CHARLIE MUNGER: No. We have — after some unpleasant early experience, we have tried to avoid places where there was a lot of compulsory reinvestment just in order to stand still.

But there are businesses out there that are still like that. It's just that we don't have any.

WARREN BUFFETT: Yeah. I would say that in the case of GEICO, for example, the earnings — the gain in intrinsic value — will be substantially greater than represented by the annual earnings.

Whether you want to call that extra amount owner earnings or not is another question. But as we build float from that business, as long as it's represented by the same kind of policyholders that we've had in the past, there is an added element to the gain in intrinsic value that goes well beyond the reported earnings for the year.

But whether you want to really think of that as earnings, or whether you just want to think of that as an increment to intrinsic value, you know, I sort of leave to you.

But I would say that there's no question that in our insurance business, where our float was $20 million or so when we went into it in 1967, and where it is now, that there have been earnings, in effect, through the buildup of the float that have been above and beyond the reported earnings that we've given to you.

I think our look-through earnings are — they're very rough. And we don't try to — we don't believe in carrying things out to four decimal places where, you know, we really don't know what the first digit is very well.

So, I don't want — I never want you to think of them as too precise, but I think they give a good rough indication of the actual earnings that are taking place, attributable to our situation every year.

And I think the pace at which they move gives you a good idea as to the progress, or the lack of progress, that we've made. The only big adjustment I would make in those is in the super-cat insurance business, we're going to have a really bad year occasionally. And you probably should take something off all of the good years, and you probably should not regard — when the bad year comes — you should not regard that as something to be projected into the future.

Charlie?

CHARLIE MUNGER: No more.

WARREN BUFFETT: No more.

15. Ratings after Walt Disney's purchase of ABC

WARREN BUFFETT: Zone 9, please.

AUDIENCE MEMBER: Mr. Buffett, I'm Rick Fulton from Omaha. Really.

Recently I was in Washington, D.C. on — with my wife on a business trip, and I wanted to tell Mrs. Graham, I know she's here, what a pleasure it is to get up in the morning to a good newspaper like the Washington Post.

Also, I have a question about CapCities and now Disney.

And is Mr. Murphy keeping busy now that ABC's owned by Disney? (Buffett laughs)

Also, every week you read in the paper the Nielsen ratings. And does it matter that ABC now, it seems that less people recently are watching? Does it matter to Disney's bottom line? Thank you.

WARREN BUFFETT: Well, the first question about Mr. Murphy is that if we could hire Mr. Murphy we would. I mean, there is no one in this world that is a better manager than Tom Murphy, or a better human being as far as that's concerned, so —

He — I think he's keeping pretty busy. He has been responsible for NYU Hospital. He wouldn't say that, but he's been the chairman of it for some years, and that's a $800 million a year or thereabouts organization. Charlie runs a hospital, so he knows how busy it can keep you.

And he — but I would say this, that I would love to find a business that I could entice Murph to come back and run. Because they don't get any better than he is.

And Charlie, you want to add anything on Murph, or?

CHARLIE MUNGER: Well, I'd like to because you're absolutely right. (Laughter)

WARREN BUFFETT: And what was the other part of the question?

AUDIENCE MEMBER: Sir, does recent — the decline in ABC's Nielsen ratings —

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: — have anything to do with the bottom line?

WARREN BUFFETT: Are we talking (inaudible) —

AUDIENCE MEMBER: — (inaudible) Forrest Gump last night? (Laughter)

WARREN BUFFETT: Yeah, it makes a difference, sure. Ratings translate in many cases into, not — depends on daypart, depends on a whole bunch of things. But overall, you make more money if your ratings are good in news, if they're good in early morning, if they're good in daytime, if they're good at late evening, whatever. I mean, ratings translate into money.

They may not translate immediately, particularly if they have some big hit show you may have sold it out too cheap. But over time the prices you receive for your product relate to ratings.

And over time, but over a longer period of time, the price that you pay for the product also relates to the ratings. But there's a difference in the time cycle. So that it makes a difference to any network's bottom line what their ratings level is.

Disney is conscious of that, and they are very able operators, and I predict you'll see in a couple of years. But you can't it immediately. The schedule fixes don't work on a, you know, week to week basis because people have habits, and there's a time lag involved in any change.

And you've seen — over the last 20 years — you've seen various networks on top or on the bottom from time to time. So it moves around. It moves around a fair amount.

Charlie?

CHARLIE MUNGER: Yeah, I think the TV network business is intrinsically a pretty tough business.

And Disney did way better on ESPN than they might have forecast, and they probably did a little worse on the network. These things happen.

WARREN BUFFETT: That was, incidentally, the situation when CapCities bought ABC. In 1985, we made the deal, I think, and it closed — I think it closed the first day or two of '86. I may be wrong on that.

But the network diminished — the ratings — diminished significantly, and particularly in daytime. We'd always thought daytime was almost a certainty to produce big earnings, and it had.

Primetime is what people pay the most attention to, but daytime slipped significantly after we bought it. It has no relationship to those movies — I mean, to a movie you saw earlier — when I started appearing on it. Don't want anybody to make that connection, but it did happen to be at the same time.

The kicker we got, again, was ESPN. ESPN was losing money when CapCities made the deal to buy ABC, and we never really regarded it as being that — having that big a potential.

And you know, it has been huge. It was enormously better for us than we ever anticipated.

Leonard Goldenson, who ran ABC, told us it was going to be that good. But, of course, we were too smart to pay any attention to him. And I think Disney has been pleasantly surprised by how well ESPN has done, too. It's a powerhouse.

16. Creation of Class B shares similar to a stock split

WARREN BUFFETT: Zone 10, please.

AUDIENCE MEMBER: My name is Bill Turan (PH). I'm from Des Moines, Iowa, and I'm a stockholder.

It would appear that there's going to be a capital gains tax cut. If it does materialize, would you consider a stock split? (Buffett laughs)

Secondly, is there an extra copy of your annual report available on the premises?

WARREN BUFFETT: My guess is we'll get you an annual report. In fact, if someone could take it up to zone 10, we'll be glad to get it to you.

I don't think — well, I'll put it this way. If they cut the capital gains tax to zero, we'll maybe — (Laughter)

I don't think I'd get Charlie's vote though, anyway. No, we will not be splitting Berkshire stock. (Applause)

Incidentally, we do not consider splitting the stock a pro-shareholder move. If we did, we'd do it.

We think that net, to take the entire experience, it's worked out well for shareholders, and we think we have a more investor-oriented — or investment-oriented — audience in this room today than we would have had if we'd split many times.

It is a way of enticing certain types of investors, and perhaps discouraging others. And so it's worked well.

But I will say this, too. We got pushed into, in effect, issuing the Class B shares last year. Wasn't our — wouldn't have been something we would have done, except for the possible formation of the unit trust. And I would say that's worked out very well from our standpoint. So we're happy that it happened, and we're happy that the Class B shareholders have joined us. And we now have something that's denominated, you know, at a much lower level.

And there have been no bad effects whatsoever from having the Class B out there. So anybody owns the A stock and wants to split, you can split 30-for-1 this afternoon. I mean, how many other companies give you that chance?

Charlie?

CHARLIE MUNGER: I think what he's trying to tell you is that you've had your stock split. (Laughter)

17. We don't know how to value Intel and Microsoft

WARREN BUFFETT: Zone 11, please.

AUDIENCE MEMBER: Yes, Mr. Buffett, I would like to thank you again for issuing the Class B shares.

WARREN BUFFETT: (Laughs) Well, I'm glad we did, and I hope you own them.

AUDIENCE MEMBER: I am a class B shareholder.

I need your comment on some analysis that we did. If someone uses your investment philosophy of building a highly concentrated portfolio of six to eight stocks, and adopts your buy-and-holding principle so that the max of compounding and no tax works for you, but however, with one major modification: invest in high-octane companies like Intel and Microsoft that are growing at 30 percent, instead of typical 15 percent growth company in your portfolio.

My question is, will this investment philosophy will translate into twice the shareholder return as you have historically provided to your shareholders?

WARREN BUFFETT: Yeah. Well, it will certainly work out to twice the return if Intel and Microsoft do twice as well as Coke and Gillette. I mean, it's a question of being able to identify businesses that you understand and feel very certain about.

And if you understand those businesses, and many people do, but Charlie and I don't, you have the opportunity to evaluate them. And if you decide they're fairly priced and they have marvelous prospects, you're going to do very well.

But there's a whole group of companies, a very large group of companies, that Charlie and I just don't know how to value. And that doesn't bother us. I mean, you know, we don't know what — we don't know how to figure out what cocoa beans are going to do, or the Russian ruble, or I mean, there's all kinds of financial instruments that we just don't feel we have the knowledge to evaluate.

And really, you know, it might be a little too much to expect that somebody would understand every business in the world.

And we find some that are much harder for us to understand. And when I say understand, my idea of understanding a business is that you've got a pretty good idea where it's going to be in ten years. And I just can't get that conviction with a lot of businesses, whereas I can get it with relatively few. But I only need a few. As you've pointed out, you only need a few, six or eight or something like that.

It would be better for you — it certainly would have been better for you — if we had the insights about what we regard as the somewhat more complicated businesses you describe, because there was and may still be a chance to make a whole lot more money if those growth rates that you describe are maintained.

But I don't think they're — I don't think you'll find better managers than Andy Grove at Intel and Bill Gates at Microsoft. And they certainly seem to have fantastic positions in the businesses they're in.

But I don't know enough about those businesses to be as sure that those positions are fantastic as I am about being sure that Gillette and Coca-Cola's businesses are fantastic.

You may understand those businesses better than you understand Coke and Gillette because of your background or just the way your mind is wired. But I don't, and therefore I have to stick with what I really think I can understand. And if there's more money to be made elsewhere, I think the people that make it are entitled to it.

Charlie?

CHARLIE MUNGER: Well, if you take a business like Intel, there are limitations under the laws of physics which eventually stop your putting more transistors on a single chip. And the 30 percent per annum, or something like that, you — I don't think — those limitations are still a good distance away, but they're not any infinite distance away.

That means that Intel has to leverage its current leadership into new activities, just as IBM leveraged the Hollerith machine into the computer. Predicting whether somebody's going to be able to do that in advance is just — it's too tough for us.

WARREN BUFFETT: Bob Noyce —

CHARLIE MUNGER: We could (inaudible) to you.

WARREN BUFFETT: Bob Noyce, one of the two founders of — two primary founders — of Intel, grew up in Grinnell, Iowa. I think he's the son of a minister in Grinnell, and went through Grinnell College and was chairman of the board of trustees of Grinnell when I went on the board of Grinnell back in the late '60s.

And when he left Fairchild to form Intel with Gordon Moore, Grinnell bought 10 percent of the private placement that funded — was the initial funding for Intel.

And Bob was a terrific guy. He was very easy to talk to, just as Bill Gates is. I mean, these fellows explained the businesses to me, and they're great teachers but I'm a lousy student. And they — I mean, they really do. They're very good at explaining their businesses.

Bob was a very down to earth Iowa boy who could tell you the risks and tell you the upside, and enormously likeable, a hundred percent honest, every way.

So we did buy 10 percent of the original issue. The genius that ran the investment committee and managed to sell those a few years later, I won't give you his name. (Laughter)

And there's no prize for anybody that calculates the value of those shares now.

Incidentally, one of the things Bob was very keen on originally, in fact he was probably the keenest on it, was he had some watch that Intel was making. And it was a fabulous watch, according to Bob.

It just had one problem. We sent a guy out from Grinnell who was going out to the West Coast to where Intel was. And Bob gave him one of these watches. And when he got back to Grinnell he wrote up a report about this little investment we had, and he said, "These watches are marvelous." He said, "Without touching anything, they managed to adapt to the time zones as they change as we went along." In other words, they were running very fast, as it turned out. (Laughter)

And they worked with that watch for about five or six years, and they fell on their face.

And as you know, you know, they had a total transformation in the mid-'80s when the product on which they relied also ran out of gas. So, it's not —

And Andy Grove has written a terrific book, incidentally, "Only the Paranoid Survive," which describes strategic inflection points. I recommend that every one of you read that book, because it is a terrific book.

But they had an Andy Grove there who made that transformation, along with some other people. But that doesn't happen every time. Companies get left behind.

We don't want to be in businesses where companies — where we feel companies can be left behind. And that means that, you know — and Intel could have, and almost did, go off the tracks. IBM owned a big piece of Intel, as you know, and they sold it in the mid-'80s.

So, you know, here are a bunch of people that should know a lot about that business but they couldn't see the future either.

I think it's very tough to make money that way, but I think some people can make a lot of money understanding those kinds of businesses. I mean, there are people with the insights.

Walter Scott, one of our directors, has done terrifically with a business that started, you know, just a gleam in the eye maybe ten or 12 years ago here in Omaha, and it turned into a huge business.

And you know, Walter explained that to me on the way down to football games, but bad student again, so — (Laughs)

Walter — if Walter could have connected, and you know, I'd cheer from the stands. But that doesn't bother me at all. I mean, what would bother me is if I think I understand a business and I don't. That would bother me.

Charlie?

CHARLIE MUNGER: Well, having flunked when we were young and strong at understanding some complex businesses, we're not looking to master what we earlier failed at — (laughs) — in our latter years. (Laughter)

WARREN BUFFETT: Zone 12? This may turn out like a revival meeting where we all confess our sins and come forward (inaudible). (Laughter)

18. Confident about Salomon but not rest of Wall St.

AUDIENCE MEMBER: Good morning, gentlemen. My name is Cary Blecker (PH) from Wellington, Florida.

I know in 1987 when you purchased — or invested — in the Salomon Brothers convertible preferred stock, you had the eight-year time frame to convert it into common or take the cash out. I know in '95 you took cash out, which was not a vote of confidence for Salomon Brothers. Any feelings on that in the future?

WARREN BUFFETT: Yeah. We — as the gentleman mentioned, we bought it in 1987, and starting in 1995 we have a — we have, every year for five years, we either have to take cash or convert to common, 20 percent of the original issue of 700 million.

We don't have to make those decisions ahead of time. So we, in 1995, we elected to take cash. In 1996 we elected to take stock.

And you know, we see no reason ever to swing at the ball while it's still in the pitcher's glove. We'd just as soon wait till it gets to the plate to make the decision. So the ball will get to the plate on October 31st of 1997, I believe, for the next 20 percent. And we'll decide whether to swing at that point. But we don't need to make that decision today.

I would say that, you know, the odds are overwhelming that we'll convert, but we'll wait until that time to make the final decision.

We have terrific confidence in the people that run Salomon. They helped us through some incredibly dark days in the past, and showed the stuff of which they were made. And so we feel very good about that.

We don't have the same degree of conviction about the profitability of the investment banking or brokerage business as a whole.

It’s not the sort of — you don’t develop that kind of conviction about that business versus a Coca-Cola or something. They’re different. They have different economic characteristics.

So we will see how the businesses — the industry — evolves. But we feel very good about the management, and the odds are extremely high that we will convert. But we will swing at the ball when it gets to the plate.

Charlie?

CHARLIE MUNGER: No more.

WARREN BUFFETT: OK.

19. Can’t exchange stocks without paying taxes

WARREN BUFFETT: Let’s see. We did 12. We’re back at 1 again.

AUDIENCE MEMBER: My name is Ted Vokali (PH) from Corpus Christi, Texas. And I would like to ask a question to you.

Companies are purchased from time to time, and the purchasing company will give shares instead of cash, and their shareholder will receive new shares.

Can an individual investor transfer non-Berkshire to Berkshire with or without going through a broker? And if not, how does Berkshire do this with another company? And if possible, I would like to also receive a copy of the annual report.

WARREN BUFFETT: OK, we’ll get you a copy of the annual report.

The only way I know of — and maybe Charlie knows some other way — the only way you can switch your shares in one company for — into shares of another company is to have a tax-free merger. And the Internal Revenue Code has specifications about that.

You can have a transaction, as we had with FlightSafety where a portion is — of the shareholders — can take cash, and a portion can take stock, and it’s still tax-free for the people who elect stock.

You can’t have too many people take cash and have that happen. There are a lot of technical rules about what’s tax-free.

But there’s no way that you can own General Motors and transfer it into General Electric stock without a tax and a broker. Well, you don’t have to have a broker. If your neighbor happens to own it you could make a deal privately. But the easiest way usually is through a broker.

But there's no way you can do it without tax, unless General Motors and General Electric decide to merge at some point.

So the opportunities to switch from one security to another without tax are really limited to merger.

And in terms of brokerage costs, it just happens to be that it's — that the most economical way of finding the person in the world that wants to both buy the stock you want to sell and sell you the stock you want to buy is through an intermediary — a broker. And the costs of that actually can be relatively low.

Charlie?

CHARLIE MUNGER: Well, I think there's one way still permitted by the tax laws. You can still form a partnership. If you own General Electric and I own General Motors and we each feel too concentrated, well, you could form a partnership and each put in your stock. And in essence you would each thereafter be invested half and half with some diversification. I will predict that Wall Street will eventually get around to promoting such partnerships.

WARREN BUFFETT: Yeah, well, they did through swap funds, you know, since 25 years ago. And then — that was where you put in your highly — your stock that had an enormous amount of unrealized appreciation in it, and a whole bunch of other people did, and then you owned a fund which itself had a lot of unrealized appreciation in it. And you had —

CHARLIE MUNGER: Plus a new layer of costs.

WARREN BUFFETT: Yeah, plus a new layer of costs, always.

And you owned a piece of this larger fund, and you owned a piece of everything else — everything that the other people wanted to get rid of, and they owned a piece of what you wanted to get rid of, and superimposed with some costs.

But that vehicle was sort of stopped in its tracks, I think, in the mid-'70s by an amendment to the Internal Revenue Code.

But as Charlie said, you could replicate the effect of a swap fund by doing it with a partnership. It'd be kind of awkward, but it can be done.

20. Strong businesses, but no "master plan"

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Gentlemen, I'm Marc Rabinov from Australia. I am a shareholder.

I had a question really related to our own businesses, and how they're going, and where you're looking to be in ten years' time.

Perhaps I could start with the insurance float. It's grown at 20 percent. Do you think that 20 percent growth rate will continue for the next ten years?

Do you think our stable businesses, which have been growing at, say, 5 or 7 percent will maintain that rate?

And do you think FlightSafety, which from the SEC filings has been growing at about 5 percent, do you think that'll continue at that rate?

WARREN BUFFETT: Well, we're glad to have you from Australia. I think we've got about 15 people here from Australia, so it — got a good representation.

I don't think the insurance float can grow at 20 percent a year. That's been helped by some acquisitions and things. I mean, it's done way better, obviously, than we ever thought it would 30, almost 30 years ago when we made the deal with Jack Ringwalt.

I would say, though, that I think GEICO is going to do even better than we expected when we bought it. And we thought it was going to do awfully well then.

In Tony Nicely, you know, we have an absolutely outstanding manager of that business. And he is focused on it. He knows it. I think he went to work there when he was 18. And he's been there 35 years or thereabouts. They don't come any better. And he is absolutely zeroed in on the things that he should be zeroed in on, and he's — the implementation gets better all the time.

I mentioned in the annual report that the unit growth of GEICO's voluntary auto business — and we talk about voluntary because you get assigned risk-type things that lose you money, but the real business is the voluntary auto business — grew at 10 percent last year, which was the best growth rate in over two decades.

First four months of this year, it's growing at about 16 percent. And 16 percent unit growth translates into about 20 percent a year premium growth.

So GEICO at present would give you some encouragement for at least that segment of the insurance float growing at a rate that's sort of comparable to the past.

Insurance is going to be a very big business for us. And the float will grow, in my view, at a good rate. But I wouldn't want to predict that good a rate.

Most of our other businesses, very good businesses. They don't have 20 percent a year growth possibilities in them. They throw off lots of cash, which we can use to buy other things, which may turn out to be a better strategy than even having a single high-growth business.

FlightSafety, about six weeks ago or thereabouts, announced a major hookup in a joint venture with Boeing, as you may have noticed. And they're a terrific partner, and it'll be a great partnership.

That's just for our — the training for our — for larger planes, primarily, I think, hundred-seat and up planes, although I think there may be a few Fokkers in there that are slightly smaller planes. But it's basically the big commercial planes.

And the combination of FlightSafety and Boeing worldwide in training over the coming decades, I think, will be a very powerful combination. So we've got some very good businesses.

And I don't see that movie that's presented before — I sit out here like you and watch it. But I like the ending of it.

And the people we have out there, they've run businesses extremely well in the past. They get better results out of those businesses, frankly, than other people would, or that other people in the industry generally do. So I think they have good futures.

But they will throw off lots of cash in aggregate. And the tough job — we like to tell people it's the tough job anyway — is that Charlie and I have to figure out where to put that cash to maintain higher — reasonable — growth rate.

AUDIENCE MEMBER: (Inaudible)

WARREN BUFFETT: Could you — I'm not sure that's — could you turn that on, please, so that —

MARK RAVENHILL: I'm sorry to pin you down, but —

WARREN BUFFETT: That's OK. You can pin me down.

AUDIENCE MEMBER: — would you guess that FlightSafety, then, is more likely to be in that 10 to 15 percent ballpark?

WARREN BUFFETT: Well, it's hard to tell on numbers. I mean, certainly there's going to be growth in pilot training around the world. But FlightSafety already has a significant portion of the corporate market, for example. So it would be hard to grow a lot faster in the corporate market, although I can hear Al grinding his teeth, you know, when I say that, because he plans to grow a lot faster than the market.

But the corporate market, we've got a significant percentage. Commercial market, there could be a lot of potential in. You know, it won't come tomorrow or the next day. But, you know, ideally we would like to see people when they buy a 777 or 747 or something, buy a lifetime pilot training contract at that time.

So I wouldn't want to stick a number on it, but I've got high hopes. And FlightSafety also announced recently a very major contract with the government through Raytheon. So it's a company that's got its sights set a lot higher than where it is now.

AUDIENCE MEMBER: And insurance, 15 percent? (Inaudible)

WARREN BUFFETT: Will you — you want tenths of a percent or will you — (Laughter)

We just don't know. I mean, we didn't know 25 — we didn't — 30 years ago we didn't know we would be in the insurance business.

I mean, Berkshire, we have no master plan. And Charlie and I did not sit down in 1960 — early '65 — and say, "We're going to do this and that," and all that.

We're going to do — we're going to try and do sensible things as we go along. The more money we have, the harder it is to find sensible things.

But that's the criteria. Insurance is certainly a major area of opportunity for us. It's been a major opportunity.

We have — in certain fields we have a terrific advantage for the three reasons I laid out in the annual report. But I mean, we have capital strength, and a willingness to take on risk, and a speed of action, and a certainty of payment, that in aggregate no one matches.

Now, how much demand there is for that depends on circumstances in the business and how much supply there is at lower prices that we think don't make sense is another question. But I think we'll do OK in insurance over time.

21. Most money managers have "gotten a lot for nothing"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, I'm Tim Medley from Jackson, Mississippi.

WARREN BUFFETT: We're glad to have you back, Jim — Tim.

How many years have you come?

AUDIENCE MEMBER: This is my 11th.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: They've been 11 great years. Thank you very much.

At this meeting four or five years ago, you commented that money managers in the aggregate have not done better than various market indices. And you attributed this, in part, to the frictional cost inherent in an actively-managed portfolio.

I wonder if today you would update your thoughts on this. And do you think that this underperformance compared to index funds will continue?

And then a related question, if the two of you were giving advice to a classroom of equity mutual fund managers, are there two or three things in particular that you would want to suggest to them?

WARREN BUFFETT: Yeah. Well, I would say this. Money managers, in the last few years since I made that statement, have not disappointed me. (Laughter)

In aggregate, they have underperformed index funds. And it's the nature of the game. They simply cannot overperform, in aggregate. There are too many of them managing too big a portion of the pool.

And for the same reason that the crowd could not come out here to Ak-Sar-Ben in the past years and make money, in aggregate, because there was a bite being taken out of every dollar that was invested in the parimutuel machines, that people that invest their dollars elsewhere through money managers in aggregate cannot do as well as they could do by themselves creating their own index fund, or it would be easier to have — just to buy into an index fund.

It's — you know, they say in this world you can't get something for nothing. But the truth is money managers, in aggregate, have gotten something for nothing. I mean, they've gotten a lot for nothing. And — (applause)

And people — investors have paid — and the corollary is investors have paid something for nothing.

And that doesn't mean that people are evil. It doesn't mean that they're charlatans or anything. It's the nature, if you got a 6 or $7 trillion, or whatever it may be, equity market, and you have a very significant percentage of it managed by professionals, and they charge you significant fees to invest with them, and they have costs when they change around.

They cannot do as well as unmanaged money, in aggregate.

And it's the only field in the world that I, you know, that I can think of — Charlie'll think of some others — but where the amateur, as long as he recognizes he's an amateur, will do better than the professional does for the people whose money he's handling.

And therefore if I were in a — teaching this class or speaking to that class, I would probably tell them that for their own psychological well-being they should probably leave the room. (Laughter)

Charlie?

CHARLIE MUNGER: Well, I pretty well said what I had to say on this subject in that talk I gave at USC. And anybody that wants to read that, why, can read it.

I will say that one of the things I like about the annual meeting is I get to interface with a whole lot of people that have even lower annual investment management expenses than Berkshire Hathaway the company does. I mean, if you stop to think about it, we've got our costs almost to zero, and many of you have gotten it to zero.

WARREN BUFFETT: Yeah, we — Charlie and I would be glad to take any money management organization in the world that manages — oh, just been handed a note that says, "Unfortunately, we don't have extra annual reports on site. Those shareholders desiring one should call us or write." So. And we're also on the internet. You can run it off there, too.

So I apologize for not having them on the — here. But they're easy to get. Just dial 346-1400 and there's an annual report line, and you'll have one sent to you.

We would be willing to take any money management organization in the world managing 10 billion or more, and in the case of brokerage houses who have their brokers in aggregate handling 10 billion or more, and we would be willing to bet that their aggregate investment experience over the next five years or ten years for the group that they advise will be less — will be poorer — than that achieved by a no-load, very low-cost index fund.

And we'd put up a lot of money to make that wager with anybody that would care to step forward.

Gambling may be illegal, but now you can do it through something called derivatives, you see? (Laughter)

We could create an instrument that would allow that, even though it might be against the laws of the state of Nebraska.

Charlie, would you join me on that or —?

CHARLIE MUNGER: Well, I certainly agree with you. I always say that the — exactly one-fifth have to be in the bottom 20 percent, and — (Laughter)

There are certain fundamental forces at work here that —

But it is a very peculiar profession where you have to be in a state of psychological denial to shave in the morning if you do the work. I don't think that's true for a handful —

WARREN BUFFETT: Well, it isn't.

CHARLIE MUNGER: — of investment managers. I think we know investment managers who add value. But it's a comparatively rare and small percentage.

WARREN BUFFETT: Yeah. There — we have identified, in the past even — I mean, on a prospective basis, not retrospective — managers who have added value. And there's couple of them in this room.

CHARLIE MUNGER: Well, and there's Lou Simpson of GEICO.

WARREN BUFFETT: Well, he's the one I had in mind. (Laughter)

You can do it. You can't do it with unlimited amounts of money, and a good record tends to attract money. Even a mediocre record presented by a good salesperson tends to attract money.

But there are people working with smaller amounts of money that — (coughs) — where the probabilities are that they will do better than — excuse me. (Clears throat)

Where the probabilities are that they will — (clears throat) — do better than average. But they're very rare.

Incidentally, I apologize on this voice. I had to leave Gorat's early last night, and there were a number of you I was hoping to see. But I just — it was gone entirely last night, and then I —

I'd like to tell you I did it by Cherry Coke, but I've managed to nurse it back to where it's working again in reasonable shape.

22. USAir CEO Stephen Wolf has done "terrific" job

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Martha Copeland (PH) from San Francisco.

My question involves the headwinds which face USAir. Are you considering redeploying assets? Or how will your management plan to improve this company?

WARREN BUFFETT: Well, we're just an investor in US — they call it now US Airways — but we're just an investor. We've owned a preferred stock for almost eight years.

The company had some very rough going. Charlie and I would not have thought its chances for survival were very good, even some years back.

But it's done quite well lately. Stephen Wolf has done a terrific job of running it.

So as of the middle of April, all of our dividends are — were caught up, current. We've received, I don't know, 260 or '70 million in dividends in the last eight years.

But we have nothing to do with managing the company. Matter of fact, there are some people that might have noted that when Charlie and I left as directors, that was when the fortunes of the company turned abruptly upward. (Laughter)

But — and we feel very good about what Stephen Wolf has done. I mean, he — there's no tougher job than running an airline. That is not a job I would wish on anyone. And he's improved the operating performance dramatically, and the financial performance has improved. And better yet, the preferred dividends have been paid. So we thank him for that, but we have nothing to do with it.

By the terms of our preferred, in just a little over two years, we are due to be paid back our principal amount. It was really a loan in equity form, with a kick — possible kicker on the upside because of the conversion privilege on the preferred.

We would have sold the conversion privilege for nothing a few years ago, but it actually is not so far away now. The stock's in the low 30s, and our conversion is in the high 30s. So we actually have some chance of even having conversion value on that. It's been a very pleasant surprise.

You know, I made a mistake in getting into it, but Mr. Wolf is — seems to be capable of nullifying my mistake.

Charlie?

CHARLIE MUNGER: Pass. (Laughter)

WARREN BUFFETT: We'll give him this (inaudible). (Laughter)

23. Put all your money into Berkshire stock?

WARREN BUFFETT: Zone 5, please.

AUDIENCE MEMBER: I'm Eric Butler (PH) from Menlo Park, California. A couple of questions, one serious, one not quite.

Considering Berkshire Hathaway is well run at low cost, and is diversified, why should anyone do anything but put all their money into Berkshire Hathaway instead of maintaining a diversified portfolio?

And in some of these hagiographic kind of biographies, it's apparent that you have other investments yourself beyond Berkshire Hathaway.

The second question I had, is there any significance to the fact that the Omaha World-Herald does not include Berkshire Hathaway in its stock tables on any day? Is this a sign that they do not honor profits?

WARREN BUFFETT: (Laughs) No, they — actually, they have a separate little table called Midlands — I think it's entitled Midlands Investment. But they pick out about 50 stocks that are of particular interest to people in this area, and they lift those from the regular table and put it in this separate table, which is usually on a second page right following the main stock table. So they give us our just due on that, but you do have to — you should look in a different table for that.

Second question about putting all your money in, I've got 99 percent of my money in Berkshire. But it was bought at a different price. (Laughter)

And Charlie's was bought a little cheaper, too, I think. So you know, we like the idea of having it all in there, but we don't recommend that people do that because it's — you will get very low-cost management. What we hope — well we hope is that from this point forward, that that cost does not reflect its value.

But the price at which you enter is very important. You do get a great group of businesses. You get a lot of great operating managers. You get very reasonable costs. But that is fairly widely recognized now compared to the past, and people pay more for it than they used to.

I'm still very comfortable with it, and I think Charlie's comfortable with it, too. But everyone has to make up their own mind about price.

Charlie?

CHARLIE MUNGER: Yeah. Eventually, if the success continues and we have more of this hagiography, the stock will get to such a high price that it's no longer sensible at all to buy.

We hope we dampen that process as we go along. And of course, there's always the very substantial chance that we'll just fail to meet expectations due to the vicissitudes of life.

WARREN BUFFETT: Falling on our face is what we call it. (Laughter)

24. Won't buy a tobacco company, but could buy tobacco stocks

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: My name is Michael Hooper. I'm from Grand Island, Nebraska. I applaud Berkshire for starting the Class B shares.

My question deals with tobacco stocks, which have been beaten down lately. Does Berkshire own any tobacco stocks, and are some of these stocks attractive now that prices are down on some of them? And in particular, a company called UST. Thank you.

WARREN BUFFETT: Yeah. We have owned — we won't comment on what we own now — but we have owned tobacco stocks in the past. We've never owned a lot of them, although we may have made a mistake by not owning a lot of them. But we've owned tobacco stocks in the past, and I've had people write me about whether we should do it or not.

We own a newspaper in Buffalo. It carries tobacco advertising. We don't — well, actually, Charlie's a director of a sensational warehouse chain called Costco, which used to be called PriceCostco. You know, they sell cigarettes.

So we are part of the distribution chain in — with a hundred percent-owned subsidiary in the Buffalo News. And so we have felt that if we felt they were attractive as an investment, we would invest in tobacco stocks.

We made a decision some years ago that we didn't want to be in the manufacture of chewing tobacco. We were offered the chance to buy a company that has done sensationally well subsequently, and we sat in a hotel in Memphis in the lobby and talked about it, and finally decided we didn't want to do it.

Can I give you some —?

CHARLIE MUNGER: But it wasn't because we thought it wouldn't do well. We knew it was going to do well.

WARREN BUFFETT: We knew it was going to do well.

But now, why would we take the ads for those companies, or why would we own a supermarket, for example, that sells them, or a 7-Eleven, you know, or a convenience store that sells them or something of the sort, and not want to manufacture them? I really can't give you the answer to that precisely.

But I just know that one bothers me and the other doesn't bother me. And I'm sure other people would draw the line in a different way.

So the fact that we've not been significant holders of tobacco stocks has not been because they've been on a boycotted list with us. It just means that overall we were uncomfortable enough about their prospects over time that we did not feel like making a big commitment in them.

Charlie?

CHARLIE MUNGER: Yeah. I think each company, each individual, has to draw its own ethical and moral lines, and personally, I like the messy complexity of having to do that. It makes life interesting.

WARREN BUFFETT: I hadn't heard that before. (Laughter)

We'll make him in charge of this decision.

CHARLIE MUNGER: Yeah, no, no. But I don't think we can justify our call, particularly. We just — we have to draw the line somewhere between what we're willing to do and what we're not, and we draw it by our own lights.

WARREN BUFFETT: We owned a lot of bonds at one time of RJR Nabisco, for example, some years back. And should we own the bonds and not own the stocks?

Should we own, you know — should be willing to own the stock but not be willing to own the business? Those are tough calls.

Probably the biggest distributor of — the biggest seller — of cigarettes in the United States is probably Walmart, but — just because they're the biggest seller of everything. They're the biggest seller of Gillette products, and they're huge.

And you know, do I find that morally reprehensible? I don't. If I owned — we owned all of Walmart, we'd be selling cigarettes at Walmart. But other people might call it differently, and I wouldn't disagree with them.

25. Buffett on anti-abortion protesters

WARREN BUFFETT: Zone 7?

AUDIENCE MEMBER: Gentlemen, I'm John Tarsney (PH), a shareholder from Omaha, Nebraska.

People have already asked any sophisticated question that I might have, so I'm reduced to my simple ones.

I first became a shareholder through FlightSafety, and at that time I wasn't sure that I wanted to be bought out. However, I decided that any man who could agree with me on FlightSafety might be a good man to go along with.

CHARLIE MUNGER: (Laughs) Well, that's one way of doing it. (Laughter)

Maybe you'd fit in well at headquarters. (Laughter)

AUDIENCE MEMBER: I have a couple — well, I don't use Gillette products, either, as those of you who are close to me can see. (Laughter)

My questions, my simple ones then, are, a couple of years ago, or within the recent times, you had said you would not necessarily buy Berkshire Hathaway. And I'd like to know whether you still feel the same way.

Secondly, since I came to you through FlightSafety I'm wondering if there's any other positions I should be looking at in that same — (laughter) — same light.

And thirdly, there was a very distressing sign to me — sign that I saw when I drove in. And I don't know what the meaning of it is, or if you do. And it said something about abortion. And I just don't have a clue.

If you do — now, you can use yes or no answers to these and save your voice. (Buffett laughs)

Or suit yourself and elaborate.

WARREN BUFFETT: Yeah, we'll work backwards.

I think the signs probably relate to the contributions to Planned Parenthood. (Applause)

Thank you.

We follow a policy, as you know, at Berkshire of corporate contributions being designated by shareholders. We have some made by our operating companies to their local communities, and the local managers do what they think appropriate within their communities and with their own businesses.

So Tony Nicely at GEICO — I have no idea what GEICO contributes to, but they make those decisions at GEICO.

But in terms of the parent company, we let the shareholders designate the contributions. We have a number of shareholders who designate Planned Parenthood. We have other shareholders who designate organizations that are — would be opposed to the ideas of Planned Parenthood. We make no judgment about those. (Mild applause)

And in terms of — I designate the Buffett Foundation every year, and then the Buffett Foundation, in turn, gives money to other things, including Planned Parenthood.

And so, in the sense that those funds come indirectly from Berkshire, they come in direct proportion to ownership the same way as everybody else gets a chance to do with their shares.

And we've had people write us about it. You know, I — there's no way in the world we would — you know, in fact there's some that would say that we should be boycotted because I do this.

And we would not dream of questioning, you know, the people that we buy our almonds from, or walnuts from, or chocolate from, as to what their beliefs were, you know, before we bought that, or whether we would hire somebody that they'd have to agree with our beliefs, so —

It seems to me perfectly appropriate for people to express their views on it, and they probably don't like — clearly they don't like — what I do on that. But it's where my reasoning and, you know, my own judgment leads me.

But they're out there, the few people out there expressing their views on it, and they're entitled to do that. And I don't have any problem with that.

I think when they start saying, you know, "We don't want to hire you because you have a different view than we do," or "We don't want to buy your products," I think that's a little different position to take. I wouldn't do that. But again, it's their right to do that.

26. Berkshire stock is now "more appropriately valued"

WARREN BUFFETT: Going back to whether we would buy the stock, I would say this a year ago — well, it was about March 1st because that's when I wrote the annual report in 1996 — the stock was 36,000 and I said it was not undervalued at that point.

And since we were more or less forced to have an offering by the unit trust, which I'm very glad in retrospect we did, but it was not our idea, we felt that it was only appropriate in connection with that offering to point out that we had said it was not undervalued, and since Charlie and I like to buy undervalued securities, that we would not buy it ourselves at that price or recommend that others do.

And in the ensuing year, the intrinsic value of Berkshire changed quite dramatically. And the price didn't change. In other words, the stock, after years of overperforming the business somewhat, underperformed the business. Which, of course, it's bound to do.

And we're glad that they got back more in tandem. So we said this year that we regarded the stock as being much more appropriately valued than it was a year earlier, which is obvious.

And I would say that the caution I made about securities generally would apply. I would not except Berkshire from that caution, but I would rather own or purchase Berkshire myself than I would most other securities. I can tell you that.

Charlie? (Applause)

Charlie gives to Planned Parenthood, too, so he has to — (laughs). They didn't put his names on those signs, but I'll take care of that. (Laughter)

CHARLIE MUNGER: I'm perfectly willing to have that limelight passed, as well as the opportunity to say more on the subject.

WARREN BUFFETT: Did I miss one question up there? I think there were three of them, and I addressed two of them.

AUDIENCE MEMBER: About any other area I should be looking at.

WARREN BUFFETT: That's the reason I skipped it. (Laughter)

Yeah, we don't direct people to any specific investments.

27. World Book encyclopedia vs Microsoft's Encarta

WARREN BUFFETT: Zone 8, please.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. This is Nancy Jacobs (PH) from Omaha, a shareholder for about four years now.

Before I leave today, I'm planning to purchase the World Book on CD-ROM for my ten-year-old daughter. And I'd like a few words from either one of you, or both of you, about why I'm making the right choice.

And second, does purchasing World Book over a competitor give her a somewhat improved chance of becoming a brilliant billionaire investor?

WARREN BUFFETT: Practically guarantees it, but go ahead. (Laughter)

AUDIENCE MEMBER: OK. I'm buying, then.

WARREN BUFFETT: Charlie, you want to — you love to talk about World Book.

CHARLIE MUNGER: Well, I think World Book is clearly the class of the field. They have every word in the English language graded for reading comprehensibility, and the articles are cleverly written so the difficulty of comprehension rises slightly as you go through it.

And it's very user-friendly to young people. And since it's something you want to encourage, making it user-friendly is wonderful. I also find that with whatever intellect I have, it's more user-friendly to me. And so I think it's a hell of a product, either for the young people or the old.

And for a quick reference system, I don't think there is anything better.

Personally, I like the reading version, being an old-fashioned fellow. And I can hardly imagine a world where the wise people don't do a lot of reading.

Now, maybe we're going to have wise people in the future who spend all their time in front of screens in the course of getting that wisdom. But I doubt it. That's all. (Laughter)

I think you may have bought a wonderful product, but I would have the other one, too. (Laughter)

WARREN BUFFETT: The product you see there was the joint development, and was launched in January of this year in conjunction with IBM. IBM has been our partner in that product. I believe it's being bundled into all the IBM PCs now being sold. So they've worked very well with us. Frankly, there's a book, even, that deals with this.

Bill Gates did a very good job of developing a product that was bundled with millions and millions and millions of PCs. It's called Encarta. It's actually Funk and Wagnalls. He hates it when that comes out, but they changed the name to Encarta, which was smart of him. (Laughter)

And there are a few people in this room who were witness to a demonstration four or five years ago in Bermuda, where in connection with Encarta, they showed the moon and the earth.

And the moon bumped into the earth in this. And I just, I don't know why it sticks in my mind. I thought I would mention it today, that the — (Laughter)

But his is doing very well. So apparently there are a number of people that don't care about the fact the moon and the earth collide, but in the World Book the moon and the earth never bump into each other. (Laughter)

He's done extremely well with Encarta, incidentally. I mean, it was a masterpiece of moving into an area and pushing hard. And you know, I tip my hat to him, but now we're going to —

CHARLIE MUNGER: Yeah, we copied him.

WARREN BUFFETT: Yeah, we copied him. Right. (Laughter)

OK, Nancy, be sure to buy the print version, too, so Charlie will respect you. (Laughter)

28. Tax fairness, economic prosperity, and the "ovarian lottery"

WARREN BUFFETT: Zone 9.

AUDIENCE MEMBER: Good morning, gentlemen. My name is Patrick Byrne. I'm here today from Hanover, New Hampshire.

I've searched for a couple questions upon which I might get the two of you to disagree.

First, what level of taxation — and I direct these as much to Mr. Munger, therefore, as to you Mr. Buffett — first, what level of taxation on capital gains is most conducive to the long-term economic health of a society, and is that also the fair or just rate?

In other words, is the just rate of taxation on capital gains precisely that rate that creates the most economic stuff? Or is there some other goal a state might pursue?

And as a not-so-subtly related question, I work in a New Hampshire factory that makes industrial torches.

WARREN BUFFETT: As CEO, I might add, Patrick. (Laughter)

AUDIENCE MEMBER: Say again?

WARREN BUFFETT: As CEO of — that "working" made it sound like you were down there on the floor. I just wanted people to — (Laughter).

Patrick writes me letters from chairman to chairman, so I think we've got to get him back at it.

AUDIENCE MEMBER: Continuing. (Laughter)

Well, it's a small company. I do work as CEO, but it's not much of a hierarchy.

We make torches used in heavy manufacturing, and the fortunes of our factory echo those of industrial America.

Do you agree with the conventional wisdom that maintains that the age of classical industrial America has passed, and that we will — that America cannot be competitive in the long term with low-wage countries?

So the first question is on taxation of capital gains, and then the second is on the future for industrial America.

WARREN BUFFETT: I have a sensational answer on the tip of my tongue, but I think I'll let Charlie go first — (laughs) — while I refine it a bit.

CHARLIE MUNGER: Well, I think there's an easy answer to your capital gain issue. And one is what makes an economy work best in some abstract mathematical sense. And the other is the consideration that you allude to, which gets into issues of fairness.

Aristotle felt that systems work better when they were generally perceived as fair. The civilization worked better if people saw the differences in rewards as having been fairly — reasonably fair, anyway.

And I think that if you had a civilization where if you work 90 hours a week driving a taxicab with no money, no medical insurance and so forth, and somebody else does nothing but own Berkshire Hathaway shares and sit on the country club porch and peel off a few every year to pay the bills, that would be regarded as so unfair that even if it had some theoretical economic efficiency it would be counterproductive for our particular civilization to have that kind of a tax code.

So I'm all for having some taxation of capital gains. Once you reach that conclusion, you get into the question of what should — what is the fair rate?

I think the fair rate might well be a little lower than it is now, but not much lower.

WARREN BUFFETT: Sounds to me like he's a seller — of Berkshire. (Laughs)

Patrick is a former heavyweight boxer, and just got his Ph.D. fairly recently from Stanford with a 700-page dissertation, which has in it some commentary that actually bears on this.

And I thank Patrick, actually, for introducing me to kind of a system of construct — mental construct — to attack questions like this.

Patrick gave me the example one time — and I think this may go back to John Rawls at Harvard — but he said, just imagine that you were going to be born 24 hours from now.

And you'd been granted this extraordinary power. You were given the right to determine the rules — the economic rules — of the society that you were going to enter. And those rules were going to prevail for your lifetime, and your children's lifetime, and your grandchildren's lifetime.

Now, you've got this ability in this 24-hour period to make this decision as to the structure, but there — as in most of these genie-type questions there's one hooker.

You don't know whether you're going to be born black or white. You don't know whether you're going to be born male or female. You don't know whether you're going to be born bright or retarded. You don’t know whether you’re going to be born infirm or able-bodied. You don’t know whether you’re going to be born in the United States or Afghanistan.

In other words, you’re going to participate in 24 hours in what I call the ovarian lottery. (Laughter)

It’s the most important event in which you’ll ever participate. It’s going to determine way more than what school you go to, how hard you work, all kinds of things. You’re going to get one ball drawn out of a barrel that probably contains 5.7 billion balls now, and that’s you.

Now, what kind of a society are you going to construct with that in prospect?

Well, I suspect you would focus on two issues that Patrick mentioned in his question. You would try to figure out a system that is going to produce an abundant amount of goods, and where that abundance is going to increase at a rapid rate during your lifetime, and your children and your grandchildren, so they can live better than you do, in aggregate, and their grandchildren can live better.

So you’d want some system that turned out what people wanted and needed, and you’d want something that turned them out in increasing quantities for as far as the eye can see.

But you would also want a system that, while it did that, treated the people that did not win the ovarian lottery in a way that you would want to be treated if you were in their position. Because a lot of people don’t win the lottery.

I mean, Charlie — when we were born the odds were over 30-to-1 against being born in the United States, you know? Just winning that portion of the lottery, enormous plus. We wouldn’t be worth a damn in Afghanistan.

We’d be giving talks, nobody’d be listening. Terrible. (Laughter)

That’s the worst of all worlds.

So we won it that way. We won it partially in the era in which we were born by being born male, you know —

When I was growing up, you know, women had — they could be teachers or secretaries or nurses, and that was about it. And 50 percent of the talent in the country was excluded from, in very large part, virtually all occupations.

We won it by being white. You know, no tribute to us, it just happened that way.

And we won it in another way by being wired in a certain way, which we had nothing to do with, that happens to enable us to be good at valuing businesses.

And you know, is that the greatest talent in the world? No. It just happens to be something that pays off like crazy in this system. (Laughter)

Now, when you get through with that, you still want to have a system where the people that are born —like Bill Gates or Andy Grove or something — get to turn those talents to work in a way that really maximizes those talents. I mean, it would be a crime to have Bill or Andy or people like that, or Tom Murphy, working in some pedestrian occupation just because you had this great egalitarian instinct.

The trick, it seems to me, is to have some balance that causes the people who have the talents that can produce goods that people want in a market society, to turn them out in great quantity, and to keep wanting to do it all their lives, and at the same time takes the people that lost the lottery and makes sure that just because they, you know, on that one moment in time they got the wrong ticket, don't live a life that's dramatically worse than the people that were luckier.

And when I get all through that long speech, I probably come out with the idea that the capital gains tax as it exists today is probably about right, so —

I see very few people — and I've been around a lot of people with money and talent over time — they don't always go together — but I've been around both classes — (laughs) — and the — I see very few of them that are turned off from using their talents by a 28 percent capital gains tax. It just doesn't happen.

I mean, they do what they like to do. And part of the reason they're good at what they do is they like to do it. And I've just never seen it happen.

And I've seen a lot of people that pay taxes that are higher than 28 percent that are contributing more to society, by some judgment other than a pure market system.

(BREAK IN TAPE)

29. "American economy encourages adaptation"

WARREN BUFFETT: The other question about the low-cost industrial — you know, how does the industrial society evolve, I — you know, the world evolves in a way, in a market society, so people do what they're best at. And this country's done very well in recent years — something like, you know, software that — where a Microsoft has been leading or an Intel or something. I mean, we have done very well.

Ten years ago the American public was sort of down on itself, or 15 years ago, in terms of what the economy could do.

But here we are with our unemployment rate — in Nebraska it's under 3 percent.

And you know, you look at the countries of Europe that were supposedly going to beat us into the ground, or you look at Japan.

I think the American economy encourages adaptation. I mean, Singapore may be better, but in terms of major large economies, I think the American economy does awfully well in encouraging adaptation to what people want, and delivering it to them in ever-increasing amounts. And you know, I view that as all to the good.

So I don't regard any industry as sacred. I regard innovation and freeing up the able people to — able, in terms of production of goods in a market economy — to spend 12 hours a day all the time — I don't see Andy or Bill letting up at all, in terms of where Intel and Microsoft are now.

I don't see Roberto Goizueta at Coca-Cola, or Michael Eisner at Disney, or any of those people.

They don't work 40-hour weeks, they work 70 or 80-hour weeks. And I think that system works very well in this country, and I don't worry particularly about the specific products that are turned out.

Charlie?

30. Munger critical of Harvard philosopher John Rawls

CHARLIE MUNGER: I would not like the conclusion that both Warren and I have reached, that issues of fairness are properly to be considered in the tax laws, to cause anyone here to believe that I have a great respect for Harvard University's philosopher John Rawls.

He is perhaps the world's best-known living philosopher. And personally, I think he's had a pernicious influence on human thought.

He doesn't know enough science. He doesn't know enough economics. He doesn't know enough about how systems work to be really good at figuring out what's fair in systems. And he studied too much philosophy and too little of everything else. (Laughter)

If anybody thinks we love John Rawls, well, you can count me out. (Laughter)

WARREN BUFFETT: No — I wasn't endorsing his conclusions, I was endorsing his thought — his original construct.

Charlie, how about the industries part of the question that Patrick asked?

CHARLIE MUNGER: Well, if Patrick isn't the smartest person in the room, there can't be many in his class.

You are getting questions from a very able man, and he's deliberately made them very difficult. (Laughter)

And that whole issue is too complex for me to usefully discuss here. There are also certain limitations on ability that enter the equation. (Laughter)

31. Class A stock may be exchanged for Class B at any time

WARREN BUFFETT: So we'll go to zone 10. (Laughter)

AUDIENCE MEMBER: Good day, gentlemen. My name is Bill Rodenberg (PH) from Dayton, Ohio. I'm a shareholder, and my daughter Sarah, who is 13, is also a shareholder. She chose not to join me in the limelight. I think the hot dogs had a higher appeal to her.

WARREN BUFFETT: Not to mention —

AUDIENCE MEMBER: And I'd like to say that it's very reassuring to know that Uncle Warren and Uncle Charlie are taking care of her college fund. And it's easy to sleep at night.

I have two questions, one related to a question my wife asked me, which I was unable to fake a good answer to, and a second one related to my daughter's one share of Berkshire A.

My wife asked me, in the annual report you stated that if anyone out there has a good company like FlightSafety, please let you know and you'd be glad to look it over and give an answer within five minutes or less.

And her question is, how can he do that? Where does he get the information to make that decision? And how does he know that that information is valid?

My second question has to do with my daughter. She's 13. In five years she'll be off to college, perhaps UNL, perhaps not.

In any case, she's going to face a significant capital gains when she sells that one share of stock.

WARREN BUFFETT: I hope so. (Laughter)

AUDIENCE MEMBER: You mentioned earlier, and I believe this is correct, you said that you could trade one share of A for 30 shares of B this afternoon. And I thought, wait a minute, I thought there was a limited window on that. We happened to be out of the country at the time that exchange took effect, and we missed it.

WARREN BUFFETT: No, the exchange exists forever. You can —

AUDIENCE MEMBER: Forever?

WARREN BUFFETT: You can always exchange a share of A for 30 shares of B. You cannot do it in reverse. You cannot shift 30 shares of B into one share of A. But there was no window or timetable on that.

The A stock is forever exchangeable for 30 shares of B. I don't recommend that she does it, because it's always an option, and in the meantime she gets the shareholder-designated contribution, and there's always the chance that the A will sell slight — at a price slightly above 30 shares of B. It doesn't do it very often and it won't be very much if it does, but —

We didn't want to create an incentive for people to exchange A for B, but we — they will always have the right to do so.

32. Just takes 5 minutes to know if we're interested in a company

WARREN BUFFETT: The five minute test is a — you know — Charlie and I have — we're familiar with virtually every company of a size that would interest us in the country. I mean, if you've been around for 40 or more years looking at businesses, it's just like if you were looking at — you know, studying baseball players every day. You get to know all the players after a while. And that's the way it works.

Then we have a bunch of filters we've developed in our minds over time. We don't say they're perfect filters. We don't say that those filters don't occasionally leave things out that should get through. But they're very — they're efficient.

And they work just as well as if we spent months and hired experts and did all kinds of things. So we really can tell you in five minutes whether we're interesting in something, and —

We'd never owned shares in FlightSafety but we'd been familiar with the company for at least 20 years, wouldn't you say, Charlie?

CHARLIE MUNGER: Sure, I had a partner who bought a lot of it 20 years ago. Yeah.

WARREN BUFFETT: Yeah. But that's true of almost any business. And we know — we've got a fix on what we don't understand, and then we don't care to know any more about them, particularly, although we'll pick up a little as we go along, maybe.

And then the ones that are — we're capable of understanding, we've probably gotten about as far as we'll get already. So we do know in five minutes.

Now, when we do something with FlightSafety, before the purchase and even for somewhat — a little after the purchase — I'd never been — I'd never set foot on a piece — they have 40 or so training centers around the world — I'd never set foot on one of them.

I'd never been to their headquarters. We never looked at a lease. We never look at title of the properties. I mean, we don't do all of those things.

And I will say this: to date, that's never cost us a penny. What costs us money is when we misassess the fundamental economic characteristics of the business.

But that is something we would not learn by what people generally consider due diligence. We could have lawyers look over all kinds of things, but that isn't what makes a deal a good deal or a bad deal. And we don't kid ourselves by having lots of studies made and lots of reports made. They're going to support whatever they think the guy that pays them, you know, wants anyway. So they don't mean anything. They're nonsense.

But we do care about being right about the economic characteristics of the business, and that's one thing we think we've got certain filters that tell us in certain cases that we know enough to assess. And then we make some mistakes.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that, except that people underrate the importance of a few simple big ideas. And I think that to the extent Berkshire Hathaway is a didactic enterprise teaching the right systems of thought, I think that the chief lessons are that a few big ideas really work, as I think these filters of ours have worked pretty well. Because they're so simple.

WARREN BUFFETT: Yeah, I think most of the people in this room, if they just focused on what made a good business or didn't make a good business and thought about it a little while, they could develop a set of filters that would let them, in five minutes, figure out pretty well what made sense or didn't make sense.

I mean, there may be some reason after five minutes we don't get together on a deal of some sort, but —

Another thing you can usually tell — at least you can tell it in the extreme cases — you can tell whether you've got the kind of manager, very quickly, that you want to have. I mean, if you've got somebody that's been batting .400 all their life, and fortunately age doesn't change that picture, in terms of business performance, and they love what they do, it's going to work.

If the seller cares a lot about the money, you're probably not going to make a very good deal. If their real interest is going in the — is what they're going to do with the money, they may fall out of love or have less interest in their business subsequently.

We love working with people who are just plain nuts about their businesses. And it works very well. And you can usually spot that.

Now, having said that, we'll have a few people figuring out how to fake that attitude, you know, when they try and sell us some piece of junk here, but — (Laughter)

Charlie says we can get conned by some guy with a green eyeshade, you know, and a low-rent office and all that. But we won't get taken in by the guy with the suede shoes. (Laughter)

33. Buffett describes a "normal" day

WARREN BUFFETT: Zone 11.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, thank you for having me here today. My name is Dorsey Brown from Baltimore, Maryland.

I have two quick questions for you. Could you please comment on any observations that either of you may have concerning executive compensation and option issuance, a topic that seems to be getting a lot more media attention? And are we going to — getting a little bit of excesses in that area?

And my second question to you, Mr. Buffett, could you just give us some idea of what a normal day, how you would like to spend a reasonable, normal day and — working on the investment side of the equation, or analysis, or reading, or just to give us some flavor of that? Thank you.

WARREN BUFFETT: OK, I'll answer the second question first. Very easy.

I just — I read a lot, and I talk on the telephone a fair amount. We have no meetings. We have no committees. We have no slide presentations. You know, we have nothing, I mean it — (Laughter)

And so I read a lot. I read annual reports. I read business publications. I could do it in way less time, but I enjoy doing it so I make it last, I mean, you know, like some other activities in life. The - (laughter)

So it's — there's really — it's the most boring job to anybody watching it, but I'm in love with it, you know. And so I like doing that.

And I don't like talking about it a lot, I just like to kind of keep up with what's going on. Like I say, by this point in life I could filter out so much of that I would — I just don't need to do that much of it.

But I kind of enjoy just seeing what's going on vicariously through doing a lot of reading. And I spend some time on the phone, and I'm on the computer a lot playing bridge, and I get to do what I like all the time.

We'll let Charlie describe what he does, which is even more bizarre. (Laughter)

And then we'll talk about compensation and options.

CHARLIE MUNGER: Well, there's a little more foolishness in my life than Warren's, and — including being chairman of a large hospital. I'm not suggesting that hospitals are foolish, I'm just suggesting that it takes a certain quirk of mind to be willing to be the chairman of a hospital.

And so my life is even more — it's less rational than Warren's. Warren lives one of the most rational lives I've ever seen. And it's almost unbelievable, and — (Laughter)

WARREN BUFFETT: He's got me wondering why I'm here today. (Laughter)

34. Abuse of stock options as executive compensation

WARREN BUFFETT: Well, we'll talk about comp then, a little.

CHARLIE MUNGER: Yeah, comp, yeah.

WARREN BUFFETT: The — comps — there are three or four aspects to that.

On the subject of options, I would say that most options are constructed poorly, from the standpoint of the owner, but they're constructed very well from the standpoint of the person who receives them, which is not entirely unexplainable because the — it's a very strange form of negotiation when the beneficiary is the one that also really does all the design and hires the experts to come in and tell him what is good for the company when the expert knows that the guy who signs the check would be quite interested also in hearing what's good for him.

There's nothing wrong with options per se, at all. Frankly, in terms of Berkshire, it would have been perfectly appropriate if a properly designed option had been given to me or to Charlie.

I mean, we have responsibility for the whole enterprise, and we believe that any kind of incentive for performance should be related to the area in which you have responsibility.

We feel that if you want a typist to type 100 words a minute, that you ought to pay for typing 100 words a minute, not what the earnings per share were last year.

We feel if a salesman gets paid for how many of the product is sold, he should get paid for that and not for some production quotas met.

So we believe in tying incentive comp to performance for which you have responsibility. And there are certain areas of a business that don't lend themselves to that staff performance and so on.

But that would lead to the corollary, that the people that are responsible for the entire results of the business, it's perfectly appropriate to compensate them by options that in some way reflect the performance of that entire business.

The trouble is that stock prices reflect other things than the performance of the business.

For one thing, over a period of time, they reflect simply the reinvestment of earnings. You know, I have pointed out in the past that if you gave me an option on your savings account — to manage your savings account — and you reinvested all the interest, I would take away a significant payment at the end of ten years simply because you left the interest in.

With a company that pays no dividend like Berkshire, if you're going to leave all your capital in every year, for me to get a fixed-price option for ten years would mean that I was getting a royalty on money that you left with me. And I made the choice to have you leave it with me. So that does not strike me as equitable.

So I think any option should have a step-up in price that reflects the fact that money is reinvested by the shareholders annually. That if somebody wants to pay out a hundred percent of the earnings every year, then I'd say that you can have a fixed-price option. If you give me the money every year, and you do more with the money that's left with you than the original sum, that's fine.

But if money is left with someone for ten years, there's going to be some increase in value even if they spend every day golfing. And to give a piece of that away simply over — to have a royalty on the passage of time for them is a mistake.

I think options ought to be granted, basically, at the fair value of the business at the time they're granted. Sometimes that's the market price, sometimes it isn't the market price, but —

Certainly the management of a company would not give an option on their business to some third party at a market price they felt was way too low, so I find it a little disingenuous when managements say that they're — when they get a takeover bid, they say that the company's really worth twice that much, but they're perfectly willing to issue options to themselves at this price which they say is totally inadequate, when the owners get the option elsewhere.

But options, properly structured, for people with responsibility for the business, I think, makes — can make sense. And I think that if something happened to me and to Charlie, in terms of the manager of the business subsequently, if it was structured properly, I would not see anything wrong with an option arrangement.

We carry this philosophy down to our subsidiaries where they generally get incentive arrangements that relate to the operation of their business. But they don't have incentive arrangements that relate to Berkshire overall, because if Chuck Huggins does a wonderful job at

See's Candy, as he has done, and I fall on my face, in terms of allocating capital, Berkshire stock will go no place despite what Chuck does.

And to penalize him, or to tie his rewards to something over which he has no control, I think, is kind of silly. So we tie it instead to the operations of the candy business.

In terms of overall level of compensation, the real sin is having a mediocre manager. I mean, that is what costs owners very significant amounts of money over time.

And if a mediocre manager is paid a relatively small sum, it's still a great mistake. And if they're paid huge sums, it's a travesty. And that happens sometimes.

It's almost impossible to pay the outstanding manager a sum that's disproportion to the value of that outstanding manager, when you get a large enterprise.

Coca-Cola had a market value of $4 billion when Roberto Goizueta took over. It had stagnated during the previous decade under an earlier management, despite having the same product and those great Mean Joe Greene commercials you saw, that was — Mean Joe Greene was in the '70s. The "Teach the World to Sing" commercial was in the '70s. All these great commercials. But the company didn't do much.

Roberto — if we'd bought the entire Coca-Cola Company — I wish we had — in 1981 or '2, whenever he came in, for 4 billion and we now had a business worth 150 billion, Roberto would have earned more money with us than he's earned under the present arrangement.

I mean, having the right person in place is just enormously important.

How much they should take is another question. That's more a philosophical question.

Tom Murphy, best manager, you know, in the world, he just didn't feel like taking a lot of money out of it, you know. And you know, I tip my hat to him, but I don't think that necessarily makes it wrong for somebody else to take more money for doing the job. But I think it ought to be related to doing the job.

When I ran a partnership in the 1960s, I took a quarter of the profit over 6 percent a year. And I didn't get paid any salary, but I could make a lot of money doing that. And that thought occurred to me as I ran the place from day to day, and I think it probably helped a little. (Laughter)

So I don't think it's a terrible thing to have somebody get paid for making money for the shareholders.

But they ought to get paid for really making it, not simply because the shareholders reinvest money with them. They ought to make it based on the fair value of what they had when they took over, and they ought to make it really for just excellent performance.

Charlie?

CHARLIE MUNGER: Well, we have remarked in previous Berkshire Hathaway meetings that we regard present mandated corporate accounting, with respect to stock options as weak, corrupt, and contemptible. And it is.

WARREN BUFFETT: Otherwise, we're undecided. (Laughter)

CHARLIE MUNGER: If something is so wonderful as a standard technique of compensation, why does it have to be masked under weak, corrupt, and contemptible accounting? I think it is no credit to our civilization that we've drifted into this particular modality.

And you can get, if you overuse stock options, where the whole thing is sort of a chain letter. I mean, in Silicon Valley there's one company that practically paid everybody in options, and as long as the chain letter galloped, it worked as far as the income account because nothing went through expense.

And then once everybody is issuing stock options, everybody else feels that he has to do it. And the practice spreads.

So I am not totally wild about the extreme prevalence of the stock option modality in American corporate life. Personally, I would vastly prefer different modalities, which would probably involve stock instead of stock options.

I'm all for sharing with the kind of people who are doing the important work pretty well down in the organization in a place like Costco or Coca-Cola or any other such company. But I don't much like the present scheme that civilization has drifted into.

With respect to the subject of do we have some wretched excesses in American corporate compensation, my answer would be yes. I don't think the excess is necessarily the guy who got the most money. In many cases I agree with Warren, that the money has been deserved.

But such is the envy effect that the practice spreads to everybody else. And then the taxi driver and everybody starts thinking the system is irrational, unfair, crazy.

And I think that's what causes some people, as they rise in American corporations, to, at a certain point of power gaining and wealth gaining, they start exercising extreme restraint as a sort of moral duty. And that's what Warren was saying about Tom Murphy.

And I would argue that the Tom Murphy attitude is the right attitude. And it goes way, way back in the history of civilization. The word "liturgy" comes from a Greek word which is just the same. I mean, if you were an important citizen of Athens, it was a lot like being an important person in Jewish culture.

I mean, you had duties to give back and to act as a certain example. And the civilization had social pressures that enforced those duties. And I would argue that the Berkshire Hathaway compensation system, considering what the people at the top already have, it would be better if we saw a little more of it.

WARREN BUFFETT: A few —

CHARLIE MUNGER: I think Warren and I do all right. (Laughter and applause)

WARREN BUFFETT: A few years — I think an added problem is the sort of, in terms of the accounting, the sort of hypocrisy that it pushes people into, and then which becomes accepted and sort of a norm, particularly when leaders do it.

And you know, you had a situation a few years back when there's no question that any manager would say that stock options are a form of compensation. They would say that compensation is a form of expense, and they would say that expense belongs in the income account. But they didn't want to have stock options counted because they felt that it might restrict their use.

So when the federal — the FASB, Financial Accounting Standards Board — came up with a proposal to actually have reality reflected en masse, corporate chieftains descended on Washington to pressure legislators to have Congress start enacting accounting standards, which as I mentioned, one time in Indiana in the 1890s, there was a legislator that introduced a bill to have the value of pi changed to an even 3 because he thought that 3.14159 was too tough for the schoolchildren and it would ease computational problems.

Well, that sort of behavior by corporate chieftains when they are in there, you know, arguing that black is white, in order to feather their own nest and maybe create a little higher stock prices, I think that it means that they forfeit, to some degree, their right to be taken seriously when they claim they're operating for the good of the Republic, and march on Washington in other regards.

And I just think that when the organization recognizes its hypocrisy and so on, I think there's a degradation that can set in through an organization that — whose leaders are also leaders in hypocrisy.

Like I say, we have no strong feelings on this subject, but — (Laughter)

Charlie, do you have anything?

CHARLIE MUNGER: It’s rather interesting, though. There’s an earlier example. Commodore Vanderbilt took no salary from his railroads. After all, he controlled the railroads. They paid all the dividends that he needed, and he got the fun of running the whole railroad, and he thought it was beneath Commodore Vanderbilt to take a salary.

We’ve never quite reached the Vanderbilt standard, but — (Laughter)

WARREN BUFFETT: We don’t have any dividends, Charlie.

CHARLIE MUNGER: Yeah, yeah. (Laughs)

Well, maybe that’s the reason. (Laughter)

Afternoon Session - 1997 Meeting

1. When opportunity knocks …

WARREN BUFFETT: OK. If we're live now — what we might do is maybe have just — I think maybe we only need four microphones for the afternoon session. So we'll have two on each side, one toward the back, one toward the front. And we'll just go around in four microphones. Are we OK on that?

And we'll start just one second. Everybody has a chance to get to their seats.

Charlie has promised to stop tapping the Coke can during this — (laughter) — session.

CHARLIE MUNGER: I only did that when somebody else was talking. (Laughter)

WARREN BUFFETT: Number 2? OK.

I used to have a friend that was a stock salesman many years ago. And when you'd have lunch with him, he would just keep going like this: (knocking sound).

And finally, it would get to you. And you'd say, "What's that?" And he'd say, "That's opportunity." (Laughter)

He was pretty good.

2. How to buy a business

WARREN BUFFETT: OK, let's — Kelly tells me we should start with number 2, zone 2. So we're going to start with zone 2.

AUDIENCE MEMBER: Yes. I'm Fred Cooker (PH) from Boulder, Colorado.

And this is a question about intrinsic value. And it's a question for both of you because you have written that, perhaps, you would come up with different answers.

You write and speak a great deal about intrinsic value, and you indicate that you try to give shareholders the tools in the annual report so they can come to their own determination.

What I'd like you to do is expand upon that a little bit. First of all, what do you believe to be the important tools, either in the Berkshire annual report or other annual reports that you review, in determining intrinsic value?

Secondly, what rules or principles or standards do you use in applying those tools?

And lastly, how does that process, that is the use of the tools, the application of the standards, relate to what you have previously described as the filters you use in determining your valuation of a company?

WARREN BUFFETT: If we could see, you know, looking at any business, what its future cash inflows or outflows from the business to the owners — or from the owners — would be over the next, we'll call it, a hundred years, or until the business is extinct, and then could discount that back at the appropriate interest rate, which I'll get to in a second, that would give us a number for intrinsic value.

In other words, it would be like looking at a bond that had a whole bunch of coupons on it that was due in a hundred years. And if you could see what those coupons are, you can figure the value of that bond compared to government bonds, if you want to stick an appropriate risk rate in.

Or you can compare one government bond with 5 percent coupons to another government bond with 7 percent coupons. Each one of those bonds has a different value because they have different coupons printed on them.

Businesses have coupons that are going to develop in the future, too. The only problem is they aren't printed on the instrument. And it's up to the investor to try to estimate what those coupons are going to be over time.

As we have said, in high-tech businesses or something like that, we don't have the faintest idea what the coupons are going to be.

When we get into businesses where we think we can understand them reasonably well, we are trying to print the coupons out. We are trying to figure out what businesses are going to be worth in ten or 20 years.

When we bought See's Candy in 1972, we had to come to the judgment as to whether we could figure out the competitive forces that would operate, the strengths and weaknesses of the company, and how that would look over a ten or 20 or 30-year period.

And if you attempt to assess intrinsic value, it all relates to cash flows.

The only reason for putting cash into any kind of an investment now is because you expect to take cash out. Not by selling it to somebody else, because that's just a game of who beats who, but, in a sense, by what the asset, itself, produces.

That's true if you're buying a farm. It's true if you're buying an apartment house. It's true if you're buying a business.

And the filters you describe. There are a number of filters which say to us we don't know what that business is going to be worth in ten or 20 years. And we can't even make an educated guess.

Obviously, we don't think we know to three decimal places, or two decimal places, or anything like that, precisely what's going to be produced. But we have a high degree of confidence that we're in the ballpark with certain kinds of businesses.

The filters are designed to make sure we're in those kinds of businesses. We, basically, use long-term, risk-free government bond-type interest rates to think back in terms of what we should discount at.

And, you know, that's what the game of investment is all about. Investment is putting out money to get more money back later on from the asset. And not by selling it to somebody else, but by what the asset, itself, will produce.

If you're an investor, you're looking at what the asset — you're looking at what the asset is going to do — in our case, businesses.

If you're a speculator, you're primarily focusing on what the price of the object is going to do independent of the business. And that's not our game.

So we figure if we're right about the business, we're going to make a lot of money. And if we're wrong about the business, we don't have any hopes — we don't expect to make money.

And in looking at Berkshire, we try to tell you as much as possible as we can about our business, of the key factors. Those are the things that Charlie and I —

With the things we put in our report about those businesses are the things that we look at ourselves.

So if Charlie had nothing to do with Berkshire but he looked at our report, he would probably, in my view, he would come to pretty much the same idea of intrinsic value that he would come to from being around it, you know, for X number of years. The information should be there.

We give you the information that, if the positions were reversed, we would want to get from you.

And in companies like Coca-Cola or Gillette or Disney or those kind of businesses, you will see the information in the reports. You have to have some understanding of what they're doing. But you have that in your everyday activities. You'll get that kind of knowledge.

You won't get it, you know, in terms of some high-tech company. But you'll get it with those kind of companies. And, then, you sit down and you try to print out the future.

Charlie?

CHARLIE MUNGER: I would argue that one filter that's useful in investing is the simple idea of opportunity cost.

If you have one opportunity that you already have available in large quantity, and you like it better than 98 percent of the other things you see, well, you can just screen out the other 98 percent because you already know something better.

So the people who have a lot of opportunities tend to make better investments than people that don't have a lot of opportunities. And people who have very good opportunities, and using a concept of opportunity cost, they can make better decisions about what to buy.

With this attitude, you get a concentrated portfolio, which we don't mind. That practice of ours, which is so simple, is not widely copied. I do not know why. Now, it's copied among the Berkshire shareholders. I mean, all of you people have learned it.

But it's not the standard in investment management, even at great universities and other intellectual institutions.

Very interesting question. If we're right, why are so many eminent places so wrong? (Laughter)

WARREN BUFFETT: There are several possible answers to that question. (Laughter)

The attitude, though — I mean, if somebody shows us a business, you know, the first thing that goes through our head is would we rather own this business than more Coca-Cola? Would we rather own it than more Gillette?

It's crazy not to compare it to things that you're very certain of. There's very few businesses that we'll find that we're certain of the future about as companies such as that. And therefore, we will want companies where the certainty gets close to that. And, then, we'll want to figure that we're better off than just buying more of those.

If every management, before they bought a business in some unrelated deal that they might not have even heard of, you know, more than a short time before that's being promoted to them, if they said, "Is this better than buying in our own stock, you know? Is this better than even buying, you know, buying Coca-Cola stock or something," there'd be a lot fewer deals done.

But they don't — they tend not to measure — we try to measure against what we regard as close to perfection as we can get.

Charlie, anything?

CHARLIE MUNGER: Well, I will say this, that the concept of intrinsic value used to be a lot easier, because there were all kinds of stocks that were selling for 50 percent or less of the amount at which you could've easily liquidated the whole corporation if you owned the whole corporation.

Indeed, in the history of Berkshire Hathaway, we've bought things at 20 percent of then-liquidating value.

And in the old days, the Ben Graham followers could run their Geiger counters over corporate America. And they could spill out a few things. And you could easily see, if you were at all familiar with the market prices of whole corporations, that you were buying at a huge discount.

Well, no matter how bad the management, if you're buying at 50 percent of asset value or 30 percent or so on down, you have a lot going for you.

And as the world has wised up and as stocks have behaved so well for people, good stocks, generally, have gone to higher and higher prices. That game gets much harder.

Now, to find something at a discount from intrinsic value, those simple systems, ordinarily, don't work. You've got to get into Warren's kind of thinking. And that is a lot harder.

I think you can predict the future in a few places best if you understand a few basic ideas that come from a good general education. And that's what I was talking about in that talk I gave at the USC Business School.

In other words, Coca-Cola's a simple company if it's stripped down and analyzed in terms of some elemental forces.

WARREN BUFFETT: When Charlie —

CHARLIE MUNGER: It's not hard to understand Costco, either, you know —

There are certain fundamental models out there that do not take — you don't have the kind of ability that quantum mechanics requires. You just have to know a few simple things and really know them.

WARREN BUFFETT: When Charlie talks about "liquidating value," he's not talking about closing up the enterprise. But he's talking about what somebody else would pay for that stream of cash, too, I mean —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: You could've looked at a collection of television stations owned by Cap Cities, for example, in the early to mid — well, 1974. It would've been worth, we'll say, four times what the company was selling for. Not because you'd close the stations, but just their stream of income was worth that to somebody else. It's just that the marketplace was very distressed — depressed.

Although, like I say, on a negotiated basis, you could have gone and sold the properties for four times what the company was selling for. And you got wonderful management.

I mean, those things happen in markets. They will happen again. But part of investing and calculating intrinsic values is if you get the wrong answer when you get through — in other words, if it says don't buy, you can't buy just because somebody else thinks it's going to up or because your friends have made a lot of easy money lately or anything of the sort.

You just — you have to be able to walk away from anything that doesn't work. And very few things work these days. You also have to walk away from anything you don't understand which, in my case, is a big handicap.

CHARLIE MUNGER: But you would agree, wouldn't you, Warren, that it's much harder now?

WARREN BUFFETT: Yeah. But I would also agree that almost anytime over the last 40 years that we've been up on a podium, we would've said it was much harder in the past, (laughs) too.

But it is harder now. It's way harder.

Part of it being harder now, too, is the amount of the capital we run. I mean, if we were running $100,000, our prospects for returns would be — and we really needed the money — our prospects for return would be considerably better than they are running Berkshire. It's very simple. Our universe of possible ideas would expand by a huge factor.

We are looking at things today that, by their nature, a lot of people are looking at. And there were times in the past when we were looking at things that very few people were looking at.

But there were other times in the past when we were looking at things where the whole world was just looking at them kind of crazy. And that's a decided help.

3. Stocks look high, but not as high as they look

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: My name is Bakul Patel (PH). I'm from upstate New York. I've got a few questions. And I need your permission to ask each question separately and wait for the answer.

WARREN BUFFETT: Well, we'll take a couple, but —

I got through college, you know, only answering three or four questions. So I don't want to go through that again. (Laughter)

AUDIENCE MEMBER: They are unrelated questions.

WARREN BUFFETT: OK. OK. We'll give you a couple, then we'll let other people have a chance. How about two, OK?

AUDIENCE MEMBER: Fine. Mr. Market is valuing Dow Jones at about 7,000 and S&P at about 800.

By your valuation model, at the current interest rate and current inflation rate and current growth rate, what is a fair valuation of both these companies?

WARREN BUFFETT: Well, that's a good question but a tough question. But I would say that if you believed American — the American business, in aggregate, could earn the kind of returns on equity that they have been earning in the last — or has in the last couple of years — and then you postulate no change in interest rates, you can justify 7,000 on the Dow and 800 on the S&P.

Now, you know, there's a couple ifs I threw in there. And if interest rates go higher, the valuation goes down automatically.

And more importantly, if the returns on equity of American industry — which are historic highs, and which sort of classical economics would tell you would be hard to maintain — if those returns go down, on average, that also would pull it down.

But if you're willing to accept the current level of returns on equity as being typical of the future case for American business and you're willing to assume present interest rates are lower, then, you can justify a valuation on the Dow and S&P.

And it's interesting because I got all that commentary after I wrote that line in the report which was, as I said earlier, designed for a little something else. I'll give you a little trivia quiz.

What two years in this century has the Dow had the greatest overall gain? The two years in the 1900s are 1933, which most of you don't think of as a banner year, and 1954. And in both of those years, the Dow was up over 50 percent, counting dividends.

In March of 1955, because of that, the fact that the Dow had gone up — bear in the mind that the high on the Dow was 381 in 1929 and it took 25 years before that was surpassed. And in 1954, the Dow went from, say, 280 up to 404, or something like that, just a little over 50 percent.

So what did they decide to do? They decided to have congressional hearings about it. And they did.

In March of 1955, they had hearings in the Senate Banking and Currency Committee, Chairman Fulbright. And my boss, Ben Graham, was called down to testify. And it's fascinating reading. Bernard Baruch was there, all kinds of people. I've got the hearings at home.

And Ben's opening comments about the market at that time were that the market looks high, it is high, but it's not as high as it looks. Well — (Laughter)

That's about the present situation. I mean, it looks very high, just by comparing 7,000, certainly, to the 404 at the end of 1954 when was Ben was testifying.

But there are — there have been huge changing in earnings and return on equity on American business in general. And, then, you had this big move in interest rates.

Now, those are underlying fundamentals that have had — powered a huge bull market. After a while, as I mentioned earlier, people get captivated simply by the notion of rising prices without going back to the underlying rationale. And that's when you get very dangerous conditions in terms of possible bubbles.

And it would — you know — I have no idea where markets will go. But if you had the kind of conditions that could cause real excesses, just like you had excesses in 1973 and '4, going back to when you could buy things at 20 cents on the dollar, you had excesses in the other direction.

You know, the country didn't disappear or anything. It's just people behave in extreme ways in markets. And over time, that's very good for people that keep their heads.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: OK. You get one more. (LAUGH)

4. When Berkshire is cheap, other things are usually cheaper

AUDIENCE MEMBER: If Mr. Market goes in the depressed phase that Berkshire Hathaway has got an investment portion of its book value about 28,000 per Class A share, that would put that Berkshire Hathaway share much lower than what it is now. Would Berkshire Hathaway consider buying back its own share? Or has it done so in the past? Or is it out of the question?

WARREN BUFFETT: If the market went in the tank, Berkshire stock would go in the tank, too. And so there shouldn't be anybody in this room that owns the stock that would not find it palatable, if not become positively enthusiastic, about the stock going down 50 percent.

It would not bother Charlie. It wouldn't bother me, because we would have very intelligent things, then, to do with whatever capital we came into. And we would be generating capital as we went along.

We wouldn't have sold our Coke. We wouldn't have sold our Gillette. We wouldn't have sold our businesses. So most of our capital would've ridden that down. But at least, we would have intelligent things to do with the money.

One of the intelligent things, possibly, could be to buy in our own stock. But that would imply that our own stock was cheaper relative to value than anything else we could find among possible opportunities. And the chances are we could find things that were more attractive.

Back in 1973 or '4, when we were buying Washington Post at a fraction of what it was worth, Berkshire stock may have been cheap then. But it wasn't as cheap as the Washington Post.

In 1987 or — well, in 1988 and '89, you know, Berkshire stock may or may not have been cheap. But it wasn't as cheap as Coca-Cola.

And it's unlikely that among the thousands of the possible investments that Berkshire will be the most attractive at any time. But if it were, you know, obviously, we would buy in our own stock.

But I think if the Dow went down 50 percent, we would have plenty of interesting things to do. And we would not be unhappy.

Charlie?

CHARLIE MUNGER: Yeah. We don't have any rule against it. Opportunity cost is the game around here.

5. International earnings in the United States

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: I'm David Day from Coppell, Texas. And I'm a Berkshire shareholder.

Mr. Buffett, what is your opinion of investing in foreign company stocks?

WARREN BUFFETT: Well, we have a number, well, at least several major businesses, three or four at least, five, six, I mean, as I count along, that derive very significant percentages of their earnings from international operations.

Coca-Cola earns 80 percent or more from international operations. Gillette would earn two-thirds or more from international operations.

So if you look to where earnings are coming from, we get a lot from international companies. They don't have to be domiciled outside the United States.

It's a slight advantage to us to have them domiciled in this country. For example, their dividends are treated better. We get better treatment on the dividends if they are domestically based rather than based someplace else, just because of the way the U.S. tax laws work.

But if Coca-Cola were domiciled in Amsterdam, or Gillette were domiciled in London, they had the same basic businesses, we would be attracted to them to virtually the same degree we are as having them domiciled in Atlanta and Boston.

We look at businesses outside this country that are domiciled outside this country. Many don't meet our size requirements. But that's true here, too. We have to look at very big companies. But we have nothing against buying into companies that are domiciled — or even buying the entire business of a company — that's domiciled outside the United States.

We feel slightly less familiar with the tax laws and the corporate cultures, perhaps. But that would not be a huge factor in a great many countries. And, you know, we will keep looking. We need to look everywhere with the kind of money that we have available for investment.

Charlie?

CHARLIE MUNGER: Again, we've had a wonderful way of playing the rapid development of economies outside the United States. And so far, we haven't seen anything that attracted us as being better.

And if you can sell Coca-Cola, you know, do you really want to get into steel in Malaysia or something? (Laughter)

WARREN BUFFETT: We sold a substantial number of Kirby units outside of the United States last year. And that business has grown very significantly in recent years. And I think it promises to grow.

We're always looking for opportunities. Some things travel very well. And some things don't.

I mean, Gillette travels. Disney travels. McDonalds travels. Coke travels.

You know, See's Candy doesn't travel as well. It might if you spent 50 years working on it. But it's not an easy thing to travel. Actually, candy bars, themselves, don't travel very well.

If you look at the top-selling candy bars in France or in England and Japan, you don't find the similarity that you find in terms of the bestselling soft drinks or movies or fast food hamburgers or razor blades, and —

CHARLIE MUNGER: Except Snickers. For some reason, Snickers. (Laughter)

WARREN BUFFETT: Well.

CHARLIE MUNGER: It travels very well. Don't ask me why. (Laughter)

WARREN BUFFETT: Yeah. Well, Charlie's had a lot of experience as he goes around the world. (Laughter) You don't want to eat where we eat. You may want to invest where we invest, but — (Laughter)

6. Businesses with "natural limits" welcomed at Berkshire

WARREN BUFFETT: OK. Section 1.

AUDIENCE MEMBER: I'm Richard Tomkins (PH) from Gallatin, Tennessee. And I have just two quick questions.

Could both of y'all discuss the Kansas Bankers business and its competitors? How big of a moat Kansas Bankers has in the industry and if they're going to expand, you know, outside of the 22 or 20 states that they're currently in. And that's A.

And, then, secondly, just clue us in a little bit more on the five-year discount notes that you did that were tied to the Salomon stock. And was that a way to unload it? Or just kind of give us a little more than what we saw in the annual.

WARREN BUFFETT: Sometimes in the insurance business, you have a choice between being a good business or a big business. And fortunately, Don Towle, who runs Kansas Banker Surety, has chosen for a good business.

It's a specialized operation that sells, as its name implies, to bankers, and primarily policies that have fidelity coverage.

That is just not a big volume business in the whole United States. They do it exceptionally well. Don knows every, you know, he knows every account. He knows every claim. You know, he runs a fabulous operation. But it's not an operation that can double or triple in size doing what it does and doing well. There just aren't — there's not the opportunity there.

On the other hand, I think it's tough to compete against Don because he brings an element of knowledge and personal attention to the account and factors of that sort that a really large company would have trouble duplicating.

Charlie, you want to add anything on Kansas Bankers?

CHARLIE MUNGER: Yeah. There's a huge class of businesses in America which are very strong and will throw out large amounts of cash in relation to their size but which can't rationally be expanded very much. And if you try and expand certain kinds of businesses, you're throwing money down the rat hole.

The beauty of the Berkshire Hathaway system is that such businesses are very welcome here because the cash comes into headquarters and is allocated there.

If there's anything sensible to do at the subsidiary level, we always want it done. But there are businesses where — lots of businesses — where there isn't much of a way of redeploying the cash.

WARREN BUFFETT: Part the reason they have a moat around them is that they're of a size and have specialized skills that other organizations just can't get into it. I'll give you another example, and that's somewhat the same field.

There's a company called Western Surety. It's changed ownership a couple of times. Charlie and I went up to see them 15 years ago about buying it at Sioux Falls.

They write notary bonds. And they write a whole bunch of things that have $50 premiums or $25 premiums. They have — it was a company doing not that many millions of premiums, but they had 30,000 agents. But each agent, you know, may have done $500 worth of business within a year or a thousand dollars.

Well, Chubb can't go after that business the same way. We certainly can't at National Indemnity. They have a distribution system that works wonders. But you can't pump two or three times the volume through that distribution system. And if you could pump it through, there would've been more competition.

So there are businesses that have certain natural limits that, you know, you want to be careful that you don't talk yourself into thinking a business that has limits and find out that it really has way more potential.

I mean, it would've been a shame if Mr. [Asa Griggs] Candler decided that Coca-Cola only appealed to people in Atlanta or something of the sort. So you have to be a little careful on that.

But we — a fellow like Don will be very good at understanding, you know, where his competitive advantages can take him and where they don't take him. He's done a terrific job over the years doing it.

7. Debt deals vs. buying stock

WARREN BUFFETT: There was a second question, was there?

AUDIENCE MEMBER: Just the $500 million I think that y'all did, of the discount.

CHARLIE MUNGER: Oh, the Salomon notes.

WARREN BUFFETT: Oh, the Salomon notes. Yeah. Well, that is simply an issue of Berkshire — by Berkshire — of 500 million, as you mention, of a very low-coupon note — low-interest rate note, too — that is convertible — or exchangeable — into Salomon stock anytime during the next five years.

And it's a way of taking the capital out of that block of stock at a low-interest cost to use elsewhere, while retaining a limited portion of the upside in the Salomon stock.

And we just — we made that decision, whenever it was, six months ago or so, based on the thought that we might have some good opportunities at some point to use that money, and raising the money at a little over a one percent current cost, or a three percent cost to maturity — and we think the actual cost is likely to be close to the one percent — made sense for us.

We have never owned — I mean, we have the convertible preferreds of Champion, of US Airways, and of Salomon. And those are three industries — I don't think we've ever owned an airline stock, common stock. I don't think we've ever owned a paper company common stock. And we've only had a very limited amount of investment in the investment banking businesses.

Those are industries that we don't feel that we've got the same kind of long-term economic advantage that we have in something like a Coke or a Gillette. So those are not natural places for us to be common shareholders. And the issuance of that exchangeable debt reflected that view.

Charlie?

CHARLIE MUNGER: I agree. (Laughter)

8. Lower tax rate probably won't trigger Berkshire stock sales

WARREN BUFFETT: OK. Zone 2.

CHRISTINE SHRAM: My name Kristen Schramm (PH). I am from Springfield, Illinois.

I am a proud shareholder of Berkshire Hathaway. In light of the upcoming capital gains tax reduction, do you envision any increased selling pressure, such as buying opportunities for Berkshire stock?

WARREN BUFFETT: That's a good question, Kristen. We're proud to have you, too. (Applause)

A very high percentage of Berkshire shares is owned by people with a very low tax basis. So that if I had to guess, I would say that probably 80 percent, at least, of the shares are owned by people whose cost is less than a hundred dollars a share on the A stock.

And that, undoubtedly, contributes to some people's reluctance to sell, particularly if they're older, and —

But I think it would probably — it might make less difference than you think. I think most people, if there were a lower capital gains rate, I don't think it would be a huge change in the propensity to sell the stock.

I would hope, even if there was a zero capital gains tax, that there really wouldn't be any rush for the exits. It wouldn't affect my attitude, particularly. But I think it's perfectly reasonable to assume that as the tax rate goes down, there will be some greater tendency to sell by people with a low tax basis on their shares.

Charlie?

CHARLIE MUNGER: Well, I think the laws of microeconomics and the laws of psychology are such that if you said, "The tax rate will, for one month, go down to zero," you would have some very dramatic effects in the markets. It's not going to happen, of course.

WARREN BUFFETT: No. But if you said the tax rate was going to zero for one month, and then going to a hundred percent subsequently, I think you'd get a certain amount of activity. (Laughter)

CHARLIE MUNGER: But then you'd really —

So you could tinker with the tax laws in a way that would cause dramatic market effects. I don't anticipate any such things happening.

We had something similar back when they — what was it, '86 — where the tax rate was 20 percent on long-term capital gains. And it was the last year you could liquidate a corporation and not pay gains taxes on appreciated assets that were disposed of in the liquidation. And we got a great flood of liquidations in that year.

So it's possible to do things to the tax laws that have big market effects. But it gets very unlikely that any such thing is going to happen this year.

WARREN BUFFETT: Yeah. I agree with that.

9. We know our super-cat insurance risks, but many others don't

WARREN BUFFETT: Zone 2?

VOICE: (Inaudible)

VOICE: What number is this? Is this three or four? What is it?

WARREN BUFFETT: Is there a zone 2?

VOICE: Is this it?

WARREN BUFFETT: The microphone working?

Zone 3? Well, we'll go to zone 3, then.

AUDIENCE MEMBER: I am Charles Parcells (PH) from Grosse Pointe, Michigan. Very glad to be here. I'm a recent stockholder of Berkshire. I'm sorry to say that. (Laughter)

But it does not diminish my admiration for past performance or my confidence in future performance.

I heard recently a remark by, I think, a very successful investor, whom I think worked with the Bass family in Texas for a while.

And one of his comments, if I understand it correctly, said something like this. "Hurricane Andrew destroyed the super-cat industry." And that's about all he said. And I know we're into it. I'm interested in its importance to Berkshire and your comments on it, Mr. Buffett and Mr. Munger.

WARREN BUFFETT: Yeah. I guess I would say I don't fully understand why he would — or even partially understand — why he would say that.

I mean, we are in business in the super-cat business — and I should explain, super-cat business is very much like it sounds. I mean, we write insurance for other insurance companies, other reinsurance companies, to protect them, to pay them at a time when something really big comes along, a super catastrophe. And Hurricane Andrew was certainly a super catastrophe.

But that's the reason people do business with us, so —

We pay off infrequently, but we pay off big. And we paid off about 120 million at Hurricane Andrew. But if Hurricane Andrew happened today — well, at least in one of the policies (inaudible) we have — we would certainly be paying off at least, what, 6, 700 million, something like that.

And if it happens five years from now, we'll pay off a lot more than that because we will, undoubtedly, be writing more business at that time.

So it's just part of the game. And there will be super-cats of various kinds. There will be, you know, huge quakes. There will be more hurricanes than huge quakes. And when that time comes, we will write a big check.

But that doesn't — you know, prices may be firmer after such an event. They may not be. They didn't firm as much as you might expect after Andrew happened. Andrew was a huge surprise to people.

As a digression, you know, people in the insurance business thought that — they all had these models — and some of them were prepared by reinsurance brokers and some of them by various research institutes — as how much they would lose under certain kinds of circumstances.

And they couldn't have been further off with an Andrew, or with the Northridge earthquake.

Fortunately, we don't rely on those. We — I don't know what exactly we do rely on, but we don't rely on those. (Laughter)

And the — Hurricane Andrew was, you know, that was just — that's part of business with Berkshire.

And we will have another one. And we'll have another one after that. So every three, or five, or seven years, or who knows what, we will lose significant money in the super-cat business. And we expect that over 20 or 25 years, we will make more money than we lose.

We bring some real advantages to that business, as I wrote about in the report. And it makes sense for us to be in it. It only makes sense for us to be in it when the premium prices are right. But when they are appropriate, we will — we're more than willing to step up and take on a fair amount of risk.

As I wrote in the report, on the California Earthquake Authority, you know, we could, tomorrow, face a demand for roughly a billion dollars. And we are prepared to write a check that day to take care of that. And we will write it, if it happens. And there aren't many people in the world that an insured can count on to do that.

The interesting thing is that the worst exposure, still, for super-cats, are not borne by us. But they're borne implicitly by some very big direct writing companies that have lots of risk on Long Island or along the New Madrid Fault or other places.

And they have got, well, millions of policies, and maybe hundreds of thousands of exposed policies. And they don't think of themselves as being in the super-cat business. Well, they really do, but they don't think, you know, day by day about it. And they are very exposed.

Our exposures are limited to a given dollar amount. That dollar amount may be large. But at least we know what it is. And we take risks — that we're willing to take risks when we think we're appropriately paid.

There's a mentality to bring to the super-cat business that's somewhat akin to what you bring to the investment business. So we think we're well equipped for it.

Charlie?

CHARLIE MUNGER: Yeah. A billion dollars would be, what, 2 1/2 percent, or less, of the liquid assets and securities around Berkshire. And so that's irritating, but it — (laughter) — it's not going to destroy the enterprise.

Whereas, if you have an unwitting super-cat exposure that you don't even recognize you have, it could destroy your company. Twentieth Century, a very well-run direct writer of insurance, they all but went broke with the Northridge Earthquake.

WARREN BUFFETT: And they didn't think it was possible, either.

CHARLIE MUNGER: And they had no idea they had a super-cat exposure in what they thought was a simple, little direct writing insurance operation.

No, I don't think we've got the main super-cat risks at all at Berkshire.

WARREN BUFFETT: GEICO lost something like 150 million in Andrew. And their initial estimate of the loss was, like, $35 million. And that's after they thought they'd heard about most of it. You can really get fooled in this business.

In fact, 20th Century, which lost a billion dollars at Northridge just at the end of 1996, I think, added $40 million, as I remember, to the reserves for the Northridge Quake, which I think was in January of '94.

Now, you think on an earthquake, you know, you'd kind of know when it was over. But — (laughter) — you can really — you can get fooled.

And down at Andrew, I mean, the costs of construction go up dramatically in an area that's been wiped out. And then there were all kinds of things in the codes. I mean, I think they started requiring architects' drawings on everything, you know, over $5,000 in the way of repairs, some number like that — don't hold me to the number. And, of course, the architects had a field day.

And then it turned out that everybody had a homeowner's policy in the Oakland fire, for example. They all had a $300,000 book collection in their library. And, you know, who knows after the place has burned down? (Laughter)

It's not — you get a lot of surprises in that field. And the surprises in insurance are never symmetrical. They're all bad. (Laughs)

10. "You need a large margin of safety"

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Yes. My name is (inaudible). I'm from New Mexico. And I'm a shareholder. I have two questions.

First, in your '91 letter, you wrote about investors eventually repeat their mistakes. So what do you do to keep you from making the same mistake twice?

And the second question is, in your '92 letter, you wrote that you tend to deal with a problem of future earning in two ways. The first way is the business you understand. And the second is the margin of safety. And you say they are equally important. But if you — (loud noise) — but if you cannot find the happy combination of faster growth at a low key, which one do you think is more important, faster growth or low key? That's my two questions.

WARREN BUFFETT: I think we were told by — (loud noise) — we were told by some higher authority which one was more important there for a second. (Laughter)

Well, they're bound together. Obviously, if you understood a business perfectly — the future of a business — you would need very little in the way of a margin of safety.

So the more volatile the business is — or possibility is — but assuming you still want invest in it, the larger the margin of safety.

I think in that first edition of [Benjamin] Graham — I doubt if I'm right — was it (inaudible) and said, you know, maybe it was worth somewhere between 30 or 110, or some number. He said, "Well, that sounds — how much good does that do you to know that it's worth between 30 and 110?" Well, it does you some good if it's selling below 30 or above 110."

That's — you need a large margin of safety.

Well, if you're driving a truck across a bridge that holds — it says it holds 10,000 pounds — and you've got a 9,800 pound vehicle, you know, if the bridge is about six inches above the crevice that it covers, you may feel OK.

But if it's, you know, over the Grand Canyon, you may feel you want a little larger margin of safety, in terms of only driving a 4,000 pound truck, or something, across. So it depends on the nature of the underlying risk.

We don't get the margin of safety now that we got in a 1973-4 period, for example.

The biggest thing to do is understand the business. If you understand the business, and get into the kind of the businesses where surprises — by their nature — surprises are few. And we think we're largely in that type of business.

11. Learn from the mistakes of others

WARREN BUFFETT: The earlier part about — you know, I've said about learning from your mistakes, the best thing to do is learn from other guys' mistakes, I mean, you know —

It's like, you know, [U.S. General George] Patton used to say, you know, "It's an honor to die for your country. Make sure the other guy gets the honor," you know and — (Laughter)

So our approach is really to try and learn vicariously. But there's a lot of mistakes that I've repeated, I can tell you that.

The biggest one, probably — or the biggest category over time — is being reluctant to pay up a little for a business I knew was really outstanding, or to continue to buy it at higher prices when I knew it was outstanding.

So the cost of that has been many, many billions. And I'll probably keep making that mistake.

There are — the mistakes are made when there are businesses you can understand and they're attractive and you don't do something about it.

I don't worry at all about the mistakes that come about because when I met Bill Gates, I didn't buy Microsoft or something. That's not my game. But the mistakes are made when you — most of our mistakes have been mistakes of omission rather than commission.

Charlie?

CHARLIE MUNGER: Yeah. I think most people get very few, what I call, no-brainer opportunities, where it's just so damned obvious that this is going to work. And since they are very few and they may be separated by periods of years, I think people have to learn to have the courage and the intelligence to step up in a major way when those rare opportunities come by.

WARREN BUFFETT: Yeah. You got to be willing to take a really big bite. And it's crazy if you don't. And it's crazy if you dabble around at the edges, so you're not prepared to take a big bite when the time comes.

12. Treasury bonds are yardstick to compare investments

WARREN BUFFETT: We, apparently, have lost mike 4. So we're just going to use three mikes from now on. And if you'll just make your way to those mikes, we'll see how we do with them.

How about zone 1?

AUDIENCE MEMBER: Mr. Buffett, my name is Pete Brown (PH) from Columbus, Ohio, a Class B shareholder.

I had a couple questions if I could. The first is, I don't have a very good idea in my mind how our typical insurance operations work. I mean, in particular, how money leaves the insurance pool and enters the investment pool, and how our operations are different than the typical, run-of-the-mill insurance operation, you know, around the country.

Why are we able to generate so much more float than, you know, the XYZ Company, you know, somewhere else?

And a second question is, it kind of goes back to an article you wrote for Fortune Magazine back in the late '70s about the effect of inflation on equity values and that sort of thing. And in it, you asserted that stocks were — in businesses — were really like bonds. They just had their own par. And the par being the average 12 percent return on equity that companies have averaged.

You know, a company does better than that has assets that are worth way more than a hundred cents on a dollar. A company does less, you know, will be less, correspondingly.

My question is, when you're projecting cash flows of a company as a prospective investment, why would you use the interest rate, you know, of risk-free Treasury bills? Why wouldn't you use the sort of opportunity cost to discount that maybe Charlie was referring to, maybe 12 percent return on equity of average corporations? Maybe, you know, your 15 percent goal may be Coca-Cola's return on equity as a comparison.

I mean, doing that would dramatically change the value of the company that you're, you know, evaluating, as I'm sure you know. Why would you use the risk-free rate is my question.

WARREN BUFFETT: The risk-free rate is used merely to equate one item to another. In other words, we're looking for whatever's the most attractive. But in terms of present valuing anything, we're going to use a number.

And, obviously, we can always buy the government bonds. So that becomes the yardstick rate. It doesn't mean we want to buy government bonds. It doesn't mean we want to buy government bonds if the best thing we can find is only — has a present value that works out at a half percent a year better than the government bond.

But it's the appropriate yardstick, in our view, to simply use to compare across all kinds of investment opportunities, oil wells, farms, whatever it may be.

Now, it gets into degree of certainty, too. But it's the yardstick rate. It's not because we want to buy government bonds. But it does serve to make that a constant throughout the valuation process.

13. Insurance and investing are equal, but distinct, businesses

WARREN BUFFETT: In our insurance business, we really have a group of insurance businesses. And they have different characteristics.

The consistent characteristic, actually, is that they're all very, very good businesses. Some of them are a lot larger and have opportunities to get larger. And some of them are not so large and have limited opportunities, in terms of growth. But every insurance operation we have is a distinct asset to Berkshire.

We've got smaller — a worker's comp operation. We've got a credit operation — credit card — operation. We've got a Homestate operation. We have all these different businesses, Kansas Bankers Surety, whatever.

They're all good businesses. Some of them don't develop a lot of float relative to premium volume.

The nature of Kansas Bankers Surety is that it won't develop a lot of float. It just happens to be the kind of business they write.

The nature of comp is that it develops more float, because comp claims pay more slowly.

We — you really should think of each one, though, as having different characteristics.

GEICO is entirely different than the super-cap business. They're both good businesses.

In terms of how we invest the money when it comes in, we invest it when it comes in. I mean, we'll get a large super-cap premium today. It's invested.

Now, if we have a claim tomorrow, then, we disinvest and in a substantial way.

If you take something like GEICO, the cash flow is always going to be positive, probably, on that, you know.

We won't have another Hurricane Andrew, because we've backed out of the homeowner's business to quite an extent.

So month by month, the money comes in at a GEICO. And the faster it grows, the more the money that comes in.

We have so much capital that we can, basically, put that money into whatever makes the most sense for Berkshire. So we have none of either the mental or psychological constraints, or regulatory constraints, that many insurance companies operate under.

Many of them think they sort of should have this portion in this and this portion in that and so on.

Investments usually play second fiddle to the insurance business at most companies that are in the insurance business. We look at them as being of equal importance.

And we run them as two distinct businesses. We do whatever makes the most sense on the investment side, whatever makes the most sense on the insurance side. We never do anything on the investment side that will impinge on our business on the insurance side.

But you really should look at each one of our businesses separately. GEICO has entirely different characteristics than the super-cat business. They both call themselves insurance. They both develop float.

But in economic terms and in terms of competitive strengths and that sort of thing, they're two very different businesses. And our smaller businesses are different businesses. Some of those may grow reasonably well. We'll keep working on it.

Charlie?

14. Munger on choosing your spouse

CHARLIE MUNGER: Yeah. That — if you look at a corporate stock, it's obvious you can buy any maturity of government bond you want. So one opportunity cost of buying the stock is to compare it with a bond.

But you may find that half the stocks in America, you're so fearful about or know so little about or think so poorly of, that you'd rather have the government bond. So on an opportunity cost basis, they're taken out of the filter.

Now, you start finding corporations where you like the stocks way better than government bonds. You got to compare them one against the other. And when you find one that you regard as the best opportunity, that you can understand as the best opportunity, now you've got one to buy.

It's a very simple idea. It uses nothing but the most elementary ideas from economics or game theory. It's child's play as a mental process. Now, it's hard to make the business appraisals. But the mental process is a cinch.

WARREN BUFFETT: If Charlie and I were forced — told we had a choice of buying stock A, B, C or D and all 2,500 or 3,000, or whatever it may be, listed on the New York Stock Exchange, or buying a ten-year government bond and we had to hold the stock for ten years or the bond for ten years, probably in at least 80 percent of the cases, we'd take the ten-year Government, you know.

In many cases, because we didn't understand the business well enough elsewhere. Or secondly, we may understand it and still prefer the 10 percent Government.

So — but we would measure everything that way.

And I don't know, did you come up with 80 percent or where, Charlie?

Desert island, ten years. Get to fondle a stock certificate or fondle a government bond. Which one are you going to choose? (Laughter)

CHARLIE MUNGER: I think life is a whole series of opportunity costs. You know, you got to marry the best person who is convenient to find who will have you. (Laughter)

Investment is much the same sort of a process. (Buffett laughs)

WARREN BUFFETT: I knew we'd get in trouble after lunch. (Laughter)

15. Why don't more companies copy Berkshire?

WARREN BUFFETT: Zone 2. (Laughs)

AUDIENCE MEMBER: Hello. Martin Wiegand, Bethesda, Maryland, stockholder. For myself, my family and other small business owners, I want to thank you for the annual reports. They help a lot in helping us make business decisions and life decisions.

My question is, many people come here — (Applause)

Many people come here to listen to you and to copy and understand your investment philosophy. But why don't more people, in your opinion, try to copy your investment vehicle, a corporation that pays no dividends?

WARREN BUFFETT: Well, I don't really think if the right — I think there are other things that are probably better to copy about Berkshire, but they don't get copied either.

It was always interesting to me how few people — everybody read [Benjamin] Graham's — and they didn't really disagree with him. They just didn't like following him because it didn't promise enough, in a sense. I mean, people really wanted something very quickly.

In terms of not paying dividends, we don't pay dividends because we think we can turn every dollar we retain into more than a dollar of market value. I mean, the only reason for us to keep your money is if it becomes worth more by us keeping it than it would be worth if we gave it to you.

And if we can create more than a dollar of market value for every dollar we keep, you're better off, whether you want to take that dollar out by selling a little piece of your stock, or whether you continue to leave it in. That's the test.

If we come to the conclusion that we can't do that, and we could come to that conclusion sometime, then we should distribute it to you.

The interesting thing is, we're in certain businesses, for example, See's Candy being one — we don't have a way to intelligently use all of the money that See's generates within the See's Candy Company.

So if See's were a standalone company, it would pay very large dividends, not because it, you know, just had some dividend paying policy. It would be simply because we wouldn't have a way of using, in this case, $30 million a year, intelligently in expanding that business.

The Buffalo News is the same way. We don't have a way of using money within that specific business, intelligently, to use the money it generates.

We hope that in the overall Berkshire Hathaway scheme of things that we can intelligently use the money that the companies, in aggregate, generate for us.

And we think, so far, we have. And we think the prospects are reasonably good that we can continue to do that.

But dividend policy should really be determined by that criteria, also bearing in mind the possibilities of repurchase of stock, too.

But they should be determined by whether a dollar left in the business is worth more to the shareholder than a dollar paid out.

Someplace like Coca-Cola, you know, if Coca-Cola paid no dividends and simply repurchased shares and developed the bottling system and done the things that they have, the shareholders probably would've been even better off. They've been sensationally well off as it is. But they probably would've been even better off than they have been with the dividend policy they have had.

And that's true for Gillette and Disney and the companies of that sort that have got these terrific opportunities to use capital within the business, or to repurchase shares of a company that simply can't be replaced.

If — that usually is the best use of capital. It's probably better than dividends. And, you know, we have written some about that, Martin. But people usually keep doing what they've been doing. They're hard to change.

Charlie?

CHARLIE MUNGER: Well, it's interesting that you take that simple standard, you should retain money if you can make it worth more than it is by retaining it. That is not the standard thing that's taught in the corporate finance departments of our major universities.

Why do we have this simple idea and they have another one? Time after time, we find that so.

I've tried to understand why they think the way they do. And I have great difficulty with it. I've just concluded that they're wrong, and — (Laughter)

But that isn't enough. There has to be reason why so many smart people are that wrong. And — (laughter) — that's a story for another day. But there are things gravely wrong with American education that I hope that Berkshire Hathaway is slowly helping to fix.

WARREN BUFFETT: Can you imagine if the — pick any one of you here. And let's say the two of us were in a business together. You know, it was earning $100,000 a year. How would we decide whether to leave the 100,000 each year? And it'd be exactly what we've talked about here. If we thought the 100,000 would translate into a present value of more than 100,000 by some action, we'd leave it in. And if it didn't, we'd take it out. And it doesn't seem to register, generally.

And incidentally, in our own case, we'll probably go too long before we come to the conclusion that we're not really using it that effectively, because there'll be a certain — denial — we'll go through. And we'll say, "Well, that was just temporary last year."

But that will — that is our approach. And we'll do our best to apply it.

16. Corporate profits can't stay so high

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, my name John Shane (PH). I'm from Nashville, Tennessee.

You touched on the subject of return on equity in response to a different question. I wonder whether you might be willing to elaborate along the following line.

Right now, the Standard & Poor's 500, in aggregate, have a return on equity of about 22 percent. The average over the decades for corporate America has been more like 12 or 13 percent.

How did we get to this point of extraordinary profitability? And how likely do you think we are, over the next ten or 15 years, to revert back to the mean of the low teens?

WARREN BUFFETT: Well, I would say is, I never thought it would happen. So I start out with the fact that if you'd listened to me, you'd have been dead wrong, in terms of what the return on equity in 1996 or 1995, 1997 would be.

It does not seem to me that 22 percent returns on equity are sustainable in a world where the long-term interest rate is 7 percent, and where the capability of saving large amounts in the economy, you know, are quite dramatic.

You would just think that there would be some sort of leveling effect between 7 and the 22 you named, that as savings got directed within the economy and as the competitive forces operate that we've been taught will operate over time, would come into play.

But, you know, I've been wrong on that subject. And that's why I say these levels are not unjustified if those kinds of returns can be made.

Because let's just say that you had a 22 percent perpetual bond. And you had the ability — and let's say that a quarter of that — a third of that coupon — would be paid out. So you got a bond with a 22 percent coupon and, say, 7 percent is paid out, being the dividend payout on the S&P, we'll say. And the other 15 percent is reinvested in more 22 percent bonds with similar characteristics.

Now, what's that instrument worth on a present-value basis in a 7 percent world? It's worth a lot of money.

In fact, it's worth so much money that it becomes a mathematical fallacy at some point, because when the compound rate becomes higher than the discount rate, you get into infinite numbers, which are — or you get into infinity.

And that's a number — that's the concept we like to think about around Berkshire — (laughs) — we haven't figured out how to attain it.

There's a book called "The Petersburg Paradox" — there's an article called "The Petersburg Paradox and the Growth Stock Fallacy." I think that's the name of it, by a fellow named, I think, David Durand, written about 25 years ago. And it gets into this bit where the growth rate is higher than the discount rate. And it shouldn't work for an extended period of time. But it's sure fun while it's going on.

Charlie?

CHARLIE MUNGER: Yeah. I think a couple of things contributed to this phenomenon that we so carefully mispredicted.

Number one, it became very fashionable for corporations to buy in shares. And I think that we helped, in a very small way, bring on that enlightenment. And I think that was a plus, in terms of rational corporate decision making.

The other thing that happened is that the anti-trust administration got way more lenient in allowing people to buy competitors.

And I think those two factors helped raise returns on capital in the United States.

But that can't — you wouldn't think that can go on forever. And what 15 percent per annum compounded will do is grow way faster than the economy can grow, way faster than aggregate profits can grow, over a long pull. So, sooner or later, something has to happen. I don't think we've reached a new order of things where the laws of mathematics are somehow repealed.

WARREN BUFFETT: If real output in this country grows at, say, 3 percent a year — or real GDP grows at 3 percent a year — and the capitalized value of industry in the country grows at 10 percent a year, at some point you get into mathematical absurdities, I mean, at the low inflation rates.

You know, you can't have it — if we have an economy that's seven or eight trillion now in GDP and seven or eight trillion in equity valuation, that may or may not make sense. But if you have one that's 15 billion in GDP and 75 billion in equity valuation — 75 trillion in equity valuation — you know, you get to things that don't — can't make any sense.

So if you get these differential rates of growth among items that have some relationship, however tenuous, or at least non-specific in the short run, it doesn't work after a while. And, you know, nobody wants to think about that. They don't want to think about their own death. But I mean, it doesn't go away just because you don't want to think about it.

And we haven't gotten to any point like that. But you can project out numbers. And they just won't make any sense after a while.

CHARLIE MUNGER: Yeah. Corporate profits can't be 200 percent of GNP.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Indeed, they can't be 50 percent of GNP. So these high rates of compounding just go automatically into absurdity.

WARREN BUFFETT: Yeah. They really can't be 20 percent of GDP or some number like that. So if — and if you start saying you can't have a multiple of more, you get differential rates. And they just simply — you leave the tracks after a while.

CHARLIE MUNGER: And all you people should be aware of this because all the people who are professional sellers of investment advice and brokerage service, et cetera, et cetera, have an immense vested interest in believing that things that can't be true are true. (Laughter)

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And not only that, they've been selected in a Darwinian process to have formidable sales skills and large energy. (Laughter)

And this is dangerous to the rest of us. (Laughter)

WARREN BUFFETT: Yeah. Well, you've been selected to be the recipients of their advice. (Laughs)

CHARLIE MUNGER: Right.

Furthermore, they figure out who we are and come in about 6 o'clock in the evening. (Buffett laughs)

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

WARREN BUFFETT: Zone 1 again.

AUDIENCE MEMBER: Mike Assail (PH) from New York City.

Could you explain a little more about what you call the "mind of the consumer" and the "nature of the product" and explain how you actually apply these concepts to find the companies with the growing demand and the best investment potential? And thank you for being two of the greatest professors I've ever had.

WARREN BUFFETT: Thanks. (Applause)

You know, what you really — when you get into consumer products, you're really interested in finding out — or thinking about — what is in the mind of how many people throughout the world about a product now, and what is likely to be in their mind five or ten or 20 years from now?

Now, virtually every person on the globe — maybe, well, let's get it down to 75 percent of the people on the globe — have some notion in their mind about Coca-Cola. They have — the word

"Coca-Cola" means something to them. You know, RC Cola doesn't mean anything to virtually anyone in the world, you know, it does to the guy who owns RC, you know, and the bottler.

But everybody has something in their mind about Coca-Cola. And overwhelmingly, it's favorable. It's associated with pleasant experiences.

Now, part of that is by design. I mean, it is where you are happy. It is at Disneyland, at Disney World. And it's at ballparks. And it's every place that you're likely to have a smile on your face, including the Berkshire Hathaway meeting I might add. (Laughter)

And that position in the mind is pretty firmly established. And it's established in close to 200 countries around the world with people.

A year from now, it will be established in more minds. And it will have a slightly, slightly, slightly different overall position. In ten years from now, the position can move just a little bit more.

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

Disney, same way. Disney means something to billions of people. And if you're a parent of a couple young children and you got 50 videos in front of you that you can buy, you're not going to sit down and preview an hour and a half of each video before deciding what one to stick in front of your kids. You know, you have got something in your mind about Disney. And you don't have it about the ABC Video Company. Or you don't even have it about other — you don't have it about 20th Century. You know, you don't have it about Paramount.

So that name, to billions of people, including lots of people outside this country, it has a meaning. And that meaning overwhelmingly is favorable. It's reinforced by the other activities of the company.

And just think of what somebody would pay if they could actually buy that share of mind, you know, of billions of people around the world. You can't do it. You can't do it by a billion dollar advertising budget or a $3 billion advertising budget or hiring 20,000 super salesmen.

So you've got that. Now, the question is what does that stand for five or ten or 20 years from now? You know they'll be more people. You know they'll be more people that have heard of Disney. And you know that there will always be parents that are interested in having something for their kids to do. And you know that kids will love the same sort of things.

And, you know, that — (Munger accidentally knocks over his microphone) — what's? (Laughter)

He emphasizes the key points when we get to those. (Laughter)

But that is what you're trying to think about with a consumption product. That's what Charlie and I were thinking about when we bought See's Candy. I mean, here we were. It's 1972. You know, we know a fair amount about candy. I know more than when I sat down this morning. (Laughs)

I mean, I had about 20 pieces already. (Laughter)

But, you know, what — whose, you know — does their face light up on Valentine's Day, you know, when you hand them a box of candy and say, you know, it's some nondescript thing and say, "Here, honey, I took the low bid," you know, or something of the sort, and — (Laughter)

No. I mean, you want something — you know, you've got tens of millions of people — or at least many millions of people — that remember that the first time they handed that box of candy, it wasn't that much thereafter that they got kids for the first time or something.

So it's — the memories are good. The association's good.

Total process. It isn't just the candy. It's the person who takes care of you at Christmastime when they've been on their feet for eight hours, and people have been yelling at them because they've been in line with 50 people in line, and that person still smiles at them.

The delivery process. It's the shop in which they get all kinds of things, the treat we give them. It's all part of the marketing personality.

But that position in the mind is what counts with a consumer product. And that means you have a good product — a very good product — it means you may need tons of infrastructure, because you've got to have that — I had a case of Cherry Coke awaiting me at the top of the Great Wall when I got there in China. Now that — you've got to have something there so that the product is there when people want it.

And that happened — in World War II, General Eisenhower, you know, said to Mr. Woodruff that he wanted a Coca-Cola within arm's length of every American serviceman in the world. And they built a lot of bottling plants to take care of that.

That sort of positioning can be incredible. It seems to work especially well for American products. I mean, people want certain types of American products worldwide, you know, our music, our moves, our soft drinks, our fast food.

You can't imagine, at least I can't, a French firm or a German firm or a Japanese firm having that — selling 47 or 48 percent of the world's soft drinks. I mean, it just doesn't happen that way. It's part of something you could broadly call an American culture. And the world hungers for it.

And Kodak, for example, probably does not have quite the same — and George Fisher's doing a great job with the company. This goes back before that.

But Kodak probably does not have the same place in people's mind worldwide quite as it had 20 years ago. I mean, people didn't think of Fuji in those days, we'll say, as being in quite the same place.

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

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

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

So that's what you're doing with consumer products.

With See's Candy, you know, we are no better — we want — no better than the last person who's been served their candy or the last product they've been served.

But as long as we do the job on that, people can't catch us. You know, we can charge a little more for it because people are not interested in taking the low bid. And they're not interested in saving a penny a bottle on colas. Remember we've talked about in these meetings, private labels, in the past.

And private label has stalled out in the soft drink business. They want the real thing. And 900 and some odd million eight-ounce servings will be served today of Coca-Cola product around the world. Nine-hundred million, you know. And it'll go up next year, the year after. And I don't know how you displace companies like that.

I mean, if you gave me a hundred billion dollars — and I encourage if any of you are thinking about that to step forward — (laughter) — if you gave — and you told me to displace the Coca-Cola Company as the leader in the world in soft drinks, you know, I wouldn't have the faintest idea of how to do it. And those are the kind of businesses we like.

Charlie?

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

Warren said we were — it's the first time we really stepped up for brand quality. And it was a very hard jump for us. We'd been used to buying dollar bills for fifty cents.

And the interesting thing was that if they had demanded an extra $100,000 for the See's Candy company, we wouldn't have bought it. And that was after Warren had been trained under the greatest professor of his era, and had worked 90 hours a week.

WARREN BUFFETT: And eaten a lot of chocolates, too. (Laughs)

CHARLIE MUNGER: Yeah. Absorbing everything in the world. I mean, we just didn't have minds well enough trained to make an easy decision right. And by accident, they didn't ask the extra $100,000 for it. And we did buy it. And as it succeeded, we kept learning.

I think that shows that the name of the game is continuing to learn. And even if you're very well-trained and have some natural aptitude, you still need to keep learning.

And that brings along the delicate problem people sometimes talk about: two aging executives. (Laughter)

I don't know what the hell that means as an adjective because I don't know anybody that is going in the other direction. (Laughter and applause)

But you people who hold shares are betting, for a while at least, until younger successors come along, you're betting to some extent on what we'll now tactfully continue to call "aging executives" continuing to learn.

WARREN BUFFETT: Yeah. Well, if we hadn't have bought See's, with some subsequent developments after that because that made us aware of other things, we wouldn't have bought Coca-Cola in 1988. I mean, you can give See's a significant part of the credit for the, I guess, $11 billion-plus profit we've got in Coca-Cola at the present time.

And you say, "Well, how could you be so dumb as not to be able to recognize a Coca-Cola?" Well, I don't know, but —

CHARLIE MUNGER: You were only drinking about 20 cans a day.

WARREN BUFFETT: Yeah. Right. It wasn't that I hadn't been exposed to it, or — (Laughter)

It's amazing. But it just made us start thinking more. I mean, we saw how decisions we made in relation to See's played out in a marketplace and that sort of thing.

And we saw what worked and didn't work. And it made us appreciate a lot what did work and shy away from things that didn't work. But it led — it definitely led to a Coca-Cola. And we've had the good luck to buy some businesses themselves in their entirety that taught us a lot.

You know, we bought — and it's worked in the other direction. I mean, we were in the windmill business, one time. I was. Charlie stayed out of the windmill business. But I was in the windmill business and pumps and — third-level department — or second-level — department stores.

And I just found out how tough it was and how it didn't — you could apply all kinds of energy to them. And it didn't do any good. It made a great deal of sense to figure out what pond to jump in. And what pond you jumped in was probably more important than how well you could swim.

Charlie?

CHARLIE MUNGER: I don't think it's necessary that people be as ignorant as we were, as long as we were. (Laughter)

I think American education could be better, but not in the hands of any of the people who are now teaching. (Laughter)

WARREN BUFFETT: Is there any group we've forgotten to offend? I mean — (Laughter)

18. Life advice: "You will do well in what you enjoy"

WARREN BUFFETT: OK. Zone 2.

AUDIENCE MEMBER: Yes. Good afternoon, Mr. Chairman and Mr. Vice Chairman. My name is Ha Tsin Tsu (PH) and originally from China. Now, I'm living Kansas. And it's my honor to speak to you both.

My question is, if someone like to form a company doing what you did 30 or 40 years ago, what is your suggestion to them? And would you share some of your wisdom with us? Thank you.

WARREN BUFFETT: First thing we'd suggest is they send us a royalty. (Laughter)

Charlie, you take over on that. You've thought more about starting over again than I have. (Laughter)

CHARLIE MUNGER: I want to frankly say that that's a question I ordinarily duck.

I always believe in getting the fundamental mental tools in place. And I always believe in running reality, as it comes in, preferably vicariously through the newspaper, et cetera, instead of through personal painful experience, through the filter of these sound ideas.

And I not only think that that works in life to create success, I think it makes life more fun. So I argue for sound thinking. But the exact specific techniques of turning yourself into another Warren Buffett, I leave to you. (Laughter)

WARREN BUFFETT: Well, the one thing I would advise is I would be — A, I think there's a ton of opportunity out there. And I would do something I enjoyed. I wouldn't do something because I thought it was going to get me to a life I was going to enjoy later on, because if I made a lot of money I was going to be a lot happier, or anything like that.

I've never done that. And I think that you will do well in what you enjoy. And I think it's crazy in life to endure a whole lot that — I don't mean — Charlie and I worked in a grocery story. We didn't really jump up and down over it all the time.

But in terms of making a commitment to really being a business that you're only in it for the money, I think that's crazy.

And if we were in this only for the money, you know, we'd have quit a long time ago, obviously.

It just — you ought to have fun while you're doing it. It should not be jam tomorrow and not jam today. It just doesn't make any sense to me. And I think you'll get better results that way, too.

19. Buffett rejects criticism of Disney over same-sex benefits

WARREN BUFFETT: Zone 2? Or did we just do zone 2? I think we did. Yeah. It'd be zone 3.

AUDIENCE MEMBER: Dave Youberg (PH) from Sac City, Iowa.

And I must —

I haven't heard you on the moral and ethical considerations of stocks like ABC and Disney. They are now getting more and more criticism from mainstream religious groups in this country, main — their reliance on sex and violence and their cronyism — homosexuality — and —

VOICE: Did they hear it? I couldn't hear it.

(Scattered applause)

WARREN BUFFETT: I didn't — we didn't cut anybody off there.

CHARLIE MUNGER: (Inaudible)

WARREN BUFFETT: What?

The — what I would — I would say, you know, I'm delighted to have my grandchildren exposed to the full range of Disney product. (Applause)

You know, I'd love to take them to Disneyland or Disney World or take them to Disney movies or Disney videos. You know, I think the Disney Company is being run in an absolutely first-rate way. And I have no problem whatsoever with gays being employed or receiving benefits or anything of the sort. (Applause)

20. We don't care who is buying or selling securities

WARREN BUFFETT: Zone one?

AUDIENCE MEMBER: Good afternoon, Mr. Buffett. Good afternoon, Mr. Munger. My name is Bashir Narema (PH) from Arlington, Texas.

I see in the USA Today article about the shortage of labor in the state. And I was wondering when you analyze a company, do you take that into consideration by choosing companies who are not dependent so much on labor?

The second question is, I heard you in the beginning of the meeting that so much capital coming from foreign country, you mentioned so many different country, who buy — who bought the Berkshire Hathaway. And I'm sure they buy all companies in the Dow.

Do you feel like the analyst who analyze the Dow had that into consideration that the Dow now is becoming as the Walmart of the security business in the world, where all the national different country, they bypass their market and they come in and buy in the United States.

And as a result that the idea of [Federal Reserve Chairman] Mr. [Alan] Greenspan, as far as exuberant, it's moot because if you remember how the Japanese were when they start to buy the real estate in America, they force us to pay high premium for the price. And I think that's what's going to happen in the market. And we, as Americans, who've been accustomed to low P/Es, now we're going to miss on and the price is going to continue going up.

And the third question is —

WARREN BUFFETT: Maybe we better stop at two. (Laughs)

AUDIENCE MEMBER: Alright. Thank you.

WARREN BUFFETT: OK. Thanks.

We pay very little attention — we don't pay any attention — to capital flows. In other words, we don't really care who's buying or selling any securities. Somebody is buying or selling each one.

So, obviously, there's, you know, you could focus on the buyers. You could focus on the sellers. But — you can say now that there's 20 billion a month or so going into equity funds and all.

But it doesn't make any difference to us. All we're interested is what the business is worth. And what people are paying attention to, in terms of capital flows or whatever — or market signals or whether the Fed's going to move, that all changes.

Do you remember ten years ago, it was, you know, it was M2 that everybody — every — whatever day of the week it was, you know, what's M2 this week?

I always thought of having a mystery, you know, about whatever happened to M2? (Laughter)

There's always something that people are talking about. There's so much time to fill with chatter, you know, and pages to fill, that they write about all these things that, to us, don't make much difference, because we don't care if the market closes for the next five years.

We care how much Coca-Cola has sold five years from now, and what percentage of the world market they have, and what they're charging for it, and how many shares are outstanding, and that sort of thing.

But we just — we don't care who's buying or selling it in the least, except we like it when the company's buying it.

The same way with Gillette. We care about whether people are trading up in the shaving experience.

So capital flows and all of those macro factors that people like to write about a lot just have nothing to do with what we do. We're buying businesses.

And I really think it is not a bad mindset, whenever you buy a stock to say, "Would I be happy buying this stock if the market closed for five years?" Because then you're buying a business, if you say yes to that. If you don't say yes to that, you may not be focusing on the proper thing.

By its nature, the U.S. is running a substantial trade deficit, merchandise trade deficit.

If you buy more from the rest of the world than you're selling them, which is what happens when you're running a trade deficit, you have to balance the books. I mean, they get something in exchange. And what happens is they get some sort of capital asset in exchange.

They may get a government bond. They may get a piece of the U.S. business or something. But the key thing in economics, whenever somebody makes some assertion to you about economics, you always want to say, "And then what?" In fact, it's not a bad idea to say that about everything in life. But you always have to say, "And then what?"

So when you read that the merchandise trade deficit is nine billion, what else does that mean? Well, it means that somehow we have to have created nine billion of capital assets, claims on our production in the future, with somebody else in the world. So they have to invest. They don't have any choice.

When somebody says, "Won't it be terrible if the Japanese sell all their government bonds?" They can't sell all their government bonds without getting something else in exchange, you know, they get some other American asset in exchange because there's no other way to do it. They could sell it to the French. But then the French have the same problem.

So trace through where the transactions go anytime someone starts talking about one specific action in economics.

21. "We like a business with low labor costs"

WARREN BUFFETT: Question about labor. Generally speaking, obviously, we like a business with low labor costs. But we like a business with low costs of every kind, I mean, because the rest is profit.

So it would be true that on balance we would not be high on labor-intensive companies. But there's some very good businesses that are labor intensive.

(BREAK IN TAPE)

WARREN BUFFETT: But if you say, "Would I rather have a labor intensive business or a non-labor intensive business and everything else is equal," the answer is the less labor intensive business. Charlie, you want to comment on either one?

CHARLIE MUNGER: No. I don't think I've got anything more. (Laughter)

22. Subsidiaries make own decisions on accepting American Express

WARREN BUFFETT: Area two?

AUDIENCE MEMBER: First, I'd like to thank you both for being so generous with your time and with your ideas for us today. (Applause)

WARREN BUFFETT: Thank you.

We get paid by the hour, so — (Laughs)

AUDIENCE MEMBER: Well, I'll try and talk quickly then.

WARREN BUFFETT: Oh no. (Laughs)

AUDIENCE MEMBER: My name is Bob Costa (PH) from Evansville, Indiana. I've been a shareholder for four years.

This is my first visit to Omaha. And I went to the mega mart. And I actually bought something there. And I tried to pay for it with American Express card.

WARREN BUFFETT: Uh huh.

AUDIENCE MEMBER: And they told me, just like the ad, you can't use it here. I hope you'd both comment on that or at least one of you.

But my real question is that I just stumbled across the idea of intellectual capital and how that might be useful in valuing a business. And I was hoping that one or both of you could clarify that for me and whether that's useful to us as investors or just another academic theory that we'd be better off ignoring.

WARREN BUFFETT: Yeah. Harvey Golub, who runs American Express and has done a terrific job of running it, has written me about the Furniture Mart as well as about See's.

And we, basically, let our managers run their own businesses. So, the people at each entity — Borsheim's takes American Express. Others of our businesses do, too. We let every manager make his decisions.

As soon as I start telling the managers that they ought to, say, take American Express or not take Visa or whatever it may be, you know, at that point, they've lost some of the responsibility for their operations and, perhaps, to an extent even, you know, some of the pride that comes from running them.

Most of our managers do not need to work for a living. They run their businesses for the same reason Charlie and I run Berkshire. They love doing it. They jump out of bed in the morning because it's exciting to do.

And the one thing that would keep the two of us, or drive the two of us away from Berkshire, is if we were getting second-guessed all the time or somebody else was telling us when to swing or not to swing.

We would have no interest in running it. We'd go run — we'd do something else then. And maybe our other managers aren't as extreme as we are in that respect. But we feel they've built successful businesses. They know how to do it.

We do allocate the excess capital they generate. But aside from that, we really let them make their own decisions. So we have no companywide policy on virtually anything that I can think of, except send money to Omaha. (Laughter)

But — and, you know, we're delighted to have American Express give the Furniture Mart the reasons why the Furniture Mart will be better off using American Express. And my guess is they have some very good reasons.

But they're going to have to sell them on that, and just like any vendor of anything has to sell each operation. We wouldn't tell the people at See's who to buy the nuts from, or who to buy the container from, or anything of the sort, how to design the stores, or whatever it may be. And that's just the Berkshire philosophy on that.

Charlie, you want to comment?

23. Berkshire's intellectual capital is its managers

CHARLIE MUNGER: Yeah. Let me shift to intellectual capital.

Berkshire has a lot of intellectual capital in these very able executives in the various businesses. And we hope we've got some intellectual capital in the few hundred square feet at headquarters. (Laughter)

But we are not in the business of designing oil refineries with armies of engineers, or developing software with armies doing complicated accounting work all over the world. We just haven't drifted into that kind of a business.

And intellectual capital has gotten to be a new buzzword, because we've now developed huge businesses, like Microsoft, which really didn't exist on that scale not so very long ago.

And so people have suddenly realized, my God, there's really a lot of money in the aggregation effects and momentum effects when you get a bunch of really bright people working in the same direction. And that's what's made the concept so fashionable.

By and large, we've avoided the field. Again, it's hard for us to understand.

WARREN BUFFETT: Yeah. We look for brains and energy and integrity in people that we work with. And if you get that combination and you're in a decent business, you know, you can own the world.

And, you know, whether you call it intellectual capital or anything — you know, you can stick the names on it. And that's who we try to associate with. I mean, it's a lot easier than doing it yourself.

And when we get, in our own businesses — you saw that group there at the end of the movie — I mean, that's a huge asset to Berkshire.

They talk about getting into accounting for it. That's nonsense in my view. I mean, you don't need to do that. But you should pay for it. And you should pay for it as shareholders. You should pay for it as managers.

When we get people, you know, whether it's Tom Murphy, or Al Zeien at Gillette, or Roberto Goizueta, or Michael Eisner, I mean, those people have added billions of dollars of value.

And, it's just — you know, that's who we want to be associated with. And we don't want to be associated with the mediocre managers because the difference is just — is huge.

But we don't go through an elaborate exercise. We just recognize the people that have got those — we think we — we try to recognize the people who have got those qualities. And, then, we — and then if they're in a good business and they've got those qualities, we want to take a big bite.

CHARLIE MUNGER: But take intellectual capital. People think patents. They think copyrights. Patents and copyrights have gotten to be way more valuable, as a percentage of the investment assets of the world.

And so people are very much more interested in intellectual capital.

Think of the great drug companies and how small they were 20 years ago and how everything they have is, basically, intellectual capital. It's the few products that have — that really work that have the patents. But by and large, we're not in drug companies.

WARREN BUFFETT: No. But that's — there are different forms — as Charlie said, there's businesses you sort of think of that way as their whole being being intellectual capital.

But I would argue that when Roberto Goizueta, 15 years ago, saw how to make the future of Coke — same product — dramatic — and basically the same system, although it required some changes — but saw how to make that dramatically more valuable by doing a lot of little things over a long period of time and doing them consistently and not getting his eye off the ball.

Michael Eisner did the same thing. Disney hadn't gone anyplace, you know, in the 15 years or so after Walt died. Now, you know, we all knew who Mickey Mouse was and everything. But Michael really saw what the future should be. And he still does, you know.

And you say it's easy when it's all over. But how many people were doing something about it at the time? The place was languishing, basically, 15 years ago. They had the assets.

And, to me, that's — you know, it's different than what Bill Gates does or Andy Grove does. But it's our form of intellectual capital. And it's what we can understand better.

24. "Mistake" to not buy pharmaceutical stocks

WARREN BUFFETT: Zone, what do we have? Three.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my name's Will Jacks. (PH) I'm from Chicago, and I'm a happy shareholder.

I, first, want to thank both of you for the unusual privilege you give us for your time and your expertise. This is very unusual. And I think it's to be commended. (Applause)

And my question has to do with one of the major American industries that, unless I missed something in the reading, that is the pharmaceutical industry, the companies that make medicines.

I wonder under what circumstances you might consider those industries for investment by Berkshire Hathaway?

WARREN BUFFETT: Well, those industries — the pharmaceutical industry's, obviously, been a terrific industry to invest in.

We have trouble, or at least I have trouble, distinguishing among the companies, in terms of seeing which ones, ten years from now, might be the best ones to be in.

I mean, it's easy for me to figure out that Coca-Cola's the soft drink company to be in, or Gillette is the shaving company to be in, or Disney's the entertainment company to be in, than it is for me to figure out which one in the pharmaceutical.

But that — I'm not saying you can't do it. I'm just saying that that's difficult for me.

We have — we started buying one of them a couple of years ago. And we should've continued, but we didn't because it went up an eighth, and — (Laughter)

Your chairman was a little reluctant to follow it, a terrible mistake.

But I would say the biggest — and we could've bought the whole industry and done very well at various times, particularly when the threat of — what people thought was the threat of the Clinton health program cast a big cloud over the pharmaceutical industry.

That was the time you could've just bought the whole industry and done very well. We didn't do it. It was a mistake.

Charlie?

CHARLIE MUNGER: Well, it's hard to think of any industry that's done more good for consumers, generally. When you think of the way children used to die and now, they very seldom die. And it's been a fabulous business. And it's been one of the glories of American civilization.

But it's — we've admired it. But we haven't been part of it.

WARREN BUFFETT: We've missed a lot of things. And I'm dead serious about that. And we've missed things that should not have been beyond our capacity to grasp. A lot of things that should be beyond our capacity to grasp, but there's some that haven't been. And we've just plain missed them.

25. Munger: Good general education helps investors

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Hello. I'm another Chicagoan, (inaudible), and a share owner.

This question is directed, first, to Mr. Munger, and then to Mr. Buffett.

Mr. Munger, I am intrigued by your marshalling of the Commodore [Cornelius Vanderbilt] and Aristotle to support your points. Very few of today's money managers would, or could, do that.

Could you elaborate on what role a study of history of civilization plays in developing a sound investment philosophy? Thanks.

CHARLIE MUNGER: Well, I don't want to praise Aristotle too much. You know, he was the one who thought that women had a different number of teeth from men — (laughter) — and never looked in his wife's mouth. (Laughter)

WARREN BUFFETT: Maybe his wife did. (Laughter)

CHARLIE MUNGER: I'm all in favor of a good general education. And I think it helps investment performance. And it helps business performance. And it helps one be a better citizen.

And some of the things people say are quite memorable. And therefore, they're helpful to the mind by the very ease of which they're remembered.

And I think you'd be surprised how many bright investment professionals could talk a lot about Aristotle, or even people I can't stand — (laughter) — like [German philosopher Georg Wilhelm Friedrich] Hegel.

WARREN BUFFETT: You want to quote a little more from anybody to reinforce your —? (Laughs)

CHARLIE MUNGER: One of my favorite quotations in the whole world is from Einstein. He says everything should be made as simple as possible, but no more simple. And I think that describes the reality that we all face.

WARREN BUFFETT: Charlie's favorite, though, is Ben Franklin. That's probably true, isn't it, Charlie?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: We get more from Ben than anybody else. "Keep thy shop and it will keep thee," that sort of thing. I mean, we're just — we're loaded with that stuff. (Laughter)

CHARLIE MUNGER: "Three removes are as good [bad] as a fire."

"It's hard for an empty sack to stand upright." (Laughter)

That's the bible around Berkshire.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I once heard Warren say, "The reason I'm so financially conservative is I don't want to find out how badly I might behave if I were stretched." (Laughter)

WARREN BUFFETT: I think we better cut him off here. (Laughter)

26. "Why risk losing what you need and have for what you don't need and don't have?"

WARREN BUFFETT: Zone 2.

You better cut the thumping there.

CHARLIE MUNGER: Yeah. (Laughter)

AUDIENCE MEMBER: My name is Stanley Watkins and — from Manhattan, Kansas. And I'm a shareholder. And I have two questions.

And the first one, I know the answer. So you can just say yes or no. (Laughs)

Would you consider investing in indexes such as OEX? Pure speculation, you're going to say yes.

And number two, would you encourage investors to, if they were trying to get a lot of their investment, to use LEAPS on investments such as Coca-Cola instead of buying the stock?

WARREN BUFFETT: Use what on? I missed that —

CHARLIE MUNGER: LEAPS.

WARREN BUFFETT: Leak?

CHARLIE MUNGER: LEAPS, L-E-A-P-S.

WARREN BUFFETT: Oh, I see. We're still on options.

CHARLIE MUNGER: (Inaudible)

WARREN BUFFETT: Oh yeah.

WARREN BUFFETT: Both the questions relate to futures of one sort, calls, or whatever they may be, and —

I think that investors should stick to buying ownership in businesses. It's not that you can't come up with a theoretical argument for buying, say, a —

I mean, if you think Coca-Cola's attractive, you can say, well, I'd rather buy a five-year option on Coke than buy the stock directly because it introduces leverage without the risk of going broke.

But I think that that's a dangerous path to start down, because it —

If it works well, it's so — it's dynamite to start playing with things that can expire and become worthless, or can be bought with very low margin, as the OEX options you were talking about.

Borrowed money usually — or frequently — leads to trouble. And it's not necessary.

I mean, if you had some compelling reason — if you're going — if you had to double your money by the end of the year or be shot, you know, then, I would head for the futures market because, you know, you need to do it. I mean, you have to introduce borrowed money.

But you really ought to figure out how you can be happy with the present amount of money you've got and, then, figure that everything else is, you know, all to the good as you go along, and —

I don't think people — once they start focusing on short-term price behavior, which is the nature of buying calls, or LEAPS, or speculating in index futures, once you start concentrating on that, I think you're very likely to take your eye off the main ball, which is just valuing businesses. I don't recommend it.

Charlie?

CHARLIE MUNGER: Well, this is a group of affluent investors. I don't think many of them did it in LEAPS. (Laughter)

WARREN BUFFETT: Yeah. It's certainly true. If we'd operate Berkshire with considerable borrowed money over the years, you know, it would've done very much better than it has.

But nobody knew what that amount of borrowed money would have — the appropriate level would have been.

And it wouldn't have made any difference to us. I mean, we have just as much fun doing what we've done than if we'd owned it on leverage and had it been twice as much. I mean, it just — it's just — it's not the way we approach it.

If you have X and you think you're going to be way happier when you've got 2X, it's probably not true.

You really ought to enjoy where you are at a point. And if you can make, you know, if you can make 12 or 15 percent a year, and you desire to save, and you like piling it up, you know, it'll all come in time.

And why, you know, why risk losing what you need, you know, and have, for what you don't need and don't have? It's never made a lot of sense to us.

CHARLIE MUNGER: Warren wrote a letter when they were developing the security options businesses. And he urged the civilization not to allow the new exchanges. And you can see how much attention they paid to him. (Buffett laughs)

WARREN BUFFETT: The usual amount.

CHARLIE MUNGER: Yeah, right.

27. Haven't looked at hazardous waste business, but have seen toxic waste in markets

WARREN BUFFETT: Area 3?

AUDIENCE MEMBER: Hi, my name's Greg Collart (PH), a shareholder from Calgary, Canada, the home of Bre-X Minerals. (Laughter)

My question for you is, the companies in the hazardous waste disposal industry have underperformed the market for about a decade now. Do you see any value in that area?

WARREN BUFFETT: We've never looked at that business. I'm familiar with the names of the companies. But that's been a business that I've never looked at.

And maybe Charlie knows more about it than I do. He almost has to. (Laughs)

CHARLIE MUNGER: No. We have never really looked at the hazardous waste business.

We've observed a lot of toxic waste in the securities market. (Laughter)

Maybe we'd get our fill that way. (Laughter)

28. Lesson of State Farm's improbable success story

WARREN BUFFETT: Area one.

AUDIENCE MEMBER: My name is Hugh Stephenson. I'm a shareholder from Atlanta, Georgia. My question involves GEICO.

If I remember correctly from last year, GEICO had about 2 percent of the insurance market and had approximately $4 billion in float.

My question is, as their market share expands, will the float, in your expectation, expand in a somewhat linear fashion?

And related to that, what is your guess might be the top end? Could they ultimately become as dominant as a Gillette or a Coke and their businesses?

Or is the nature of it such that, you know, they might stop at ten percent of the market or 15 percent when they start to hit a significant hurdle?

And second, to follow up on this other gentlemen's question, if you don't adjust for risk by using higher discount rates, how do you adjust for risk? Or do you?

WARREN BUFFETT: Well, the second question: we adjust by simply trying to buy it at a big discount from that present value calculated using the risk-free interest rate.

So if interest rates are 7 percent and we discount it back to flows — which Charlie says I never do anyway and he's correct — but in theory, if we discount them back at 7 percent then we would look at a substantial discount from that present value number in order to warrant buying.

The question about GEICO: the float will grow, more or less proportionately, to premium volume. There's a moderate amount of our float, a very small amount of the float, that's accounted for by some discontinued lines from the past. And, of course, that won't grow the same way.

But if we double the size of GEICO on premium volume, we'll come close to doubling the size of the float.

You know, the history of auto insurance is quite interesting. It's something that isn't studied at business schools and should be studied, because the great insurance companies of the early 1900s were, you know — whether it's Aetna, Hartford, Travelers — they had these agency forces nationwide, and wrote what was then more property business.

They wrote a lot of fire business in those days. And, of course, the automobile only came in, you know, in the early 1900s. And so their orientation was to property business.

But they had this huge agency force throughout the United States. There were property insurance agents representing these big companies in every — throughout the country. And they had lots of capital.

And now, if you look at the business in 1997, something well over 20 percent — probably close to 25 percent — of the personal, auto, and homeowners business in insurance is written by a company called State Farm.

And State Farm was started, I believe, in the '20s, by a fellow in Bloomington, Illinois with no capital to speak of, no agency force initially, and started as a mutual company, no incentive, I mean, no stock options, no capital invested where he could become a billionaire if he built the business up or anything.

So here this company starts without any of the capitalist incentives that are we are taught are essential to a business growing, and in a huge industry, becomes the dominant player — has more than twice the market share of Allstate, the second player — becomes the dominant company against these extremely entrenched competitors with great distribution systems and loads of capital.

Now I say that's — and incidentally, State Farm, on the Fortune 500 list of companies, has the third largest net worth of any company in the United States. Number three from Bloomington, Illinois with a guy with no money in it.

Now, how does that happen? Well, I would say that's a subject worth studying, you know, in business schools, because it —

You know, Darwin used to say that any time he got any evidence that flew in the face of his previous convictions, he had to write it down in the first 30 minutes or the mind was such that it would reject contrary evidence to cherished beliefs.

And certainly, there's some cherished beliefs around business schools that might, at least, find some interesting aspects in studying how a company could become the third largest company in net worth in the country with no apparent advantage going in.

There’s another company down in Texas called USAA, United States —

It’s for the United Services Auto Association. And it’s been enormously successful, has billions of net worth, loads of satisfied policy holders, the highest renewal ratio among policy holders in the country. Nobody studies that, to my knowledge, either.

The people who started GEICO came from that company. In 1936, Leo Goodwin and his wife, who had worked for USAA, went over and started this little GEICO company with practically no capital. And, now, it’s — we have about 2.7 percent of the market. And we’re — we’ll write probably 3 1/2 billion of voluntary auto this year.

Catching a State Farm is going to be very difficult. So I wouldn’t want to predict we’d do that. I will predict that we will gain very materially in market share over the next ten years. And we’ll gain materially this year. But we will — we have got a very good mousetrap.

I said in the report that 40 percent of you would save money insuring with — I didn’t say a hundred percent or 80 percent or 60 percent, because there are areas and professions where somebody else is going to have a lower price than we are.

But across the country, we are going — and for all classes of citizens — we are going to have a low price — the low price — more often than anyone else.

And we’ve got that because we’ve got low costs. And our costs are going to get lower. And we’ve got a virtuous circle going, in terms of it feeding on itself.

So GEICO will grow a lot. But I — State Farm is plenty tough. So I’m not going to predict catching State Farm. I’m not even going to predict catching Allstate. But we’ll catch somebody.

And Charlie, you want to say anything more?

CHARLIE MUNGER: Well, I love your example of State Farm. I mean, the idea of picking some extreme example and asking my favorite question, which is what in hell is going on here — (laughter) — that is the way to wisdom in this world.

And it is too bad. A lot of the mutual companies are now trying to demutualize, helped by a bunch of consultants and so forth.

And they are not looking at State Farm. They’re looking at some other model, and —

Everybody can’t be a State Farm. That place got some fundamental values into its operating mechanics, the way it selected personnel, the way it selected agents, the way it discarded agents. It was huge discipline, wouldn’t you agree, in that operation?

WARREN BUFFETT: Yeah. Somebody would — you would say somebody had to do something very right. But the question — I don't know anybody studying what they did that was right.

You know, they don't want to because it doesn't fit the pattern. And you know, when something like a State Farm happens in this world, you should try to understand it.

When something like a GEICO happens in this world, you should try to understand it.

In 1948, I think it was two-thirds or three-quarters — I think it's two-thirds — of GEICO was for sale because the fellow that had originally backed these two people from USAA died. And so they had the stock for sale in 1948.

You couldn't sell it. That's how Ben Graham ended up buying it for Graham-Newman, because they hocked it all over for six months. They went to all the big insurance companies. And the insurance companies, who could see this company on a very, very tiny scale offering a product for way less money and making lots of money doing it, they simply couldn't shake themselves loose from the mists of the past to step up and buy it.

They could've bought it for a million-two-hundred-thousand dollars, as I remember, and owned the whole company. And instead, they've watched their own distribution system get their heads beaten in, you know, over the years. And all the time, you know, with these ideas from the past.

So you have to be very careful to look hard at what's really happening. You know, as Yogi Berra https://en.wikipedia.org/wiki/Yogi_Berra said, "You can observe a lot just by looking." (Laughter)

29. Love it when a wonderful business buys back its stock

WARREB BUFFETT: OK. Zone one?

EVERETT PUREE: I'm Everett Puree (PH) from Atlanta, Georgia. And I wanted to ask you if you could comment on the matter of intrinsic value as it applies to some of "The Inevitables," given that the overpayment risk now is high and the share repurchases that are going on there.

WARREN BUFFETT: Yeah. Well, we won't stick a price on them. We just — we tell you that they are absolutely wonderful businesses run by sensational people, and that they are selling at prices that are higher than they sold at most of the time. And then — but that — you know —

They may be — they may well be worth it and worth a lot more, even in terms of present terms. Or it may turn out they're a couple years ahead of themselves. We don't know the answer to that. We know we're very happy owning them.

Gillette does not repurchase its shares, or hasn't in any significant quantity for many years. Coke consistently repurchases its shares.

We generally like the policy of companies that have really wonderful businesses repurchasing their shares.

There aren't that many super businesses in the world. And the idea of owning more and more of a company like that over a period of time has an appeal to us, and almost an appeal regardless of price.

The problem is that most companies that repurchase their shares, you know, are so-so — are frequently — so-so businesses. And they're being done for motivations other than intensifying the interests of the shareholders in a wonderful business.

But we really know you have a wonderful business. And we think most of the ones we own are anywhere from extremely good to wonderful. We think it usually makes a lot of sense.

It's hard to do things intelligent with money in this world. And Coke has been very intelligent about using their capital to, particularly, to fortify and improve their bottler network around the world. I mean, they've done a terrific job that way. That was a neglected area for a long time. And that comes first.

But there's only so far you can go with that — and to enhance the ownership of the shareholders in a company like Coca-Cola — when we bought our first Coca-Cola in '88, we bought about 6.2 percent of the company. And at that time, they may have been 600 million servings — not any more than that — a day. So we had an interest in 36 or 37 million servings.

Now we have 8 percent of 900 million-plus. So we have an interest in 75 million or so servings a day. Seventy-five million people are drinking Berkshire Hathaway's share of Coca-Cola products today, in an eight-ounce serving. And you know, the profit's gone up a little per serving.

So that gets pretty attractive. And we'd just as soon they keep doing that.

30. Coca-Cola history lesson: "One of the dumbest contracts" ever

WARREN BUFFETT: The bottling thing's actually kind of interesting. And a fellow from Omaha — or at least lived in Omaha for a long time — Don Keough, had a lot to do with this. And Roberto had plenty to do with it, too, obviously.

But Candler — Asa Candler — back in the late 1880s, in a series of transactions — I think some of it's a little fuzzy, exactly, as to the timing of them — but he essentially bought the whole Coca-Cola Company for $2,000. And that may be the smartest purchase in the history of the world.

And, then, in 1899, I believe it was, a couple of fellows from Chattanooga came down. And in those days, soft drinks were sold over the counter to people in drug stores, primarily. But there was a little bottling going on. There already was somebody bottling in Mississippi, as I remember.

But a couple fellows came down. And they said, “You know, bottling’s got a future. And you’re busy on the fountain side of the business. So why don’t you let us develop the bottling system?”

And I guess Mr. Candler didn’t think much of bottling. So he gave them a contract, in perpetuity, for almost all of the United States, for a dollar he sold it to them, and gave them the right to buy Coca-Cola syrup at a fixed price forever.

So Asa, who had scored with his $2,000 — (laughs) — in a rather big way, managed to write what — you know, it’s easy for us to look back — but certainly looks like one of the dumbest contracts in history. (Laughs)

And, of course, as the years went by, and particularly around World War II when the price of syrup was — the primary ingredient, in terms of cost, in syrup was sugar. And sugar went wild during and after World War I in price. And so here was a guy that, in effect, had contracted to sell sugar at a fixed price forever.

And he’d also given these people perpetual rights and so on. In those days, they sold the subrights to bottler contracts. And those were usually the distance that a horse could go in a day and come back. That was sort of the circle that you gave people.

And the Coca-Cola Company was faced, over the years, with a problem of having the bottling system, which soon became the dominant system for distribution of Coke, being subject to a contract where there was no price flexibility and where the contracts ran in perpetuity.

And, of course, every bottler on his death bed would call his children, his grandchildren around. And he propped himself up and croak out in his last breath, you know, “Don’t let them screw with the bottling contract.” You know, and then he’d croak. (Laughter)

So the Coca-Cola Company faced this for decades. And they really couldn’t do much about that bottling system for a long time.

And Roberto and Don Keough and some other people spent 20 or 25 years getting that rationalized. There were lawsuits back in the ’20s and some things. But it was a huge project. But it made an enormous difference over time in the value of the company.

And that’s what I mean when I talk about intellectual capital, because you know you aren’t going to get results on that in a day, or a week, or a month, or a year, if you set out to get that all rationalized. But they decided that to get the job done, they had to do this.

And that took capital. And they used capital to get that job done. But they used capital beyond that to repurchase shares in a big way. And it's been very smart. And I hope they keep — you know, I — they are repurchasing shares, probably, as we talk. And that's fine with me.

Charlie?

CHARLIE MUNGER: Well, I do think Coca-Cola Company is one of the most interesting cases in the history of business. And it ought to be way more studied than it is. And there's just lesson after lesson after lesson in the history of the Coca-Cola Company. But it's too long a story for today. (Buffett laughs)

31. Wesco is part of Berkshire due to "historical accident"

WARREN BUFFETT: Section two?

AUDIENCE MEMBER: I'm Jolene Crowley (PH) from San Diego. And I want to say I feel very lucky to be here today. When I tried to buy my first Baby Berkshire share last year, my stockbroker, who's a value investing devotee, tried to talk me out of it, telling me that it was overvalued. So I feel lucky to be here.

I've recently also discovered Wesco stock. And I'd like you to explain to me the ownership and management relationships between Berkshire Hathaway and Wesco, and how you use them together.

And since I may not understand the answer to that question, could you just tell me, is it possible that buying Wesco today at about $20 a share is like buying Berkshire Hathaway was 20 years ago?

CHARLIE MUNGER: Well, if you could buy Wesco today at $20 a share, you should buy all you can.

WARREN BUFFETT: (Laughs) No, no —

AUDIENCE MEMBER: Beg your pardon. Two —

WARREN BUFFETT: Two-hundred dollars a share.

AUDIENCE MEMBER: Two-hundred.

WARREN BUFFETT: Yeah. Charlie is — (laughter) — chairman of Wesco. And why don't you talk about it first, Charlie?

CHARLIE MUNGER: Wesco's 80 percent owned by Berkshire. And in terms of operating businesses now, it's got two. And it has an immense percentage of its net worth in marketable securities in its insurance subsidiary.

It's a very quiet company. And as the chairman of Wesco, I have always delighted in saying that we have way less human value in the executive staff than Berkshire Hathaway does.

It's a — it's a — what is it Daniel Webster said about Dartmouth? He says, "A small school but there are those who love her."

Well, Wesco's a small place. And it's there in Berkshire as sort of an historical accident. But the main current of Berkshire is right here in the Berkshire shares.

WARREN BUFFETT: Yeah. I don't know which one I would rather buy at present prices. I mean, I think it's — you could flip a coin.

It does not have dramatically better growth potential just because it happens to sell at $200 a share instead of 38,000 a share than Berkshire. I mean, I think the prospects, probably, are relatively close between the two.

And they're run by the same people, pretty much, in effect. Charlie may spend a little more time on Wesco than I do, but — they are — they've got the same prospects.

But one problem that Wesco would have is that if people — and this is not a huge problem — but if people want to do a share exchange deal, they're going to want to do it, probably, with Berkshire rather than Wesco.

At Wesco, we have small acquisitions in fields we knew — Wesco's a logical place to put them unless they happen to be in areas that Berkshire's already in. And for the really large things, you know, Berkshire can do them and Wesco can't.

But there's nothing — I don't think there's anything significantly superior or inferior about investment in Wesco compared to Berkshire.

CHARLIE MUNGER: Well, the long-run record of Berkshire is better.

WARREN BUFFETT: Yeah.

The one thing — It is a mistake to think that just because it's cheaper per share on a dollar price that it's got way more potential, I think, because that just isn't the case.

A very large percentage of Wesco's value is represented by its interest in Freddie Mac. And a very large percentage of Berkshire's interest is represented — Berkshire's value — is represented by an interest in Coke, for example.

So there's different emphasis between the two places. I think Wesco owns some Coke. And Berkshire owns some Freddie, but in different proportions. That's an historical accident.

We'd love to see them both do well, obviously. There's another family that's in Wesco that we like a great deal. And we would hope that Wesco would perform as well or better than Berkshire. It's performed fine over the years. But it hasn't performed quite as well as Berkshire.

32. How Buffett surpassed Benjamin Graham

WARREN BUFFETT: Area 3?

AUDIENCE MEMBER: Yes. Hi. It's Jeff Hawthorne (PH), Toronto, Canada.

Mr. Buffett and Mr. Munger, you're both a positive influence on all of us and our generations to come. There were a few significant individuals that had helped to guide your way in the beginning.

Could you please share the current percentage of impact and evolution on your investment philosophy and approach between Graham-Dodd's — Graham and Dodd's versus Philip Fisher, and comment on each please.

WARREN BUFFETT: Charlie, you want to —? If you've got it worked out there. Calibrate —

CHARLIE MUNGER: Weren't you —

WARREN BUFFETT: Do you want that to tenths of a percent or hundredths of a percent? (Laughs)

CHARLIE MUNGER: You were closer to Ben Graham.

WARREN BUFFETT: Yeah. Well, Ben — yeah — things would've happened — good things would've happened with following either party irrespective the other.

Graham, obviously, had way more influence on me than Phil. I worked for Ben. I went to school under him.

And his — what I call the three basic ideas that underlie successful investing — which is to look at stocks as businesses, and to have the proper attitude toward the market, and to operate with a margin of safety — they all come straight from Graham. I didn't think of any of those.

And Phil Fisher opened my eyes more to the idea of trying to find the wonderful business.

Charlie did more of that than Phil did, actually, so you'd have to put Charlie —

But Phil was espousing that entirely. And I read his books in the late ’50s, early ’60s. So, you know, I — Phil’s still alive as you know. And, you know, I owe Phil a lot. But I — it doesn’t compare to what I owe Graham.

And that, in no way, reflects poorly on Phil. Ben was one of a kind.

Charlie?

CHARLIE MUNGER: Ben Graham was a truly formidable mind. And he also had a clarity in writing.

And we’ve talked over and over again about the power of a few simple ideas thoroughly assimilated. And that happened with Graham’s ideas, which came to me indirectly through Warren, but also some directly from Graham.

The interesting thing for me is to watch Buffett the former protégé — and by the way, Buffett was the best student Graham had in 30 years of teaching at Columbia. And — but what happened — and since I knew both men — was that Buffett became way better than Graham.

That is a natural outcome. It’s what Newton said. He said, “If I’ve seen a little farther than other men, it’s by standing on the shoulder of giants.”

And so Warren may have stood on Ben’s shoulders, but he ended up seeing farther. And no doubt, somebody will come along in due course and do a lot better than we have.

WARREN BUFFETT: I enjoyed making money more than Ben. I mean, candidly.

With Ben, it just — it really was incidental, at least by the time I knew him. It may have been different when he was younger. But it just didn’t — the process didn’t — of the whole game did not interest him more than a dozen other things may have interested him.

With me, I just find it interesting. And therefore, you know, I’ve spent way more — a way higher percentage of my time thinking about investing and thinking about businesses. I’ve probably thought way more about businesses than Ben ever did. He had other things that interested him.

So I’ve pursued the game a little — quite a bit — differently than he did. And therefore, measuring the record is really — the two records — it’s not a proper measurement. I mean, he was doing victory laps while I still thought I was out there running against, you know, the whole field.

CHARLIE MUNGER: But Graham had some blind spots, partly of sort an ethical professorial nature. He was looking for things to teach that would work for every man, that any intelligent layman could learn and do well.

Well, if that's the limitation of what you're looking for, they'll be a lot of reality you won't go into, because it's too hard to figure out and too hard to explain.

Buffett, if there was money in it, had no such restriction. (Laughter)

WARREN BUFFETT: Yeah. Ben sort of thought it was cheating if we went out and talked to the management, because he just felt that the person who read his book, you know, living in Pocatello, Idaho, could not go out and meet the management. So he didn't — and we didn't do it. I mean, when I worked for Graham-Newman, I don't think I ever visited a management in the 21 months I was there. He just —

But, you know, he wasn't sure whether it would be useful, anyway.

But if it would be useful, you know, that meant that his book was not all that was needed, that you had to add something to it.

I found it fun to go out and talk about their businesses with people, or to check with competitors, or suppliers, or customers, and all that.

But — Ben didn't think there was anything wrong with that. He just felt that if you had to do that, then his book was not the complete answer. And he didn't really want to do anything that the reader of his book couldn't do if he was on a desert island, you know, basically, with just one line to a broker.

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

WARREN BUFFETT: And we still can't find any donkeys these days. (Laughter)

33. Gillette customers more loyal than McDonald's customers

WARREN BUFFETT: OK. Area 1.

AUDIENCE MEMBER: I'm Joe Nobbe (PH) from Seattle, a shareholder.

Mr. Buffett and Mr. Munger, I wonder if you could comment a little bit further on McDonald's, carrying forward your comments of this morning, but more oriented toward how McDonald's would stack up against "The Inevitables" in international-type business. What your vision would be on their growth potential in places like Germany, China, so on and so forth.

WARREN BUFFETT: Yeah. I guess I just would have to stick with my comment that you won't get the inevitability in food that you will get in a single consumer product, you know, such as blades.

I mean, if I'm using a Gillette Sensor blade today, the chances are I'll try the next generation that comes out. It'll be the Sensor Excel right now. But I will try the next one that comes out, obviously. But I will not fool around at all in between.

And a very high percentage of people that shave, including women in shaving, they're happy with the product.

You know, it's not expensive. It's 20-odd dollars a year, you know, if you're a typical user. And if you're getting a great result, you're not going to fool around.

Whereas a great many of the decisions on fast food, as to where you eat, is simply based on which one you see. I mean, convenience is a huge factor.

So if you are going by a McDonald's, or a Burger King, or a Wendy's, and you happen to be hungry at that point, if you're traveling on the road and you see one of those signs up, you're probably going to stop at — you may very well — stop at the one you see.

So there's — there is not the — there's a loyalty factor, but it's just not going to be the same in food.

People want to vary their — I don't. I mean, I'm happy to eat there every day. But most people want to vary where they eat as they go through the week, or the month, or the year.

And they don't really have any great desire to vary their soft drink the same way. It's not the same thing.

So it's no knock on McDonald's at all. It's just the nature of the kind of industry they're in.

Charlie?

CHARLIE MUNGER: I can't think of anybody else who, before McDonald's, ever did what McDonald's did to create a chain of restaurants on such a scale, that worked.

WARREN BUFFETT: Oh, Howard Johnson's tried.

CHARLIE MUNGER: Yeah. There were a lot of failures. Some of you are old enough around Omaha to remember Reed's.

WARREN BUFFETT: Harkert's.

CHARLIE MUNGER: Or Harkert's — Harkett's Hamburgers.

WARREN BUFFETT: Harkert's.

CHARLIE MUNGER: Harkert's Holsum Hamburgers.

WARREN BUFFETT: Right.

CHARLIE MUNGER: Yeah. And they came and they went, those chains, and — but the —

It is a much tougher business that McDonalds is in.

WARREN BUFFETT: It's price sensitive, too, I mean, obviously.

CHARLIE MUNGER: Part of that's comparative. You can spend a lot more money on hamburgers in the course of a year than razor blades. I mean, you can't save that much by changing razor blades.

WARREN BUFFETT: Yeah. The average person will buy 27 — in the United States — 27 Sensor Excels a year. You know, that's one every, roughly, 13 days.

And I don't know what the retail price is because they give them free to us as directors, but the — (laughter) — you know —

If they're a dollar, it's 27 bucks, I mean, and —

It makes a lot of difference. That's what's happening, of course, around the world is people that are using cheap double-edged blades, or whatever is, they keep moving up the comfort scale — the comfort ladder. And Gillette is a direct beneficiary of —

If it's a difference between having great shaves and very so-so shaves, and lots of nicks and scratches and everything, is ten bucks a year or 12 bucks a year. I mean, that is not going cause many people to change their habits, and —

Incidentally, the Sensor for women has just been a huge success. I think they've had more razors go out on that in the same period than when the original Sensor was — came out for men.

So that's been an enlargement of the market. I would not have guessed that would work that well. Before that, all the women just used the disposables, or their husband's — boyfriend's — razor. But thank God they've gotten over that. (Laughter)

34. "Invisible hand does not work perfectly"

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: Gentlemen, my name is Ted Downey. I live in Mankato, Minnesota.

Mr. Munger, your reference to Einstein, I happen to have an article called "Strange Is Our Situation Here On Earth," which is somewhat related to my question.

This morning, you brought up the shortcomings of accountability. And I would like you to address the aspects of the environmental impact in our accounting system and how this might relate to a social screen for investment in other areas.

CHARLIE MUNGER: Well, again, that is broad enough and tough enough so that I think I should pass. (Applause)

WARREN BUFFETT: Yeah.

The — I would say the "unseen hand" — or [Adam Smith's] "invisible hand" — you know, does not work perfectly for all aspects of an economy, so —

But in terms of accounting for it — in terms of an individual balance sheet or income account, you know, that would be way beyond me. But there are things that the "invisible hand" won't do, and therefore, that unfettered market-driven economic action will not lead to the best result for society in my view.

I think the market works awfully well in an awfully — in a tremendous number of ways. It produces what people want in increasing quantities. And it — you know, it's enormously beneficial to have a market-driven society. But a pure market-driven society will do things that will have anti-social consequences.

CHARLIE MUNGER: You certainly need environmental rules.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: The pioneers died like flies because the drinking water was too near the sewage. And one of the glories of the world we live in now is that the sewage systems are so good.

And, you know, you don't think about it much, but it's dramatically changed our prospects and the general quality of how we live.

And there are a lot of other places where you need environmental rules.

All that said, some of the environmental stuff has gone way too far. But it's too complicated to try and offer precise lines.

35. Aim to increase both operating earnings and investments

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: My name is Gul Asnani (PH). I'm from Allentown, Pennsylvania.

I have a question concerning page four of the annual report where you talk about the investments per shares, et cetera.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: And my question is, how much claim do the operating businesses have on these marketable securities?

WARREN BUFFETT: Yeah. Well, that table's a very important table in my view. And we measure our progress, to some extent, by the figures in both columns of that table, one of which shows the investments per share. And the other shows the operating earnings from everything other than investments.

The operating businesses have first claim on anything that relates to their business. I mean, if See's is going to buy a new plant, which it probably is now — or buy an additional building, I shouldn't say a new plant — you know, that comes first. The business has grown. It'll produce some economies and all that. We do that. You know, we try and do it as intelligently as possible. But that comes first. The —

That doesn't use but a small fraction of the capital. All of those needs don't use but a small fraction of the capital that Berkshire will generate. The investments reside largely in insurance companies because that's where largely the liquid funds are.

They have to have capital strength, obviously, because they have huge promises outstanding.

But where they reside does not determine who manages them. Lou Simpson manages GEICO's portfolio specifically. But in effect, Charlie and I manage everything else.

So where they precisely reside really makes no difference. I mean, they're sitting someplace. They're not for the operating management to use in projects that are far afield from what they're doing.

But if they need money in any operating business, you know, we'll have a check there that day. FlightSafety, for example, will be a fairly capital-intensive business.

I mean, if our project with Boeing goes as we hope it goes, you know, there will be substantial money in there because there — you know, we will have many more simulators around the world, and we'll be paying our proportional cost of it.

But they don't need to keep money around to prepare for that day, which they would if they were a standalone operation. We can — money's fungible.

We can deploy it all the time. And whenever anybody needs it, we'll come up with it. But we don't leave it around awaiting the day when some specific operation needs it.

Charlie?

CHARLIE MUNGER: The odds are very good that the marketable securities will keep going up, even as the businesses expand. That's the way the game has worked in the past. And we hope it'll keep going that way.

WARREN BUFFETT: What we are doing is trying to increase the numbers in both columns. We don't have any favoritism for this over that or anything of the sort. But we're looking, all the time, for things that will do — will help both columns. And we'd be disappointed if five or 10 years from now that they both haven't increased significantly.

But which column will increase at the greater rate, we don't know.

36. "We wouldn't be surprised" if stock returns are lower

WARREN BUFFETT: Area 1?

AUDIENCE MEMBER: Good day, my name is John Semanovich (PH) from Ottawa, Canada, which, incidentally, has nothing to do with Bre-X whatsoever. (Laughter)

My question more goes back to the discussion of intellectual capital, in particular, perhaps, your intellectual reserves.

And so, speaking of "Security Analysis," the first edition in 1934, Ben Graham talked about the development of the "New Era Theory" and its consequences on the security business.

In today's terms, we see a lot of the same words and phrases being repeated by analysts on Wall Street. And with the historical returns on common stocks, dating back to the 1800s, coming in at about 7 percent, pair that together with the concept of regression to the mean in statistics, do you not think that we're in a very dangerous period?

WARREN BUFFETT: Well, the answer — we never know, I mean, we — in terms of what markets will do, we —

I don't think that the Coca-Cola Company's in a dangerous position, you know — in a dangerous era — or Gillette is in a dangerous era, or McDonald's, or Wells Fargo, or whatever, but — or See's Candy, or the businesses we own in their entire, Kirby, whatever it may be.

Whether valuations are too high gets back to the question that we said — we talked about earlier. If businesses, in aggregate, they keep earning very high returns on equity and interest rates stay where they are, we are not in an overvalued period.

If it turns out that these returns are not sustainable, or interest rates go higher, we will look back and say this was a high point, at least for a while.

But we have no notion on that. And we really don't think about it, basically, because we don't know. You know, our job is to focus on things that we can know and that make a difference.

And if something can't make a difference or we can't know it, you know, we write that one off. So we're looking for the —

CHARLIE MUNGER: But Warren, you would expect average returns from stock market index-type investing to regress somewhat down —

WARREN BUFFETT: Oh, I don't think the —

CHARLIE MUNGER: — where they've have they been the last few years?

WARREN BUFFETT: I don't think you'll get the investment result from owning the S&P over the next 10 years that you've gotten over the past 10 years.

I would — if someone wanted to put some real money on that, they would find a taker with me. That's very unlikely to happen.

CHARLIE MUNGER: That's not predicting a crash.

WARREN BUFFETT: No.

CHARLIE MUNGER: It's just saying that the guaranteed result from the next 10 years is almost certain to be less than —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — that of the last.

WARREN BUFFETT: It wouldn't surprise — I mean, this is no way predictive. But I mean, it wouldn't surprise us in the least if stocks averaged 4 percent a year, you know, for the next 10 years.

That doesn't mean they will. We don't know the number. But that would not be a surprising outcome. And it wouldn't bother us particularly, either.

Charlie?

CHALIE MUNGER: No.

37. "We don't want to talk down something in order to buy it"

WARREN BUFFETT: Two.

LARRY WHITMAN: Hello. My name is Larry Whitman (PH) from Minot, North Dakota.

You have both talked today about the shrinking universe of stocks you could purchase, less margin of safety than ever, and a higher opportunity cost.

And you've also talked about looking to, potentially, purchase your great companies that you already have at reasonable prices.

And so I wonder if by talking so positively about some of your stocks — in particular Disney, such as in the '95 annual report when you talked about actually telling everyone that you were buying more shares on the open market and, again, at the '97 meeting — at their meeting — when you talked about maybe not selling the shares — those were both opportunities, maybe, when Disney may have dropped, because of such things as increased debt, or even people's concern about the Ovitz compensation package.

And I just wondered if that may hurt your ability to buy these great companies at reasonable prices by talking so positively about them when, in fact, maybe you could buy them at lower prices when people get irrational.

WARREN BUFFETT: Yeah. You're saying that — which I probably agree with — that if we would say the world is going to hell at Coke or Disney or Gillette — (laughs) — we might be better off, in terms of being able to buy more stock.

But, you know, I got asked the question at Disney and I answered it. And that's my general approach, that —

I think it's usually a bad mistake to sell your interest in wonderful businesses. I don't think people find them that often. And I think they get hung up, if they've sold them at X that they want to buy them back at 90 percent of X, or 85 percent of X, so they'll never go back in at 105 percent of X.

I think, on balance, if you are in a business that you understand and you think it's a really outstanding business, that the presumption should be that you just hold it and don't worry.

And if it goes down 25 percent in price or 30 percent in price, if you have more money available, buy more. And if you don't, you know, so what? Just look at the business and judge how it's doing.

But there’s no question. I mean, we try not to talk very much about the businesses, except maybe to use them as an illustration in a teaching mode or something of the sort. We’re not touting anything.

And I did try to stick those precautions in when I do talk about them as being wonderful businesses, so people don’t take it as an unqualified buy recommendation or something of the sort.

But we won’t try and put any spin on any — when we’re talking about businesses generally.

We may not talk about them at all. You know, if we’re buying something, we might be — particularly if no one knows that we’ve been in that stock at all — we might be somewhat quiet about the fact. But we don’t want to talk down something in order to buy it.

Charlie?

CHARLIE MUNGER: Well, I always — Jerry Newman, as I understand it, didn’t like Ben Graham giving all these courses explaining what Newman and Graham were doing, and —

But Graham’s attitude was that he was a professor first. And if he made just slightly less money by being very accurate in what he taught, why so be it.

And I think it’s fair to say that Warren has assimilated a bit of that ethos. And I think it’s all to the good. And if it costs us a tiny, little bit of money from time to time, there are probably compensating benefits. And if there aren’t, it’s probably the right way to behave anyway.

WARREN BUFFETT: Charlie, if you were in a less charitable mood, I might point out I didn’t behave that way till I got rich. (Laughter and applause)

Actually, I used to teach a course at what was then the University of Omaha. And we’d use all these current examples. And things were cheap then — (laughs) — that nobody paid any attention.

38. We don’t want to “hear stories” or buy from “jerks”

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: Hello, Mr. Munger and Mr. Buffett. My name is Liza Rema (PH) from Burbank, California.

I wanted to find out — earlier, you mentioned you looked at — you used filters to look at a company. So could you elaborate on what those filters are?

WARREN BUFFETT: Charlie, you want to —?

CHARLIE MUNGER: Well, we've tried to do a good deal of that, and —

Opportunity cost is a huge filter in life. If you've got two suitors who are really eager to have you, and one is way the hell better than the other, you do not have to spend much time with the other. And that's the way we filter stock buying opportunities.

Our ideas are so simple, people keep asking us for mysteries, when all we have is the most elementary idea.

WARREN BUFFETT: Yeah. The first filter we probably put it through is whether we think — and we know instantly — whether it's a business we're going to understand, and whether it's a business that — if it passes through that, it's whether a company can have a sustainable edge, you know.

And that gets rid of a very significant percentage of the things people have —

They always want to tell you some story or anything. And I'm sure they regard me and Charlie as very arbitrary, in terms of, you know, in the middle of the first sentence saying, "Well, you know, we appreciate the call, but we're not interested."

I mean, you know, they just think if they explain something — and I get letters on this all the time.

But we really can tell, in the middle of the first sentence, usually, whether those two factors exist. And if we can't understand it, obviously, it's not going to have — we can't make a decision as to whether it has a sustainable edge.

And if we can't understand it, we, very often, can come to the conclusion that it's not the kind of the business where it will have a sustainable edge.

So 98 percent of the conversations we can end, you know, in the middle of somebody's first sentence, which, of course, goes over very big with the caller, but — (Laughter)

And then, sometimes if you're talking about an entire business, we can tell by who we're dealing with whether a deal's ever going to work out or not.

I mean, it — if there's an auction going on, we don't want to — we have no interest in talking about it. And it just isn't going, you know, it isn't going to work.

If someone is interested in, essentially, doing that with their business, you know, they're going to sit down and want to renegotiate everything with us all over again after the deal is done. And we're going to have to buy the business two or three times before we get through.

You just see all these things coming.

And on the other hand, we've had, you know, terrific experience, basically, with the people we have associated with.

So it works. It's efficient. You know, we don't want to listen to stories all day. And we don't read brokerage reports of anything of the sort. It's just — there's other things to do with your time.

Charlie?

CHARLIE MUNGER: Yeah. Another filter that Warren was eluding to is this concept of the "quality person." And, of course, most people define "quality person" as somebody very much like themselves. (Laughter) But —

WARREN BUFFETT: Identical, actually, is the word you're searching for. (Laughter)

CHARLIE MUNGER: But there's so many wonderful people out there. And there's so many awful people out there. And there's signs frequently, like flags, particularly over the awful people. And generally speaking, those people are to be avoided.

It just — the amount of misery you bring into your life by trusting some awful person and the amount of felicity that you can bring in by making the right business associations — look around this room.

And there's some wonderful people who have created some wonderful businesses. And their customers can trust them. The employees can trust them. The problems can trust them to be fairly faced and reasonably solved. And those are the kind of people you want. And people who take their promises seriously.

I had some experience, recently, with a company. And they have their brand on a particular product. And somebody invented a better product in the same field. And they're taking their brand off their product. (Laughs) If it isn't the best, they don't want their brand on it.

People who think like that frequently do very well in business. And the flags are flying.

WARREN BUFFETT: It's like they got a sign on their chest that just says, "Jerk. Jerk. Jerk." (Laughter)

And then you think you're going to buy the business and they aren't going to be a jerk, you know, anymore. I mean, it's — (Laughter)

39. Why Dr Pepper has a future

WARREN BUFFETT: OK. Area 1.

AUDIENCE MEMBER: Hi. David Winters, Mountain Lakes, New Jersey, shareholder.

I'm just wondering if there's an organizational model where you deal with a plethora of information so you can physically and intellectually organize it so you have your maximum output and retain focus.

And secondly, if I may, in the domestic soft drink business, is it winner take all? I mean, is there room for three competitors? And, honestly, does Dr Pepper have a future?

WARREN BUFFETT: Yeah. I would say Dr Pepper has a future. I'll answer the second one.

But sure, there's room for more than one. I think Coke's market share will go up pretty much year after year. But not — you know, we're talking tenths of a percent in that business. But tenths of a percent are important.

The U.S. market is what? It must be 10 billion cases. So, you know, one percent's a hundred million cases.

There will be — Dr Pepper appeals to a lot of people.

It's interesting how regional tastes can be. I mean, Dr Pepper will have a share in Texas that's, you know, far higher than it will be in Minnesota or something. But there are people who are going to prefer it.

And an interesting thing, though, is that the high percentage of people that prefer cola, for example.

Although the cola percentage has gone down a little bit, the fastest growing big beverage at Coke is Sprite. Sprite has had huge gains in sales. It does well over a billion cases a year. And it sells very well in a whole bunch of countries.

So they'll — you can make money with a soft drink company that doesn't dominate the business. You'll do a lot better with one that does dominate. But it's not a winner take all. It's not like two newspapers in a town of 100,000 or 200,000.

There are certain businesses that are winner take all, clearly, but soft drinks, not one of them.

40. "Advantage of accumulation of useful information"

WARREN BUFFETT: What was the first question? Oh, the part about organizing —

AUDIENCE MEMBER: Oh, I'm just wondering, for those of us on the other side of the table, we get barraged with information. And I'm wondering how do you both — do you just read annuals, 10-Ks, and talk to people, and ignore everything else? And how do you keep track of everything, intellectually —?

WARREN BUFFETT: Well, we don't keep track of everything. But the beauty of — to some extent — of evaluating businesses — large businesses — is that it is all cumulative. I mean, if you started doing it 40 or so years ago, you really have got a working knowledge of an awful lot of businesses.

But there aren't that many, to start with, that are, you know —

And you can get a fix. You know, how many — what are there? Seventy-five, maybe, or so important industries. And you'll get to understand how they operate.

And you don't have to start over again every day. And you don't have to consult a computer for it or anything like that, it —

So it has the advantage of accumulation of useful information over time. And, you know, you just add the incremental bit at some point.

You know, why did we decide to buy Coca-Cola in 1988? Well, it may have been, you know, just a couple small incremental bits of information. But that came into a mass that had been accumulated over decades.

And it's a very — it's a great business that way. It's why we like businesses that don't change too much, because the past is useful to us.

Charlie?

CHARLIE MUNGER: I can't add a thing to that.

41. We'd "push" to buy cheap stocks, but not enough to lose sleep

WARREN BUFFETT: OK. Over there in 2.

AUDIENCE MEMBER: I'm Barbara Morrow (PH) from Wisconsin and New York.

If you both live as long as I believe you will, it could happen that they'll be a year when you write two big checks for super-cat claims when the market is throwing away things at really silly prices.

Could you share your thinking about how much debt you would consider taking on to buy great businesses that's cheap in that kind of a situation?

WARREN BUFFETT: Well, if we had both a big hurricane in the northeast or in Florida, and we had a big quake in California in the same year, and we had a financial market — the financial markets tanked, perhaps because of those events, but perhaps for other reasons, we would be thinking about ways — it might not be borrowing money directly — but we would be thinking to ways to buy securities if they got cheap enough.

I mean, any time securities get cheap — Charlie, you're thumping again here — (laughter) — any time securities get cheap, you know, we don't like to go to the office and not write a ticket. I mean, that, so —

We certainly would have the ability to borrow some money. We would never borrow a ton of money, relative to capital. We're just not set out that way.

We don't want to disappoint anybody in this world. We don't even want to worry about disappointing anybody in this world. So, we're not going to do that.

But we have a lot of extra firepower overall.

And I would say under almost any conditions that cause securities to get very cheap, we would find a way to buy some of them.

Charlie?

CHARLIE MUNGER: The beauty of our situation is that it has enormous flexibility built into it.

If something were large enough and cheap enough, we could stop writing super-cats. We're measuring opportunities one against the other, and we understand the way the numbers interplay.

And so we have a lot of different options.

And that's a huge advantage. There's so many places in business life where you have practically no options at all. You're just in a channel that you have to — waltz down the channel and you don't have any options to do anything else.

We have enormous options. We may not exercise them. But we have enormous flexibility.

WARREN BUFFETT: Yeah. We know they're there, and —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — and there's no reason to push on anything now. At least, we don't have any reason to push ourselves.

But if it ever became advantageous to push somewhat, we would push, although never to a degree that, in any way, causes us to lose a minute of sleep about fulfilling every obligation we had.

Morning Session - 1998 Meeting

1. Welcome

WARREN BUFFETT: Morning. Morning. I'm Warren Buffett, chairman of Berkshire, and — this is my partner. This hyperactive fellow over here is Charlie Munger. (Laughter)

And we'll do this as we've done in the past, following the Saddam Hussein school of management, we're going to go through the business meeting in a hurry, and then we're going to do questions.

And we'll do those until 3:30, with a break at noon, when we'll take off for 30 minutes or so while you can grab lunch. And those of you — there's — we're operating in an overflow room as well — so those of you who are in the overflow room now can join the main floor after the noon break, because we'll have plenty of room then.

We'll go until 3:30. We'll try to get to all the questions we can. We've got 11 zones, ten of them in this room, and we'll just make our way around them. I've got a little map here, which I'll get oriented on here in a second. And let's see.

And I think we'll get through the business meeting now. Incidentally, I don't see that movie before it's shown, but that was one of our directors singing at that final session there. (Applause)

We keep costs down at Berkshire. (Laughter)

2. Board of directors introduced

WARREN BUFFETT: OK, the meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company and I welcome you to this 1998 annual meeting of shareholders.

I will first introduce the Berkshire Hathaway directors that are present in addition to myself.

So we have — and I can't see very well with the lights here, but if you'll stand as I name you.

Susan T. Buffett, the vocalist. (Applause)

Howard G. Buffett, the non-vocalist. (Applause)

Malcolm G. Chace. (Applause)

Charlie, you've met. And Ron Olson. (Applause)

And Walter Scott Junior. (Applause)

Also with us today are partners in the firm of Deloitte and Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Miss Becki Amick has been appointed inspect of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy owners for this meeting are Walter Scott Junior and Marc D. Hamburg. Proxy cards have been returned through last Friday, representing 1,039,276 Class A Berkshire shares, and 1,080,509 Class B Berkshire shares to be voted by the proxy holders as indicated on the cards.

The number of shares represents a quorum and we will therefore directly proceed with the meeting.

We will conduct the business of the meeting and then adjourn the formal meeting. After that, we will entertain questions that you might have.

3. Minutes and shares outstanding

WARREN BUFFETT: First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott Jr., who will place a motion before the meeting.

WALTER SCOTT JR.: I move the minutes — the reading — reading of the minutes of the last stockholders meeting be dispensed with.

WARREN BUFFETT: Do I hear a second? (Voices)

A lot of seconds. The motion has been moved and seconded. Are there any comments or questions? We will vote on this motion by voice vote. All those in favor say aye.

VOICES: Aye.

WARREN BUFFETT: Opposed? Motion's carried.

Does the secretary — (laughter) — have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent by first-class mail to all shareholders of record on March 6, 1998, the record date for this meeting, there were 1,199,680 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at this meeting.

And 1,245,081 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,039,276 Class A shares and 1,080,509 Class B shares are represented at this meeting by proxies returned through last Friday.

WARREN BUFFETT: Thank you, Forrest.

If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so. Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you. Those persons desiring ballots, please identify themselves so that we may distribute them.

4. Election of directors

WARREN BUFFETT: The one item of business at this meeting is to elect directors. I now recognize Mr. Walter Scott Junior to place a motion before the meeting with respect to election of directors.

WALTER SCOTT JUNIOR: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Junior, be elected as directors.

WARREN BUFFETT: Is there a second? It’s been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Junior be elected as directors.

Are there any other nominations? Is there any discussion? Nominations are ready to be acted upon.

If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors, voting the proxies in accordance with the instructions they have received.

Miss Amick, when you are ready you may give your report.

BECKI AMICK: My report is ready. The ballots of the proxy holder, in response to proxies that were received through last Friday, cast not less than 1,039,298 votes for each nominee. That number far exceeds the majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as those cast in person at this meeting, if any, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Junior have been elected as directors.

After adjournment of the business meeting, I will respond to questions that you may have that relate to the businesses of Berkshire that do not call for any action at this meeting.

Does anyone have any further business to come before this meeting before we adjourn?

5. Adjournment of formal business meeting

WARREN BUFFETT: If not, I recognize Mr. Walter Scott Junior to place a motion before the meeting.

WALTER SCOTT JUNIOR: I move this meeting be adjourned.

WARREN BUFFETT: Second? (Laughter)

Motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say aye?

VOICES: Aye.

WARREN BUFFETT: All opposed say I'm leaving. This meeting is adjourned. (Laughter and applause)

Charlie and I may not get paid much, but we work fast on an hourly basis. (Laughter)

6. Q&A session begins

WARREN BUFFETT: Now, we're going to do this by zones, and I think you can see who is manning each — yeah, I see we've got a number out there already.

And please ask just one question.

The only thing that I can think of that we won't discuss is what we're buying or selling or may be buying or selling, but we'll be glad to talk about anything that's on your mind. So let's go right to zone 1 and start in.

7. Price/earnings explanation

AUDIENCE MEMBER: Thanks for the beautiful — beautiful weekend in Omaha. I'm Mike Asale (PH) from New York City, with a question for Warren and Charlie about what makes a company's price-earnings ratio move up relative to other companies in its industry.

How can we, as investors, find companies, and even industries, that will grow their relative price-earnings ratios as well as their earnings?

And thank you for the wonderful weekend and for sharing your brilliance with the shareholders.

WARREN BUFFETT: Oh, thank you.

AUDIENCE MEMBER: Thank you. (Applause)

WARREN BUFFETT: You know, it's very simple, the price-earnings ratio — relative price-earnings ratios — move up because people expect either the industry or the company's prospects to be better relative to all other securities than they have been — than their proceeding view. And that can turn out to be justified or otherwise.

Absolute price-earnings ratios move up in respect to the earning power — or the prospective earning power of — that is viewed by the investing public of future returns on equity, and also in response to changes in interest rates.

And in the recent — well really, ever since 1982, but accentuated in recent years, you've had decreasing interest rates pushing up stocks, in aggregate.

And you've had an increase in corporate profits. Return on equity of American businesses improved dramatically recently. And that also — and people are starting to believe it, so that has pushed up absolute price-earnings ratios.

And then within that universe of all stocks, when people get more enthusiastic about a specific business or a specific industry, they will push up the relative P/E ratio for that stock or industry.

Charlie, you got anything?

8. No "degree of difficulty" bonus

CHARLIE MUNGER: Yes, I think he also asked, how do you forecast these improvements in price-earnings ratios.

WARREN BUFFETT: That's your — that's your part of the question. (Laughter)

CHARLIE MUNGER: Around here I would say that if our predictions have been a little better than other people's, it's because we tried to make fewer of them. (Laughter and applause)

WARREN BUFFETT: We also try not to do anything difficult, which ties in with that.

We really do feel that you get paid just as well — you know, this is not like Olympic diving. In Olympic diving, you know, they have a degree of difficulty factor. And if you can do some very difficult dive, the payoff is greater if you do it well than if you do some very simple dive.

That's not true in investments. You get paid just as well for the most simple dive, as long as you execute it all right. And there's no reason to try those three-and-a-halfs when you get paid just as well for just diving off the side of the pool and going in cleanly. (Laughter)

So we look for one-foot bars to step over rather than seven-foot or eight-foot bars to try and set some Olympic record by jumping over. And it's very nice, because you get paid just as well for the one-foot bars.

9. Efficient market hypothesis "contaminates" business schools

WARREN BUFFETT: OK, zone 2.

AUDIENCE MEMBER: Good morning. My name is Joe Lacey (PH). I'm from Austin, Texas.

In this era when the financial departments of the institutions of higher learning are referring to you as an anomaly, and they preach the efficient markets hypothesis, saying that you can't outperform the market, where does one go to find a mentor like you found in Ben Graham? Someone you can ask questions to regarding value investing.

WARREN BUFFETT: My understanding is that the University of Florida has instituted a couple of courses that, actually, Mason Hawkins gave them a significant amount of money to finance. And I believe they're teaching something other than efficient markets there.

There's a very good course at Columbia I know that gets a lot of visiting teachers to come in. I go there and teach occasionally, but a number of practitioners do.

So there — I think the efficient market theory is less holy writ now than it was 15 or 20 years ago in universities, but it's — there's a lot of it taught, but I think you can find more diversity in what is being offered now than ten or 20 years ago. And I'd recommend, you know, looking into those two schools.

You know, it's really quite useful. If you had a merchant shipping business, if all of your competitors believe the world is flat, you know, that is a huge edge, because they will not take on any cargo to go to places that are beyond where they think they will fall off. And so we should be encouraging the teaching of efficient market theories in universities. (Laughter)

It amazes me. But, you know, I think one time that — was it Keynes that said that most economists are most economical about ideas? That they make the ones they learned in graduate school last a lifetime. (Laughter)

And what happens is that you spend years getting your Ph.D. in finance and you learn theories with a lot of mathematics in them that the average layman can't do.

And you become sort of a high priest. And you get an enormous amount of yourself and ego, and even professional security, invested in those ideas. And it gets very hard to back off after a given point. And I think that to some extent has contaminated the teaching of investing in the universities.

Charlie?

CHARLIE MUNGER: Well, I would argue that the contamination was massive. (Laughter)

But it's waning.

WARREN BUFFETT: Yeah, it is waning.

CHARLIE MUNGER: It's waning. The good ideas eventually triumph.

WARREN BUFFETT: Yeah. The word "anomaly" I've always found interesting on that, because, you know, after a while — I mean Columbus was an anomaly, I suppose, for a while. But what it means is something that the academicians could not explain, and rather than re-examine their theories, they simply discarded any evidence of that sort as anomalous.

And I think when you find information that contradicts previously cherished beliefs, that you've got a special obligation to look at it and look at it quickly.

I think Charlie told me that one of the things Darwin did was that whenever he found anything that contradicted some previous belief, he knew that he had to write it down almost immediately because he felt that the human mind was conditioned, so conditioned to reject contradictory evidence, that unless he got it down in black and white very quickly his mind would simply push it out of existence.

Charlie knows more about Darwin than I do. Maybe he can explain that.

CHARLIE MUNGER: Well, I don't know about Darwin, but I did find it amusing. One of these extreme efficient market theorists explained Warren for many, many years as an anomaly of luck. And he got the six sigmas, six standard deviations of luck. And then people started laughing at him because six sigmas of luck is a lot. So he changed his theory. Now Warren has six or seven sigmas of skill. (Laughter)

WARREN BUFFETT: No.

CHARLIE MUNGER: So you see —

WARREN BUFFETT: I'd rather have the six sigmas of luck, actually. (Laughter)

CHARLIE MUNGER: The one thing he couldn't bear to leave was his six sigmas. (Laughter)

10. "Time is the enemy of the poor business"

WARREN BUFFETT: Let's try zone 3.

AUDIENCE MEMBER: My name is Warren Hayes (PH). I'm from Chicago, Illinois.

I understand from various publications, like Outstanding Investor Digest, that many of the best value investors are buying high-quality, multi-national Japanese companies that are trading below net-net working capital value.

Do you agree that these values exist in Japan? And would you consider a purchase of some of them?

WARREN BUFFETT: Well, Henry Emerson, who publishes the Outstanding Investor's Digest is here, so I will give a tout on it.

I read the Outstanding Investor's Digest, OID, and it's a very good publication. And I have read some of the commentary about Japanese securities.

We've looked at securities in all major markets, and we certainly looked at them in Japan, particularly in recent years when the Nikkei has so underperformed the S&P here.

We're quite a bit less enthused about those stocks as being any kind of obvious bargains than the people that you read about in OID.

The returns on equity in most areas of Japanese business, returns on equity are very low. And it's extremely difficult to get rich by owning — by being the owner of a business that earns a low return on equity. You know, we always look at what a business does in terms of what it earns on capital.

We want to be in good businesses. Where you really want to be is in businesses that are going to be good businesses and better businesses ten years from now. And we want to buy them at a reasonable price.

But many years ago we gave up what I've labeled the "cigar butt" approach to investing, which is where you try and find a really kind of pathetic company, but it sells so cheap that you think there's one good free puff left in it.

And — (laughter) — we used to pick up a lot of soggy cigar butts, you know. I mean, I had a portfolio full of them.

And there were free puffs in them. I mean, I made money out of that. But A, it doesn't work with big money anyway, and B, we don't find many cigar butts around that we would be attracted to.

But those are the companies that had low returns on equity. And if you have a business that's earning 5 or 6 percent on equity and you hold it for a long time, you are not going to do well in investing. Even if you buy it cheap to start with.

Time is the enemy of the poor business, and it's the friend of the great business. I mean if you have a business that's earning 20 or 25 percent on equity, and it does that for a long time, time is your friend.

But time is your enemy if you have your money in a low-return business. And you may be lucky enough to pick the exact moment when it gets taken over by someone else.

But we like to think when we buy a stock we're going to own it for a very long time, and therefore we have to stay away from businesses that have low returns on equity.

Charlie?

CHARLIE MUNGER: Yeah, it's not that much fun to buy a business where you really hope this sucker liquidates before it goes broke. (Laughter)

WARREN BUFFETT: We've been in a few of those, too.

CHARLIE MUNGER: Right. (Laughter)

WARREN BUFFETT: Yeah, Charlie and I, we — or at least I have, I've owned stock in an anthracite company. There are probably people in this room that don't know what anthracite is. Three railway companies. Windmill manufacturers. What other gems have we had, Charlie?

CHARLIE MUNGER: Textiles. (Laughter)

WARREN BUFFETT: Yeah, textiles. Don't even think. (Laughter)

Yeah, Berkshire was a mistake, believe it or not. I mean we went into Berkshire because it was cheap statistically just as a general investment back in the early '60s, and it was a company that in the previous ten years had earned less than nothing. I mean it had a significant net loss over the previous ten years.

It was selling well below working capital, so it was a cigar butt. And it was — I mean we could have done the things we've done subsequently from a neutral base rather than a negative base, and actually it would have worked out better, but it's been a lot of fun.

11. Munger wants "a good idea we can understand"

WARREN BUFFETT: Number four.

AUDIENCE MEMBER: Hello. My name is Martin Weigand from Bethesda, Maryland. Again, I want to thank you for your letters and principles. They're a great help for small business people running their business.

My question is, last year you said you had filters in your mind to help you quickly analyze businesses.

How do your filters take into account the very fast changes of technology and the way that businesses communicate with their customers, take orders, things like that?

WARREN BUFFETT: Well, we do have filters, and sometimes those filters are very irritating to people who check in with us about businesses, because we really can say in ten seconds or so "no" to 90 percent-plus of all the things that come in, simply because we have these filters. We have some filters in regard to people, too.

But the question of technology is very simple. That doesn't make it through our filter. I mean, so if something comes in where there's a technological component that's of significance, or where we think the future technology could hurt the business as it presently exists, we look at, you know, we look at that as something to worry about. We will — it won't make it through the filter.

We want things that we can understand, which filters out a lot of things. (Laughter)

And we want them to be good businesses, and we want the people to be people we're very comfortable with. That means ability and integrity.

And we can do that very fast. We've heard a lot of stories in our lives, and it's amazing how they — you can become quite efficient in, probably, getting 95 percent of the ideas through in a very short period of time that should get through.

Charlie?

CHARLIE MUNGER: Yeah, we have to have an idea that is A, a good idea, and B, a good idea that we can understand. It's just that simple. And so those filters are filters against consequences from our own lack of talent. (Laughter)

WARREN BUFFETT: Filters haven't changed much over the years, either. (Laughter)

12. "A lot of different talents" within Berkshire

WARREN BUFFETT: OK, area five.

AUDIENCE MEMBER: Hi. I'm Allan Maxwell. I live in the wonderful tropical island of O-maha. (Laughter)

WARREN BUFFETT: That's right up there with Aksarben. That's Nebraska spelled backwards. (Laughter)

AUDIENCE MEMBER: Everybody in this room's got to be wondering the same question. Who, in your opinion, both of you, is the next Warren Buffett?

WARREN BUFFETT: Charlie? Who's the next Charlie Munger? Well, let's try that first. That's a more difficult question. (Laughter)

CHARLIE MUNGER: There's not much demand. (Laughter)

I don't think there's only one way to succeed in life, and our successors, in due time, may be different in many ways. And they may do better.

WARREN BUFFETT: Incidentally, we have a number of people in the company, some of whom are in this room today, and the ones you saw on that screen, who are leagues ahead of Charlie and me in various kinds of abilities.

I mean a lot of different talents. We've got a fellow in this room today who's the best bridge player, probably, in the world. And Charlie and I could work night and day, and if he spent ten minutes a week working on it, he'd play better bridge than we would.

And there are all kinds of intellectual endeavors that, for some reason or another, one person's a little bit better wired for than someone else.

And we have people running our businesses that if Charlie and I were put in charge of those businesses, we couldn't do remotely as well as they do.

So there's a lot of different talents. The two that we're responsible for is, we have to be able to keep able people, who are already rich, motivated to keep working at things where they don't need to do it for financial reasons. I mean it's that simple.

And that's a problem any of you could think about, and you'd probably be quite good at it if you gave it a little thought, because you'd figure out what would cause you to work if you were already rich and didn't need the job. Why would you jump out of bed and be excited about going to work that day? And then we try to apply that to the people who work with us.

Secondly, we have to allocate capital. And these days we have to allocate a lot more capital than we had to allocate a decade ago.

That job is very tough at present. Sometimes it's very easy. And it will be easy at times in the future and it'll be difficult at times in the future. But there are other people that can allocate capital, and we have them in the company.

Charlie, you have any —?

CHARLIE MUNGER: No.

13. One of the few reasons to sell a stock

WARREN BUFFETT: OK. Number 6.

AUDIENCE MEMBER: Good morning. My name is Jad Khoury (PH). I'm from Gaithersburg, Maryland. I just want to thank you for sharing your wisdom.

And my question is, what criteria do you use to sell stock? I kind of understand how you buy it, but I'm not sure how you sell.

WARREN BUFFETT: Yeah. Well, the best thing to do is buy a stock that you don't ever want to sell. I mean — and that's what we're trying to do.

And that's true when we buy an entire business. I mean, we bought all of GEICO or we bought all of See's Candy or The Buffalo News. We're not buying those to resell.

I mean, what we're trying to do is buy a business that we will be happy with if we own it the rest of our lives, and we expect to with those.

It's the same principle applies to marketable securities. You get extra options with marketable securities. You can add to holdings. Obviously easier — we can never own more than a hundred percent of a business, but if we own 2 percent of a business and we like it at a given price, we can add and have 4 or 5 percent. So that's an advantage.

Sometimes, if we need money to move to another sector, like we did last year, we will trim some holdings, but that doesn't mean we're negative on those businesses at all. I mean, we think they're wonderful businesses or we wouldn't own them.

And we would sell A, if we needed money for other things.

The GEICO stock that I bought in 1951, I sold in 1952. And it went on to be worth a hundred or more times — before the 1976 problems — 100 or more times what I'd paid. But I didn't have the money to do something else. So you sell if you need money for something else.

You may sell if you believe the valuations between different kinds of markets are somewhat out of whack. And, you know, we have done a little trimming last year in that manner. But that could well be a mistake. I mean the real thing to do with a great business is just hang on for dear life.

Charlie?

CHARLIE MUNGER: Yes, but the sales that do happen, the ideal way is when you found something you like immensely better. Isn't that obvious that's the ideal way to sell?

WARREN BUFFETT: And incidentally, the ideal purchase is to find — is to have something that you already liked be selling at a price where you feel like buying more of it. I mean, we probably should have done more of that in the past in some situations.

But that's the beauty of marketable securities. You really do — if you're in a wonderful business, you do get a chance, periodically, maybe to double up in it, or something of the sort.

If the market — if the stock market were to sell a lot cheaper than it is now, we would probably be buying more of the businesses that we already own. They would certainly be the first ones that we would think about. They're the businesses we like the best.

Charlie?

CHARLIE MUNGER: Nothing more.

14. Make up your own mind

WARREN BUFFETT: OK. Zone 7.

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger. My name is Ron Wright (PH) from Iowa City, Iowa.

New companies have always been an interest to me. Is it reasonable to assume an Omaha-based company with only $5 billion in the bank might succeed in telecommunications?

WARREN BUFFETT: Well, I think that a new company with 5 billion in the bank is probably better off than most new companies. (Laughter)

Be like Jennifer Gates, as a newborn. (Laughter)

I think you're probably referring to a company that was created out of one of our local operations that's run by Walter Scott, one of our directors, from the Kiewit Company, Level 3.

I can tell you, it's got very able management. And I'll take your word for it that it's also got 5 billion in the bank, but you'll have to make your own judgment on the stock.

I know Charlie won't comment on that one. (Laughs)

15. Buffett jokes about Nebraska football's Tom Osborne

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: Yes, good morning. This is Mo Stintz (PH) from Omaha, Nebraska.

In the past you've often said that the insurance operation is the most important business in Berkshire's portfolio. Is that true? And what are numbers two and three?

I'd also like to ask, is it true that Charlie chose the colors for the cover of this year's annual report?

WARREN BUFFETT: Did Charlie chose them? (Laughs)

He had nothing to do with them. I chose them. (Laughter)

They were a tribute to the Nebraska football team and Tom Osborne, who you saw. (Applause)

Tom, incidentally, has a very low-key style, and Bobby Bowden, a few years ago, was in Lincoln. And he said that on their first date that Nancy had to slap Tom three times. And somebody said, "Was he that fresh?" And she said, "No, I was just checking to be sure he was alive." (Laughter)

Tom had a fairly conservative offense for a time in the past, although it hasn't been so conservative the last few years, but somebody said at that time the most reckless thing he did was to eat some cottage cheese the day after the expiration on the carton by then. (Laughter)

But I — no, I chose the colors. Now what was the question? (Laughter)

What was the question, Charlie? Do you remember?

A memorable question, but give it to us again. (Laughter)

16. Proud not to have a strategic plan

WARREN BUFFETT: Are we back there in zone 8? Oh, the number — yeah, sure.

The question was about the insurance business, which we have said will be, by far, the most important business at Berkshire. We said that many, many years ago, and it's proven to be the case.

It obviously got a big leg up when we purchased all of GEICO. Insurance, as far as the eye can see, will be, by far, the most significant business at Berkshire.

And the question about two and three: in terms of earnings, FlightSafety is the second largest source of earnings. But we don't really think of them that way. I mean we do know our main business is insurance, but we really have a lot of fun out of all of our businesses. And I had a great time out at Borsheims yesterday, or at a Dairy Queen.

So it will be accident, to some extent, over the next ten years, what ends up being the second or third or fourth largest. That'll be determined by opportunity.

We bid on certain businesses — or negotiated on them — that could have been very large businesses if they become part of Berkshire. And that'll happen again in the future.

So we have no predetermined course of action whatsoever at Berkshire. We have no strategic planning department. We don't have any strategic plan.

We react to what we think are opportunities. And if it's a business we can understand, and particularly if it's big, you know, we would love to make it number two.

Charlie?

CHARLIE MUNGER: I also want to say proudly that we have no mission statement.

WARREN BUFFETT: No. (Laughter and applause)

It's hard to think of anything that we do have, as a matter of fact. (Laughter)

Yeah, we have never had — I mean I'm sure you all know this. We've never had a consultant. And we try to keep things pretty simple.

We still have 12 people at headquarters. We have about 40,000 people that now work for Berkshire. And we hope to grow a lot, but we don't hope to grow at headquarters. (Laughter)

17. In "good shape" to handle Y2K problem

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Yes, my name is Patty Buffett and I'm from Albuquerque, New Mexico.

WARREN BUFFETT: I like your name. (Laughter)

AUDIENCE MEMBER: Thanks.

In your opinion, what effect will the year 2000 compliant issue have on the U.S. stock market and the global economy?

WARREN BUFFETT: Well, I get different reports on 2000, but the main report I hear — I think, you know, we — you wouldn't want to rely on me on this, but you could rely on our managers. And I think we're in good shape.

It's costing us some money but not huge amounts of money to be prepared for 2000.

With companies in which I'm a director, you know, I hear some reasonably good-sized numbers. Those numbers are in their annual reports and described as to the cost of compliance.

But what I'm told by people that know a lot more than I do, is that they think probably that the weakest link may be in governmental units. They seem to think that in terms of where they stand versus the commercial sector, in terms of reaching where they need to be by 2000, that there's some areas of both national and state and local governments, and foreign government, where they're really behind the curve.

Now, that is not an independent judgment of mine. But somebody said, "You want to be very careful about making a phone call at five seconds before midnight at the millennium because you may get charged for 100 years," you know. (Laughter)

So it'll be interesting.

I don't think it's going to affect Berkshire in any material way, and I certainly have a feeling that the world will get past it very easily. But it is turning — it is expensive for some companies, and it's going to be very expensive for governments.

Charlie?

CHARLIE MUNGER: Yeah, I find it interesting that it is such a problem. You know, it was predictable that the year 2000 would come.

WARREN BUFFETT: Yeah. (Laughter and applause)

Yeah. Yeah, we decided that back in 1985, actually. (Laughter)

We didn't welcome it, understand. That's not Berkshire's style, though. (Laughs)

It is fascinating, isn't it, when you think about it, that a whole bunch of people with 160 IQs that could build up such a problem, but here we are. And — (laughter) — that's why we stick with simple things. (Laughter)

18. Laws needed to check campaign spending "arms race"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: My name is Kristin Cham (PH). I'm from Springfield, Illinois. And I'm a proud shareholder of Berkshire Hathaway. (Applause)

WARREN BUFFETT: We're glad to you have you here.

AUDIENCE MEMBER: I've heard a little about your thoughts on trying to control campaign spending. Could you tell us more about your thoughts and efforts on this topic? Thank you.

WARREN BUFFETT: Charlie, did you get all of that?

CHARLIE MUNGER: I think it was campaign spending.

WARREN BUFFETT: Oh, campaign spending. Yeah, I have joined something that Jerry Kohlberg — this is personal. This has nothing to do with Berkshire — that Jerry Kohlberg spearheaded.

And it's taken a position — and probably 30 or so mostly business people — taken a position against soft money, and also taken a position on very fast disclosure of campaign finance money, because I personally think that the arms race, in terms of campaign spending by businesses, you know, has just begun. It doubled in the last election.

But political influence — and I don't mean that by buying a vote, but I mean just in terms of having a (inaudible) in Washington or in other state capitols.

Political influence has been an underpriced product in the past. I mean, the government is enormously important in this country to most companies. It was amazing how cheap — cheaply — it could be — attention could be purchased.

But the price is going up, and there will be an escalation. And I don't think it's easy — if you're the manager of a business and you own 1/10th of 1 percent of it and you're in a business that's heavily affected by government, I don't think it's very easy to tell your board of directors that you're going to take a hands-off approach.

So I think legislation is needed in that arena, and there are over a hundred campaign finance reform bills that have been introduced. Everybody wants to have their name on a bill. They just don't want to have it passed. (Laughter)

And, you know, John McCain's been working hard on it. And it's something I think we have to come to grips with because it's going to be a battle of the wallets for influence.

And, like I say, if I were running some other company, and my competitors were spending money to get the attention of would-be legislators, or actual legislators, it'd be very difficult to take some high and mighty position that I wasn't going to do it myself, and my board and my shareholders might ask me why I was taking that position.

We are lucky, basically, to be in a business that's relatively unaffected by legislation, although we will — we're going to pay a lot of tax this year. I said two years ago that it would only take 2,000 entities in the whole United States — businesses, individuals, any kind of entity — to pay the same amount of taxes as Berkshire, and that would take care of the entire budget.

You'd need no Social Security taxes. You'd need no nothing.

I think we're going to be able to say that again this year. I think that if you multiply our tax by 2,000 you will more than account for the entire federal budget, including Social Security and everything else.

So you might say, "Why aren't you in Washington lobbying for a capital gains rate at corporations that's the same as individuals?" or something, but we basically haven't played that game. We feel very fortunate.

I'll say this. I would rather, in this country, be a huge taxpayer myself than be somebody who needed the other end of it, the government dispensing.

I mean, if anybody here is paying taxes and they want to — (applause)

If you'd like to shift positions with somebody in a veteran's hospital or, you know, that has a couple of children by age 19 and is getting a check from the government, you know, I don't want to shift positions. I'm happy to be paying the taxes.

19. "The secret of life is weak competition"

WARREN BUFFETT: Zone 11, please. I think 11 is probably the remote — yeah. So we're going to hear this from the overflow room. Are we there?

AUDIENCE MEMBER: Yes. Good morning, Mr. Buffett, Mr. Munger. My name is Patrick Rown (PH) from Charlotte, North Carolina.

And I've watched returns on equity for the banking sector in the U.S. go up a good bit over the last few years. And returns on tangible equity for some of the major banks that have led to consolidation have gone up a good bit more. Leads me to wonder whether these returns are sustainable over the near-term or the longer-term, five, 10 years out.

WARREN BUFFETT: Well, that's the $64 question, because the returns on equity — and particularly tangible equity, as the gentleman mentioned — and particularly tangible equity in the banking sector, even — those returns have hit numbers that are unprecedented. And then the question is, if they're unprecedented, are they unsustainable?

Charlie and I would probably think the — we would certainly prefer — we would not base our actions on the premise that they are sustainable. Twenty percent-plus returns on tangible equity — or on book equity — and much higher returns on tangible equity. In the banking field, you have a number of enterprises that on tangible equity are getting up close to the 30 percent range.

Now, can a system where the GDP in real terms is growing, maybe, 3 percent — where in nominal terms this grows 4 to 5 percent — can businesses consistently earn 20 percent on equity?

They certainly can if they retain most of their earnings, because you would have corporate profits rising as a percentage of GDP, to the point that would get ludicrous.

So under those conditions, you'd either have to have huge payouts — either by repurchases of shares or by dividends or by takeovers, actually — that would keep the level of capital reasonably consistent among industry, because you couldn't sustain — let's just say every company retained all of its earnings and they earned 20 percent on equity — you could not have corporate profits growing at 20 percent as a part of the economy year after year.

This has been a better world than we foresaw, in terms of returns, so we've been wrong before. And we're not making a prediction now, but we would not want to buy things on the basis that these returns would be sustained.

We told you last year, if these returns are sustained and interest rates stayed at these levels or fell lower, that stock prices, in aggregate, are justified. And we still believe that.

But those are two big ifs. And a particularly big if, in my view, is the one about returns on equity and on tangible assets. It goes against — it certainly goes against classic economic theory to believe that they can be sustained.

Charlie, how do you feel about it?

CHARLIE MUNGER: Well, I think a lot of the increase in return on equity has been caused by the increasing popularly of Jack Welch's idea that if you can't be a leader in a line of business, get out of it.

And if you have fewer people in the business, why, returns on equity can go up.

Then it's got more and more popular to buy in shares, even at very high prices per share. And if you keep the equity low enough by buying shares back, why, you could make return on equity whatever you want.

It would be that, to some extent, a slow revolution in corporate attitudes.

But Warren is right. You can't have massive accumulations of earnings that are retained and keep earning these rates of return on them.

WARREN BUFFETT: An interesting question is to think about, if you had 500 Jack Welches and they were running the Fortune — they're cloned — and they were running all of the Fortune 500 companies, would returns on equity for American business be higher or lower than they are presently?

I mean if you have 500 sensational competitors, they can all be rational, but that doesn't — and they will be. And they'll be smart and they'll keep trying to do all the right things. But there's a self-neutralizing effect, just like having 500 expert chess players or 500 expert bridge players. You still have a lot of losers if they get together and play in a tournament.

So it's not at all clear that if all American management were dramatically better, leaving out the competition against foreign enterprises, that returns on equity would be a lot better. They might very well drive things down.

That's what, to some extent, can easily happen in securities markets. It's way better to be in securities markets if you have a hundred IQ and everybody else operating has an 80, than if you have 140 and all the rest of them also have 140.

So the secret of life is weak competition, you know. (Laughter)

Somebody said, "How do you beat Bobby Fischer?" You play him in any game except chess, well — (Laughter)

That's how you beat Jack Welch. You play him in any game except business, although he's a very good golfer, I want to — (laughs) — point out.

He shot a 69 a few months ago when I saw him at a very tough course. Jack manages to play 70 or 80 rounds of golf a year, and come in sub-par occasionally, while still doing what he does at

GE. He's a great manager. But 500 Jack Welches, I'm not at all sure would make stocks more valuable in this country.

20. Book recommendations

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: I'm Ben Knoll and I'm from Minneapolis. And first, I just wanted to thank you for providing your past annual letters to the shareholders, and Mr. Munger for providing your speech to the graduate students at USC a couple years ago.

Drawn a lot of insights from that, not only in investing but also in my day job as a business manager.

And I'm wondering if you could help me with my summer reading list and provide some additional suggestions for reading in the fields of investing and management, other than the standards of Graham and Fisher and so forth.

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Yeah. I have recently read a new book twice, which I very seldom do. And that book is "Guns, Germs and Steel" by Jared Diamond. And it's a marvelous book. And the way the guy's mind works would be useful in business. He's got a mind that is always asking why. Why, why, why. And he's very good at coming up with answers.

I would say it's the best work of its kind I have ever read.

WARREN BUFFETT: I read a little easier book — (laughter) — recently.

I'm not even sure of the title. I don't pay much attention to titles when I get into the book, but it's something to the effect of "The Quotable Einstein." I mean it's a lot of his commentary over the years, and it's great reading.

"The Fermat Theorem" was the book that — that isn't an exact title either — but it's the story of the discovery of the answer. That's a very interesting book. One of our shareholders from Sweden gave me a copy of that when I was in New York and I've enjoyed it.

21. Higher rates would hurt Freddie and Fannie

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Marc Rabinov. I'm a shareholder from Melbourne, Austria.

Gentlemen, we have large holdings in Freddie Mac and Fannie Mae, and as you both know, they were quite — well, they were hurt quite a lot when interest rates went up in the past.

I'm wondering if you think there'll be hurt again when interest rates go up in the future?

WARREN BUFFETT: Well, the question about Freddie Mac and Fannie Mae on interest rates, they are not as interest rate sensitive as people formerly thought they were.

But it would be the pattern, and I have a feeling that if interest rates got extremely low, so that there was a huge turnover in the portfolio, and then rates went up dramatically, that even though they have various ways of protecting themselves against interest rate scenarios, that that might get very tough. I think there would be some kind of squeeze there.

They may have good answers as to why that wouldn't happen, incidentally, because they certainly worry about every kind of interest rate scenario. That's their job.

But I think, in a sense, very low interest rates are more of a long-term threat, because if you get a portfolio chock full of, say, 4 percent mortgages or something of the sort, and then you had a huge move upward, that would be quite painful for some period of time, no matter what you've done in the way of hedging.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: Yeah. That's what happened to the savings and loans, in effect, you see, 25 years ago or whenever it was.

And Freddie and Fannie have other functions, and they've got a lot of advantages, but they have a savings and loan-type operation. They just do it on a very big scale and they get their money from — in a very different manner than from millions of depositors. But the basic economics have some similarly.

22. No worries about tough times: "It's a lot of fun"

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Jane Bell (PH), Des Moines. Since I became a Berkshire Hathaway shareholder I've been coming to these meetings. This is my second. (Laughter)

WARREN BUFFETT: I've been coming to these meetings ever since I've been a shareholder. (Laughter)

AUDIENCE MEMBER: Mr. Buffett, I'm a partner and owner in a consulting business, and we tell our clients and potential clients that we design solutions for what keeps them awake at night.

Mr. Buffett, from your perspective as an investor, what keeps you awake at night?

WARREN BUFFETT: Well, that's a good question. And that's one I always ask the managements of our subsidiaries, as well as any new investment. I want to know what their nightmare is.

Andy Grove, in his book "Only the Paranoid Survive," talks about the silver bullet for a competitor. So in terms of, if you only had one silver bullet, which competitor would you fire it at?

And it's not a bad question. And your question's a little broader. If you only had one worry that you could get rid of, what would it be?

I would say that, and I think I speak for Charlie — (inaudible) — but we really don't worry. You know, we will do the best we can, and when we have capital allocated, sometimes it's very easy to do. Sometimes it's almost impossible to do.

But we're not going to worry about it, because, you know, the world changes. And if we had something we were worried about in the business, we would correct it.

I'm not worried about any — I'm not really worried about — you know, we can lose a billion dollars on a California earthquake. But I'm not worried about it, although I have a sister who's in the audience that lives in California. I told her to call me quickly if the dogs start running in circles or anything like that. (Laughter)

But there's — you know, if you're worried about something, the thing to do is get it corrected and get back to sleep. And I can't think of anything I'm worried about at Berkshire. That doesn't mean that I have any good ideas as to what we should be doing with a whole lot of money that we have around.

But, you know, I can't do anything about that except keep looking for things that I might understand and do something with the money. And if they aren't there, they aren't there. And we'll see what happens tomorrow and next week and next month and next year.

Charlie, what are you worried about?

CHARLIE MUNGER: Well, in the 30-some years I've been watching you, I would say what it takes to make you not sleep at night is an illness in the family.

Short of that, Warren likes the game. I like the game. And even in the periods that look tough to other people, it's a lot of fun.

WARREN BUFFETT: It's a lot of fun.

CHARLIE MUNGER: It's a lot of fun. (Laughter)

WARREN BUFFETT: In fact it probably is the most — (applause) — it's sort of, it is the most — I mean we define tough times differently than other people would, but our idea of tough times is like now, and our idea — we don't feel it's tough times when the market's going down a lot or anything of the sort. So we are having a good time then.

I mean we don't want to sound like undertakers during a plague or anything, but — (Laughter)

But there really — you know, it makes no difference to us whether the price of Berkshire is going up or down. We're trying to figure out ways to make the company worth more money years down the road, and if we figure that out, the stock will take care of itself, so —

And usually when the stock is going down, it means other things are going down. And it's a better chance for us to deploy capital, and that's our business.

So you will not see us worrying. Maybe we should. You know, "What, me worry?" (Laughs)

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

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: My name is Paul Yoon (PH) from L.A., California.

Mr. Warren Buffett, Mr. Charles Munger, I am one of the persons who highly admire you both. I have two questions.

Question one: your view on the world financial business environment in the next decade.

Question two — (laughter) — U.S. position for economic competition in the next decade. Thank you.

WARREN BUFFETT: Well, you've asked two big questions, but you're going to get very small answers, I'm afraid. (Laughter)

And that's no disrespect. But we — we just — we don't have that. We don't think about those things very much.

We just are looking for decent businesses. And incidentally, our views in the past wouldn't have been any good on those subjects.

We try to think about two things. We try to think about things that are important and things that are knowable.

Now, there are things that are important that are not knowable. In our view, those two questions that you raised fall in that. There are things that are knowable but not important. We don't want to clutter our minds up with those.

So we say, "What is important and what is knowable?" And what among the things that fall within those two categories can we translate into some kind of an action that is useful for Berkshire.

And we really — there are all kinds of important subjects that Charlie and I, we don't know anything about, and therefore we don't think about them.

So we have — our view about what the world will look like over the next ten years in business or competitive situations, we're just no good.

We do think we know something about what Coca-Cola's going to look like in ten years, or what Gillette's going to look like in ten years, or what Disney's going to look like in ten years, or what some of our operating subsidiaries are going to look like in ten years.

We care a lot about that. We think a lot about that. We want to be right about that. If we're right about that, the other things get to be — you know, they're less important. And if we started focusing on those, we would miss a lot of big things.

I've used this example before, but Coca-Cola went public in, I think, it was 1919. And the first year one share cost $40. The first year it went down a little over 50 percent. At the end of the year, it was down to $19. There were some problems with bottler contracts. There's problems with sugar. Various kinds of problems.

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

And you could always find a reason to postpone why you should buy that share of Coca-Cola. But the important thing wasn't to see that. The important thing was to see they were going to be selling a billion eight-ounce servings of beverages a day this year. Or some large number.

And that the person who could make people happy a billion times a day around the globe ought to make a few bucks off doing it.

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

Charlie?

CHARLIE MUNGER: Yeah, we're predicting the currents that will come, just how some things will swim in the currents, whatever they are.

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

WARREN BUFFETT: Zone 5, please.

AUDIENCE MEMBER: Good morning, Marc Gerstein from Value Line.

Mr. Buffett, considering the large amounts of demands on your time, how do you go about reviewing the entire spectrum of choices in the equity markets?

WARREN BUFFETT: Give me that last part again? I got the demands on my time and —

MARK ERSTEIN: How do you and Mr. Munger manage to review the whole spectrum of choices in the equity markets?

WARREN BUFFETT: A fat pitch coming up. (Laughter)

But I don't mind it at all, because the truth is that we get — I don't even know what we pay for Value Line. Charlie and I both get it in our respective offices, but we get incredible value out of it because it give us the quickest way to see a huge number of the key factors that tell us whether we're basically interested in the company.

And it also gives us a great way — good way — of sort of periodically keeping up-to-date. Value Line has 1,700 or so stocks they cover, and they do it every 13 weeks. So it's a good way to make sure that you haven't overlooked something if you just quickly review that.

But the snapshot it presents is an enormously efficient way for us to garner information about various businesses.

We don't care about the ratings. I mean that doesn't make any difference to us. We're not looking for opinions. We're looking for facts.

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

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

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

CHARLIE MUNGER: Oh yeah.

WARREN BUFFETT: The detailed financial information. You can run your eye across that.

The chart of the price action doesn't mean a thing to us, although it may catch our eye, just in terms of businesses that have done very well over time.

But we — price action has nothing to do with any decision we make. Price itself is all-important, but whether a stock has gone up or down, or what the volume is, or any of that sort of thing, that is — as far as we're concerned, you know, those are chicken tracks, and we pay no attention to them.

But that information that's right below the chart, in those 10 lines or so — 15 lines — if you have some understanding of business, that's a — it's a perfect snapshot to tell you very quickly what kind of a business you're looking at.

25. Insurance mergers haven't hurt GEICO

WARREN BUFFETT: Zone 6, please.

AUDIENCE MEMBER: David Winters from Mountain Lakes, New Jersey.

With the consolidation in the insurance industry, how do you think that will affect Berkshire's insurance businesses and the long-term development of the float?

And if I may, not to encourage your dogma to run over your karma, but how do you think your policy of partnership and fair dealing has enhanced or detracted from your investment returns? Thank you.

WARREN BUFFETT: Now, with the consolidation taking place in insurance, it's been taking place for some time. There have been some big mergers over the years.

It should — there are developments in insurance. We mentioned the super-cat bonds, which are not bonds at all. But that has an effect.

But I would say that there's no merger that has taken place that I regard as being detrimental, either to our GEICO business or to our reinsurance business.

That has not been a factor, and I think if there were some more mergers it would not be a factor. I see no way that any entities being put together would change the competitive situation in respect to GEICO.

GEICO operating just as it does, independently, is as competitive as can be, and it would not benefit by being part of any other organization.

And our reinsurance business is much more opportunistic. And it's not consolidation there, it's just lack of fear, generally, by competitors who can price — particularly cat business — at a rate that could be totally inadequate, as I use in an illustration in the report. But nevertheless, it could appear to be profitable for a long time.

And there's probably more of that going on now, and there'll probably be a lot more going on in that arena.

We have some sensational insurance businesses, though. I have to tell you that — I don't think you really have to worry too much about how we do in insurance in the future.

We have a number of GEICO people here today. I hope you got a chance to meet them. GEICO — and you saw Lorimer Davidson. I really was hoping he could be here, but Davy is 95 years old. I went to visit him a few months ago, and it just isn't easy for him to get around.

But he built a sensational company and it stumbled once. Jack Byrne got it back on track and Tony Nicely's got it going down the track at about a hundred miles an hour and it's getting faster all the time. So we've got a great business there.

Charlie?

CHARLIE MUNGER: Nothing to add.

26. "Wonderful companies" should buy back stock

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: Yes. Bill Ackman from New York.

Is there a price at which it's inappropriate for a company to use its capital to buy back its stock?

WARREN BUFFETT: Give me that again?

AUDIENCE MEMBER: Example. Coca-Cola at 40 P/E. Is that a smart place for Coke to deploy capital?

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

Coca-Cola is, in my view, among businesses that I can understand, it's the best large business in the world. I mean it is a fantastic business.

And we love it when Coke repurchases shares and our interest goes up. We owned 6.3 percent of Coca-Cola in 1988 when we bought in. We actually increased that a little bit a few years later. But if they had not repurchased shares, we probably would own about 6.7 percent or 6.8 percent of Coke now. As it is, we own a little over 8 percent, through repurchases.

There are going to be about a billion eight-ounce servings of Coke sold around the world — Coca-Cola products — sold around the world today. Eight percent of that is 80 million and 6.8 percent is 68 million. So there are 12 million extra servings for the account of Berkshire Hathaway being sold around the world. And they're making a little over a penny a serving, so, you know, that gets me kind of excited. (Laughter)

I think it — all I can tell you is, I approve of Coke repurchasing shares. I'd a lot rather have them repurchasing shares at 15 times earnings, but when I look at other ways to use capital, I still think it's a very good use of capital.

And maybe the day will come when they can buy it at 20 times earnings, and if they can I hope they go out and borrow a lot of money to ton of it at those prices, and —

I think we will be better off 20 years from now if Coke follows a consistent repurchase approach.

I do not think that is true for many companies. I mean I think that repurchases have become en vogue and done for a lot of silly reasons. And so I don't think everybody's repurchase of shares is well reasoned at all. You know, we see companies that issue options by the ton and then they repurchase shares much higher, you know —

I started reading about investments when I was six, and I think the first thing that I read was, you know, buy low, sell high. But these companies, through their options, you know, they sell low and then they buy high. And they've got a different formula than I was taught.

So there are a number that we don't approve of. When we own stock in a wonderful business, we like the idea of repurchases, even at prices that may give you nose bleeds. It generally turns out to be a pretty good policy.

Charlie?

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

WARREN BUFFETT: Sure.

CHARLIE MUNGER: And you can even get into gross abuse. Before the crash, the Insull utilities were madly buying their own shares as a way of promoting the stock higher. It was like a giant Ponzi scheme at the end.

So there's all kinds of excess that possible, but the really great companies that buy at high price- earnings, that can be wise.

WARREN BUFFETT: Our interest in GEICO went from 33 percent to 50 percent without us laying out a dime, because GEICO was repurchasing its shares. And we've benefitted substantially.

But we benefitted a lot more, obviously, when prices were lower. I mean we would — our interest in The Washington Post company has gone from nine and a fraction percent, to 17 and a fraction percent over the years without us buying a single share. But The Post or Coke or any number of companies don't get the bargain in repurchasing now that they used to. We still think it's probably the best use of many in many cases.

27. Berkshire insurance float has a negative cost

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: My name is Hutch Vernon. I'm from Baltimore, Maryland.

My question has to do with float. You said in the annual, and you've said in the past, that float has had a greater value to Berkshire than an equal amount of equity.

I wondered if you could clarify that statement. Is that because the float has been generated at such a low cost relative to an imputed cost for equity, or is there something else behind that statement?

WARREN BUFFETT: No, it's because the float, which is now, we'll say, 7 billion, comes to us at a negative cost. We would not make that statement if our float was costing us a couple percent a year, even though float would then be desirable. Highly desirable.

But our float is even better than that, or it has been, and so it comes to us with a cost of less than zero. It comes to us with a profit attached.

So if we were to replace — if we were to get out of the insurance business and give up the 7 billion of float and replace it with 7 billion of equity, we would have less going for us next year than under the present situation, even though our net worth would appear to be 7 billion higher.

And I have said, if we were to make the decision — if we were offered the opportunity to go out of the insurance business, and that 7 billion liability would — as part of that decision — would evaporate from our balance sheet, so that our equity would go up 7 billion, with no tax implications, we would turn down that proposition.

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

The key is what is the float going to be 10 or 15 years from now, and what is the cost going to be 10 or 15 years ago. And, you know, we will work very hard at both increasing the amount of float and keeping the costs down somewhere close to our present level.

That makes it a very attractive business when that can be done. GEICO's a big part of doing that, but we've got other things, other insurance operations, that'll be important in that, too. And we may have others besides that in the future.

Charlie?

CHARLIE MUNGER: Yeah. If the float keeps growing, that is a wonderful thing indeed.

We really have a marvelous insurance business. In addition to having this remarkable earning power, it's way less likely to get really clobbered than most insurance businesses. So I think it's safer on the downside and has a better upside.

WARREN BUFFETT: And it may sound strange, but we don't regard losing a billion dollars in a California quake as getting really clobbered. I mean that is —

CHARLIE MUNGER: No, no.

WARREN BUFFETT: — I mean that's part of the game.

There are many companies that have greater exposure than that that really aren't getting paid for it. And you don't see it specifically, but any company that has a ton of homeowners' business in Florida or Long Island or along the coast of Texas, may have exposures many times our billion, and really not even be getting paid appropriately or specifically for taking that risk.

28. Not worried Japan might "dump" U.S. bonds

WARREN BUFFETT: Zone 9.

AUDIENCE MEMBER: Hi, my name is Mary Semler (PH) from Seattle, Washington.

Japan is a major holder of U.S. Treasurys. Given the troubled Japanese economy, do you foresee Japan cashing in their U.S. investments to bail themselves out? Why or why not?

WARREN BUFFETT: Probably didn't get all that. I was busy chewing.

CHARLIE MUNGER: I didn't get that, either.

WARREN BUFFETT: I was busy chewing here and —

AUDIENCE MEMBER: Japan is a major holder of U.S. Treasurys. Given the troubled Japanese economy, do you foresee Japan cashing in their U.S. investments to bail themselves out? Why or why not?

WARREN BUFFETT: The problems with the Japanese economy and does that mean that — are you thinking particularly about them dumping Treasurys or something of the sort?

CHARLIE MUNGER: That's exactly what she's —

WARREN BUFFETT: Yeah. (Laughter)

Well, you know, it's very interesting. All the questions about what so-called foreigners do with investments.

Let's just assume the Japanese, or any other country, decides to sell some U.S. government holdings that they have. If they sell them to U.S. corporations or citizens or anything, what do they receive in exchange? They receive U.S. dollars. What do they do with the U.S. dollars? You know, I mean they can't get out of the system.

If they sell them to the French, you know, the French give them something in return. Now the French own the government securities.

But really as long as we, the United States, run a deficit — a big deficit — a trade deficit — we are accepting goods and giving something in exchange to foreigners. I mean when they send us whatever it may be — and on balance they send us more of that then we send over there — we give them something in exchange.

We give them — we may give them an IOU. We may give them a government bond. But we may give them an investment they make in the United States.

But they have to be net investors in this country as long as we're net consumers of their goods. It's a tautology.

So I don't even know quite how a foreign government dumps its government bonds without getting some other type of asset in exchange that may have an effect on a different market.

The one question you always want to ask in economics is — and not a bad idea elsewhere, too — but is, "And then what?" Because there's always a second side to a transaction.

And just ask yourself, if you are a Japanese bank and you sell a billion dollars' worth of government bonds — U.S. government bonds — what do you receive in exchange, and what do you do with it? And if you follow that through, I don't think you'll be worried about foreign governments selling U.S. bonds. It is not a threat.

Charlie?

CHARLIE MUNGER: If I owned Japan, I would want a large holding of U.S. Treasurys. You're on an island nation without much in the way of natural resources. I think their policy is quite intelligent for Japan, and I'd be very surprised if they dumped all their Treasurys.

WARREN BUFFETT: If they're a net exporter to us, though, what choice do they have? When you think about it.

If they send over more goods to us than we send to them — which has been the case — they have to get something in exchange. Now for a while they were taking movie studios in exchange, you know — (Laughter)

They were taking New York real estate in exchange.

I mean they've got a choice of assets, but they don't have a choice as to whether — if they send us more than they get from us — whether they get some investment asset in return.

I mean it's amazing to me how little discussion there is about the fact that there's two sides to an equation. But it makes for better headlines, I guess, when read the other way.

29. Mild endorsement for some Social Security money in stocks

WARREN BUFFETT: Zone 10.

AUDIENCE MEMBER: This is John Vaughan (PH) from Detroit, Michigan.

Nebraska's Senator Kerrey has proposed private investment accounts for up to two percentage points of the current payroll tax. His words were, and I quote, "People want more than just a transfer payment. They want wealth."

Do you approve this proposal? And if you do, would you recommend passive investing, i.e. index, or if you recommend active investing, would you and Charlie want to give it a shot? (Laughter)

WARREN BUFFETT: Well, I talked with Bob Kerrey about that, and Bob does like the idea of giving everybody some piece of the American economy and an interest in it. As you know, he's proposed, really, sort of small grants to the 3 1/2 million or so children born every year, and then some buildup of that account. Senator Moynihan has come up with something recently in conjunction with Kerry.

I personally would not like to see any major amount of Social Security — and Moynihan was talking about 2 percent. And actually, I suggested the idea that maybe 2 percent out of the 12 and a fraction percent, at the option of the beneficiary — Social Security participant — could be devoted to some other system, but then they would only get 5/6ths of the basic Social Security benefit.

I don't think you could drop it below that, because you wouldn't want people turning 65 — or maybe a more advanced age in the future, 70 — and not having the safety net of Social Security. So I wouldn't want to drop it below about 5/6ths of the present benefits.

I don't — I think it's a perfectly reasonable topic to discuss whether you want to take that 2 percent, then, and let people build up an account, perhaps tax-free, perhaps an IRA-type account, so they would have both wealth and the safety net. But I wouldn't want to drop the safety net very far.

And I think that I would not want to turn an army of salespeople loose on the American public with a mandatory 2 percent going in some direction. I don't think that would be particularly healthy.

Charlie?

CHARLIE MUNGER: I am much less enthusiastic than you are. (Laughter)

In other words, your negative, or conservative, attitude is way more affirmative than mine.

I think the idea of getting the government into promoting the value of equities — in Japan we have a taste of that now. The Japanese government has been using the postal savings system to buy equities massively year after year after year. I don't think we need to get the government into the equity market. (Applause)

30. Business schools "incoherent" on cost of capital

WARREN BUFFETT: We go to zone 11, please.

AUDIENCE MEMBER: I'm Dale Max from University Park, Illinois. And I've got a question for each of you. A short question for Charlie, and maybe a little longer for Warren.

My question for Charlie is, in a business school sense, what is the cost of capital for Berkshire Hathaway?

And my question for Warren is that I've been on the internet and I look at Yahoo and they give you recommendations for companies. And when I search for Berkshire Hathaway, it shows that nobody is recommending Berkshire Hathaway — (laughter) — despite the fact that there are maybe a thousand people that are wearing signs here, "I love Berkshire Hathaway." And of course I've got mine on, too.

But what seems to be the problem in lack of recommendations?

WARREN BUFFETT: Well, we're not recommending Yahoo, incidentally, either. (Laughter and applause)

But I'll let Charlie have that first question about the cost of capital, which has puzzled people for thousands of years. And then —

CHARLIE MUNGER: The way that is taught in most business schools now, I find incoherent. So I'm the one that asks that question and gets the incoherent answers. I don't have a good answer to a question I consider kind of a stupid question.

WARREN BUFFETT: That isn't —

CHARLIE MUNGER: What is the cost of capital at Berkshire Hathaway when we keep drowning in this torrent of cash which we have to reinvest?

WARREN BUFFETT: Yeah. There's really only two questions that get to that, but you don't need a mathematical answer.

The first question is, is when you have capital, is it better to keep it or return it to shareholders? It's better to return it to shareholders when you cannot create more than a dollar of value with that capital. That's test number one.

And if you pass that threshold, that you think you can achieve more than a dollar of value for every dollar retained, then you simply look around for the thing that you feel the surest about, and that promises the greatest return weighted for that certainty.

So our cost of capital is, in effect, is measured by the ability to create more than a dollar of value for every dollar retained. If we're keeping dollar bills that are worth more in your hands than in our hands, then we've exceeded the cost of capital, as far as I'm concerned.

And once we think we can do that, then the question is, is how do we do it to the best of our ability? And frankly, all the stuff I see in business schools — and I've not found any way to improve on that formula.

Now the trouble that you may have is that many managements would be reluctant to distribute money to shareholders even if they would rationalize that they would do better than they actually do. But that's — that may be a danger on it, but that won't be solved by them hiring a bunch of people to come up with some cost of capital that also justifies them keeping the money, because that's what they'll do otherwise.

31. We prefer individual shareholders

WARREN BUFFETT: The question about recommending the stock, we very seldom had stock recommendations over the years. As I think back to 1965, I can't think of a lot of brokerage reports that have recommended Berkshire.

I'm not looking for any, you know, reports at all. We are not looking to have Berkshire sell at the highest possible price, and we're not looking to try and attract people to Berkshire who are buying stocks because somebody else recommends them to them.

We prefer people who figure out for themselves why they themselves want to buy Berkshire, because they're much more likely to stick around if they enter the restaurant because they decide it's the restaurant they want to eat at, than if somebody has touted them on it. And that's our approach.

So we do nothing to encourage. But I think even if we did, we probably wouldn't generate a lot of recommendations. It's not a great stock to get rich on, if you're a broker.

CHARLIE MUNGER: Yeah, I think the reason — (Laughter and applause)

I think one of the main reasons why it's so little recommended in the institutional market is that it's perceived as hard to buy in quantity. (Laughter)

WARREN BUFFETT: We prefer — we've got some good institutions as holders, including one that's run by a very good friend of ours, but frankly it's more fun for us to have a bunch of individual shareholders.

I mean you see it — it translates — if there's money made, it translates into changes in people's lives and not some change in somebody's performance figure for one quarter.

And we think that individuals are much more likely to join us with the idea of staying with us for as long as we stay around. And, you know, that's the way we look at the business.

Very few institutions look at investments that way, and, frankly, we think they're often less rational holders than we get with individuals.

32. "The earthquake doesn't know the premium you receive"

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Good morning. Good morning, gentlemen. I'm Hugh Stevenson (PH), a shareholder from Atlanta.

My question involves the company's super-cat reinsurance business. You've addressed some of this, but I would like for you to expound on it, please.

You've indicated that you think this is the most important business of the company. And my question is, what do you think the long-term impact of catastrophe bonds and catastrophe derivatives will be on the float and the growth in float of the company?

And I understand that the mispricing of risk in these instruments doesn't really affect the way you price your business, but I'm wondering how you think it can affect the volume of the business.

And I remember several years ago, Mr. Buffett, you talked about, you can never be smarter than your dumbest competitor.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: And these are some potentially dumb competitors.

WARREN BUFFETT: You've got it. (Laughter)

I just want to put an asterisk on one thing. We say insurance will be our most important business. We've not said the super-cat business will be our most important.

Super-cat has been a significant part of our business, and may well over the years remain a significant part, but it is far less significant than GEICO. And I'll mention a word or two about that.

But the super-cat business, you can price wrong, as I illustrated in my report. You can be pricing it at half what it should be priced at.

I used an illustration in the report of how you could misprice a policy that you should be getting, say, a million and a half for, namely a $50 million policy on writing — on something that had one chance in 36 of happening, so you should get almost a million and a half for it.

I said if you price it at a million a year, you know, you would think you were making money after ten years 70-odd percent of the time. The interesting thing about that is if you price it for a dollar a year you would have thought you made money 70-odd percent of the time, because when you are selling insurance against very infrequent events, you can totally misprice them but not know about it for a long time.

Super-cat bonds open up that field wide open. I mean you've always had the problem of dumb competitors, but you have a much more chance of having dumb competitors when you have a whole bunch of people who, in the case of hedge funds who have bought some of these, where the manager gets 20 percent of the profits in a year when there are profits and there is no hurricane, and when there happens to be a hurricane or an earthquake he doesn't take the loss. His limited partners do.

So it's very likely to be a competitive factor that brings our volume down a lot. It won't change our prices.

You know, the thing to remember is the earthquake does not know the premium that you receive. (Laughter)

I mean the earthquake happens regardless.

So it doesn't say — you know, you don't have somebody out there on the San Andreas Fault that says, "Well, he only charged a 1 percent premium so we're only going to do this once every 100 years." (Laughter)

Doesn't work that way.

So we will probably do a whole lot less volume in the next few years in the super-cat business. We have these two policies that run for a couple more years. But in terms of new business, we will do a whole lot less.

GEICO is by far the most important part of our insurance business, though. GEICO in the 12 months ended April 30th had a 16.9 percent increase in policies in force. Year-end, I told you it was 16.0. A year ago, I told you it was 10. Year before that, I think it was six and a fraction.

So its growth is accelerating and it should be in a whole lot more homes around the country than it is now, you know, by a big factor. And it will be, in my view. So that will be the big part of our insurance business.

But we may be in the insurance business in some other ways too as time goes along. It's a business that if you exercise discipline you should find some ways to make money, but it won't always be the same way.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

33. What Buffett wants in an annual report

WARREN BUFFETT: OK. Zone 2.

AUDIENCE MEMBER: Hello. I'm Steve Davis (PH) from San Francisco.

I'd like your advice on how to understand annual reports. What you look for, what's important, what's not important, and what you've learned over the years from reading thousands of reports? Thank you.

WARREN BUFFETT: Well, we've read a lot of reports, I will tell you that.

And we — well, we start by looking at the reports of companies that we think we can understand. So we hope to find — we hope to be reading reports — and I do read hundreds of them every year — we hope to be reading reports of businesses that are understandable to us.

And then we see from that report whether the management is telling us about the things that we would want to know about if we owned a hundred percent of the company.

And when we find a management that does tell us about those things, and that is candid in the same way that a manager of a subsidiary would be candid with us, and talks in language that we can understand, it definitely improves our feeling about investing in such a business.

And the reverse turns us off, to some extent. So if we read a bunch of public relations gobbledygook, you know, and we see lots of pictures and no facts, it has some effect on our attitude toward a business.

We want to understand the business better when we get through with the annual report than when we picked it up. And that is not difficult for a management to do if they want to do it.

If they don't want to do it, you know, we think that is a factor in whether we want to be their partners over a ten-year period or so.

But we've learned a lot from annual reports. For example, I would say that the Coca-Cola annual report over the last good many years is an enormously informative document. I mean, I can't think of any way if I'd have a conversation with Roberto Goizueta, or now Doug Ivester, and they were telling me about the business, they would not be telling me more than I get from reading that annual report.

We bought that stock based on an annual report. We did not buy it based on any conversation of any kind with the top management of Coca-Cola before we bought our interest. We simply bought it based on reading the annual report, plus our knowledge of how the business worked.

Charlie?

CHARLIE MUNGER: Yeah. I do think the — if you've got a standardized bunch of popular jargon that looks like it came out of the same consulting firm, I do think it's a big turnoff. That's not to say that some of the consulting mantras aren't right. But I think there's a lot — that for a sort of candid, simple, coherent prose — a lot to be said for it.

WARREN BUFFETT: Almost every business has problems, and we'd just as soon the manager would tell us about them.

We would like that in the businesses we run. In fact, one of the things, we give very little advice to our managers, but one thing we always do say is to tell us the bad news immediately. And I don't see why that isn't good advice for the manager of a public company.

Over time, you know, I'm positive it's the best policy. But a lot of companies, for example, have investor relations people, and they are dying just to pump out what they think is good news all the time.

And they have this attitude that, you know, you've got a bunch of animals out there to be fed. And that they're going to feed them what they want to eat all the time. And over time the animals learn.

So we've tried to stay away from businesses like that.

CHARLIE MUNGER: What you seldom see in an annual report is a sentence like this: "This is a very serious problem and we haven't quite figured out yet how to handle it." (Laughter)

But believe me, that is an accurate statement much of the time.

VOICE: — just a moment.

(Buffett leaves the table after someone tells him something in his ear.)

34. Munger goes it alone on Coke vs Pepsi

CHARLIE MUNGER: All right. Zone 3. (Laughter)

AUDIENCE MEMBER: I'm Leta Gurtz (PH) and I live in the area. And I would like to know what your prediction is for Coca-Cola's long-term growth versus Pepsi-Cola's recent efforts to increase the competitiveness with Coke?

CHARLIE MUNGER: Yeah. (Laughter)

Long-term, I would expect Coke to continue to gain versus Pepsi. (Laughter and applause)

(Buffett returns and sits down)

WARREN BUFFETT: What has he been doing while I was gone? What'd you say, Charlie? (Laughter)

I knew I was taking a chance. (Laughter)

What was the question?

CHARLIE MUNGER: I said that long-term I expected Coke to continue to gain versus Pepsi.

WARREN BUFFETT: Oh. Well. It's those kind of insights as to why we keep him on the job year after year. (Laughter)

In a moment of particular confidence, he one time told me the same thing about RC. (Laughter)

Now, that was probably zone 3 you were answering, so we'll go to 4.

What have you got there? You got peanut brittle?

CHARLIE MUNGER: Um-huh. (Laughter)

35. Ignoring asset gains at Coca-Cola

WARREN BUFFETT: Zone 4, please.

AUDIENCE MEMBER: Nat Chase (PH), Houston, Texas.

My first question's on the quality of earnings and your evaluation of quality of earnings in the U.S. right now.

And the second is, what multiples should be put on asset gains such as sale of bottling assets or reversal of merger reserves? Thanks.

WARREN BUFFETT: Yeah, well, taking the second question, for example, with Coca-Cola, the bottling transactions are incidental to a long-term strategy which, in my view, has been enormously successful to date, and which has more successes ahead of it.

But in the process of rearranging and consolidating the bottling system, and expanding to relatively undeveloped markets, there have been, and there will be, a lot of bottling transactions. And some produce large gains. Some produce small gains. I ignore those in my evaluation of Coke.

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

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

And that is what counts, in terms of the Coca-Cola Company. If you think the Coca-Cola Company's going to sell some multiples of its present volume 15 or 20 years from now, and you think there'll be a lot fewer shares outstanding, you've gone about as far as you need to go. But I would pay no attention to asset gains. I would just take those out of the picture.

36. Stock options and inflated earnings

WARREN BUFFETT: Now, as to quality of earnings, Charlie and I feel that, in several respects, but in one important respect, that the quality of earnings has gone down. Not because the policy has changed, but because it's just become more significant. And that's in the case of stock options.

We have — there are certain companies that we've evaluated for possible purchase where, in our calculation of earnings, the earnings are maybe 10 percent less per year per share than reported. And that isn't necessarily the end of the world, but it is a difference in valuation that is significant and is not reported under standard accounting.

So we think the quality of earnings as reported by a company with significant stock option grants every year, we think is dramatically poorer than for one where that doesn't exist. And there are a lot of companies that fall in that category.

Coca-Cola's earnings are very easy to figure out. Just figure out what they're, you know, what they're earning per case from operations, and you'll see over the years the earnings per case go up. And the cases go up and the shares go down. And it doesn't get much more complicated than that.

Charlie?

CHARLIE MUNGER: You've said it wonderfully. (Laughter)

I just wish we had more like that.

WARREN BUFFETT: Yeah.

GEICO, the key — I mean the same way. It's policies in force and underwriting experience per policy. And that is exactly the way, as noted in the annual report, we pay people there. We pay them, from the bottom to the very top, based on what happens with those two variables.

And we don't talk about earnings per share at GEICO, and we don't talk about investment income. We don't get off the track, because there are two things that are going to determine what kind of business that GEICO is over a long period of time. And policies at GEICO are unit cases at Coca-Cola.

37. Benjamin Graham and how Buffett would teach investing

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name's James Claus (PH) from New York City. And I just wanted to ask you a question.

Both you and Mr. Munger have repeatedly said that you don't believe that business valuation is being taught correctly at our universities, and as a Ph.D. student at Columbia Business School, that troubles me, understandably, because in a couple of years I'll be joining the ranks of those teaching business valuation.

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

WARREN BUFFETT: Well, I was lucky. I had a sensational teacher in Ben Graham, and we had a course there, there's at least one fellow out in the audience here that attended with me. And Ben made it terribly interesting, because what we did was we walked into that class and we valued companies.

And he had various little games he would play with us. Sometimes he would have us evaluate company A and company B with a whole bunch of figures, and then we would find out that A and B were the same company at different points in its history, for example.

And then there were a lot of little games he played to get us to think about what were the key variables and how could we go off the track.

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

But I would, you know, if I were teaching a course on investments, there would be simply one valuation study after another with the students, trying to identify the key variables in that particular business, and evaluating how predictable they were first, because that is the first step.

If something is not very predictable, forget it. You know, you don't have to be right about every company. You have to make a few good decisions in your lifetime.

But then when you find — the important thing is to know when you find one where you really do know the key variables — which ones are important — and you do think you've got a fix on them.

Where we've been — where we've done well, Charlie and I made a dozen or so very big decisions relative to net worth, but not as big as they should have been. And we've known we were right on those going in. I mean they just weren't that complicated. And we knew we were focusing on the right variables and they were dominant.

And we knew that even though we couldn't take it out to five decimal places or anything like that, we knew that in a general way we were right about them. And that's what we look for. The fat pitch. And that's what I would be teaching — trying to teach students to do. And I would not try to teach them to think they could do the impossible.

Charlie?

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

WARREN BUFFETT: Yeah, probably on the final exam I would take an internet company, and I would say the final exam, the question is, "How much is this worth?" And anybody that gave me an answer I would flunk. (Laughter)

CHARLIE MUNGER: Right. Right.

WARREN BUFFETT: Make grading papers easy, too. (Laughter)

38. Munger: Wesco is a "historical accident"

WARREN BUFFETT: OK, zone 6.

AUDIENCE MEMBER: Good morning. Laurence Balter (PH), Carlsbad, California. Question for the two of you.

There was an article, I think about last year in The New York Times, that regarded Wesco as a Berkshire Class C share-type company, and I'd like to know your comments on that.

And the second question is, if I were to write you a check for the operating businesses that Berkshire owns, how much would it have to be?

WARREN BUFFETT: Big. (Laughter)

Charlie is the resident expert on Wesco, so I'm going to let him address that side. He gets very eloquent on this.

CHARLIE MUNGER: Yeah. We always say that, per unit of book value, Wesco is worth way less than Berkshire, and indeed the market is saying the same thing. It is not a clone of Berkshire. It's a historical accident. (Audience mumbling)

WARREN BUFFETT: We want it to do well, obviously, for Wesco. We own 80 percent of it and we've got strong feelings about the people who are partners there, particular the Peters family, who, in effect, invited us in 20-odd years ago and trusted us to manage a big part of their money, in effect, by letting us buy control. So we've got strong fiduciary feelings about it.

It suffers in comparison with Berkshire because for one thing, anybody that wants a tax-free merger is going to want to come to Berkshire. You know, that's just the way it is, unfortunately.

And we are looking for big ideas, primarily, and the big ideas are going to fit into Berkshire.

We would love to get ideas that fit into Wesco, and we had a very good one a couple years ago, thanks to Roy Dinsdale pointing me in the right direction. And we added Kansas Bankers Surety to Wesco, and it's a gem. And it's run by Don Towle, who's done a terrific job.

But that's the exception, unfortunately. Because if a FlightSafety comes along, it's not going to fit Wesco.

So we will do our best for Wesco, but the nature of things is that most of the opportunities that make a lot of sense are going to come to Berkshire.

Charlie, do you have anything?

CHARLIE MUNGER: Nothing more.

39. Buy Berkshire or the stocks it buys?

WARREN BUFFETT: OK. Zone 7.

AUDIENCE MEMBER: My name is Bob Swanson (PH) from Phoenix.

And I'm wondering, what are the advantages of investing in Berkshire Hathaway as opposed to investing in the stocks that Berkshire owns?

WARREN BUFFETT: Well, a lot of people do one or the other and some people do both. But you have to really make up your own mind on that.

We're not going to go to great lengths to tell you about everything that Berkshire is doing as we go along, and there could be some changes, and there will be things that can happen in Berkshire that I think you would have trouble duplicating elsewhere.

But on the other hand, you know, if you'd put all your money in Coca-Cola some years back, you might have done better than if you'd put it in Berkshire.

So we really make no recommendations as to what people do with their money. We do not seek to become investment advisors through, in effect, our portfolio actions at Berkshire.

Charlie?

CHARLIE MUNGER: Amazingly, we hate it when people following us — follow us around buying what we buy. (Laughter)

WARREN BUFFETT: Nothing personal.

CHARLIE MUNGER: No. (Laughter)

40. Shareholders get info they need to value Berkshire

CHARLIE MUNGER: By the way, the questioner before this last one asked what is the market value under the hammer of all Berkshire's operating subsidiaries, and the answer is you have to figure that out yourself. (Laughter)

WARREN BUFFETT: Mr. Nice Guy. (Laughter) Zone —

But we give you the information, incidentally, where your judgment on it should be about as good as ours. There's nothing mysterious about valuing The Buffalo News, or See's Candy, or FlightSafety, or Dairy Queen. So you really have the same information we have in that.

I mean if there's material information that we aren't giving you about any important Berkshire subsidiary, we'd like to give it to you, because we think you are entitled to have the information. It enables you to value the various pieces.

Because of the aggregate size of Berkshire now, in terms of market capitalization and some of the positions we own, the smaller subsidiaries really cannot have that much effect. We love them just as much. I enjoy all of the businesses we're in and I enjoy the people that run them.

So, we don't make a — there's not — we don't differentiate in our attitude within the company, but in terms of the actual impact on the valuation of Berkshire, there are a number that really just don't make that much difference in terms of figuring out whether Berkshire's worth X or X minus a thousand or plus a thousand, because a thousand now is over a billion dollars, in terms of valuation. A billion is still a lot of money.

41. Three factors driving the bull market

WARREN BUFFETT: Area 8, please.

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger. My name is Robert McCormick, I'm from Holdrege, Nebraska.

And I would like to know how much you attribute the gains enjoyed by the stock market these past years to the baby boomer generation investing for their retirement?

WARREN BUFFETT: Yeah, I would say that, personally, I would not think that has much to do with it.

I think the two big factors are in — well, there's three big factors. One is the improved return on equity, which was a fundamental factor that pushed stock prices up.

Two is a decline in interest rates that pushed stock prices up.

And then finally, stock prices advancing, themselves, brings in buying. It doesn't go on forever, but it creates its own momentum, to some extent, if you have these underlying factors that started to push it along.

So I would say two of the three factors are fundamental and the third is a market-type factor that bull markets do feed on themselves, and I think that you've seen some evidence of that.

But I don't think that any specific — you know, the 401(k) factor or whatever it may be, was it by itself.

But I do think money is pouring into mutual funds, for example, because people have had a very favorable experience with those funds. And that does bring investors along. People want to be on the train.

Charlie?

And I think, incidentally, many of them have very unrealistic expectations.

CHARLIE MUNGER: Yeah. The general investment experience in the last, what, 18 years in common stocks has been awesomely high, I think by any past standards now, isn't that right, Warren?

WARREN BUFFETT: Right. Well you've had — since 1982 you've had roughly tenfold in the Dow, and probably similar in the S&P. With a huge amount of money and with more participants all the time.

And there are people coming into the market every day because they feel that they've missed the boat or they're coming in heavier than they came in before, simply because they've had a pleasant experience.

Past experience doesn't — does not mean much, in terms of what you should expect from your investments. You will do well in your investments because you own or bought things at the right price and the businesses behaved well from that point forward.

CHARLIE MUNGER: Well, you won't have 18 more years of 17 percent or 18 percent per annum. That I think we can virtually guarantee.

42. Buffett and Munger about equal at "goofing off"

WARREN BUFFETT: Area 9.

AUDIENCE MEMBER: Hello. I'm Tubby Stayman from Palm Beach, Florida.

I know you enjoy bridge very much. I know you play my late husband's convention.

Tell me, how often are you able to devote to this wonderful game? How many times a week do you play other than the internet?

WARREN BUFFETT: I didn't get all of that, Charlie? Did you?

CHARLIE MUNGER: How much bridge are you playing?

WARREN BUFFETT: Uh-oh.

AUDIENCE MEMBER: Yes. (Laughter)

WARREN BUFFETT: Well, this week — we should put this in the annual report, because it may be a material factor. (Laughter)

I'm probably — at least ten hours a week. Maybe a little more. I don't get any better by doing it, either, so it's rather discouraging, but it is a lot of fun. And it has to have come out of reading time.

I don't think it's hurt Berkshire yet, but that may be because we're in a slow period generally.

If the market goes down a lot, I promise to cut back on my bridge. (Laughter)

Charlie?

CHARLIE MUNGER: Yeah. Well, I probably play three or four hours a week. But I don't play on the internet.

WARREN BUFFETT: He plays a lot of golf, though. Confess Charlie.

CHARLIE MUNGER: Oh yes. (LAUGH)

WARREN BUFFETT: Yeah, we both spend about the same amount of time goofing off. I mean if you —(laughter) — want to know.

43. Defending Walt Disney-Capital Cities accounting

WARREN BUFFETT: OK. Area 10.

AUDIENCE MEMBER: Yes, my name is Cary Blecker (PH), also from West Palm Beach, Florida.

With all due respect to Mr. Eisner if he's in the audience, there's been some criticism levied recently at the Disney Company, mainly from an accounting professor at one of the state universities in New York, in reference to Disney's purchase of Capital Cities and the way they accounted for that purchase.

Basically, what this professor is saying is that Disney somehow created a slush fund and is charging the expenses to the merger to this slush fund rather than earnings.

If you're familiar with this criticism, I'm wondering what you think of it? And if you're not, are you familiar with the way Disney accounted for the purchase of Capital Cities?

WARREN BUFFETT: Yeah, I am familiar.

AUDIENCE MEMBER: Thank you.

WARREN BUFFETT: And actually, Abe Briloff, who wrote that, is a fellow who, in general, I admire.

Abe wrote me a letter not more than about three or four weeks ago and asked me to talk at a university where he teaches. And I wrote him back and I told him I wouldn't be able to do it because it's not in proximity to where I'll be.

And I told him — and he asked me about the Disney thing. And I told him I disagreed with him on —

I admire what Abe does in the attempt to have accounting reflect economic reality, but he and I don't see it exactly the same on some points, although we would agree on other points.

I think — I don't think Disney is a very complicated enterprise to evaluate. I mean there are — when Cap Cities bought ABC, there were purchase accounting adjustments, and they tend to wash through, to some extent.

I mean if you have programs that you're stuck on, you may write those down from what the previous carrying cost was. Maybe the previous management should have written them down, too, at that point. But I don't think that — I think with Disney, what you see now is what you get.

Charlie?

CHARLIE MUNGER: Yeah. I've got no great quarrel with the accounting at Disney. I think —

WARREN BUFFETT: Abe Briloff is a wonderful guy.

CHARLIE MUNGER: Yeah. He's got a good sense of humor and he generally fights the right demons, but I don't think you can criticize Disney's accounting.

WARREN BUFFETT: We certainly disagree with Abe, who, like I say, I agree with Charlie, he is a good guy.

But he — we disagree with him on amortization of intangibles entirely. So we would say that if Disney is charging, whatever it may be, probably 400 million a year for amortization of intangibles, which is not tax deductible, we would include that as a component of earnings.

So there might be some plusses and minuses that you'd make in adjustments, but I would say, by the time you add back amortization of intangibles that we would probably think the economic earnings of Disney might well be more than the reported earnings in the next few years.

44. Buffett wants accounting change

WARREN BUFFETT: I think that the intangible amortization question — which the FASB is looking at now — I think it should be changed. I mean I think it absolutely distorts economic reality, and I think that it influences whether people go to purchase, or accounting, or pooling, and they do all kinds of acrobatics to try and get pooling accounting.

And, you know, it shouldn't make that kind of difference in reported numbers, based on whether a transaction, which has exactly the same economics, is done through a purchase or pooling. But I have seen managements, some I know quite well, arrange to do things on a pooling basis that they think — where if they were private they would do it on a purchase basis.

And I think that's nuts. And I think if accounting is pushing people to doing things that are nuts, that it's time for accounting to look at itself.

I would say that — (applause) — net, the economic earnings of Disney, in our view, are somewhat higher than reported earnings.

45. I'll never know enough to buy tech stocks

WARREN BUFFETT: Zone 11, please.

AUDIENCE MEMBER: Good morning, Mr. Munger and Mr. Buffett. My name is Prakash Puram (PH) from Minneapolis.

There seem to be great values in the technology sector that meet most of your criteria and philosophy in investing, with the exception of the simplicity criterion. Names like IBM, Microsoft, HP, Intel.

Would you ever consider investing in companies in this sector in the future?

WARREN BUFFETT: Well, the answer is no, and it's probably pretty unfortunate, because I've been an admirer of Andy Grove and Bill Gates and, you know, I wish I had translated that admiration into backing it up with money.

But the truth is, I don't know where Microsoft or Intel — I don't know what that world will look like in 10 years.

And I don't want to play in a game where I think the other guys have got an advantage over me, and —

I could spend all my time thinking about technology for the next year and I wouldn't be the hundredth or the thousandth or the 10,000th smartest guy in the country in looking at those businesses.

So that is a seven or eight foot bar that I can't clear. There are people that can clear it, but I can't clear it. And no matter how I train, I can't clear it.

So, the fact that there will be a lot of money made by somebody doesn't bother me, really. And I mean there may be a lot of money made by somebody in cocoa beans, but I don't know anything about them.

And there are a whole lot of areas I don't know anything about. So, you know, more power to them.

And I think it would be a very valid criticism if Charlie and I — if it were possible that Charlie and I, by spending a year working on it, could become well enough informed so that our judgment would be better than other people's, but that wouldn't happen. And it would be a waste of time.

It's much better for us to swing at the easy pitches.

Charlie?

CHARLIE MUNGER: Whatever you think you know about technology, I think I know less. (Laughter)

WARREN BUFFETT: That's probably about true, incidentally. Charlie has a little more of — he understands some things in the physical world a lot better than I do.

46. We've "missed the boat" on share buybacks

WARREN BUFFETT: But anyway. We'll go to zone 1.

AUDIENCE MEMBER: Good morning. I'm Murray Cass from Markham, Ontario.

First off, against my dentist's advice, I'd like to thank you for the free Coke and ice cream last night. (Laughter)

Earlier this morning, Mr. Buffett, you mentioned that you liked when wonderful companies like Coke purchased their shares back.

Similarly, I own shares in a wonderful company, that's Berkshire. Should I be hoping that you buy your own shares back?

WARREN BUFFETT: Well, it's interesting, we should have — perhaps we should have bought some shares back, but usually at the time we could have bought something else that also did very well for us.

I mean maybe when we were buying Coke we could have been buying our own shares back. To some extent there hasn't been that much trading in it.

But I think it's a valid criticism to say that we have missed the boat at various times in not repurchasing shares.

We'll see what we do in the future on it. If it looks like the best thing to do with money, it's what we should be doing.

And in the past, I've probably been not optimistic enough in respect to Berkshire compared to other things we were doing with money.

Now, the money we spent buying the GEICOs and all of that has turned out to be a good use of money, too.

But we've never wanted to leverage up. That's just not our game. So we've never wanted to borrow a lot of money to repurchase shares. We might advise other people to do it, but we would — it's not our style ourselves.

We've got all our money in the company. We've got all of our friends' and our relatives' money virtually.

So we have never felt that we wanted to leverage up this company like it was just one of a portfolio of a hundred stocks.

But it's a valid criticism to say that we have not repurchased shares when we should have. And it's also a valid criticism to say that we've issued some shares we shouldn't have issued.

Charlie?

CHARLIE MUNGER: Oh, I would agree with both comments.

47. "Smile train"

WARREN BUFFETT: Area two.

AUDIENCE MEMBER: Fellow investors of Berkshire and Hathaway, Warren Buffett and Charlie Munger. I am from originally China. Now I have a company in Michigan.

I want to ask questions based on facts. I want to sell Coke, GEICO, and a little book called The Wizard of Omaha: The Investment Philosophy of Warren Buffett, in China. Through all the villages, the cities, little towns, I want to make that a reality. Cheers.

WARREN BUFFETT: Cheers. (Applause)

CHARLIE MUNGER: Cheers.

WARREN BUFFETT: Zone three. (Laughter)

AUDIENCE MEMBER: I have not asked the question.

WARREN BUFFETT: Oh, just warming up. OK. (Laughter)

AUDIENCE MEMBER: I will.

WARREN BUFFETT: They always tell me to get off the stage while you're in good shape, but I'll say it. (Laughter)

AUDIENCE MEMBER: I could (inaudible), but you missed your chance. (Laughter)

I'm a owner of Berkshire and I spent 6 percent of my net worth to be engaged to Berkshire.

WARREN BUFFETT: Wise decision. (Laughter)

AUDIENCE MEMBER: I did better than guess who? Bill Gates. I notice Bill Gates and you were traveling on a slow boat in China. I want to go home, on a fast train.

You want to cut me off?

VOICE: Do you have a question or —?

AUDIENCE MEMBER: If you want to cut off, fine. Up to the investors. (Applause)

I'll quit if you want to do that.

VOICE: Do you have a question? A question?

AUDIENCE MEMBER: I come long ways.

VOICE: OK. Ask your question.

AUDIENCE MEMBER: OK. I know I'm a problem for you. (Laughter)

VOICE: Not a problem. Just ask the question.

AUDIENCE MEMBER: But I'm here for a reason. Because I made some money, I'm go on a train. A smile train. Yesterday, or the day before, at the baseball I asked Mr. Warren Buffett, "Have you heard of the smile train?" He said, "No." I'm back here to respond. This is a smile train.

WARREN BUFFETT: OK, we thank you. But I think that's your question.

48. Why Buffett bought silver

WARREN BUFFETT: We'd better go to zone 4, I think. (Applause)

AUDIENCE MEMBER: Good morning, or afternoon, actually. My name's Matt Schwab. I'm from New York. Pound Ridge, New York.

I actually had a question about the silver purchase last year. When you announced it, you said that you believed that supply and demand fundamentals would only be established at a higher price — re-established at a higher price.

I was just wondering if you could go into more detail about what some of those fundamentals are. I mean, we've read a lot about, like, battery technology and some other things.

WARREN BUFFETT: Yeah, we have no inside information about great new uses for silver or anything of the sort. But the situation — and you can get these figures and they're not precise, but I think they're in general — they're generally accurate.

You can see from looking at the numbers that aggregate demand, primarily from photography, from industrial uses, and from ornamental jewelry-type uses, is close. Call it 800 million-plus ounces a year.

And there are 500 million or so ounces being produced of silver, annually, although there will be more coming on in the next couple of years. There's more coming on right now.

However, most of that silver is produced as a byproduct in the mining of gold or copper and lead zinc, so that since it's a byproduct, it's not responsive to — not very responsive to price changes, because obviously, if you've got a copper mine and you get a little silver out of it, you're much more interested in the price of copper than silver.

So you have 500 million ounces or so of mine production, and you have 150 million ounces or so of reclaimed silver, a large part of which relates to the uses in photography.

So there's been a gap in recent years of perhaps 150 million ounces — but none of these figures are precise — which has been filled by an inventory of bullion above ground, which may have been a billion-two, or more, ounces a few years back, but which has been depleted.

And no one knows the exact figures on this, but there's no question that the bullion inventory has been depleted significantly.

Which means that the present price for silver does not produce an equilibrium between supply, as measured by newly-mined silver plus reclaimed silver, and usage.

And that — eventually something will happen to change that picture. Now, it could be reduced usage, it could be increased supply, or it could be a change in price.

And that imbalance is sufficiently large, even though there is some new production coming on, and there's the threat of digital imaging that will reduce silver usage, perhaps, in the future in photography.

But we think that that gap is wide enough so that it will continue to deplete inventories — bullion inventories — to the point where a new price is needed to establish equilibrium.

And because of the byproduct nature, which makes the supply inelastic, and because of the nature of demand, which is relatively inelastic, that — we don't think that that price change would necessarily be minor.

It's interesting, because silver has been artificially influenced for a long time. You saw that movie about — you know, it was William Jennings Bryan, who was editor of The Omaha World-Herald and a congressman from Nebraska — and his brother was governor of Nebraska — who was the big silver man.

And they used to talk 16-to-1. The 16-to-1 ratio, I think, goes back to Isaac Newton, when he was master of the mint. Charlie will know all about that, because he's our Newtonian expert here. But that ratio had kind of a mystical significance for a while. Didn't really mean anything.

And in 1934, the government passed an act called The Silver Purchase Act of, surprisingly, 1934, which set an artificially high price for silver at that time, when production and usage was much less.

And the government, U.S. government, ended up accumulating two billion ounces of silver. Now, this was at a time when demand was a couple hundred million ounces a year, so you're talking ten years' supply.

So there was an artificially high price for a while. By the early 1960s, that became an artificially low price of $1.29, and at that time I could see the inventories of the U.S. government being depleted, somewhat akin to what inventories are being depleted now.

And despite the fact that Lyndon Johnson and the administration said they would not demonetize silver, they did demonetize it, and silver went up substantially. That was the last purpose we had of silver, but I've kept track of the figures ever since.

The Hunt brothers caused a great amount of silver to be converted into bullion form, including a lot of silver coins. So they, again, increased the supply in a very big way by their action in pushing the price way up to the point where people started melting it down.

So you had this — dislocations in silver over a 60-plus year period, which has caused the price to be affected by these huge inventory accumulations and reductions.

And we think right now that — or we thought last summer when we started buying it — that the price we bought it, that that was not an equilibrium price, and that sooner or later — and we didn't think it was imminent, because we don't wait till things are imminent.

You know, we were going to buy a lot of silver. We didn't want to buy so much as to really disrupt the market, however. We had no intention of replaying any Hunt scenario. So we wanted to be sure we didn't buy that much silver. But we liked it.

Charlie?

CHARLIE MUNGER: Well, I think this whole episode will have about as much impact on Berkshire Hathaway's future as Warren's bridge playing. (Laughter)

You've got a line of activity where once every 30 or 40 years you can do something employing 2 percent of assets. This is not a big deal for —

WARREN BUFFETT: No.

CHARLIE MUNGER: — Berkshire. The fact that it keeps Warren amused and — (Laughter)

WARREN BUFFETT: Yeah, I do like —

CHARLIE MUNGER: — and not doing counterproductive things — (Laughter)

WARREN BUFFETT: It makes me feel good about — it makes me feel better about all those pictures that people take over the weekend. (Laughs)

They all use a little bit of silver. (Laughter)

CHARLIE MUNGER: At least it shows something that teaches an interesting lesson. Think of the discipline it takes to think about something for three or four decades, waiting for a chance to employ — (laughter) — 2 percent of your assets.

I'm afraid that's the way we are. (Laughter)

It means there'll be some dull stretches.

WARREN BUFFETT: Right. Yeah, it's less than a billion dollars in silver. It's $15 billion in Coke. You know, it's a —

CHARLIE MUNGER: It's a non-event.

WARREN BUFFETT: It's 5 billion in American Express. I mean it is close to a non-event, but if you see it there — you know?

CHARLIE MUNGER: At least it shows the human personality at work. (Laughter)

Very peculiar personality, I might add. (Laughter)

WARREN BUFFETT: Reinforced by a partner.

CHARLIE MUNGER: Yes. (Laughter)

49. I only talk to students

WARREN BUFFETT: OK, let's go to area five.

AUDIENCE MEMBER: My family is a Class B shareholder. Thank you for issuing those shares.

I have one observation and one question. Your Class B share is creating a new phenomenon in this country. These "baby shares" are not only attracting my baby boomer generation, but also X generation and (inaudible) generation, your grandchildren.

My question is, this next generation would like to hear from you your investment discipline, your lifestyle, and your philosophy of contributing the wealth back to the society in a language they can understand and communicate back to their friends when they get back to school on Tuesday. Thank you.

WARREN BUFFETT: Thank you. (Applause)

Well, I appreciate that, and I would say the only speeches I give — I get a lot of requests, perhaps because I don't do them. But I get a lot of requests, including from a lot of our managers, in terms of trade conventions, all kinds of things.

I don't do — the only groups I talk to are students. And I try to talk to college and university students, although I talk to high school students, too. Whenever it fits, in terms of travel schedules.

And I just think that if you're going to spend your time with groups talking, that rather than entertain people, that it probably is better to talk to the group you talked about.

Charlie and I are never reluctant to talk, so we do it. Charlie has given a couple of talks. One I sent you a few years ago from USC, but there's been another one recently that I think everybody would profit by reading.

So, it was reprinted in the Outstanding Investor Digest, but if you write Charlie, I'm sure he'll send you a copy.

50. If forced to choose, we'd keep the operating businesses

WARREN BUFFETT: Area six, please.

AUDIENCE MEMBER: Hi, my name is David Oosterbaan. I'm from Kalamazoo, Michigan.

This is a hypothetical question about Berkshire. It's going to take a little imagination, I think.

The scenario is as follows, that the U.S. Justice Department makes a ruling that Berkshire must split into two parts immediately. You and Mr. Munger must decide which part to keep.

You can either choose your marketable securities, Coke, Gillette, Disney, et cetera, or you can choose your insurance and private businesses. Which one do you choose and why?

WARREN BUFFETT: Well, that's an easy question for me. I would choose the operating businesses anytime, because it's more fun.

And I have a good time out of the investments too, but I like being involved with real people, in terms of the businesses where they're a cohesive unit that can grow over time, and —

You know, I wished we owned all of Disney or Coca-Cola or Gillette, but we aren't going to. So if I had to give up one or the other, I'd give up the marketable securities.

But it's not going to happen, so we're going to be happen in both arenas, and I look forward to being in both arenas for the rest of my life.

Charlie?

CHARLIE MUNGER: Well, I'll be in a hell of a fix if I am not in the same arena. (Laughter)

WARREN BUFFETT: We'd both be in a hell of a fix.

CHARLIE MUNGER: Yeah, yeah.

51. We'd be fine even if our top 25 execs all dropped dead

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: Yes, hello to Mr. Munger and Mr. Buffett. My name is Jerry Gonzalez (PH) from Plantation.

My question is, what are your recommendations of Berkshire Hathaway if Charlie Munger were in charge, or your third man in charge — your third man, which I think you said, is the CEO of GEICO, what are your recommendations?

WARREN BUFFETT: I missed that.

JERRY GONZALES: If Charlie Munger were to stay in charge fully, 100 percent, or your third man, the CEO of GEICO.

CHARLIE MUNGER: Well, in due course this corporation will have a change in management. I'm afraid we have no way of fixing that. (Laughter)

But we do not — apart from making sure we've got good options and having some system in place, we are not obsessing about a future management yet.

WARREN BUFFETT: No. The directors —

CHARLIE MUNGER: Warren plans to live almost indefinitely.

WARREN BUFFETT: Absolutely. (Laughter)

Although I must say, at my last birthday somebody asked me how old I was. And I said, "Well, why don't you just count the candles on the cake?" And he said he was driven back by the heat, so — (Laughter)

But we're not going to leave willingly.

And we do — the directors know who — they have a letter that says who we think should be the ones to succeed us at both the operating aspect and the investment allocation aspect. And those letters can change over time as we keep hanging around.

But I don't worry about the fact that 99 percent-plus of my estate will be in Berkshire Hathaway stock or that a foundation will eventually receive that stock. So it doesn't bother me in the least. I can't think of a place I'd rather have it.

And that includes my appraisal of the managers that we have who can step in and do what Charlie and I do. And who knows, one of them may even understand technology. (Laughter)

CHARLIE MUNGER: I think this place would have very respectable prospects if the top 25 managers all dropped dead at once.

WARREN BUFFETT: Well, that's not an experiment we intended to pursue. (Laughter)

CHARLIE MUNGER: No, but I see no reason to think it wouldn't continue to do quite well.

WARREN BUFFETT: Right.

CHARLIE MUNGER: It's been lovingly put together to have a certain margin of safety.

WARREN BUFFETT: Right. We actually — if we have a choice, it's number three through 23, though — 25 — that we're interested in. (Laughter)

52. "Honesty will only do so much for you"

WARREN BUFFETT: OK. Area 8, please.

AUDIENCE MEMBER: This is Raul from Walnut Creek, California.

Thanks Mr. Buffett, thanks Mr. Munger, thanks for your great company. I wish I had known about it 10 years ago. You are not only the greatest but the most honest. I want to commit 99 percent of what I have to Berkshire Hathaway, and I will.

The question I want to ask is, how do you calculate the intrinsic value of the company? And based on intrinsic value, to me, Berkshire Hathaway looks a great bargain at these prices, especially based on look-through earnings. Is that true?

And one last question I want to ask, just for fun. What do you think about telecom IPOs like Qwest, (inaudible)? They seem to pop up 50 percent at opening. Does it make any sense to invest in these? Thank you very much.

WARREN BUFFETT: Charlie, you want to tackle that?

CHARLIE MUNGER: I didn't follow that all.

Intrinsic value, we give you the facts and you make your own conclusions.

I like the fact that you think we're honest, but, you know, if you people keep bidding up the price of our stock, honesty will only do so much for you in the future. (Laughter)

WARREN BUFFETT: Yeah, we've never been tested. I mean we're very lucky. We've never had anything that we needed, really, that we haven't had.

And, you know, who knows what the situation would be if your family was starving or something? So our intention is to continue the position where we'll never be tested, too, I might add.

53. Intrinsic value: "Easy to say and impossible to figure"

WARREN BUFFETT: The intrinsic value question. I mean, by definition, intrinsic value is the present value of the stream of cash that's going to be generated by any financial asset between now and doomsday.

And that's easy to say and impossible to figure, but it's the kind of thing that we're looking at when we look at a Coca-Cola, where we think it's much easier to evaluate the stream of cash that comes in the future than it is in a company such as Intel, marvelous as it may be. It's easier for us. Andy Grove may be better at figuring out Intel than Coke.

And in Berkshire, it is complicated by the fact that we have no business that naturally employs all of the capital that flows to us, so it is dependent, to some extent, on the opportunities available and the ingenuity used when that cash pours in, as it does.

Some businesses have a natural use for the cash. Actually, Intel has a good natural use for the cash over time as they've expanded in their business. And many businesses do.

But we do not have a natural use. We have some businesses that use significant amounts of cash. FlightSafety will buy a lot of — build a lot of simulators this year and they cost real money.

But in relation to the resources available, we have to come up with new uses, new ways to use cash. And that makes for a more difficult valuation job than if you've got — well, the classic case used to be a water or electric utility where the cash could be deployed and the return was more or less guaranteed within a narrow range, and it was very easy to make calculations then as to the expectable returns in the future.

But that's not the case at Berkshire. We've got very good businesses, both directly and partially owned. And those businesses are going to do well for a long, long time.

But we do have new cash coming in all the time, and sometimes we have good ideas for that cash and sometimes we don't. And that does make your job more difficult, in terms of computing intrinsic value.

We'll have — yeah, we're going to break after the next question. At that time — we break whenever Charlie and I run out of candy up here, actually. (Laughter)

We're going to let everybody — you can get something to eat, if you want to stick around, and we will be here till 3:30 when we reconvene at 12:30.

And those of you who have been with us this morning and had enough, we thank you for being here this weekend. We've had a terrific time with you, so I'm very appreciative of that.

54. "Multiple models is the game" for Munger

WARREN BUFFETT: Let's have a question from zone 9 and then we'll go to lunch.

AUDIENCE MEMBER: Good morning. My name's Frank Gurvich (PH). I'm a shareholder from London, Ontario in Canada.

My question is for Mr. Munger, and it concerns his models. And the question specifically is related to market valuation. I know I'm not going to get a prediction. That's not your bag.

What I'm curious about, is there any specific touchstone models that you reflect upon in trying to gain perspective at these markets where the historic valuations are quite high? And why do you draw on those models?

And my second question is for Mr. Buffett and it relates to taxation. If you were able to trade your portion of your portfolio, at least, in a tax-exempt fashion, like 401(k) plans, or in Canada, the RSP plans, would you possibly trade more actively?

WARREN BUFFETT: Charlie, you want to answer yours first?

CHARLIE MUNGER: Yeah. Well, the Munger system for dealing with reality is to have multiple models in the head, and then run reality against multiple models.

I think it's a perfect disaster to look at reality through just one model or two. It's —

There's an old proverb that says, "To the man with only a hammer, every problem looks pretty much like a nail." (Laughter)

And that is not our system. So I can't sit here and run through all the models in my head, even though there aren't that many. But multiple models is the game.

55. Buffett: Taxes don't bother me

WARREN BUFFETT: The question about taxation. It would not — if we were running Berkshire absent a capital gains tax, I don't think it would make much difference in what we do. I don't think it would make — certainly it wouldn't make a difference in causing us to trade actively.

We own the businesses we want to own. We don't own them because taxes have restrained us from selling them.

And as I mentioned earlier, I'm fairly sure we'll pay at least a billion dollars in income tax this year. We might not, but it looks that way to me, that we'll pay a billion dollars.

And I could do things that at least deferred, and perhaps — and I certainly could do things by doing nothing — that avoided paying that billion in tax, or a good bit of the billion, call it 800 million of the billion. But that is not a big factor with me. It's never been a big deal with me.

I paid my first income tax when I was 13, so I guess I got brainwashed at the time. And it doesn't bother me a lot to be paying taxes. I think, net, personally, I'm under-taxed in relation to what the society has delivered to me, and, you know, I don't send along any voluntary payments to I.R.S., I want you to understand. (Laughter)

But I really do. I mean, there's nobody I want to trade places with because their tax situation is better than mine. So it would not increase the activity.

56. Looking for owners who love their business more than money

WARREN BUFFETT: I've been asked to take one more question from zone 10. I'm not sure why, but maybe because they see that I still have candy up here. (Laughter)

So zone 10, please, and then we'll break.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my name is Sanjiv Mirchandani, shareholder from Boston.

First of all, thank you to both of you for everything. I have two questions.

For you, Mr. Buffett, you obviously have filters that you apply on selecting people as you do on stocks. Can you tell us a little bit about what those filters are?

WARREN BUFFETT: Filters on people?

AUDIENCE MEMBER: Yes, in selecting — you have an ability to motivate people who have a lot of money to keep working. What do you look for to figure out who those people are?

WARREN BUFFETT: Well, that's a key, key question, because when we buy businesses we don't have managers to put in them. I mean we are not buying them that way. We don't have a lot of MBAs around the office that we're —

CHARLIE MUNGER: Thank God.

WARREN BUFFETT: Yeah. (Laughter)

And, you know, I have not promised that they're going to have all kinds of opportunities or anything.

So as a practical matter, we need management with the businesses that we buy. And three times out of four, thereabouts, the manager is the owner and is receiving tens of millions, maybe hundreds of millions of dollars. So they don't have to work.

And we have to decide in that time when we meet them whether they love the business or love money. And we're not making a moral judgment. Charlie may, but I'm not making a moral judgment about whether it's better to love the business or love money, but it's very important for me to know which of the two is the primary motivator with them.

And we have had extremely good luck in identifying people who love their business. And so all we have to do is avoid anything that, on our part, that diminishes that love of the business or makes other conditions so intolerable that they overcome that love of the business.

And we have a number of people working for us, they have no financial need to work at all. And they probably outwork, you know, 95 percent or more of the people in the world, and they do it because they just love smacking the ball. And we almost — we virtually had no mistakes in that respect.

And we have identified a number of people, Charlie and I have, in terms of proposals to us, where we've felt that they did really — they liked the money better than the business. They were kind of tired of the business. You know?

And they might promise us that they would continue on and they would do it in good faith, but something would happen six months later or a year later and they'd say to themselves, "Why am I doing this, you know, for Berkshire Hathaway when I could be doing," whatever else they want to do?

I can't tell you exactly how we — what filter it is that we put them through mentally, but I can tell you that if you've been around a while, you can — I think you can have a pretty high batting average in coming to those conclusions. As you can about other aspects of human behavior.

I'm not saying you can take a hundred people and take a look at them and analyze their personalities or anything of the sort. But I think when you see the extreme cases, the ones that are going to cause you nothing but trouble, or the ones that are going to bring you nothing but joy, I think you can identify those pretty well.

Charlie?

CHARLIE MUNGER: Well, yeah, I think it's pretty simple. You've got integrity, intelligence, and experience, and dedication. And that's what human enterprises need to run well, and we've been very lucky in getting this marvelous group of associates to work with all these years.

It would be hard to do better, I think, than we've done on that respect.

Look around this place. I mean, and really, you young people look around this place. And look at how much gratification can come into these lives which have been mostly spent in deferring gratification. It's a very funny group of people, you shareholders. (Laughter)

Afternoon Session - 1998 Meeting

1. When is it time to buy a house?

WARREN BUFFETT: Let's settle down please and we'll —

We're going to go to — we skipped one last time so we're going to go first to zone 4.

AUDIENCE MEMBER: Hello. My name's Nelson Arata (PH), I'm from Southern California.

And I have a question. It's not really related to intrinsic value or any of that stock stuff, but more on — (laughter) — houses.

I'm still quite young, I don't have a house yet and I'm thinking about buying a house someday soon. And in order to do that I'm going to have to put a down payment, which means I might have to sell my shares.

And I was wondering if you can provide some insight on when is the best time to buy a house and how much down payment — (laughter) — you should be putting down, in relation to interest rates and also in relation to available cash and the stock market.

WARREN BUFFETT: Well, Charlie's going to give you an answer to that in a second. I'll just relay one story, which was when I got married we did have about $10,000 starting off, and I told Susie, I said, "Now, you know, there's two choices, it's up to you. We can either buy a house, which will use up all my capital and clean me out, and it'll be like a carpenter who's had his tools taken away for him. (Laughs)

"Or you can let me work on this and someday, who knows, maybe I'll even buy a little bit larger house than would otherwise be the case."

So she was very understanding on that point. And we waited until 1956. We got married in 1952.

And I decided to buy a house when it was about — when the down payment was about 10 percent or so of my net worth, because I really felt I wanted to use the capital for other purposes. But that was a way different environment in terms of what was available to buy.

In effect, if you have the house you want to buy, you know, I definitely believe in just going out and probably getting the job done. But in effect, you're probably making something in the area of a 7 or 8 percent investment, implicitly, when you do it. So you know, you'll have to figure out your own equation from that.

Charlie probably has better advice on that. He's a big homeowner — (laughter) — in both senses of the word.

CHARLIE MUNGER: I think the time to buy a house is when you need one. (Laughter)

WARREN BUFFETT: And when do you need one?

CHARLIE MUNGER: Well, I have very old-fashioned ideas on that, too. The single people, I don't care if they ever get a house. (Laughter)

WARREN BUFFETT: When do you need one if you're married, Charlie? I'll follow up for the — (Laughter)

You need one when your wife wants one.

CHARLIE MUNGER: Yeah, yes. (Laughter) I think you've got that exactly right. (Laughter)

VOICE: Mr. Buffett?

WARREN BUFFETT: Yeah.

VOICE: May I make an announcement?

WARREN BUFFETT: Sure.

VOICE: Gregory Crawford needs to go to the security office, please, for emergency message. Gregory Crawford to the security office for emergency message. Thank you.

WARREN BUFFETT: OK, hope it isn't a margin call. (Laughter)

2. Executive compensation: Buffett slams big money for mediocrity

WARREN BUFFETT: OK, we'll go to zone 1, please.

AUDIENCE MEMBER: I'm Ralph Bedford (PH) from Phoenix, Arizona.

The question I'm going to ask does not pertain to Berkshire Hathaway, but I would appreciate it if you gentlemen, if you can, explain the justification and rationalization for the exorbitant salaries, bonuses, perks, directors' fees, and other benefits that most public corporations are paying. (Applause)

WARREN BUFFETT: I would say this. In my own view, the most exorbitant are not necessarily the biggest numbers. What really bothers me is when companies pay a lot of money for mediocrity, and that happens all too often.

But we have no quarrel in our subsidiaries, for example, for paying a lot of money for outstanding performance. I mean, we get it back 10 or 20 or 50-for-1.

And similarly in public companies, we think that there have been managers — in our managers — who have taken companies to many, many, many billions of market value more than would've happened with virtually anyone else.

And they sometimes take a lot of money for that. Sometimes, as in the case of Tom Murphy at Cap Cities, you know, it just didn't make a difference to him.

I mean, he performed in a way that would justify — would have justified huge sums, but it wasn't — he would tell you that he had all the money he needed and he just didn't care to take what the market might bear.

But I am bothered by irrational pay systems. And I'm particularly bothered when average managers take really large sums.

I'm bothered when they design, or have designed for them, systems that are very costly to the company — maybe partly to make themselves look good because they want huge options themselves, so they feel if they give options widely throughout the company — so they design a system that is illogical company-wide because they want one that's illogical for them personally.

But large sums, per se, don't bother me. I'm not saying, you know, whether any individual should — might want to take them or not. But I do not mind paying a lot of money for performance.

It's done in athletics, it's done in entertainment, but in business the people who are the .200 hitters and the people who would not attract a crowd as an entertainer have worked it out so that — I mean, the system has evolved in such a way that — many of them take huge sums. And I think that's obscene, but I can tell you, there isn't much you can do about.

The system feeds on itself. And companies do look at other companies' proxy statements, every CEO does. And they say, "Well, if Joe Smith is worth X I have to be worth more." And they tell the directors that, "Certainly you wouldn't be hiring anybody that was below average, so how can you pay me below average?" And the consultants come in and ratchet up the rewards.

And it's not anything that's going to go away. It's like we were talking about campaign finance reform earlier. The people who have their hands on the switch are the beneficiaries of the system. And it's very hard to change the system when the guy whose hand is on the switch is benefitting enormously, and perhaps disproportionately, from that system.

Charlie?

CHARLIE MUNGER: Well yeah, I'd like to report that the original Vanderbilt behaved even better than the people at Berkshire Hathaway. He didn't take any salary at all. He thought it was beneath him as a significant shareholder to take a salary. That ideal, I'm afraid, died with him. (Laughter)

WARREN BUFFETT: Yeah, Charlie and I — our directors are paid $900 a year, but I tell them on an hourly basis they're making a fortune because we don't work them that hard. (Laughter)

But Charlie and I did not think through, when we established that $900 a year, is that they set our salaries, too, so — (Laughter)

We have not followed the standard procedure, which is to load it on the directors, and the directors shall load it on you.

CHARLIE MUNGER: I do think it will have pernicious effects for the country in its entirety as this thing keeps escalating, because I think you're getting a widespread perception that at the very top, corporate salaries in America are too high. And that is not a good thing for a civilization, when the leaders are regarded as not dealing fairly with the institutions that they head.

WARREN BUFFETT: Yeah. If — (Applause)

CHARLIE MUNGER: And as for the corporation consultants who advise on salaries, all I can say is that prostitution would be a step up for them. (Laughter)

WARREN BUFFETT: Put him down as undecided. (Laughter)

3. Class B stock "worked out as well as possible"

WARREN BUFFETT: Zone two, please.

AUDIENCE MEMBER: I'm Dan Blum (PH), from Seattle, Washington via Cambridge, Massachusetts.

I want to ask whether the issuance of Class B stock has achieved the objective which you announced for it, when it was created.

WARREN BUFFETT: Well, I would say this, that considering the alternatives we faced, which was the imminence of unit trusts that would've been promoted with heavy front-end commissions, with substantial annual fees, with bad tax consequences, and with, probably, a misrepresentation of the historical record in such a way that people who really didn't know much about securities would've been enticed in — with that as an alternative I think the B stock was the best thing we could've done, and I feel good about how it's worked out.

I think that, you know, we didn't set out to issue it. We don't like talking anybody into buying our stock. But I don't think in any way that the group we have here is diminished in the least by having a mix of B and A shareholders, as opposed to A only.

The B has worked out as well as possible. I hope that, you know, we haven't enticed anybody in with unreasonable expectations. That's the biggest thing that Charlie and I worry about. And it's hard not to have that happen with the historical record. I know it would've happened in a big way with the unit trust.

So, you know, it's like making the mistake originally of starting with Berkshire, I think. We enjoy things as they come along and we've gotten a good group with the B shareholders, and we're happy with the present situation.

Charlie?

CHARLIE MUNGER: Yeah, we wanted to step hard on what we regarded as a disreputable financial scheme, and that we did. And — (Laughter)

WARREN BUFFETT: And I think the way we sold the B was such as to not — as to attract the kind of people who really did look at it on a long-term basis. We did everything we could to discourage people who thought they were going to make a lot of money in a hurry.

So I think we attracted a whole new group of shareholders who are quite similar in perspective to the shareholder group that we already had, and that was our hope.

4. Berkshire's investing minimum

WARREN BUFFETT: Zone 3, please?

AUDIENCE MEMBER: My name is Alan Rank from Pittsburgh.

I first want to thank Susan Jacques for returning the cocktail yesterday, and I hope she was rewarded with good sales at Borsheims.

Question is regarding the fact that you don't report details of anything under $750 million, and with the change of the values of small-cap in relation to large-cap, would that be something that Berkshire or individuals might try to look as opportunity with the small-cap premium shrinking, as it has?

WARREN BUFFETT: We don't worry about whether a stock is small-cap or large-cap except to the extent that by now we've gotten to a point where anything below a certain level just is not of interest to us because it can't be material to our results, so —

We never think of opportunities as existing because something is small-cap, or sectors, or all that, you know, what generally gets merchandised.

So our cutoff point is set more or less at the point where we think it's material. That's not as defined by the SEC, we could have a higher limit.

But we think when you get down below 2 percent of assets or thereabouts that the reporting of positions would not affect anybody's calculation of intrinsic value or give them insights about the way we run the business, but it would be more for the people who were looking for things to piggyback on.

And so we will move the cutoff point up as we go along. Because of our size, we will never be in companies that have capitalizations that, you know, of a half a billion or a billion dollars, because we just can't put enough money in it. Occasionally we'll be in one just by accident.

But we're looking at things that we can put $500 million in ourselves, at least. At 500 million, a 5 percent position has a $10 billion market cap.

That limitation has hurt, will hurt, is hurting, our performance to some degree. You would — if Berkshire were exactly 1/100th of its present size in all respects, owning the operating businesses it did but all 1/100th the size, our prospects would be better than they are with the kind of money we have presently.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

5. "Sandy Weill is a very, very good manager"

WARREN BUFFETT: OK. Zone four, please.

AUDIENCE MEMBER: OK. My name is Tom Conrad (PH), I'm from McLean, Virginia.

I just wanted to first thank you, Mr. Buffett and Mr. Munger, for each year answering our questions. I found myself at 5 a.m. standing outside the door here, and I don't do that for anyone. (Laughter)

And it's a real pleasure to hear your answers. I have two questions.

One is, with Travelers, the company Travelers, and their merger with Citibank, do you have confidence in the management of Sandy Weill?

My second question is, you said it in a few meetings ago that diversification is a protection against ignorance. And it only takes three great companies to be set for an investment lifetime. And I invested in those three companies: Coca-Cola, Gillette, and Disney.

And I went ahead and invested in a fourth company without asking you. I invested in Pfizer. And I just wonder what you think about the pharmaceutical industry, if you feel there's some great companies in that industry. Thank you very much.

WARREN BUFFETT: Yeah. Well, A) we think Sandy Weill is a very, very good manager. Sandy is — I mean, the record is clear. It is not easy to manage in Wall Street, and Sandy has done an excellent job there as well as in other allied, or somewhat allied, fields. So his record is proven.

And he has been (inaudible) ever since buying Commercial Credit from Control Data. He's built a terrific company.

And he built a terrific company in businesses that themselves aren't necessarily so terrific, so it's required real management skill.

6. Pharmaceutical stocks: "We stupidly blew that one"

WARREN BUFFETT: Pharmaceuticals, we missed. We would not have known how to pick out any single business, but we — single company — within the industry, but we certainly should've recognized — did recognize, didn't do anything about it — that the industry as a whole represented a group that would achieve good returns on equity, and where some sort of a group purchase might've made sense.

We did buy one a while back, but we didn't — it was peanuts. And it would of been — it was within our circle of competence to identify the industry as likely to enjoy very high profits over time. It would not have been within our circle of competence to try and pick a single company.

Charlie?

CHARLIE MUNGER: Yeah, we stupidly blew that one. (Laughter)

WARREN BUFFETT: We'll blow more, too. (Laughter)

7. Decentralization "just short of total abdication"

WARREN BUFFETT: Zone five.

AUDIENCE MEMBER: Yes, sir. Good afternoon. My name is Matt Lovejoy from Lexington, Kentucky. And gladly, I'm not a consultant. (Laughter)

I have a question, sir, Mr. Buffett, about your operating management style. In my opinion, the mainstream media minimizes the significance of your nonpublic operating investments.

When you consider capital allocation in these companies, do you have the managers submit annual business plans? And if so, do you formally meet with those managers to see how well you can track progress against those plans?

WARREN BUFFETT: Yeah, that's a good question. And the answer is that we may meet with some of them annually, we may meet with others semiannually, but we have no formal system whatsoever, and we will never have a formal system. We don't demand any meetings of any of our managers. We have no operating plan submitted to headquarters.

Some of the companies use operating plans themselves, some of them don't. They are all run by people who have terrific records, and they have different batting styles. And we're not about to tinker with somebody that's batting with .375 just because somebody else holds the bat a little differently or uses a different weight bat, or something of the sort.

So we believe in letting them do, currently and in the future, what has been successful for them in the past.

And different people have very different styles. I've got my own style, you know?

But we have managers that like to talk things over, we have other managers that like to go their own way. And we have managers that have a by-the-book approach which works well, we have other managers who wouldn't dream of that. We have managers that — most managers probably have monthly statements of financials. We have other managers that don't.

And that really isn't a problem. What we want to have is good managers, and there's more than one way to get to, at least, business heaven, and we have a number that have found different ways to get there.

So we have never imposed — we have certain requirements because we're a public company, and SEC requirements, and International Revenue Service coordination.

But we've never imposed anything from the top on any of the operating managements.

We have MBAs running companies, we have people who never saw a business school. And talent is the scarce commodity, and when you find talent and they've got their own way of doing things, we let it — we're delighted to have them do it. More than letting them do it — we want them to do it their way. We don't want to change them.

Charlie?

CHARLIE MUNGER: Yeah, the truth of the matter is that we have decentralized power in the operating businesses to a point just short of total abdication. (Laughter)

And we don't think our system is right for everybody. It has suited us and the kind of people that have joined us. But we don't have criticism for other people, like Emerson Electric or something, who have operating plans, and compare performance quarterly against plan and all that sort of thing. It's just not our style.

WARREN BUFFETT: Yeah, we centralize money and — (laughs) — everything else we decentralize, pretty much, but —

I don't know whether you've met him here, but for example, Al Ueltschi is here. He started FlightSafety in 1951 and he's — I don't know what he'll spend on simulators this year, but it could easily be a hundred million dollars or thereabouts.

And he — if I spent hours with him, I couldn't add 1/100th of 1 percent to his knowledge of how to allocate that money. It would be ridiculous. It'd be a waste of his time and it would be an act of arrogance on my part. And I have no worries about how Al allocates the money. And that's an unusually capital intensive business compared to most of our businesses.

There's some that I get into the details more because I just worked with the person that's running things a long time and we kind of enjoy it.

Ajit and I talk virtually every night about the reinsurance business. You know, I am not improving the quality of his decisions at all, but it's an interesting game and I like hearing about it, and he doesn't mind talking about it, so we talk them over. But that's just a matter of personal chemistry.

And as we add managers, we will adapt to them. We adapt our accounting systems, to a degree, to them. Now, we do have certain requirements that result from the SEC and IRS. But we don't — our managers know their businesses and they know how to run them.

And if they don't — this hasn't been the case — but if they didn't, we would, you know, we'd do something about the manager, we wouldn't try and build a bunch of systems.

8. Avoid the "Frozen Corporation"

WARREN BUFFETT: Zone 6, please.

AUDIENCE MEMBER: Good afternoon, gentlemen. My name is George Donner from Fort Wayne, Indiana.

My question has to do with estimating the intrinsic value of a company, in particular the capital intensive companies like you were mentioning. I'm thinking of things like McDonald's and Walgreens, but there are lots of others where you have a very healthy and growing operating cash flow, but it's marginally or completely offset by heavy expenditures on putting up new stores or restaurants, or building a new plant.

And so my question is, what do you do for your estimate of future free cash flow? And with Treasurys around — long Treasurys around 6 percent — at what rate do you discount those cash flows?

WARREN BUFFETT: Well, we discount at the long rate just to have a standard of measurement across all businesses. But we would take the company that is spending the money as it comes in, and they don't get credit for gross cash flow, they get credit for whatever net cash is left every year.

But of course, if they're spending the money wisely, even though you have to discount it for more years, the growth in cash development should offset that or they weren't investing it wisely.

The best business is one that gives you more and more money every year without putting up anything to get it, or very little. And we've got some businesses like that.

The second-best business is a business that also gives you more and more money. It takes more money, but the rate at which you invest — reinvest — the money to get that growth is a very satisfactory rate.

The worst business of all is the one that grows a lot, and where you're forced — forced, in effect — forced to grow to stay in the game at all, and where you're reinvesting the capital at a very low rate of return. And sometimes people are in those businesses without knowing about it.

But in terms of discounting, in terms of calculating intrinsic value, you look at the cash that is expected to be generated and you discount back at — in our case, we use the long-term Treasury rate. That doesn't mean that you pay the amount that that present value calculation leads to, but it means that you use that as a common yardstick, that Treasury rate.

And that means that if somebody is reinvesting all their cash flow the next five years, they'd better have some very big figures coming in down the road. Because at some day, a financial asset has to give you back cash to justify you laying out cash for it now.

Investing is the art, essentially, of laying out cash now to get a whole lot more cash later on, and something at some point better deliver cash.

Ben Graham in his class, we used to talk about what he called the Frozen Corporation. And the Frozen Corporation was a company whose charter prohibited it from ever paying anything to its owners, or ever being liquidated, or ever being sold and —

CHARLIE MUNGER: Sort of like a Hollywood producer. (Laughter)

WARREN BUFFETT: Yeah. And the question was, what was such an enterprise worth? Well, that's sort of a theoretical question, but it forces you to think about the realities of what business is all about. And business is all about putting out money today to get back more money later on.

Charlie?

CHARLIE MUNGER: I do think there is an interesting problem that you raise, because I think there is a class of businesses where the eventual cash back part of the equation tends to be an illusion. I think there are businesses where you just keep pouring it in and pouring it in, and then all of a sudden it doesn't work, and no cash comes back.

And what makes our life interesting is trying to avoid those and get in the alternative kind that drowns you in cash. (Laughter)

WARREN BUFFETT: The one figure we regard as utter nonsense is the so-called EBITDA. I mean, the idea of looking at a figure before the cash requirements and merely staying in the same place — and there usually are — any business with significant fixed assets almost always has with it a concomitant requirement that major cash be reinvested in order simply to stay in the same place competitively and in terms of unit sales — to look at some figure that is before — that is stated before those cash requirements, is absolute folly and it's been misused by lots of people to sell lots of merchandise in recent years.

CHARLIE MUNGER: It's not to the credit of the investment banking fraternity that it has learned to speak in terms of EBITDA. I mean, the idea of using a measure that you know is nonsense, and then piling additional reasoning on that false assumption, it's not creditable intellectual performance. And then once everybody is talking in terms of nonsense, why, it gets to be standard. (Laughter)

9. Checklist for selecting stocks

WARREN BUFFETT: Zone 7, please.

AUDIENCE MEMBER: Hi. My name is Brennan Vecchio (PH) and I'm in the Academy of Finance at Northwest High School in Omaha.

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

WARREN BUFFETT: Well, we look at — I'm glad you came. I hope there's a large group. I got a note, I think from your teacher, on that. (Applause)

We look at it — the criteria for selecting a stock is really the criteria for looking at a business. We are looking for a business we can understand. That means they sell a product that we think we understand, or we understand the nature of the competition, what could go wrong with it over time.

And then when we find that business we try to figure out whether the economics of it means the earning power over the next five, or 10, or 15 years is likely to be good and getting better or poor and getting worse. But we try to evaluate that future stream.

And then we try to decide whether we're getting in with some people that we feel comfortable being in with.

And then we try to decide what's an appropriate price for what we've seen up to that point.

And as I said last year, what we do is simple but not necessarily easy.

The checklist that is going through our mind is not very complicated. Knowing what you don't know is important, and sometimes that's not easy. And knowing the future is definitely — it's impossible in many cases, in our view, and it's difficult in others. And sometimes it's relatively easy, and we're looking for the ones that are relatively easy.

And then when you get all through you have to find it at a price that's interesting to you, and that's very difficult for us now. Although there have been periods in the past where it's been a total cinch.

And that's what goes through our mind. If you were thinking of buying a service station, or a dry cleaning establish, or a convenience store in Omaha to invest your life savings in and run as a business, you'd think about the same sort of things.

You'd think about the competitive position and what it would look like five or 10 years from now, and how you were going to run it, and who was going to run it for you, and how much you had to pay.

And that's exactly what we think of when we look at a stock, because the stock is nothing other than a piece of a business.

Charlie?

10. Easy decision case study: National Cash Register

CHARLIE MUNGER: Yeah. If finance were — when finance is properly taught, it should be taught from cases where the investment decision is easy.

And the one I always cite is the early history of National Cash Register Company, and that was created by a fanatic who bought all the patents, and had the best salesforce, and the best production plants. He was a very intelligent man and passionately dedicated to the cash register business.

And of course, the cash register business was a godsend to retailing when cash registers were invented. So that was the pharmaceuticals of a former age.

If you read an early annual report prepared by Patterson, who was CEO of National Cash Register, an idiot could see that this was a talented fanatic. Very favorably located, and that, therefore, the investment decision was easy.

If I were teaching finance, I would collect a hundred cases like that. And that's the way I would teach the students.

WARREN BUFFETT: We have that annual report. What was that, 1904 or something, Charlie?

But it's really a classic report because Patterson not only tells you why his cash register is worth about 20 times what he's selling for to people, but he also — (laughs) — tells you that you're an idiot if you want to go in competition with him. It's a classic.

CHARLIE MUNGER: It is just a (inaudible). But no intelligent person can read this report and not realize — (laughs) — that this guy can't lose.

11. "Norman Rockwell frame of mind"

WARREN BUFFETT: Area 8, please.

AUDIENCE MEMBER: Good afternoon. My name is Robert Rowland (PH) from London, England.

I've been in Omaha all weekend with my wife on the first leg of my honeymoon, and I've noticed you're quite a buyer of nostalgic assets. Can I ask whether nostalgia is one of your filters? (Buffett laughs)

Are there any assets like that left in the U.S. to buy? And if not, can I suggest you come to the U.K. where all we do is sell them? (Laughter)

WARREN BUFFETT: Well, I don't want to interrupt your honeymoon. (Laughter)

But if you'd send me a list of those companies over there that are long on nostalgia, that might be to our liking. Because Charlie and I tend to operate from sort of a Norman Rockwell frame of mind. And it is true that the kind of companies we like sort of do have a homey, Norman Rockwell, Saturday Evening Post-type character to them there.

They have character. And they're the kind of companies, I think, frequently, that people, when they join them, expect to spend the rest of their lives there rather than look at it as something to stick on their resume.

And there are businesses like that. If you look at the businesses that we've bought in the last three or four years, there is real character to the businesses and to the people that build them.

And that's why the people that build them stay on and feel very strongly about running them correctly, even though they have no financial consequence to themselves whatsoever, so —

If you've got a list of those in England and you still have any strength left after your honeymoon, drop me a line. (Laughter)

12. A and B shares are nearly equivalent investment choices

WARREN BUFFETT: Zone 9, please.

AUDIENCE MEMBER: Good afternoon. Joshua Andrews (PH) from Omaha Northwest High School, Academy of Finance.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: And on behalf of the Academy of Finance, we want to thank you for the tickets. There's 33 of us in attendance today.

WARREN BUFFETT: Terrific. (Applause)

AUDIENCE MEMBER: We had the opportunity to play a national game, the Investment Challenge. And on the list of the stocks there were BRK A and BRK B. Can you explain what the difference of the two stocks are?

WARREN BUFFETT: Yeah, the difference between the Berkshire A and B is simply that an A can be converted to a B at any time in the ratio of one A into 30 Bs. The B cannot be converted into the A, so it's a one-way street on conversion.

The economic value of the B is exactly 1/30th that of the A. So anytime the A ever gets any money of any kind from dividends, or liquidation, or a merger, or something of the sort, for every $30 that you get on the A you're going to get $1 on the B.

The two differences are that there is less voting power, proportionately, in the B. And the B does not participate in a designated-contributions program that Berkshire runs, simply because that would be very, very hard to administer. And when we issued the B we pointed out those two differences.

The B should never sell for more than 1/30th of the price of the A. When it sells just a tiny bit above that then arbitrage settles in as people buy the A and convert it to B, and sell the B. Occasionally the B may be at a slight discount to the A because it's not convertible the other way.

But I think as a practical matter you can treat the A and B as very equivalent investment choices. There's not enough difference to make it significant.

Charlie?

CHARLIE MUNGER: Nothing further.

13. How teenagers can prepare for the future

WARREN BUFFETT: OK. Area 10, please.

AUDIENCE MEMBER: My name is Sheena Cho (PH) from the Academy of Finance.

What recommendations would you give us as teenagers to prepare for our future and become as successful as you? (Laughter)

WARREN BUFFETT: Well, if you're interested in business, I definitely think you ought to learn all the accounting you can by the time you're in your early 20s. Accounting is the language of business.

Now, that doesn't mean it's a perfect language, so you have to know the limitations of that language, as well as all aspects of it. So I would advise you to learn accounting. And I would advise you to be — in terms of part-time employment or anything else, work at a number of businesses.

There's nothing like seeing how business operates to build your judgment in the future about businesses. You know, when you understand what kind of things are very competitive, and what kind of things are less competitive, and why that works that way, all of that adds to your knowledge.

So I would do a lot of reading. If you're interested in investments, I would — A, I would take the accounting courses.

I'd do a lot of reading about investments and I would get as much business experience. I would talk business with people that are in business to find out what they think makes their operation tick, or where they have problems and why. I just think you just kind of sop it up every place that you can.

And if it turns you on, you'll do well in it. I mean, I think that, you know, certain activities grab different people. But if business is of interest to you, my guess is you'll do well.

And if you understand business you understand investments. Investments are simply business decisions in terms of capital allocation. I wish you well on it.

Charlie?

CHARLIE MUNGER: Yeah, there's also the little matter of underspending your income year after year after year.

WARREN BUFFETT: Which we have mastered. (Laughter)

CHARLIE MUNGER: Yes. That really works if you keep at it.

WARREN BUFFETT: Yeah, I mean, Charlie and I both — Charlie started having children at a rapid rate, so — and he was lawyer when there was not big money in then.

But, I was — any money you save before you get out and start having a family is probably — any dollar — is probably worth $10 later on simply because you can save it.

The time to save is young, and you'll never have a better time to save than really, free formation of a family. Because the expenditures come along then whether you like them or not. So I —

You know, work for yourself first and put the money aside. I was lucky that way, I didn't have to pay for my own college. Probably wouldn't have gone to college if I'd had to pay for it.

But I, you know, I was able to save everything I made in my teens and those dollars got magnified quite a bit.

Whereas the money I — when I started first selling securities, I mean, the money I made then was taken up by family needs to quite an extent. So start saving early. A lot of it's habit anyway, so it's a great habit to have.

14. "We are not reluctant to invest abroad"

WARREN BUFFETT: OK, zone 1, please.

TONI: I'm Toni Ausnit (PH) from New York City, following up on the questioner from London.

In light of the current dearth of investment opportunities, do you see yourselves investing in non-U.S. companies which are well-managed, understandable, and growing?

WARREN BUFFETT: Well, if we find such companies as you describe at a price that's half attractive we're perfectly willing to buy them. So the answer to that is yes.

But we would be looking, to an extent, worldwide irrespective of market conditions in the United States. Now, market valuations in this country tend to be fairly well-matched in most of the major countries. So we don't — there's been a bull market all over the world in a huge way in the bigger markets.

And so unfortunately — I mean, it would of been nice for us if the U.S. market had tripled and other markets had stayed the same, and then we would be very likely to be finding things abroad. We're not finding them abroad, but we're certainly looking for the kind of thing you're talking about.

We are not reluctant to invest abroad.

And our two — well, all three of our largest holdings — American Express, Gillette, and Coke — and we're talking about $25 billion of market value there that we have — all three of those have major businesses abroad. And in the case of Coke and Gillette, it's a majority of their earnings from abroad.

So we're interested and there's better growth opportunities in many areas abroad than here. But we're not finding bargains as we look around the world.

Charlie?

CHARLIE MUNGER: Nothing more.

15. Philanthropy share sales won't hurt stock price

WARREN BUFFETT: OK. Area two.

AUDIENCE MEMBER: My name is Henry Allen (PH), Mamaroneck, New York.

Question I have is a little delicate, relates to my family and heirs rather than myself, because I'm a couple of decades older than you gentlemen.

You've been very candid about the succession and the estate planning, but how will the recipients of huge grants — charitable grants — get the liquidity they need without — to use the money without unduly driving the stock down?

WARREN BUFFETT: Well, I don't think that supply and demand, in terms of specific — you know, let's just say that 3 percent of Berkshire were to be added to the supply, anyway. I don't think that makes much difference.

What really makes the difference is the prospects of the business.

If my charitable foundation were operative today, it would have to sell — it would have to give away 5 percent of the value of the foundation every year. And if Berkshire paid no dividend, that means it would have to sell 5 percent of the holdings per year.

I don't think that the price of Berkshire would be materially different if there were a seller of — that would be, in this case, 2 percent of Berkshire's capitalization — I don't think it would be materially different.

If it is, it probably should be different. I mean, there should be a reasonable amount of trading that can take place annually without affecting the price of the stock materially or the price of the stock is being propped for sort of unnatural reasons.

So I wouldn't really worry about that. We had one shareholder die about a year, year and a half ago, that had 3/4 of 1 percent of the company, for example. It was sold in, I don't know, six weeks or thereabouts, and they raised, at that time, $250 million or thereabouts from the sale.

I am not worried about that. I'm worried about — I mean, I don't worry — but the key factor is what are the prospects of the businesses? If the businesses are worth money — there are all kinds of companies on the New York Stock Exchange who are perfectly decent businesses where 30 or 40 percent of the stock turns over a year.

And Berkshire's price should not be way different if 10 percent trades a year as opposed to the present 3 percent.

Charlie?

CHARLIE MUNGER: I agree with that. I don't think there'd be any problem at all at the present time if the Buffett Foundation were selling 5 percent of its holdings every year.

WARREN BUFFETT: Could be 500 shares a week or something like that. But if there isn't demand for 500 shares a week of A on a company with our capitalization, then the price probably is artificially wrong at that time.

CHARLIE MUNGER: But I just had lunch with Susie and it doesn't look to me like she's in any imminent danger of mortality. (Laughter)

WARREN BUFFETT: No. Yeah, it will — it will come into play when the survivor of the two of us dies and when the estate gets cleaned up and everything else.

So I think — I certainly hope and I think it's quite a ways away.

CHARLIE MUNGER: You people have more important things to worry about. (Laughter and applause)

16. Buffett's favorite book on his philosophy

WARREN BUFFETT: Zone 3, please.

AUDIENCE MEMBER: My name is Jim Howard (PH). I'm from Syracuse, Indiana.

My question is, does the book "Buffettology" by Mary Buffett present fairly, in all material respects, the calculations you use in evaluating a business for purchase, or did the lady just write a book?

WARREN BUFFETT: Well, it was written by two authors. But I would say that — no, I would say that in a general way, it gets at the investment philosophy.

But I wouldn't say that — it's not the book I would've written, precisely, but I have no quarrel with it, either.

I actually think by reading Berkshire's reports, you should be able to get more — I would think you'd get more of our philosophy than in any other manner.

I think Larry Cunningham, the fellow who held the symposium at the Cardozo School at Yeshiva, did the best job, actually, of sort of reconstructing the various things that have been written at Berkshire into sort of the best-organized presentation of our philosophy. So and he —

CHARLIE MUNGER: And he's selling it right here. It's a very practical —

WARREN BUFFETT: Yeah, he had it at Borsheims — in the mall outside Borsheims yesterday.

And Larry did a very good job. You know, I had nothing to do with it, but I think that that — I really think he's done a first-class job of sort of organizing by topic, I mean, all these things that I've sort of written annually and Charlie's written over time. So that would be — that would probably be my — if I were picking one thing to read, that would probably be the one.

17. Disney sale in the '60s was a "huge mistake"

WARREN BUFFETT: OK, zone 4, please.

AUDIENCE MEMBER: My name is Leigh (inaudible). I'm from Los Angeles, California.

And I want to begin by thanking you for having Bob Hamman. It was a stroke of genius. I could shop at Borsheims and my husband was entertained while I did so. (Laughter)

WARREN BUFFETT: Well, Bob is not only the best bridge player around but he is an entertaining guy, too. We —

AUDIENCE MEMBER: He's great.

WARREN BUFFETT: Yeah, he is great. I agree with you.

AUDIENCE MEMBER: My question. You owned Disney once before and sold it. You also owned advertising companies in the ’70s, I believe —

WARREN BUFFETT: Right.

AUDIENCE MEMBER: — and you sold them. Could we have some insight into your thinking as to why you sold them?

WARREN BUFFETT: I’m not sure I want to give you any insight into that thinking. (Laughs)

Well, we’ll start off with the fact that when I was 11, I bought some Cities Service preferred at 38 and it went to 200, but I sold at 40, so — (laughter) — grabbing my $2 a share of profit.

So I — everything we’ve ever sold has gone up subsequently, but some of them have gone up more painfully, subsequently, than others.

And certainly the Disney sale in the ’60s was a huge mistake. I should have been buying, forget about holding, and —

That’s happened many times. I mean, we think that anything we sell should go up subsequently, because we own good businesses and we may sell them because we need money for something else, but we still think they’re good businesses, and we think good businesses are going to be worth more over time.

So everything I sold in the past, virtually that I can think of, has gone on to sell at a lot more — for a lot more money. And I would expect that would continue to be the case.

That’s not a source of distress. But I must say that selling the Disney was a mistake, and actually the ad agencies had done very well since we sold them, too. Now, maybe some of that money went into Coca-Cola or something else, so I don’t worry about that.

I would worry, frankly, if I sold a bunch of things right at the top, because that would indicate that, in effect, I was practicing the bigger fool-type approach to investing, and I don’t think that can be practiced successfully over time.

I think the most successful investors, if they sell at all, will be selling things that end up going a lot higher, because it means that they’ve been buying into good businesses as they’ve gone along.

Charlie?

CHARLIE MUNGER: Well, I’m glad that the questioner brought this touch of humility, because it is really useful to be reminded of your errors. (Laughter)

And I think we're pretty good at that. I mean, we kind of mentally rub our own noses in our own mistakes. And that is a very good mental habit.

Warren can tell you the exact number of cents per shares that he sold at and compare it with the current price. It actually hurts him. (Laughter)

WARREN BUFFETT: It actually doesn't hurt. (Laughs)

The truth is, you know, because, you know, you just keep on doing things.

But it is instructive to look at — to do postmortems on everything and say — as long as you don't get carried away with it.

But every acquisition decision, that kind of thing, you know, there should be postmortems. Now, most companies don't like to do postmortems on their capital expenditures.

I've been a director of a lot of companies over the years and they've usually not spent a lot of time on the postmortems. They spend a lot of time on telling you how wonderful the acquisitions are going to be, or the capital expenditures, but they don't like to look so hard, necessarily, at the results.

CHARLIE MUNGER: Think of how refreshing a board of directors meeting would be if they sat down, "And now we'll spend three hours examining all our stupid blunders and how much we've blown."

WARREN BUFFETT: And then after that the compensation committee will meet. Now — (laughter) — that's not going to happen. (Laughter)

CHARLIE MUNGER: Right.

18. Phil Carret is one of Buffett's heroes

WARREN BUFFETT: OK. Area 5, please.

AUDIENCE MEMBER: My name is Keller, Harpel Keller, from Portland, Oregon.

Two questions, one of a personal nature. Obviously there are many, many people here today. And I wonder if one of the true patriarchs of the investment business is here today, Phil Carret —

WARREN BUFFETT: Well, I'll answer —

AUDIENCE MEMBER: Many of his friends and admirers would wish him well.

WARREN BUFFETT: Phil, up till a week ago was going to be here today. Phil is 101, wrote a book on investments in 1924, and I've known Phil for about 46 or '7 years.

And Phil has made all the meetings for a number of years, would be here today, and he broke a hip about five or six days ago. But he sent a message that he will definitely be here next year. (Laughter) And he will be, too. (Applause)

WARREN BUFFETT: Phil is a hero of mine. Go ahead.

19. End of Cold War isn't an investing factor

AUDIENCE MEMBER: Second question. Has to do with Ben Graham. And he changed his valuation standards as the decades progressed.

When he couldn't buy stocks below a net-net, he changed his standards because the environment changed.

Now, the world today seems to be a much different place than in 1989 when the U.S.S.R. collapsed. Even they are stumbling toward the free enterprise system. The Russian mafia is a perverse illustration of that.

Now there is only one superpower in the world, the U.S.A., and we must be extremely grateful for the men who put us on the track to the free enterprise system.

Now, the free enterprise system is out of the bottle, it's not going to get back in. It seems to be expanding and accelerating around the world. With the resulting expansion of world trade, may that lead to a reevaluation of historical measures for measuring investments?

WARREN BUFFETT: Well, my answer to that would be that I doubt it, but I, you know, I also don't know.

But I don't think that the end of the Cold War is something that I would factor into my evaluation of businesses. There are all kinds of events that happened, and their impact, in terms of being quantified, very difficult to figure over time, very difficult to isolate any single variable in a complex economic equation.

So in terms of how the world was going to work ten years from now, or the returns are going to be on equity in business, you know, I don't know what will be all the variables that impact on that.

And obviously, right now people are very bullish about the fact that those returns — or something like those returns — will continue.

But I don't — I would not rely in making such a projection on the fact that the Cold War has ended or really any political or economic development around the world.

I don't know how to predict future earnings of American business. And when I look at all of the great historic events of the past, nothing there gives me much in the way of a clue as to which ones would signal major changes in profitability of American business.

Charlie?

CHARLIE MUNGER: Well, I think you raise one very interesting question. If the rest of the world becomes very much more prosperous, as it will if it adopts the free enterprise system, which investments are likely to do best?

I would argue that the Cokes and Gillettes and so on are likely to be helped by a great increase in prosperity in what is now the Third World. And I'm not so sure that's true of a lot of other businesses.

WARREN BUFFETT: Yeah, we like the international businesses we have. And as I say, our three top holdings all have a major international aspect to them, and really, in aggregate, a dominant international aspect to them.

And there's no question in my mind that a Coke will grow faster outside of the United States than in the United States, and the same is true of Gillette, maybe the same is true of American Express. So that's built into what we — our evaluation of those businesses.

But I felt that way before 1989, too. I mean, it's very hard to evaluate how the ball is going to bounce, generally, around the world. But it is a plus to have products such as Gillette has or Coke has, that have demonstrated the fact that they travel extraordinarily well around the world, the people crave those products, and that they're going to — no one's going to find a way to do it better than those two companies in their respective fields. And they sell an inexpensive product, so all of that's going for us.

But in terms of how stocks generally sell or the profitability of American business generally is in the future, it doesn't help me much.

Charlie, any more on that?

CHARLIE MUNGER: No more.

WARREN BUFFETT: OK.

20. Subsidiary managers are never second-guessed

WARREN BUFFETT: Area 6.

AUDIENCE MEMBER: Hi. My name is Bartley Cohen (PH). I just want to thank you for a great weekend.

And my question is, after you bought Dairy Queen I heard they put Coca-Cola into all the stores, but yesterday when I went to the Nebraska Furniture Mart they said they don't take American Express. And my question is — (crowd noise) — my question is, do you encourage the subsidiaries and the companies that you have stock to use each other's products, or do you leave it up to the management of the subsidiary?

WARREN BUFFETT: Well, that's a good question. And it does tell you something about the Berkshire method of operation.

We tell each subsidiary to run their business in the way that they think is best for their operation. Borsheims takes American Express, See's takes American Express, the Furniture Mart doesn't, for example. But that'll be true in other areas, too.

If Harvey Golub at American Express — who has absolutely done a sensational job for us — if he wants to talk with — or have his representatives talk — with anybody at any of our operations, you know, we're all for that happening.

But we will never tell a subsidiary manager which vendor to patronize or anything of that sort.

Once we start making decisions for our managers in that respect then we become responsible for the operation, and they are no longer responsible for the operation.

They are responsible for their operations, and that means they get to call the decisions. And they should do what is best for their subsidiary, and it's up to any other company that wants to do business with them to prove why that is best for them. That's the Berkshire approach to things.

And I think on balance, our managers like it that way. So they're not getting second-guessed and somebody can't go over their head. I get letters all the time from people who are trying to jump over the heads of our managers, and they want us to say this advertising agency should be used or that, and that sort of thing.

It doesn't work at Berkshire. They deal with the managers of the businesses and they're not going to get around them.

Charlie? (Applause)

CHARLIE MUNGER: I love your answer. It gives Warren lots of time to read annual reports at headquarters. (Laughter)

21. Buffett smells trouble for tobacco companies in settlement

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: Hello, my name is Steve Errico (PH). I'm from New York.

What do you think is likely to happen with respect to the tobacco settlement, and what do you think should happen?

And secondly, McDonald's and Dairy Queen are similar businesses. Was there a relationship between your acquisition of Dairy Queen and the disposal of McDonald's? Thank you.

WARREN BUFFETT: Yeah, there's no connection in the second case. They have certain similarities, but there's certainly a lot of differences, too.

You know, a Burger King and McDonald's would be much more similar, or a Wendy and McDonald's. But Dairy Queen is much more of a niche and away from that.

The tobacco settlement's interesting, just in terms of watching the dynamics of it. Because one of the things in labor negotiations that's always a problem is that when you — as a manager you have a labor negotiation, at the end of the negotiation you as management are committed, and basically the union isn't, because the union is going to have a vote on it.

And that's just the way it is. I mean, you can't get away from that. But it is not fun to be in a negotiating position where you're bound and the other side is not bound.

And although that wasn't totally contractually necessarily the situation of tobacco area, it smelled like trouble to me for the tobacco companies — whether you feel they should've had that trouble or not — but it smelled like trouble to me when they were bound and you had another side that was not bound in any way, and where there were lots of political considerations, and where there was a lot of time was going to expire.

I mean, that did not smell to me like a deal that would stick.

And I don't know any of the tobacco executives that were involved in that. I don't know how much they agonized over getting in a position where they were bound and the other party wasn't. But I can tell you from labor negotiations that that's not a pleasant place to be, and it's not a great strategic place to be.

Charlie, what do you think of it?

CHARLIE MUNGER: I don't feel I've got any great expertise in this situation.

WARREN BUFFETT: Well, neither did I, but I'm — (Laughter)

22. Buffett on inheritance: "Enough to do anything, not enough to do nothing"

WARREN BUFFETT: OK, zone 8, please.

JAIME MCMAHON: Hello, I'm Jaime McMahon (PH) from Birmingham, Alabama.

And I was hoping that, Mr. Buffett and Mr. Munger, y'all would expand a little bit on your ideas of an inheritance, and the positive and negative influences that that can have on your heirs, and what you might be able to do as a businessperson, and an investor, and as a parent to sort of mitigate those negative influences.

WARREN BUFFETT: Yeah, well, I quoted — I think Kay Graham was quoting her father at the time but — some years back as saying, "If you're quite rich, probably the idea of leaving your children enough so they can do anything, but not enough so they can do nothing, is not a bad formula."

I think, if you're talking about people that aren't quite rich, I've seen — you know, socially, I wouldn't have a system that involved inheritances. But recognizing the situation that exists, I think probably at lower levels, that leaving to the children in this society is perfectly OK.

But I believe enough in a meritocracy that if I were devising the system with a consumption tax and everything, I would probably make inheritance a form of consumption that would be very heavily taxed, because I don't believe that because you happen to be the — come out of the right womb, essentially, that you are entitled to live an entirely different life than somebody who wasn't quite as lucky, in terms of womb selection. (Laughter)

But in my own case, you know, I follow the "enough so they can do anything, but not enough so they can do nothing." I think that society showered all these —

I was very lucky, I was wired the right way at the right time in history to do very well in this kind of a market economy. Whereas Bill Gates has told me if I was born some thousands of years ago, I'd been some animal's lunch. (Laughter)

You know, I don't run very fast. (Laughter)

And there are different assets that are useful at different times.

And I'll add, I'm not wired to play championship bridge, or championship chess, or not wired to be a basketball star or anything. It just so happens I'm in an area where it pays off like crazy to be good at capital allocation.

And that doesn't make me a more worthwhile human being than anybody else or anything. It just means I was lucky.

And should that luck, in effect, enable many generations of people that are good at womb selection to do nothing in this world? You know, I would have some reservations about that.

So that's my own feeling on inheritance. But Charlie has a bigger family and he can give you a better answer.

23. Munger on inheritance: Few people are "ruined by money"

CHARLIE MUNGER: Well, I feel, in a capitalist system, that there should be an inheritance tax, and that once that's been imposed and paid, what each person wants to do in his own testamentary arrangements is up to that person.

I see very few people that I regard as ruined by money. Many of the people that I see ruined who have money would have been ruined without money. (Laughter)

And I think the percentage of the people that are going to be living the life of the French aristocracy before the revolution is always going to be very small.

And there are plenty of grasping people to take the money away from the incompetents who inherit it.

I don't think we have to worry about a whole class of incompetents ruling the world as their money cascades ever higher.

So I like a fair amount of charity, and certainly some testamentary charity is OK. But I feel it's an individual choice that people have to make.

WARREN BUFFETT: They get a choice there.

24. Two conditions needed for a market that's not overvalued

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: My name is Samuel Wong from Irvine, California. I have two questions.

Question number one, do you think the U.S.A. market is overvalued today?

And question number two, would you buy Berkshire Hathaway stock today, considering the fact that they've had a nice ride up already this year?

And if yes, presuming I have a kid, 20 years old, and he has $150,000 to invest in Berkshire Hathaway, and you won't need the money until five years later, gradually, would you recommend to buy A share or B share, or the combination? Thank you.

WARREN BUFFETT: If you decide to buy Berkshire, I don't think it really makes much difference whether you buy A or B.

But we don't make any recommendations about whether people buy or sell Berkshire. We never have and that's a game we don't want to get into.

In terms of — overvalue — the question whether the market's overvalued, generally, it's simply as we said last year here in the annual report.

It's not — the general market is not overvalued if two conditions are met, which is — in our view — which is that interest rates remain at or near present levels or go lower or — and that corporate profitability in the U.S. stay at the present — or close to the present — levels, which are virtually unprecedented.

Now, those are a couple of big ifs, as we pointed out. A lot of the stories that came out after the annual report would emphasize one aspect or another but it's simply — and they say, "What does he mean by that?" Well, it means exactly what I say. If the two conditions are met, I think it's not overvalued. And if either of the conditions is breached in an important way, I think it will turn out to be overvalued.

And I don't know the answer, which is why I put it in the form that I did.

It's very tough at any given time to look forward and know what level of valuation is justified. You do know when certain dangerous things appear, and certainly if you're predicating your answer that stocks are OK at these prices — if you come to that conclusion — you have to also come to the conclusion, in our view, that corporate earnings, at present levels, are likely to be maintained. And that's a conclusion you would have to come to. I don't think it's obvious that that's the case.

25. No exact formula on retaining earnings

WARREN BUFFETT: Area 10, please.

AUDIENCE MEMBER: Good afternoon. My name's Stanley Harmon (PH) and I'm from Boston.

You say that companies should only spend a dollar on capital expenditures if it will create more than $1 of market value. I'm wondering, how do you determine this?

Is it based on A, historical returns on capital; B, a qualitative judgment of the company's competitive position; C) a quantitative projection of returns on capital; or D, something else?

WARREN BUFFETT: Yeah. Well, it's based on all of those factors you mention and more. But in the end we can say to date every dollar we've retained has been worthwhile, because on balance those dollars have produced more than a dollar of market value.

It's — actually, with a great many companies you can say that now, because things have turned out so well.

But it would be a case — the check on it is, if after three or four years, you've found that the dollars we've retained hasn't created more of that in value, then the presumption becomes very strong at that point that we should start paying out money.

But almost any management that wants to retain money is going to rationalize it by saying, "We're going to do wonderful things with the money we retain." And we think there should be checks on that, which is why in the report, in the ground rules, I suggest making checks on the validity of those projections.

Charlie and I, if you ask us today whether the single dollar we retain from the earnings today, we've got a use for today that will produce more than a dollar of value, the answer is no.

But we do think that based on history, that the prospects are better than 50 percent — well over 50 percent — that in the next few years, we would have an opportunity to do that. But there's no certainty to it.

Charlie?

CHARLIE MUNGER: Nothing more.

26. Berkshire stock tracks intrinsic value "better than most"

WARREN BUFFETT: OK. Area 1, please.

AUDIENCE MEMBER: Good afternoon. My name's Gary Bialis (PH), I'm from Southern California.

I want to thank you again for producing this Owner's Manual that you did a couple of years ago. I find it quite useful and use it quite often.

Two questions: can you tell me if the rule of thumb is still applicable regarding the statement in the Owner's Manual, that the percentage increase in the book value tracks pretty well with the percent increase in intrinsic value?

Or is the fact that you now have more owned businesses, especially ones like GEICO and FlightSafety, mean that the spread between those two has possibly narrowed?

WARREN BUFFETT: Well no, the two have tracked pretty well over the years. I mean, compared to the record of most businesses that are publicly owned, I would say that over the 33 or so year span, our market price has tracked intrinsic value more closely than, you know, 80 or 90 percent of the companies that we view, probably 90 percent.

But that doesn't mean it does it all the time. And there are times when the market price will outpace intrinsic value — the change in intrinsic value — and there are times when, obviously then, that it will lag behind. So it's far from perfect but it's better than most.

Ideally, we would like it to track it perfectly. If we ran this as a private company and we met once a year, and set a price on the stock to have it traded once a year, and Charlie and I were responsible for setting that price, we would try to set a price that was as close to intrinsic value as we could.

And that would be — to the extent that we could do it — it would be a perfect tracking. The market isn't like that, and the market responds to a lot of other things. So it's perfect. It's not getting more perfect, in our view. But we still think that Berkshire tracks it better than most companies.

Charlie, you have —

CHARLIE MUNGER: Nothing to add.

27. KKR sale of Gillette shares "means nothing to us"

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: I'm Elizabeth Cruz (PH) from New York City. I have a question about Gillette.

Another significant Gillette investor, KKR, recently sold over a billion dollars in Gillette shares, shares that they had acquired through Gillette's acquisition of Duracell.

Knowing that KKR has also been a successful investor, do you see this as a negative signal about Gillette's future prospects, particularly on the eve of the launch of the Mach 3 razor? And what do you think their plans are for the remainder of their shares?

WARREN BUFFETT: Well, I think they may have even publicly stated — I'm pretty sure they have — the Duracell shares from which the Gillette shares came were held by a specific investment fund that was formed in, I don't know what year, but a given year, and which is scheduled to disband at a certain point.

So those shares, whether they were of Duracell or whether they're of Gillette, were scheduled for disposition at some point within a given term. And I think that KKR made the decision — and they've made it with other stocks, too — is to have maybe three or so offerings between now and that terminal date for their partnership.

And why they pick any one of — any given date, you know, is up to them and their advisors.

It means nothing to us. I mean, if they didn't have that kind of a fund and they decided to sell, it wouldn't make any difference to them [us]. And I presume if we made a decision to sell, it wouldn't make any difference in their case.

So we, you know, we form our ideas of valuation independent of anybody else's thinking on it. But in the case of KKR, specifically, they have a termination date on a partnership that owned those shares, and have to dispose of them one way or another between now and the termination date, and probably decided that with the quantity of stock they had, that they were going to have several sales.

The Mach 3 is terrific, incidentally. I've been using it since October. So Henry did not decide to sell that stock based on the Mach 3. (Laughter)

28. No split means "better class of shareholders"

WARREN BUFFETT: Area 3, please.

AUDIENCE MEMBER: I am Gertrude Goodman (PH) from Palm Springs, California.

Mr. Buffett and Mr. Munger, there are many stocks that rise and eventually split. My question is, do you foresee in the near future a split for Berkshire Hathaway Class A?

WARREN BUFFETT: Well, that's an easy one. (Laughter)

No. The answer is no. We have no plans to split the A.

In effect, we let people who want to split the A split it themselves into a B. So that anybody who owns the A can have a 30-for-1 split any morning they wake up and want to have such a split. (Laughter)

Charlie, do you have any additional comment?

CHARLIE MUNGER: No, I think you said "no" perfectly. (Laughter and applause)

WARREN BUFFETT: We don't take that attitude because we're cavalier about how shareholders feel. We really think that in the long range interest of Berkshire that the policy we followed on not splitting has benefitted the company and shareholders.

Nothing dramatic about it, but I think that we have a better class of shareholders, in aggregate, in this room, than we would have if we were selling at $3 a share, or $30 a share, or maybe even $300 a share.

29. "Book value is not a factor we consider"

WARREN BUFFETT: Area 4, please.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Jack Sutton (PH) from New York City. I have two questions.

The Japanese stock market has been likened to the U.S. market in 1974. With Japanese stocks selling at very low price-to-book values, as compared to U.S. stocks, would it not make sense to invest in a basket of Japanese stocks or an index fund of Japanese stocks?

Question number two: Berkshire Hathaway tends to invest in companies with high margins and high return on common equity. Berkshire's investment in the airline business seems to have digressed widely from those principles.

Could you elaborate on why Berkshire invested in the airline industry, and would Berkshire consider new investments in the industry in the future?

WARREN BUFFETT: I'm going to the first question. The reason that — and I don't know the exact figures — that Japanese stocks would sell at a lower price-book ratio than U.S. stocks is simply because Japanese companies are earning far less on book than American companies.

And earnings are what determine value, not book value. Book value is not a factor we consider. Future earnings are a factor we consider. And as we mentioned earlier this morning, earnings have been poor for a great many Japanese companies.

Now, if you think that the return on equity of Japanese business is going to increase dramatically, then you're going to make a lot of — I mean, and you're correct, you're going to make a lot of money in Japanese stocks.

But the return on equity for Japanese businesses has been quite low, and that makes a low price-to-book ratio very appropriate because earnings are measured against book. And if a company's earning 5 percent on book value, I don't want to buy it at book value if I think it's going to keep earning 5 percent on book value. So a low price-book ratio means nothing to us. It does not intrigue us.

In fact, if anything, we are less likely to look at something that sells at a low relationship to book than something that sells at a high relationship to book, because the chances are we're looking at a poor business in the first case and a good business in the second case.

30. Airlines not "intriguing" enough to buy stock

WARREN BUFFETT: What was the other question on, Charlie?

CHARLIE MUNGER: Buying — airlines.

WARREN BUFFETT: Airlines. Yeah, I always repress everything on airlines. I don't want to — (Laughter)

No, we've never bought an airline common stock that I can remember. So what we did was we lent money to USAir for a 10-year period and we had a conversion privilege there.

It looked like it — it was a terrible mistake. I made the mistake. But we got bailed out. But we — we never made the determination — when we bought our stock, USAir was selling at $50 a share or thereabouts, the common. And we didn't have an interest in buying USAir at 50, or 40, or 30, or 20. And we got a chance to as things went along — (laughter) — all the way down to 4. (Laughter)

And we never bought it. And we've never bought American, or United, or Delta, or any other airline. It is not a business that intrigues us.

We did think it was intriguing to lend money to them with a conversion privilege and it's worked out now because we got lucky, and because Steve Wolf came along and really rescued the company from right at the brink of bankruptcy.

But we're unlikely to be in airlines, although again, we wouldn't mind lending money to a lot of businesses that we wouldn't buy common equity in. I mean, that could happen again in various industries, including the airline industry.

Charlie, do you have anything to say on either the airlines or the Japanese market?

CHARLIE MUNGER: Well, the airline experience was very unpleasant for us. The net worth just melted. It was (inaudible) a billion and a half, and it just went a hundred million, a hundred million, a hundred million, and finally the cash is running down. It is a very unpleasant experience. (Laughter)

We try and learn from those experiences but we're very slow learners. (Laughter)

31. No "good returns" on Japanese stocks unless profits increase

WARREN BUFFETT: Japanese market (inaudible)?

CHARLIE MUNGER: Oh, the Japanese market.

I suppose anything — (Laughter as Buffett reaches for box of candy)

I suppose anything could happen. After all, we bought silver. (Laughter)

But we have never made a big sector play on a country. In fact, we've almost never made a big sector play.

WARREN BUFFETT: We would have to come to the conclusion that Japanese business, instead of earning whatever it's earning on equity now, is going to earn appreciably more on equity.

I've got no basis for it — I wouldn't argue if anybody else feels that way — I wouldn't argue with them. But I have no basis for coming to that conclusion.

And unless you come to that conclusion, you're not going to make good returns. I mean, unless that happens, you're not going to make good returns from Japanese stocks.

You can not — you can't earn a lot of money from businesses that are earning 5 percent on — or 6 percent — on equity. And I look at the reports but I don't see the earning power now.

Now, maybe it'll all change. I mean, there's talk of — there's already been a small temporary tax cut, but corporate tax rates are quite high, as you know, in Japan.

And they used to be 52 percent here in the United States, now they're 35. So you could have things happen that increase corporate profits, but I don't have any special insight into that that anyone that reads the press generally would not have.

CHARLIE MUNGER: There are also readings in corporate culture that have to be made. Owning stock in a corporation where you know that if shareholders or somebody else has to suffer, the choice is likely to be that somebody else will be chosen.

That is a different kind of a company to invest in than one that thinks that the principal purpose of life is to keep some steam boiler company going in a particular community or something, no matter how much the shareholders suffer.

I think it's hard to judge corporate culture in the foreign countries as well as we can judge it in our own.

32. "We're only interested in price and value"

WARREN BUFFETT: Area five?

AUDIENCE MEMBER: Yvonne Edmonds (PH) from Cedar Mountain, North Carolina.

I have a specific question but not a trivial one. You regularly compare Berkshire Hathaway's performance to the S&P 500, which is very helpful and very interesting.

But I haven't seen a correlation coefficient between the S&P 500 daily — from day-to-day — performance — to close, say — and Berkshire Hathaway's close.

Now, it so happens for me — and I'm sure some other people in the audience — that I don't always have access to newspapers — or the internet, for that matter — newspapers that publish Berkshire Hathaway performance on a daily basis, or even a weekly basis for that matter, or a monthly basis.

It would be very helpful to know the extent of a correlation coefficient between those two variables. If you have that, would you let us know what it is? And if you don't, would you please consider calculating it in the future?

WARREN BUFFETT: Well, it could be calculated but I don't think it would have much meaning. I mean, it would be an historical correlation coefficient which, you know, I would be very reluctant to have people place any weight in.

I try to indicate even the limitations of the yearly comparison of the relative performance, because what was doable by us in the past is not doable today. I mentioned in my annual report, the best decade I ever had on comparative performance by far was the 50s.

Now, I don't think it was because I was a lot smarter then — (laughs) — unwilling to accept that.

But you know, I had some edge of — well, it's probably 40-plus points per year. But I was working with it — that has no relevance to today whatsoever. It would be misleading to publish it or make calculations based on it.

So I think that you would find — I don't know what you'd find on a specific correlation between Berkshire and the S&P.

You'd find a lot of correlation — well, you might not find so much — you'd find it in intrinsic value between that and Coke, and a few stocks like that.

But I don't really think that's particularly useful information going forward. We have no objection, anybody wants to make the calculation. But it wouldn't be something that would be of any utility to us, and if we don't think it's utility to us, we don't want to put it out for shareholders as being of possible utility.

We do think that the S&P annual calculation has some meaning because it's an alternative for people to invest. They don't need us to buy the S&P. So unless, over time, we have some advantage over that, you know, what are we contributing? What value is added by our management?

So we think that that's — people should hold us accountable even though we would prefer not to be. Because it is a tough comparison for us as a tax-paying entity against a non — pre-tax calculation on the S&P.

But we don't pay any attention to beta or any of that sort of thing. It just doesn't mean anything to us. We're only interested in price and value. And that's what we're focusing on all the time, and any kind of market movements or anything don't mean anything.

I don't know what Berkshire is selling for today and it really makes no difference. You know, it just doesn't make any difference.

What does count is where it is 10 years from now. And I can't tell you what it was selling for on May 4th, 1983, or May 4th, 1986, so I don't care what it sells for on May 4th, 1998.

I do care, you know, where it is, in general, 10 years from now, and that's where all the focus is.

Charlie?

CHARLIE MUNGER: Yeah, we're publishing data in the form where we would like it if we were the passive shareholder. And so you're getting the data and you're getting it on a time schedule based on what we would want if we were in your position. And we don't think — (laughter as Buffett holds up a Dairy Queen Dilly Bar that was just given to him) — and we don't think the correlation coefficients would help us.

WARREN BUFFETT: We don't think anything that relates either to volume, price action, relative strength, any of that sort of thing — and bear in mind, when I was in my teens I used to eat that stuff up. I mean, I was making calculations based on it all the time, and kept charts on it, even wrote an article or two on it.

But it just — it just has no place in the operation now.

CHARLIE MUNGER: One of the pleasant things about dealing with Warren all these years is he's never talked about a correlation coefficient. (Laughter)

If the correlation isn't so extreme you can see it with the naked eye, he doesn't compute it. (Laughter)

33. Beware of companies that must "spend money like crazy"

WARREN BUFFETT: OK, we're going to go to zone 6 and I'm going to have a Dilly Bar, and Charlie has got one here, too. (Laughter and applause)

These are terrific.

AUDIENCE MEMBER: My question has to do with what you mentioned earlier about how companies have to reinvest a certain amount of cash in their business every year just to stay in place.

And if one could say that the best businesses are the ones that not only throw off lots of cash, but can reinvest it in more capacity. But I suppose the paradox is that the better a company's opportunities for making expansionary capital expenditures, the worse they appear to be as consumers of cash rather than generators of cash.

What specific techniques have you used to figure out the maintenance capital expenditures that you need to do in order to figure out how much cash a company is throwing off? What techniques have you used on Gillette or other companies that you've studied?

WARREN BUFFETT: Well, if you look at a company such as Gillette or Coke, you won't find great differences between their depreciation — forget about amortization for the moment — but depreciation and sort of the required capital expenditures.

If we got into a hyperinflationary period or — I mean, you can find — you can set up cases where that wouldn't be true.

But by and large, the depreciation charge is not inappropriate in most companies to use as a proxy for required capital expenditures. Which is why we think that reported earnings plus amortization of intangibles usually gives a pretty good indication of earning power, and —

I don't — I've never given a thought to whether Gillette needs to spend a hundred million dollars more, a hundred million dollars less, than depreciation in order to maintain its competitive position. But I would guess the range is even considerably less than that versus its recorded depreciation.

Businesses you have to worry about — I mean, an airline business is a good case. In the airlines, you know, you just have to keep spending money like crazy. And you have to spend money like crazy if it's attractive to spend money, and you have to spend it the same way if it's unattractive. You just — it's part of the game.

Even in our textile business, to stay competitive we would've needed to spend substantial money without any necessary — any clear prospects of making any money when we got through spending it.

And those are real traps, those kind of businesses. And they make out one way or another, but they're dangerous. And in a See's Candy we would love to be able to spend 10 million, 100 million, $500 million and get anything like the returns we've gotten in the past.

But there aren't good ways to do it, unfortunately. We'll keep looking, but it's not a business where capital produces the profits.

At FlightSafety, capital produces the profits. You need more simulators as you go along, and more pilots are to be trained, and so capital is required to produce profits. But it's just not the case at See's.

And at Coca-Cola, particularly when new markets come along, you know, the Chinas of the world or East Germany or something of the sort, the Coca-Cola Company itself would frequently make the investments needed to build up the bottling infrastructure to rapidly capitalize on those markets, the old Soviet Union.

So those are — those are expenditures — you don't even make the calculation on them, you just know you've have to do it. You got a wonderful business, and you want to have it spread worldwide, and you want to capitalize on it to its fullest.

And you can make a return on investment calculation, but as far as I'm concerned it's a waste of time because you're going to do it anyway, and you know you want to dominate those markets over time. And eventually, you'll probably fold those investments into other bottling systems as the market gets developed. But you don't want to wait for conventional bottlers to do it, you want to be there.

One of the ironies, incidentally — and might get a kick out of it, some of the older members of the audience — that when the Berlin Wall went down and Coke was there that day with Coca-Cola for East Germany, that Coke came from the bottling plant at Dunkirk. So there was a certain poetic — (crowd noise) — irony there.

Charlie, do you have anything on this?

CHARLIE MUNGER: I've heard Warren say since very early in his life that the difference between a good business and a bad business is usually the good business just throws up one easy decision after another, whereas the bad business gives you a horrible choice where the decision is hard to make and, is this really going to work? And is it worth the money?

If you want a system for determining which is a good business and which is a bad business, just see which one is throwing the management bloopers time after time after time.

Easy decisions. It's not very hard for us to decide to open a new See's store in a new shopping center in California that's obviously going to succeed. It's a blooper.

On the other hand, there are plenty of businesses where the decisions that come across your desk are just awful. And those businesses, by and large, don't work very well.

WARREN BUFFETT: I've been on the board of Coke now for 10 years, and we've had project after project come up, and there's always an ROI. But it doesn't really make much difference to me, because in the end almost any decision you make that solidifies and extends the dominance of Coke around the world in an industry that's growing by a significant percentage, and which has great inherent underlying profitability, the decisions are going to be right and you've got people there that will execute them well.

CHARLIE MUNGER: You're saying you get blooper after blooper.

WARREN BUFFETT: Yeah. And then Charlie and I sat on USAir, and the decisions would come along, and it would be a question of, you know, do you buy the Eastern Shuttle, or whatever it may be?

And you're running out of money. And yet to play the game and to keep the traffic flow with connecting passengers, I mean, you just have to continually make these decisions — whether you spend a hundred million dollars more on some airport.

And they're agony because, again, you don't have any real choice, but you also don't have any real conviction that it's going to translate — those choices are going to — or lack of choices — are going to translate themselves into real money later on.

So one game is just forcing you to push more money in to the table with no idea of what kind of a hand you hold, and the other one you get a chance to push more money in, knowing that you've got a winning hand all the way.

Charlie? Why'd we buy USAir? (Laughter)

Could've bought more Coke.

34. Berkshire is prepared for adversity

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: My name is Bakul Patel (PH). I am from upstate New York.

And my question is, is Berkshire prepared for 1929 style of depression or, like, a prolonged bear market that exists in Japan? And would it be as successful in those situations?

WARREN BUFFETT: Well, we are probably — we don't expect what you're talking about, but we are probably about as well-prepared as any company can be for adversity, because Berkshire has been built to last.

Net, we would benefit over a 20-year period by having some periods of terrible markets periodically in that 20-year period. That doesn't mean we're wishing for them and it doesn't mean they're going to happen, but —

We make our money by allocating capital well, and the lower the general stock market would be, the better we can allocate capital. So we're well-prepared but we're not necessarily expecting.

Charlie?

CHARLIE MUNGER: Yeah, we are not going to ever sell everything and go to cash and wait for the crash so we can go back in.

On the other hand, we are structured so that I think, net, a lot of turmoil in the next 20 years will help us, not hurt us. I don't mean it'll be pleasant to go through the downcycle, but it's part of the game.

35. "We're never going to give out advice on Berkshire stock"

WARREN BUFFETT: Area 8.

AUDIENCE MEMBER: My name is Pete Banner (PH) from Boulder, Colorado. First of all, Mr. Buffett and Mr. Munger, thank you for your genuine generosity today.

Berkshire closed yesterday, the A share was about — or Friday — $69,000 and the B share was about $2,300. Do you feel that price is grossly overpriced, or grossly underpriced, or reasonably priced?

WARREN BUFFETT: Well, I'll let Charlie answer that one. (Laughter)

CHARLIE MUNGER: I'm not going to say. (Laughter)

WARREN BUFFETT: No, we're just never going to — we're never going to give out advice on Berkshire stock. There's no —

You know, that is up to people who want to buy and sell it, and anything we would say could easily get magnified, and people would be acting on it months later, and who knows all the problems that it could produce, so —

CHARLIE MUNGER: It would be quite eccentric if we were to every day put out an announcement, "Now's the time to buy, now's the time to sell," our own stock.

Eccentric we are, but that eccentric we aren't. (Laughter and applause)

36. George Burns: role model for surviving unhealthy habits

WARREN BUFFETT: Area 9.

AUDIENCE MEMBER: Irene Finster, your longtime partner from Tulsa, Oklahoma —

WARREN BUFFETT: Hi, Irene. Yeah, Irene has a soda fountain. You ought to go visit her. (Laughter)

AUDIENCE MEMBER: First I want to thank you for giving your shareholders the opportunity to select their own charities.

And second, I'm very concerned about your health due to your diet — (Laughter) — of red meat —

WARREN BUFFETT: Irene. (Applause)

Irene, these are our products that I'm eating. (Laughter)

AUDIENCE MEMBER: Red meat, candy, ice cream — (laughter) — and —

WARREN BUFFETT: And that's just what I do — that's what I do in public —

AUDIENCE MEMBER: —and Coke. (Laughter)

And I want to know what your doctor says. (Laughter)

WARREN BUFFETT: My doctor says I must be heavily relying on my genes. (Laughter)

No, I will tell you, I — I mean, Charlie and I are both very healthful. If you were in the life insurance business, you would be happy to write us at standard rates, I could assure you of that. (Laughter)

CHARLIE MUNGER: You know, they asked George Burns when he was 95, "What does your doctor say about smoking these big, black cigars?" And he said, "My doctor's dead." (Laughter and applause)

WARREN BUFFETT: Charlie and I played bridge with George when he was about 97, I'd say, at the Hillcrest Country Club. And there was a big sign behind him that said, "No smoking by anyone under 95." (Laughter)

And actually, at his 95th birthday party, he had about five very good-looking young girls that were there to greet him with a big cake and everything. And he looked them over one after another and he said, "Oh girls," he said, "I'm 95. One of you is going to have to come back tomorrow." (Laughter and applause)

We're very big on George Burns in recent years. (Laughter)

37. "We wait indefinitely"

WARREN BUFFETT: Area 10.

AUDIENCE MEMBER: My name is Hubert Vose (PH). I'm from Santa Barbara, California.

Earlier this morning, you made a comment that if the market fell you would be spending less time on the internet because you'd be very busy. And this is reinforced an impression I have had that the cash flows of Berkshire Hathaway are enormous, but that possibly in the last 12 months you've been investing less than you had previously.

And if so — if this is correct, what does that say about waiting for attractive values? How long are you willing to wait, and what does that say to the investment public in their own habits?

WARREN BUFFETT: Well, you're correct that we have not found anything to speak of in equities in a good many months, and —

The question of how long we wait, we wait indefinitely. We are not going to buy anything just to buy something. We will only buy something if we think we're getting something attractive.

And that — and incidentally, if things were 5 percent cheaper that — or 10 percent cheaper — that wouldn't change anything materially.

So we have no idea when that period ends. We have no idea whether — as I've said, it can turn out that these valuations are perfectly appropriate if returns on equity stay where they are. But even then, they aren't in the least mouthwatering, so we won't feel we've missed anything particularly if returns stay where they are.

Because if it turns out that these levels are OK, they still will not produce great returns from here, in our view. That doesn't mean you couldn't have a tremendous market in the short-term or something of the sort.

Markets can do anything. And you look at the history of markets and you just see everything under the sun.

But we will not — you know — we have no timeframe. If the money piles up, the money piles up. And when we see something that makes sense, we're willing to act very fast, very big. But we're not willing to act on anything that doesn't check out in our view.

There's no — you don't get paid for activity, you only get paid for being right.

Charlie?

CHARLIE MUNGER: Yeah. An occasional dull stretch for new buying, this is no great tragedy in an investment lifetime.

Other things may be possible in such an era, too. I mean, it isn't like we have a quiver with only one arrow.

WARREN BUFFETT: We sat through periods before. I mean, the most dramatic one being the early '70s — late '60s and early '70s.

For a long time it seemed — doesn't seem so long when you look back on it, seems long when you're going through it — but it — like having a tooth pulled or something, but it's, you know, what can you do about it?

The businesses aren't going to perform better in the future just because you got antsy and decided you had to buy something. We will wait till we find something we like.

We’ll love it when we can swing in a big way, though. That’s our style.

38. “Certified record of failure” in real estate

WARREN BUFFETT: Area 1.

AUDIENCE MEMBER: Larry Pekowski (PH), Millburn, New Jersey.

Berkshire seems never to have made any real, pure real estate investments, not counting facilities the operating companies might own, with the exception of Wesco’s involvement in the residential project in California.

I was wondering if you’ve ever looked at a real estate transaction and tried to apply the same filters, meaning competitive advantages, returns on capital, that you do in operating companies.

And if not, is it a circle of competence issue, or is there something you find disinteresting about real estate?

CHARLIE MUNGER: (Inaudible)

WARREN BUFFETT: You want to take it? OK, Charlie wants to take this one.

CHARLIE MUNGER: Let me take this one, because here’s an area where we have a perfect record that extends over many decades.

We have been demonstrably foolish in almost every operation that had to do with real estate we’ve ever touched.

Every time we had a surplus plant and didn’t want to hit the bid and let some developer kind of take an unfair advantage of us, we would of been better off later if we’d hit the bid and invested the money in fields where we had the expertise.

That housing tract that I developed because I didn’t want to let the zoning authorities rob me the way they wanted to. I wish I had let them. (Laughter)

We have a certified record of failure in this deal. (Laughter)

WARREN BUFFETT: And the funny thing is, we understand real estate. (Laughter)

CHARLIE MUNGER: And we’re good at it. (Laughter and applause)

Right.

WARREN BUFFETT: Actually, (inaudible), we do understand real estate. And Charlie got his start in real estate.

CHARLIE MUNGER: Yeah, be we understand other things better. And so the chances that we're going to be big in real estate are low.

WARREN BUFFETT: Yeah. We've seen lots of things, and we've — the prices, you know, just don't intrigue us, in terms of what we get for our money.

I tried to buy a town when I was, what, 21 years old. The U.S. government had a town in Ohio for sale and it would of worked out very well. I'm always — there's nothing about the arena that turns us off, but we don't see great returns available.

And like Charlie says, the few things — (inaudible) old plant or something, that is not — we have not been great at working our way out of those.

Fortunately, they haven't been very important in relation to the net worth of Berkshire.

39. Nike: "We keep all of those views to ourselves"

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: Good afternoon. My name is Fred Costano (PH) from Detroit, Michigan. My question concerns Nike.

Nike is a company experiencing some short-term problems, but it's a great company with an excellent track record. Phil Knight is similar to Bill Gates in the respect that he's a marketing genius and is a very hard worker. Making sneakers is a very simple business with high margins.

How do you view Nike and what do you think of the company?

WARREN BUFFETT: Well, I think Phil Knight is a terrific operator. I think — and he's a competitor. He's got a lot of money in Nike.

But as terms of what we think of the stock, you know, we keep all of those views to ourselves pretty much.

40. Buffett doesn't expect litigation over fats in food

WARREN BUFFETT: Area 3? (Laughter)

AUDIENCE MEMBER: Hello, my name is Ed Clinton and I'm from Chicago, Illinois.

I'm wondering about the tobacco litigation. There's also — there have been some comments about fatty food.

Do you think there's going to be a new trend of fatty food litigation coming out of the tobacco problems?

WARREN BUFFETT: Well, I sign a waiver before I — (laughs) — do any of that myself.

No, I would doubt — I would — I do not see those two as being remotely similar.

But Charlie, do you have any different views on it?

CHARLIE MUNGER: Well, I think the traditional tort system is particularly ill-suited for solving what might be called the tobacco health problem. So I regard that whole thing as sort of a Mad Hatter's Tea-Party. And we sit out from afar.

41. Lots of credit to go around for strong economy

WARREN BUFFETT: Area 4.

AUDIENCE MEMBER: Yes, I'm Fred Bunch from near Tightwad, Missouri.

In light of the current —

WARREN BUFFETT: What was the name of that town? (Laughter)

AUDIENCE MEMBER: Tightwad, Missouri.

WARREN BUFFETT: Tightwad, Missouri, huh? (Laughter)

AUDIENCE MEMBER: There's a bank there.

WARREN BUFFETT: Did they name it after me or Charlie? (Laughter)

AUDIENCE MEMBER: Well, either one, really. (Buffett laughs)

You'd both fit in. (Buffett laughs)

In light of today's healthy growth and stability of the American economy at the present time and over the last five years or so, how much credit, if any, do you give the Clinton administration and why?

WARREN BUFFETT: Well, I give credit to — I give credit going back to Volcker, significant credit to Volcker.

I give credit to Reagan. I give credit to — certainly to Greenspan and to Rubin, and I give credit to Clinton on that — I think that first tax bill was very important. It carried by one vote. And I think he may listen to Rubin.

So I think there's a lot to give credit for and I think you can spread it around a fair amount.

Charlie may be less charitable here. Let's see. (Laughter)

CHARLIE MUNGER: No, I've got no great quarrel with the way the country — the economy's reformed. I think it's way better than any of us would've predicted.

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

WARREN BUFFETT: Area 5?

AUDIENCE MEMBER: My name is Travis Heath (PH). I'm from Dallas, Texas.

And my question regards what Phil Fisher referred to as "scuttlebutt." When you've identified a business that you consider to warrant further investigation — more intense investigation — how much time do you spend commonly, both in terms of total hours and in terms of the span in weeks or months that you perform that investigation over?

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

So by now, I'm probably fairly familiar with most of the businesses that might qualify for investment at Berkshire.

But when I started out, and for a long time I used to do a lot of what Phil Fisher described — I followed his scuttlebutt method. And I don't think you can do too much of it.

Now, the general premise of why you're interested in something should be 80 percent of it or thereabouts. I mean, you don't want to be chasing down every idea that way, so you should have a strong presumption.

You should be like a basketball coach who runs into a seven-footer on the street. I mean, you're interested to start with; now you have to find out if you can keep him in school, if he's coordinated, and all that sort of thing. That's the scuttlebutt aspect of it.

But I believe that as you're acquiring knowledge about industries in general, companies specifically, that there really isn't anything like first doing some reading about them, and then getting out and talking to competitors, and customers, and suppliers, and ex-employees, and current employees, and whatever it may be.

And you will learn a lot. But it should be the last 20 percent or 10 percent. I mean, you don't want to get too impressed by that, because you really want to start with a business where you think the economics are good, where they look like seven-footers, and then you want to go out with a scuttlebutt approach to possibly reject your original hypothesis.

Or maybe, if you confirm it, maybe do it even more strongly. I did that with American Express back in the '60s and essentially the scuttlebutt approach so reinforced my feeling about it that I kept buying more and more and more as I went along.

And if you talk to a bunch of people on an industry and you ask them what competitor they fear the most, and why they fear them, and all of that sort of thing. You know, who would they use the silver bullet of Andy Grove's on and so on, you're going to learn a lot about it.

You'll probably know more about the industry than most of the people in it when you get through, because you'll bring an independent perspective to it, and you'll be listening to everything everyone says rather than coming in with these preconceived notions and just sort of listening to your own truths after a while.

I advise it. I don't really do it much anymore. I do it a little bit, and I talked in the annual report about how when we made the decision on keeping the American Express when we exchanged our Percs for common stock in 1994, I was using the scuttlebutt approach when I talked to Frank Olson.

I couldn't have talked to a better guy than Frank Olson. Frank Olson, running Hertz Corporation, lots of experience at United Airlines, and a consumer marketing guy by nature. I mean, he understands business. And when I asked him how strong the American Express card was and what were the strengths and the weaknesses of it, and who was coming along after it, and so on, I mean, he could give me an answer in five minutes that would be better than I could accomplish in hours and hours and hours or weeks of roaming around and doing other things.

So you can learn from people. And Frank was a user of it. I mean, Frank was paying X percent to American Express for his Hertz cars. And Frank doesn't like to pay out money, so why was he paying that? And if he was paying more than he was paying on Master Charge or Visa, why was he paying more? And then what could he do about it?

I mean, you just keep asking questions. And I guess Davy [Lorimer Davidson] explained that in that video we had ahead of time. I'm very grateful to him for doing that, because that was a real effort for him.

But that was really what I was doing back in 1951 when I visited him down in Washington, because I was trying to figure out why people would insure with GEICO rather than with the companies that they were already insuring with, and how permanent that advantage was.

You know, what other things could you do with that advantage? And you know, there were just a lot of questions I wanted to ask him, and he was terrific in giving me the answer. It, you know, changed my life in a major way. So I have nobody to thank but Davy on that.

But that's the scuttlebutt method and I do advise it.

Charlie?

CHARLIE MUNGER: Nothing to add.

43. "Real test is the gain in intrinsic value"

WARREN BUFFETT: Area 6.

AUDIENCE MEMBER: Hi, my name is Richard Lontok (PH) from Toronto, Canada. I have a question for both of you.

Mr. Buffett, Berkshire Hathaway's earnings in 1997 is less than that of 1996. What do you intend to do in 1998 to improve that earning. (Laughter)

And Mr. Munger, I've been watching you and Mr. Buffett eating the See's candies and drinking the Coca-Cola the whole day.

WARREN BUFFETT: Join in. (Laughter)

AUDIENCE MEMBER: Do you intend to do any commercials in the future like what Dave Thomas does with Wendy's? (Laughter and applause)

WARREN BUFFETT: Which of us do you think should do them? (Laughs)

Now you're talking.

CHARLIE MUNGER: We aren't old enough to be really good in a commercial. (Laughter)

What we would like to do is have somebody up here happily eating See's candy and answering these questions who's about 110 years old. Now, that would really be helpful.

WARREN BUFFETT: We — in terms of the earnings, the final bottom line GAAP reported earnings mean absolutely nothing at Berkshire to us.

Now, the look-through earnings which we publish do have some meaning, but even those have to be interpreted in terms of whether there was a super-cat occurrence, or whether GEICO had an unusually good year, and we try to mention those factors.

But we do hope that the look-through earnings do build at a reasonable clip over time.

But our final earnings include capital gains and we can report those in any number that we wanted to, and we pay no attention whatsoever to realized capital gains at Berkshire.

The IRS does, but — and that's why we may send them a billion or more dollars this year. But they mean nothing in terms of measuring our progress.

The look-through earnings say something about it. That table, the first couple of pages, it shows our change in book value versus the S&P says something about it, not perfect.

The real test is the gain in intrinsic value, for sure, over time. And there's no hard number for that, but so far Charlie and I judge it satisfactory, but we also judge it as non-repeatable.

Charlie, anything more —?

CHARLIE MUNGER: No.

44. "We prefer what other people call risk"

WARREN BUFFETT: Area 7, please.

KEIKO MAHALICK: Good afternoon, Mr. Buffett and Mr. Munger. My name is Keiko Mahalick (PH) and I'm an M.B.A. student at Wharton, but please don't hold that against me.

WARREN BUFFETT: We won't. (Laughter)

I never made it that far. I was an undergraduate student. (Laughs)

AUDIENCE MEMBER: Could you please explain how you differentiate between types of businesses in your cash flow valuation process, given that you use the same discount rates across companies?

For example, in valuing Coke and GEICO, how do you account for the difference in the riskiness of their cash flows?

WARREN BUFFETT: We don't worry about risk in the traditional — the way you're taught, actually, at Wharton. We — (Laughter)

But it's a good question, believe me. But we are — if we could see the future of every business perfectly, it wouldn't make any difference whether the money came from running streetcars or from selling software, because all the cash that came out, which is all we're measuring between now and judgment day, would spend the same to us.

It really — the industry that it's earned in means nothing except to the extent that it may tell you something about the ability to develop the cash. But it has no meaning on the quality of the cash once it becomes distributable.

We look at riskiness, essentially, as being sort of a go/no-go valve in terms of looking at the future businesses. In other words, if we think we simply don't know what's going to happen in the future, that doesn't mean it's necessarily risky, it just means we don't know. It means it's risky for us. It might not be risky for someone else who understands the business.

In that case, we just give up. We don't try to predict those things.

And we don't say, "Well, we don't know what's going to happen, so therefore we'll discount it at 9 percent instead of 7 percent," some number that we don't even know. That is not our way to approach it.

We feel that once it passes a threshold test of being something about which we feel quite certain, that the same discount factor tends to apply to everything. And we try to do only things about which we are quite certain when we buy into the businesses.

So we think all the capital asset pricing model-type reasoning with different rates of risk-adjusted return and all that, we tend to think it is — well, we don't tend to — we think it is nonsense.

But we do think it's also nonsense to get into situations, or to try and evaluate situations, where we don't have any conviction to speak of as to what the future is going to look like. And we don't think you can compensate for that by having a higher discount rate and saying it's riskier, so then I don't really know what's going to happen and I'll have a higher discount rate. That just is not our way of approaching things.

Charlie?

CHARLIE MUNGER: Yeah. This great emphasis on volatility in corporate finance we just regard as nonsense.

If we have a statistical probability of putting out a million and having it turn into —

Put it this way: as long as the odds are in our favor and we're not risking the whole company on one throw or anything close to it, we don't mind volatility in results. What we want is the favorable odds. We figure the volatility, over time, will take care of itself at Berkshire.

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

I mean, for example, if people reacted to the monthly earnings of See's, which might lose money eight months out of the year and makes a fortune, you know, in November and December — if people reacted to that and therefore made its stock as an independent company very volatile, that would be terrific for us because we would know it was all nonsense. And we would buy in July and sell in January.

Well, obviously, things don't behave that way. But when we see a business about which we're very certain, but the world thinks that its fortunes are going up and down, and therefore it behaves volatile — with great volatility — you know, we love it. That's way better than having a lower beta.

So we think that — we actually would prefer what other people would call risk.

When we bought The Washington Post — I've used that as — it went down 50 percent in a matter of a few months. Best thing that could've happened. I mean, doesn't get any better than that.

Business was fundamentally very nonvolatile in nature. I mean, TV stations and a strong, dominant newspaper, that's a nonvolatile business, but it was a volatile stock. And you know, that is a great combination from our standpoint.

45. We want shareholders who look at Berkshire the same way we do

WARREN BUFFETT: Area 8.

AUDIENCE MEMBER: Good afternoon, and thank you for staying around to answer our questions.

I have two. First of all, would you give us what logic went into your decision to both buy and sell McDonald's?

And my second question goes to a term that you've used. You talked about the caliber of the shareholders at Berkshire Hathaway. How do you define the caliber and what difference does it really make?

WARREN BUFFETT: Well, it makes a lot of difference. Our idea of a high-caliber group is one that is just like us. (Laughter)

And that's not entirely facetious in that we basically want shareholders who look at the business the same way we do. Because we're going to be around running something, and what could be worse than having a group out there had a whole different set of expectations than we did, and evaluated us in a different way, and all of this sort of thing?

I mean, if you are going to — you're going to have a given number of shares outstanding. Let's say we have an equivalent of a million, two-hundred and some thousand A shares. Somebody's going to own every single share.

Now, would you rather have them owned by people who understand your business, who understand your objectives, who measure you the same way you do, who have similar time horizons, or would you rather have the reverse? It makes a real difference over time to be in with people that are compatible with you.

So it's a significant plus to us, the operation of the business, and it leads to a more consistent relationship between price and intrinsic value when you have a group like that, because they understand themselves and the business, and they're not likely to do silly things in either direction.

So you get a much more consistent relationship than if we had a whole bunch of people who were thinking that the most important thing in evaluating this business was next quarter's earnings.

Question about McDonald's simply is, you know, it's an outstanding business and we don't talk about it when we buy it, we don't talk about it if we sell it.

Charlie?

CHARLIE MUNGER: Yeah. The question of what difference does it make to the management who the shareholders are, well, if you are into what I call trustee capitalism, where the shareholders aren't just a faceless bunch of nothings, you feel as a kind of a hair shirt, an obligation to do as well as you can by the shareholders. Well, wouldn't you rather feel an obligation to people you liked instead of people you didn't like? (Laughter)

WARREN BUFFETT: Yeah, let's say you were running a business and — (applause) — and you had a choice of three owners.

You could have a hundred percent of it owned by whatever your favorite philanthropy is, you could have a hundred percent of it owned by the U.S. government, and you could have a hundred percent of it owned by, you know, the worst person you can think of, you know, in your hometown.

I mean, I think it would make a difference in how you felt about going to work every day.

46. “Get more quality than you’re paying for”

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Yes, my name is Steve Jack (PH). I’m from Southern California. And my question has to deal with kind of quality versus price.

I’ve been to three annual meetings and I’ve heard great things about Coke every year. But as far as I’m aware, you have not bought any additional shares of Coke over the last three years even though the stock has done just fine.

If an investor has a relatively short timeframe, say three to five years, how much weight do you think one should give to quality versus price?

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

The best way to look at any investment is, how will I feel if I own it forever, you know, and put all my family’s net worth in it?

But we basically believe in buying — if you talk about quality meaning the certainty that the business will perform as you expect it to perform over a period of time, so the range of possible performance is fairly narrow — you know, that’s the kind of business we like to buy.

And all I can say is that we like to pay a comfortable price, and that depends to some extent on what interest rates are.

We haven’t found comfortable prices for the kind of businesses we like in the last year. We don’t find them uncomfortable, in the sense that we want to sell them. But they’re not prices at which we — we added to Coke one time about, I don’t know, five years ago or thereabouts, and it’s conceivable we would add again. It’s a lot more conceivable we would add than subtract.

But that’s the way we feel about most of the businesses. We did make a decision last year that we thought bonds were relatively attractive, and we trimmed certain holdings and eliminated certain small holdings in order to make a bigger commitment in bonds.

Charlie?

CHARLIE MUNGER: Yeah. You talk about quality versus price. The investment game always involves considering both quality and price. And the trick is to get more quality than you’re paying for in the price. It’s just that simple.

WARREN BUFFETT: But not easy.

CHARLIE MUNGER: No, but not easy.

47. No interest in spinning off subsidiaries

WARREN BUFFETT: Area 10.

AUDIENCE MEMBER: Gentlemen, good afternoon. Jeff Kirby from Green Village, New Jersey.

Would you comment please on tax-free spinoffs to shareholders in general, and particularly how you would feel about those were you to believe that a materially higher value would be ascribed to one of your operating companies in the public arena than as part of Berkshire Hathaway?

WARREN BUFFETT: Well, there's certainly been times in Berkshire's history when certain components of Berkshire might well have sold at higher multiples as individual companies than the amount they contributed to the whole of Berkshire, although I don't think that would be the case now.

But our reaction to spinoffs would be — even if we thought there was some immediate market advantage, it would have no interest, basically, to us.

We like the group of businesses we have as part of a single unit at Berkshire. We hope to add to that group of businesses. We will add to that group of businesses over time.

And the idea of creating a lot of little pieces because we could get a little more market value in the short term, it just doesn't mean anything to us.

Charlie?

CHARLIE MUNGER: Yeah, it would add a lot of frictional costs and overheads. We have the — I don't know anybody our size who has lower overhead than we do, and we like it that way.

WARREN BUFFETT: Yeah. (Applause)

Right now our after-tax cost of running the operation has gotten down to a half a basis point of capital value. And when you think that many mutual funds are at 125 basis points that means they have 250 times — (laughs) — the overhead ratio to capitalization that we have —

CHARLIE MUNGER: And all they've got is a bunch of marketable securities, and we got that plus businesses.

WARREN BUFFETT: Yeah. We don't need any more, incidentally —

CHARLIE MUNGER: We can get lower, Warren. (Buffett laughs)

We can get a lot lower —

WARREN BUFFETT: Yeah, I know. I know. (Laughter)

You think they'd [Berkshire's board of directors] work for $500 a year instead of $900, Charlie? (Laughter)

Groans from the front row.

48. Shareholders boost sales at Nebraska Furniture Mart and Borsheims

WARREN BUFFETT: Area 1.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger.

I was kind of curious if you could tell me, do you know or can you tell us how much business Nebraska Furniture Mart and Borsheims did this weekend?

And secondly, do you have any interest in investing in the auto industry? And if not interested now, what would change your mind about this industry in the future?

WARREN BUFFETT: Well, the first question, I don't know what the Mart did but I do know they had a lot of shareholders there. Got a verbal report on that.

There would be less change in their normal — they do — you know, you're talking about a company that — at the Mart — that does $800,000 a day on average. It is a big operation.

So our shareholders have an impact, but not the relative impact that they would have at Borsheims.

Borsheims did over twice as much this year as last year, and they had a big day. (Laughter)

49. No special insights into automobile industry

WARREN BUFFETT: And what was the other question, Charlie?

AUDIENCE MEMBER: — industry. The auto industry.

WARREN BUFFETT: Oh, the auto industry. Yeah, Charlie was big in General Motors in the mid-'60s, right Charlie? It was your biggest commitment?

CHARLIE MUNGER: I had a temporary delusion. (Laughter)

Luckily, it passed. (Laughter)

WARREN BUFFETT: Yeah.

No, he made money on it.

CHARLIE MUNGER: Yes, I did.

WARREN BUFFETT: We — it's the kind of industry that's — it's interesting for us to follow.

I mean, many years ago it was the dominant factor — or overwhelming factor — in the economy. It's diminished a fair amount but it's still a very important industry.

And it's the kind of industry that anyone can follow. I mean, you have experience with the product and competing products, and you — everyone in this room understands in a general way the economic nature of the industry.

But we've never felt that we understood it better than other people. So we've seen auto companies at very low multiples sometimes and with prices that in hindsight looked very attractive, but we never really felt that we knew who among the auto companies five years from now would have gained the most ground relative to where they are now, or that gained the most ground relative to what the market might expect. It just isn't given to us, that knowledge.

Charlie?

CHARLIE MUNGER: I agree.

50. Selling on internet could help Borsheims and GEICO

WARREN BUFFETT: Area two.

SCOTT RUDD: Hi, my name is Scott Rudd from Evening Prairie, Minnesota.

And my question is this: ten years from now — and I'm referring to Borsheims as the retail part of it to the consumer, not so much the corporate division — ten years from now, what would be the three things that you would expect to change on a day-to-day operating basis, to change the most and affect your ability to be dominant in that area.

WARREN BUFFETT: Well, I think — are you talking about Borsheims specifically?

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yeah, I think Borsheims — I won't have three things — but Borsheims may be one of a couple of our companies where the internet could be a huge — have a huge potential for us.

I don't know if that'll happen, but there's no question that we operate — and I've got a message on the internet — at considerably — very considerably — lower gross margins than does a Tiffany or publicly-held jewelry operations.

We are giving customers considerably more for their money. We've got way lower operating costs than the public companies.

And I say on the internet, our operating costs are 15 to 20 percentage points, and even more in some cases, less than publicly-owned competitors. So we've got a lot to offer.

Now, the big question people always have with jewelers is, "How do you know who to trust?" I mean, you know, it is an article that most people feel very uncomfortable buying.

And I think that the Berkshire Hathaway identification can help people feel comfortable on it. I think that the experience of customers around the country as they see it.

And I don't think that — I think it's a product — it's a high-ticket item, so saving money gets to be really important. Just like auto insurance, saving money gets to be really important.

So I think that the internet could be of significant assistance to Borsheims in terms of spreading and facilitating its nationwide reputation. So Borsheims could have a lot of growth and the internet could be a big part of it.

Our job is to get the message to people around the country that they can literally, you know, have us send a half a dozen items to them, that they can look at with no high-pressure salesmanship at all or anything of the sort, and look at the prices, decide what they want in their own homes, and they will do very well with us.

And we have a lot of people taking advantage of that now. But we could have 10, or 20, or 50 times that number as the years go by. And I think we should work very hard on that.

GEICO has possibilities through the internet, obviously, also.

Anything where you're offering a terrific deal to the consumer, but one of the problems has been how do you talk to that consumer, you know, the internet offers possibilities (inaudible). The thing is that everybody in the world is going to be there, and why should they click on you instead of somebody else?

Actually, the Berkshire Hathaway name may help a little bit on that, although GEICO's name is extremely well known. GEICO is — I said in the annual report we were going to spend a hundred million dollars in — basically in promotion this year. We'll spend more money than that.

The brand potential in GEICO is very, very big. And we intend to push and push and push on that.

Charlie?

CHARLIE MUNGER: Well all that said, if the internet helps some of our business, why certainly the CD-ROM and the personal computer combined to clobber World Book for us.

WARREN BUFFETT: Yeah, we paid our entry fee.

CHARLIE MUNGER: Yeah, we — (laughter) — it's not all plus.

WARREN BUFFETT: No.

51. McDonald's vs. Dairy Queen

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: My name is Jorge Gobbi (PH) from Zurich, Switzerland and my question refers to food businesses, mainly McDonald's and Dairy Queen.

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

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

So they have a very large investment, on which they get very good returns, in physical facilities all over the world.

Dairy Queen has — counting Orange Julius— 6,000-plus operations, of which 30-odd are operated by the company. And even those, some are in joint ventures or partnerships.

So the investment in fixed assets is dramatically different between the two.

The fixed-assets investment by the franchisee, or the person — his landlord — obviously is significant at a Dairy Queen. But it's not significant to the company as the franchisor, so that the capital employed in Dairy Queen is relatively small compared to the capital employed in McDonald's.

But McDonald's also makes a lot of money out of owning those locations and receives —

Whereas Dairy Queen will, in most cases, receive 4 percent of the franchisee's sales, in terms of a royalty, at a McDonald's there's that — there's more than that percentage, plus rentals and so on.

So they're two different — very different — economic models. They both depend on the success of the franchisee in the end. I mean, you have to have a good business for the franchisee to, over time, have a good business for the parent company. Both companies have that situation to deal with.

Charlie?

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

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

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

WARREN BUFFETT: A successful franchisee can sell his operation for significantly more than he has invested in tangible assets. And we want it that way, obviously, because that means he's got a successful business, and it means that, over time, we will have a successful business.

You want — you want a franchise operation — you want the franchise operator to make money and you want him to create a capital asset that's worth more than he's put in it. That's the goal.

52. Making money with the Byrne family

WARREN BUFFETT: Area 4.

AUDIENCE MEMBER: Good afternoon, Mr. Munger and Mr. Buffett.

My name is Patrick Byrne, I'm a shareholder, and I'm here from Cincinnati, Ohio, back again this year to ask a question to see if I can get the two of you to disagree on a subject. I've picked education as an area where we might see some daylight between the two of you.

First though, on the subject of education, I'd like to offer some brief thanks.

I'm lucky in that my parents, in the late '70s, made the wise choice of buying some Berkshire stock and putting it in a college fund for my brothers and me, and that basically paid for our higher education.

I suspect there must be thousands of people like us who had our education paid for by wealth that the two of you created, and we owe you. Although we probably all have been a lot better to skip college and keep the stock. (Laughter and applause)

Well, on the subject of education, Milton Friedman has said, or has written, that if you really care about poverty in the U.S. and the disadvantage of women and minorities and so on, and you could cure one single thing in the U.S., it would be the public education system.

Mr. Buffett, of course you've been very publicly supportive and done many things, and I'm sure Mr. Munger has as well, for public education.

But I noticed last year, in this annual meeting, Mr. Munger — or both of you, of course, criticized some aspects of higher education, like business schools.

But Mr. Munger included — he was a tad critical, I would say, of the U.S. public education system.

And I wonder if you two agree with what Friedman says and what you think the importance of public education is, and what might be done to improve it.

WARREN BUFFETT: I'm going to let Charlie go in a second, but I just want to say, Patrick Byrne is the son of Jack Byrne, who made a fortune for us by resuscitating GEICO when it got into trouble in the mid-'70s.

In fact, I met Patrick's dad on a Wednesday night, about 8 o'clock at night, in Washington, when GEICO was — it was bankrupt and it was about — very close to being declared so.

And after talking with him about three hours that night, the next day I went out and bought 500 and some-thousand shares of GEICO, that Davy [Lorimer Davidson] referred to, at 2 1/8, so — which is forty cents on the stock that we paid $70 for later on.

So Patrick's dad — we may have made — (laughs) — we may have made the Byrne family more money; he made us a lot of money.

Patrick is now running Fechheimers in Cincinnati and doing a sensational job. His brother, Mark, on June 30, if we hit the target date, will be establishing a major operation in London and Bermuda that will — in which we will be a very large partner.

So he's only got one other brother left, and he's out playing golf in California. But if times get tough we're going to try and recruit him, too.

53. Fixing public education

WARREN BUFFETT: Charlie, with all that time to prepare, what do you have to say about education? (Laughs)

CHARLIE MUNGER: Well, I certainly agree with Milton Friedman, that there's — it would be hard to name one factor, if we could fix it, that would be more worthy of fixing than education in the United States, particularly the lower grades in education where the failures are so horrible, in many big cities particularly.

So yes, I think it's a terrible problem and it needs fixing.

Of course, it's a huge debate as to what the best way is to fix it. And I am skeptical, myself, of big city school systems getting fixed under their own momentums. In other words, I'm quite sympathetic to the people who say we may have to go to an alternative, like vouchers.

That the incentive structure has — (applause) — gotten so bad in some places that you can't fix it with evolution; it takes revolution.

Warren, you're more optimistic about big city public schools —

WARREN BUFFETT: Well, I'm not necessarily more optimistic. I probably feel, though, that democracy without a good public school system available to the entire population is sort of a mockery.

Because there's so much — (applause) — inequality to start with. I mean, it isn't just inequality of money. But I mean, my kids, whether they inherit any money, or your kids, whether they inherit any money, compared to the kids of somebody where both parents are struggling to keep the place going, or maybe just one parent, and living in poverty — I mean, it is so unequal to start with that if you accentuate that inequality by giving those who are generally higher up on the ladder also a far better education than you give those who have chosen the wrong womb, I think that's just — I don't think that society should tolerate that — a rich society — should tolerate it.

That doesn't mean it's easy to solve. Because I've said a lot of times that, unfortunately, it seems like a good public school system is like virginity, that it can be preserved but not restored.

And it's very hard, when you get a system that's lousy, to do much about it, because under those circumstances the wealthy people are going to all opt out of the system, and they're going to be less interested in the bond issues, they're going to be less interested in the PTA, they're going to be less interested in the outcome of the other people's children, if they have all opted out for their own system.

And to have one educational system for the rich and another for the poor, with the poor being — getting the poorer system — strikes me as doing nothing but accentuating inequality and other problems that result from that in the future.

So I don't know the answers on improving the system. You know, I read some of the experiments that take place.

But I do believe to start with that if you have a good public school system, as we do in Omaha, that you do your damndest to maintain that so that there is no incentive for the rich grandparent or the rich parent to say, you know, "I love the idea of equality, but I love my grandchildren or my child more, so I'm going to yank him from the public school system," and then you get this sort of exodus which leaves behind only those who can't afford to make that choice.

And the problem I have with the voucher system, if there were a way — the idea of competition I like, you know, and I think a good parochial system does, for example, create a better public system — and I think we've had that situation in Omaha — but I think the voucher system, if it simply amounts to giving everyone an additional amount, simply means that the rich get X dollars of the public school system subsidized, but the poor still are — whatever that differential is — remains.

I mean, you could have a golf voucher system — because I play golf — I don't play very often — but if I play at the Omaha Country Club then you could have a voucher system so that everybody in Omaha would have more access to the country club by giving everybody a thousand dollars a year to play golf.

But it just means it would reduce my bill by a thousand bucks, but it still wouldn't do the job for the guy who's on the public course because he'd still be beyond his means to move to full-scale equality with me.

I — you know, I don't think there's anything more important — and I agree with Charlie totally — I think the first eight grades, you know, you can forget it after that. If you have the first eight grades right, good things are going to flow. And if you have those wrong, you're not going to correct it as you get beyond that point.

And I think that — you know, I commend Walter Annenberg on the $500 million. I think it is very tough to see results in that arena. And if you find something that is producing results, I think it should be replicated elsewhere.

I think that, obviously — a fellow in Chicago says that the unions have caused considerable problems in getting adjustments made, but he had the political clout behind him to overcome some of those problems.

It ought to be a top national priority. We have the money to educate everybody well in this country, and the question is, can we execute? And that's something I hope good minds like Patrick's work on.

Charlie, you have anything for that?

CHARLIE MUNGER: Yeah. I think when something is demonstrably failing at performing the function to which it's assigned by a civilization, just to keep pouring more and more money into a failing modality is not the Munger system.

So I'm all for taking the worst places where there's failure and trying a new modality. And it wouldn't bother me at all to have vouchers only for the poor.

But I think we have to do something in our most troubled schools to change our techniques. I think it's insane to keep going the way we are.

WARREN BUFFETT: So you'd go for means-tested vouchers, basically?

CHARLIE MUNGER: Oh, I —

WARREN BUFFETT: I mean, I don't disagree with that idea.

CHARLIE MUNGER: All I know is we're — it is a terrible place to fail.

And part of the trouble is ideological. If you have an absolute rule there can't be any tracking by ability, no matter how much better reading can measurably be taught by systems that involve tracking, well, people that brain-blocked shouldn't have the power. You know, we should — (applause) — do what works.

WARREN BUFFETT: You know, we got plenty — I mean, in Omaha, it works. The problem is that once it gets beyond a certain point on a downhill slope, essentially you have the citizens that are able to do something about it, essentially, opt out. And that — I don't know —

CHARLIE MUNGER: I am a product of the Omaha public schools, and in my day, the people who went to private schools were those who couldn't quite hack it in the public schools. That is still the situation in Germany today. I mean, private schools are for people who aren't up to the public schools.

I'd prefer a system like that. But once a big segment of that system measurably fails then I think you have to do something. You don't just keep repeating what isn't working.

WARREN BUFFETT: Well, I agree with that.

Patrick, have you gotten your answer? (Applause)

54. “The truth is you can have the reputation that you want”

WARREN BUFFETT: Let’s go to area 5.

AUDIENCE MEMBER: My name’s Kevin Murphy, I’m from Camarillo, California.

And my question is, what do you look for when determining if a person is honest or not?

WARREN BUFFETT: Now, that’s a good question, Kevin.

You — I think, generally, Charlie and I can do pretty well with the situations we see, but we have to have some evidence of behavior in front of us. And I would say even there’s some occupations where we’re going to expect to find a higher percentage of people who behave well than in others.

But if we work with someone over a period of a few months or more, I think we’ve got — we can come up with a pretty high batting average, in terms of how they behave.

At Salomon, I think I was able to separate out the people who I felt very good about and the people I was a little more nervous about fairly quickly, among the ones I worked with actively.

But how you spot that precisely, you know — leave your lunch money on their — (laughs) — on their desk sometime, Kevin. Maybe you’ll find out in a hurry, but — (Laughter)

We like people — you know, I mean, the great example, you know, is somebody like a Tom Murphy, where they’re just bending over backwards all the time to make sure that you get the better end of the deal.

That doesn’t mean they aren’t competitive. I mean, if you play him at a golf game for money or something like that, you know, he wants to win in the worst way. But he —

But there are people that just — they don’t take credit for things that they didn’t do. In fact, they give you credit for some of the things that maybe they did. You can get a feel for it over time.

Charlie, you have any good guidelines on that?

CHARLIE MUNGER: Yes. I think that people leave track records in life. And so, somebody at your age should figure that by the time he’s 22 or ’3, well, he will have left quite a track record and the world will be able to figure you out.

So I think that track records are very important. And if you start early, trying to have a perfect record in some simple thing like honesty, you’re well on the way to success in this world. (Applause)

WARREN BUFFETT: [Italian industrialist] Gianni Agnelli one time told me, he said, “When you get older, you have the reputation you deserve.” He said you can get away —

CHARLIE MUNGER: Yeah, yeah.

CHARLIE MUNGER: — with it for a while early on. But by the time anybody gets to be 60 or so, they very probably have the reputation they deserve. And the truth is you can have the reputation that you want.

If you list all of the things that you admire in other people, you’ll find out that almost everything you list — you may not be able to kick a football 60 yards or something of that sort — but almost everything you list in the people that you admire and like, they’re qualities that you can have if you just set out to do that.

Didn’t Ben Franklin do that, Charlie?

CHARLIE MUNGER: Oh, sure. I always say that the best way to get what you want is to deserve what you want.

WARREN BUFFETT: I’ll have some more peanut brittle. (Laughter)

55. No expectations of investment problems due to Y2K

WARREN BUFFETT: Area 6.

AUDIENCE MEMBER: I’m Nancy Sill (PH) from Atlanta, Georgia.

You were asked earlier this morning a question about the year 2000 computer problem. Do you anticipate any negative financial impact to the economy or to our companies due to the millennium problem, and if so what financial strategies are you considering?

WARREN BUFFETT: Well, I don’t think there’ll be major problems for our companies. You know, there are going to be some problems — (laughs) — anytime you have something that big.

If people didn’t see it coming in 1980 or 1985, they’re not going to be perfect at solving it by 2000, you can count on that.

But I don’t think it has any investment consequences for Berkshire Hathaway that we should be considering now. And I do think you’ll see most of the problems in the governmental area.

You know, maybe they won’t find your tax return for two or three years. (Laughter) Who knows?

Charlie?

56. McDonald's will keep its real estate

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: In your description of McDonald's, you have a sense that there's a great business buried in McDonald's and two good businesses that are mixed in with it. And the problem is with the real estate and the operational business, that as the company is currently capitalized, they can't earn the same kind of returns they can earn in the franchising business.

You were, or still are, a significant shareholder of McDonald's. I guess my question is, the solution is obvious: why don't you push for a solution that creates the same opportunity to have at International Dairy Queen?

WARREN BUFFETT: Well, my guess is — I don't know the details on it — but my guess is that with 23,000 locations all over the world, I think it would be extraordinarily difficult to separate the real estate business out from the franchising business at this point.

I think they could've gone a different route. I'm not saying it would've been a better route at all. In fact, I think the odds are they followed the right route in owning and controlling so much real estate.

But I just think the problems would be horrendous. Certainly you wouldn't want to sell it and lease it back because you would not end up with more value, in my view, by doing that.

And spinning it off in a real estate trust or something, with operating in 100-plus countries, and with all of the franchise arrangements, I think it would be a huge, huge problem. I would not want to tackle it myself.

So I think that you should look at McDonald's — and I don't know anything about their plans on this — but I think you should look at McDonald's as being a very good business, but one that will continue in its present mode vis a vis the real estate. Although I think they've signaled that they're going to do less on new properties — somewhat less — in connection with ownership, than they've done to this point.

But there's 23,000 locations out there and every operator, his own arrangement is very important to him. And it just — it would be a mammoth job, and I'm not sure how much extra value would be created in the end anyway.

Charlie?

CHARLIE MUNGER: Yeah, the net returns on capital McDonald's has earned all these years are high, even though they have owned a lot of their real estate. I think it's hard to quarrel with the way they did it. They had the best record.

WARREN BUFFETT: And the multiple is not greatly different, in my view, than if the real estate were separate. You know, I mean, if you get all the real estate detached in some arrangement, you might get a little more out of it. But it doesn't strike me as a big deal.

57. Berkshire is "poorly" structured for owning securities

WARREN BUFFETT: Area 8.

AUDIENCE MEMBER: Yeah, hi. I'm Rachel White (PH) from Missoula, Montana.

And during the lunch break, I heard some people talking about double taxation and how that impacts Berkshire's investment philosophy. So I was wondering if you could talk a little bit about it. I'm not sure I understood it. And if you could explain whether that impacts your investments.

WARREN BUFFETT: Well, we are structured very poorly. And if you were looking — if you're going to start all over again and do most of the things we've done, you would probably not do it in corporate form, or precisely like we do it.

I mean, what that gentleman was talking about in connection with McDonald's applies much more to Berkshire Hathaway by far than McDonald's, in terms of de-taxing part of the income stream.

If we own Coca-Cola with a cost of a billion-two or a billion-three and a market value of 15 billion, we're not going to sell it.

But if we did sell it, we would incur a capital gains tax on the order, almost, of $5 billion.

That means that the 15 becomes 10 billion. Now, if that 10 billion is reflected in Berkshire's value and you bought your stock when we bought our Coke, then you pay a second tax, in turn, in reflection of the Coca-Cola appreciation that has taken place after tax. So it's a very disadvantageous way of owning securities, to have a corporation in between you and the securities themselves.

If we ran as a partnership that would not be the case. I ran Berkshire Hathaway — I mean, I ran Buffett Partnership for many years and we only had one tax at the individual level.

So our stockholders are — to the extent that we own marketable securities — and we own a lot of them — and to the extent that we have a lot of profits over time in those — own those securities in a disadvantageous way.

Now, we also have a float, which helps us own them, which is a big plus.

But corporate ownership of securities — if you have the option of owning them directly or through a partnership — corporate ownership is disadvantageous.

And we're stuck with it. We've had it for all these years. We've got no plans to do anything about it. We couldn't, probably, do anything about it if we wanted to.

So that is a drag on our performance, compared to what would be the situation if we operated as a partnership.

And Lloyd's syndicates, for example, didn't have that problem. Some insurance companies that operate in Bermuda may not have that problem to the same extent. Certainly partnerships don't have that problem, to the extent they own securities. But it's a fact of life with us and we're going to pay a lot of taxes.

Charlie?

CHARLIE MUNGER: Yeah, we have no cure for the corporate income tax, and it is a big disadvantage for the indirect owner of securities.

So far we've surmounted it well enough but we're carrying a load there.

WARREN BUFFETT: It's become a bigger disadvantage since the individual rate went to 20 percent with our corporate rate being 35 percent. If we make a dollar on a stock, it becomes 65 cents, and to the extent that you've owned Berkshire, that 65 cents, now 20 percent off that, becomes 52 cents. Whereas if you'd owned the stock directly, you'd have had 80 cents.

Now, when we owned GEICO and it wasn't consolidated with us, you carried that one more extreme. I mean, GEICO had capital gains and we had a capital gain proportionately in GEICO, and so on.

I mean, how you're structured does make a real difference. But usually once you get into a given structure, you're kind of stuck with it, as I indicated in the answer to the gentleman on McDonald's.

CHARLIE MUNGER: Now, to the extent we have very long holding periods at the corporate level, the real mathematical disadvantage shrinks.

WARREN BUFFETT: Yeah, and we might not have been able to get the float that we have, if we hadn't been operating it in a corporate structure, so that is a mitigating factor, too.

But we like to have the mitigating factors without anything to mitigate, if we get our choice. (Laughter)

58. Due diligence is useless and misses the point

WARREN BUFFETT: Area 9, please.

AUDIENCE MEMBER: Good afternoon. My name is Fred Strasheim (PH) and I'm from here in Omaha.

I have a question about your acquisition methodology. And I was intrigued to read in your annual report about your acquisition of Star Furniture.

And as I understand the process you followed, Mr. Buffett, you met with Mr. — or you — I'm sorry, you reviewed financials for a brief period, liked what you saw, then you met with Mr. Melvyn Wolff for two hours and struck a deal. And you wrote you had no need to check leases, work out employment contracts, et cetera.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: I think that most companies, when they do acquisitions, would feel the need to do a significant amount of legal due diligence, to do things like check the leases, check into things like undisclosed environmental liability, or perhaps threatened litigation.

And I guess my question is, have you ever been burned by your approach?

WARREN BUFFETT: We've been burned by the — we've been burned only in the sense that we've made mistakes on judging the future economics of the business, which would've had nothing to do with due diligence.

We regard what people normally refer to "due diligence" as, as really sort of boilerplate in most cases.

It's a process that big companies go through. And they feel they have to go through it. And they're ignoring — oftentimes, in our view — they're ignoring what really counts, which is evaluating the people they're getting in with, and evaluating the economics of the business. That's 99 percent of the deal.

You know, you may run into an environmental liability problem, you know, one time in a hundred, or you may, you know, you may find a bad lease.

I asked Melvin about, you know, "Do you have any bad leases?" I mean, that's the easiest way to do it. And I could read them all and try and look for every clause or something, but it isn't going to — you know, that is not the problem.

We've made bad — lots of bad deals. We made a bad deal when we bought Hochschild Kohn, for example, the department store operation, back in 1966. But it had — fine people — but we were wrong on the economics of the business.

But the leases didn't make any difference. You know, that sort of thing just was not important. And I can't recall any time that what other people refer to as due diligence would've avoided a bad deal for us.

CHARLIE MUNGER: I can't either.

WARREN BUFFETT: No. That's 30-some years. And I —

The key thing — you just don't want to do — I go — I'm on various public company boards — I've been on 19 public company boards — and you know, their idea of the due diligence is to send the lawyers out and have a bunch of investment bankers come in and make presentations and all that.

And I regard that as terribly diversionary, because the board sits there, you know, entranced by all of that, and everybody reporting how wonderful this thing is and how they checked out patents and all that sort of thing. And nobody is focusing really on where the business is going to be in five or 10 years.

You know, business judgment about economics — and people to some extent — but the business economics — that is 99 percent of deal making. And the rest, people may do it for their protection. I think too often they do it as a crutch just to go through with the deal that they want to go through with anyway, and of course all the professionals know that. So believe me, they come back with the diligence, whether due or not. And — (Laughter)

We are not big fans of that. I don't know how many deals we've made over the years, but I cannot think of anything that traditional due diligence has had a thing to do with.

CHARLIE MUNGER: No, we've had surprises on the favorable side a couple of times —

WARREN BUFFETT: That is true. That is true.

The kind of people that we've generally dealt with have usually told us the bad things first and good things after we made the deal.

We made a deal with a fellow over in Rockford in 1969, Eugene Abegg, Illinois National Bank and Trust Company. I made that deal in a couple of hours and, I mean, there just wasn't any way that Gene was going to be hiding anything bad.

For the next ten years when I went over there, every time I'd go to lunch he'd point out some building in town that we owned that wasn't on the books, or some foundation we had that had money in it he hadn't told me about.

And he even gave me some bills, one of which I carry in my pocket, that he had still sitting around that were issued by the bank that were our own money which he never told me about.

We could cut them out like paper dolls. I mean, Gene was not a guy to show all his cards. (Laughter)

And those are the kind of people we've generally dealt with, and I would certainly say that Melvyn and [his sister] Shirley [Toomin] fit that description in spades.

Morning Session - 1999 Meeting

1. Formal business meeting begins

WARREN BUFFETT: Good morning. Really delighted we can have this many people come out for a meeting. It says something, I think, about the way you regard yourself as owners.

We're going to hustle through the business meeting. And then Charlie and I will be here for six hours or until our candy runs out — (laughter) — to answer any questions you have. We have people in a number of remote locations. And we have ways of bringing them into the questions as well.

Incidentally, if you hadn't figured it out already, this hyperkinetic bundle of energy here on my left is Charlie Munger — (laughter) — our vice-chairman. (Applause)

And we will now run through the business of the meeting.

The meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company. I welcome you to this 1999 annual meeting of shareholders.

I will first introduce the Berkshire Hathaway directors that are present, in addition to myself. And if you'll stand up. It's a little hard for me to see — there, right down here in the front row.

We have Susan T. Buffett. You stand and remain standing, please. (Applause)

If you encourage her, she'll sing another song. (Laughter)

Howard G. Buffett. Don't encourage him to sing a song. (Laughter and applause)

Malcolm G. Chace. (Applause)

Charlie, you've already met.

Ronald L. Olson. Ron? (Applause)

And Walter Scott Jr. (Applause)

Also with us today are partners in the firm of Deloitte and Touche, our auditors. They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings. Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg. Proxy cards have been returned through last Friday, representing 1,133,684 Class A Berkshire shares and 3,485,885 Class B Berkshire shares to be voted by the proxy holders, as indicated on the cards.

That number of shares represents a quorum. And we will therefore directly proceed with the meeting. We will conduct the business of the meeting and then adjourn the formal meeting. After that, we will entertain questions that you might have.

Does the secretary have a report of the number of Berkshire shares outstanding entitled to vote and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting, that was sent by first-class mail to all shareholders of record on March 5, 1999, being the record date of this meeting, there were 1,343,592 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting.

And 5,266,338 shares of Class B Berkshire Hathaway common stock outstanding with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,133,684 Class A shares and 3,485,885 Class B shares are represented at this meeting by proxies returned through last Friday.

WARREN BUFFETT: Oh, thank you Forrest.

The one item of business of this meeting is to elect directors. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you. Would those persons desiring ballots please identify themselves, so that we may distribute them.

2. General Re CEO Ron Ferguson declined to join board

WARREN BUFFETT: I'd like to make one comment before we proceed to the election of directors. And that's that in the General Re proxy material, material relating to the General Re merger, it was stated that the intention was to have Ron Ferguson, the CEO of General Re, join the board of Berkshire Hathaway.

And that offer was extended, and still remains open, and will remain open for his lifetime and mine, at least, for Ron to join the board.

After thinking about it, he decided that he preferred not to be on the board. And in that judgment, he concurs with my feelings, generally, about boards, in that they can restrict your — it can restrict your activities in purchase and sale of a stock.

For example, if you do it in a six-month period, then you're automatically in trouble with the — and you have to return any profit, as calculated in a rather peculiar way, to the company. It means that your compensation system is laid out for the world to see.

There may be some tax restrictions, in terms of the deductibility of salary paid. And so, Ron notified me a little bit before the proxy material went out that he preferred, at least, to defer any decision on joining the board.

3. Disadvantages of being a corporate director

WARREN BUFFETT: I can tell you that it has cost Berkshire significant money by the fact that Charlie and I have been on various boards, because your hands are tied, in many respects, even if you don't have any knowledge of anything that might be of material, plus or minus — the very fact that it might be imputed to you, can restrict actions significantly.

So, we make a point of not trying to be on very many boards. Charlie and I have only gone on boards where we have very significant investments by Berkshire.

And sometimes those have caused us to take on a job that we didn't intend originally, as that Salomon movie showed.

So, Ron — the offer is a hundred percent open to Ron at any time. And if he changes his mind in any way, he will be on the board.

But that explains the discrepancy between the actions that are being taken this morning and what was described as likely to happen in the proxy material.

4. Berkshire directors elected

WARREN BUFFETT: Now, with that explanation, I would like to recognize Walter Scott Jr. to place a motion before the meeting with respect to election of directors. Walter?

WALTER SCOTT JR.: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. be elected as directors.

WARREN BUFFETT: Is there a second? Somebody should second it.

VOICE: I second the —

WARREN BUFFETT: We got a second out there, Susan?

VOICE: I second the motion.

WARREN BUFFETT: Oh, good. OK. It has been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. be elected as directors.

Are there any other nominations?

Long enough. Is there any discussion?

Long enough. The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of election.

Will the proxy holders please also submit to the inspector of election, a ballot on the election of directors, voting the proxies in accordance with the instructions they have received?

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders, in response to proxies that were received through last Friday, cast not less than 1,145,271 votes for each nominee.

That number far exceeds the majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as those cast in person at this meeting, if any, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. have been elected as directors.

5. Formal business meeting adjourns

WARREN BUFFETT: After adjournment of the business meeting, I will respond to questions that you may have that relate to the business of Berkshire, but do not call for any action at this meeting.

Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Walter Scott Jr. to place a motion before the meeting.

WALTER SCOTT JR.: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second?

VOICES: I second the motion.

WARREN BUFFETT: A motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say "aye."

AUDIENCE: Aye.

WARREN BUFFETT: All opposed say, "I'm leaving." No, say, "No," I'm sorry. (Laughter)

OK, the meeting is adjourned.

6. We buy businesses and don't predict stock moves

WARREN BUFFETT: Now, we'll move forward. (Applause) Thank you.

I ask you, was Joe Stalin ever any better, I mean? (Laughter)

We will — we have this room broken into eight zones, and then we have five more zones from various off-site locations. And we will move in order. We have microphones that you can go to, and we have a monitor at each microphone that will line people up.

We will rotate around the 13 zones. There's just one question per person. I'd ask that you identify yourself and state where you're from.

Now, you have to be a little careful on that because a lot of people will say that — who really aren't — will say that they're from Nebraska for status reasons. But — (laughter) — if you get beyond that, we will try to identify where everybody is from. And we'll start off in zone 1, which is on the right here at the front.

AUDIENCE MEMBER: My name is Tim Spear (PH). And I'm from Hertfordshire, England.

I was thinking in Ben Graham's book, "The Intelligent Investor," he spends the first couple of chapters discussing the level of the market and whether it was safe for investment. I was wondering what you think of the market today?

WARREN BUFFETT: Well, we don't — Charlie and I don't think about the market. And Ben didn't very much. I think he made a mistake to occasionally try and place a value on it.

We look at individual businesses. And we don't think of stocks as little items that wiggle around on the paper and that have charts attached to them. We think of them as parts of businesses.

And it is true that, currently, we have great trouble finding businesses that we both like and where we like the management and that they — and find them at an attractive price.

So, we do not find bargains in this market among the larger companies that are our universe.

That is not a stock market forecast in any way, shape, or form. We have no idea whether the market is going to go up today, or next week, or next month, or next year.

We do know that we will only buy things that we think make sense, in terms of the value that we receive for Berkshire. And when we can't find things, the money piles up. And when we find — when we do find things, we pile in.

But the stock market — I know of no one that has been successful at — and really made a lot of money predicting the actions of the market itself. I know a lot of people who have done well picking businesses and buying them at sensible prices. And that's what we're hoping to do.

Charlie?

CHARLIE MUNGER: How could you say it any better? (Laughter)

WARREN BUFFETT: Yeah, but the question is whether you can say it better, Charlie. (Laughter)

7. Expecting slow short-term growth of Gen Re's float

WARREN BUFFETT: OK, we'll go to zone 2. That may be all you hear from him today. (Laughter)

Get used to it.

AUDIENCE MEMBER: Good morning.

WARREN BUFFETT: Morning.

AUDIENCE MEMBER: David Winters, Mountain Lakes, New Jersey.

Could you give us a few hints about the incremental value of Gen Re's float under the Berkshire Hathaway umbrella and the potential for the growth of Gen Re's float over the long term?

WARREN BUFFETT: Yeah. Gen Re's float, which is now available to Berkshire — it's a hundred percent-owned subsidiary, although part of that float is attributable to Cologne, which is only an 83 percent-owned subsidiary of Gen Re and also Berkshire.

But that, I would say, the incremental value today, because it's under the Berkshire umbrella, is zero. Because we are bringing nothing to the party that Gen Re's own investment people would not have brought to the party.

We obviously think that there will be important incremental value over a long period of time. We — but when that value will appear or how much of it develops, is a matter that's out of our hands.

We, right now, have close to 24 billion in total invested assets at Gen Re and Cologne. Like I say, 83 percent of the Cologne part is ours and 17 percent is — belongs to somebody else.

But we are bringing nothing to that party right now, in terms of any managerial skill that is going to add value. I would hope that over time, we would.

The second question, as to the growth of float, the growth of float at General Re and Cologne will certainly be very slow in the short term. The growth of float at GEICO will be significant, percentage-wise.

The reinsurance business does not have the same potential for growth as we have at GEICO. And growth is much slower to come about, because there are longer-term contractual commitments — that people are reluctant to change reinsurers. And they should be. We agree with that.

So you — at a level of 6 billion or so of premium volume and already 14 billion of float, you won't have growth of float unless premium volume is — becomes significantly higher in the future.

I think that will happen over time. It will not happen in the short term.

Charlie? If I may interrupt your breakfast? (Laughter)

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: OK. (Laughter)

8. How Berkshire's enormous bid for Long-Term Capital Management failed

WARREN BUFFETT: Zone 3. (Laughs)

You could always direct your questions to Charlie, incidentally. (Laughs)

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. Thank you for hosting another wonderful weekend. My name is Che Wai Woo (PH). I'm a proud shareholder from right here in Omaha.

One of the most interesting financial news developments this previous year was the near collapse of the hedge fund Long-Term Capital.

I'd like to get your thoughts and Mr. Munger's thoughts about how these private partnerships operate, what your thoughts about the Long-Term Capital deal, and also the Fed's intervention to save it.

WARREN BUFFETT: Yeah, in that movie you saw, the time when Yellowstone was — when Old Faithful was performing in the background and Bill was trying to get me to watch that while I was on the phone —

A lot of that trip was spent talking to New York about making a bid for, what we'll call LTCM, Long-Term Capital Management.

And the caption on that photo, incidentally, is known as the geezer and the geyser. (Laughter)

And we were up in — we started in Alaska. And we were going down these canyons in a boat.

And the captain saying, you know, "Let's go over there and look at the sea lions." And I say, "Let's stay right where we are, where we got a satellite channel," because I was trying to talk on the phone all the time.

Charlie was in Hawaii. And we never did get a chance to talk during that whole period. I didn't want to bother him with a little thing like a bid for 100 billion-plus of securities, and I couldn't find him.

So it was — we were in an awkward place to pursue that. I think it's possible that if I'd been in New York or Charlie had been in New York during that period, that our bid might have been accepted.

There was just a report published within the last three or four days by a special committee representing the SEC, the Fed, I think, the Treasury and the CFTC — I think I'm right on those four. And it describes just a tiny bit of the events leading to the bid.

It referred, on page 14, I remember, it talked about our transaction unraveling. It didn't unravel from our side. I mean, we made a firm bid for 100 billion-plus of balance sheet assets and many hundreds of billions, in fact, over a trillion, of derivative contracts.

And, you know, this was in a market where prices were moving around very dramatically. And with that bulk of assets there, we thought we made a fairly good bid for a 45-minute or hour period. I don't think anybody else would've made the bid.

But in any event, the people at LTCM took the position that they could not accept that bid.

And therefore, the New York Fed in — had a group, largely investment banks there at the Fed. And that afternoon, faced with the prospect that LTCM could not or would not accept our bid, they arranged another takeover arrangement where additional money was put in.

9. The true first hedge fund

WARREN BUFFETT: It's interesting. If you read that report, which is put together by these four very imminent bodies, I think on the first page, it says that the first so-called hedge fund — which is a term generally applied to entities like LTCM — first hedge fund was set up in 1949.

And I probably read that or heard that 50 times in the last — particularly in the last year. And of course, that's not true at all, and I've even pointed this out once or twice before.

But Ben Graham had — and Jerry Newman — had a classical hedge fund back in the '20s. And I worked for — I worked dually for a company called Graham-Newman Corp, which was a regulated investment company and Newman and Graham, which was an investment partnership with, I think, a 20 percent participation in profits and exactly the sort of entity that, today, is called a hedge fund.

So, if you read anyplace that the hedge fund concept originated in 1949, presumably with A.W. Jones, it's a — it's not an accurate history. There are now — I ran something that would generally be called a hedge fund. I didn't like to think of it that way. I called it an investment partnership. But it would've been termed a hedge fund. Charlie ran one from about, what, 1963 to mid '70s or thereabouts.

And they have proliferated in a big way. Did he blink? (Laughter)

There are now hundreds of them. And of course, it's very enticing to any money manager to run, because if you do well, or even if you don't do so well but the market does well, you can make a lot of money running one.

This report that just came out has really nothing particularly harsh to say about the operation.

So, I think you will see hundreds and hundreds and hundreds of hedge funds. I think the current issue of Barron's may have a recap of how a large group did in the first quarter.

And there's a lot of money in those funds. And there's a huge incentive to form them. And there's a huge incentive to go out and attract more money if you run one. And when that condition exists in Wall Street, you can be sure that they won't wither away.

Charlie?

10. LTCM: Smart people's dumb risks with derivatives

CHARLIE MUNGER: Yeah, what was interesting about that one is how talented the people were. And yet, they got in so much trouble. I think it also demonstrates that — I'd say, the general system of finance in America involving derivatives is irresponsible.

There's way too much risk in all these trillions of notational value sloshing around the world. There's no clearing system, as there is in a commodities market. And I don't think it's the last convulsion we're going to see in the derivatives game.

WARREN BUFFETT: It's fascinating, in that you had 16 extremely bright — I mean, extremely bright — people at the top of that. The average IQ would probably be as high or higher than organization you could find, among their top 16 people.

They individually had decades of experience and collectively had centuries of experience in operating in these sort of securities in which the LTCM was invested. And they had a huge amount of money of their own, up. And probably a very high percentage of their net worth in almost every case, up.

So here you had superbright, extremely experienced people operating with their own money. And, in effect, on that day in September, they were broke. And to me, that is absolutely fascinating.

There was book written,"You Only Have to Get Rich Once." It's a great title. It's not a very good book. Walter Gutman wrote it, but it — many years ago. But the title is right, you only have to get rich once.

And why do people, very bright people, risk losing something that's very important to them, to gain something that's totally unimportant? The added money has no utility whatsoever.

And the money that was lost had enormous utility. And on top of that, reputation is tarnished and all of that sort of thing.

So that the gain/loss ratio, in any real sense, is just incredible. I mean, it's like playing Russian roulette.

I mean, if you hand me a revolver with six bullets — or six chambers — and one bullet and you say, “Pull it once for a million dollars,” and I say, “No.” And then you say, “What is your price?” The answer is there is no price.

And there shouldn’t be any price on taking the risk when you’re already rich, particularly, of failure and embarrassment and all of that sort of thing. But people repeatedly do it. And they do it —

Whenever a bright person, a really bright person, goes broke that has a lot of money, it’s because of leverage. It — you simply — you basically can’t — it would be almost impossible to go broke without borrowed money being in the equation.

And as you know, at Berkshire, we’ve never used any real amount of borrowed money. Now, if we’d used somewhat more, you know, we’d be really rich. But if we’d used a whole lot more, we might have gotten in trouble some times. And there’s just no upside to it, you know?

What’s two percentage points more, you know, on a given year, that year? And run the risk of real failure. But very bright people do it, and they do it consistently, and they will continue to do it.

And as long as explosive-type instruments are out there, they will gravitate toward them. And particularly, people will gravitate toward them who have very little to lose, but who are operating with other people’s money.

One of the things, for example, in the LTCM case — and Charlie mentioned it in terms of derivatives — in effect, there were ways found to get around the — and they were legal, obviously — to get around the margin requirements.

Because risk arbitrage is a business that Charlie and I have been in for 40 years in one form or another. And normally, that means putting up the money to buy the stock on the long side and then shorting something against it where you expect a merger or something to happen.

But through derivatives, people have found out how to do that, essentially putting up no money, just by writing a derivative contract on both sides. And there are margin requirements, as you know, that the Fed promulgates that, I believe, still call for 50 percent equity on stock purchases.

But those requirements do not apply if you arrange the transaction in derivative form. So that these billions of dollars of positions in equities, essentially, were being financed a hundred percent by the people who wrote the derivative contracts. And that leads to trouble.

You know, 99 percent of the time it works. But, you know, 83 and a thirds percent of the time, it works to play Russian roulette with one bullet in there and six chambers. But neither 83 1/3 percent or 99 percent is good enough when there is no gain to offset the risk of loss.

Charlie?

CHARLIE MUNGER: I would argue that there is a second factor that makes the situation dangerous. And that is that the accounting for being actively engaged in derivatives, interest rate swaps, et cetera is very weak. I think the Morgan Bank was the last holdout.

And they finally flipped to a lenient standard of accounting that's favored by people who are sharing in the profits from trading derivatives. And that's why they like liberal accounting.

So, you get an irresponsible clearing system, irresponsible accounting — this is not a good combination.

WARREN BUFFETT: JP Morgan shifted their accounting — I think — I'm not sure exactly when — around 1990. But Charlie and I, we probably became more familiar with that when we were back at Salomon.

And this is absolutely standard. You know, it's GAAP accounting. But it front-ends profits. And if you front-end profits and you pay people a percentage of the profits, you're going to get some very interesting results, sometimes.

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

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Hi. Dan Kurs (PH) from Bonita Springs, Florida.

You've given many clues to investors to help them calculate Berkshire's intrinsic value.

I've attempted to calculate the intrinsic value of Berkshire using the discount of present value of its total look-through earnings. I've taken Berkshire's total look-through earnings and adjusted them for normalized earnings at GEICO, the super-cat business, and General Re.

Then I've assumed that Berkshire's total look-through earnings will grow at 15 percent per annum on average for 10 years, 10 years per annum for years 11 through 20. And that earnings stop growing after year 20, resulting in a coupon equaling year 20 earnings from the 21st year onward.

Lastly, I've discounted those estimated earnings stream at 10 percent to get an estimate of Berkshire's intrinsic value.

My question is, is this a sound method? Is there a risk-free interest rate, such as a 30-year Treasury, which might be the more appropriate rate to use here, given the predictable nature of your consolidated income stream? Thank you.

WARREN BUFFETT: Well, that is a very good question. Because that is the sort of way we think in terms of looking at other businesses.

Investment is the process of putting out money today to get more money back at some point in the future. And the question is, how far in the future, how much money, and what is the appropriate discount rate to take it back to the present day and determine how much you pay?

And I would say you've stated the approach — I couldn't state it better myself. The exact figures you want to use, whether you want to use 15 percent gains in earnings or 10 percent gains in the second decade, I would — you know, I have no comment on those particular numbers.

But you have the right approach. We would probably, in terms — we would probably use a lower discount factor in evaluating any business now, under present-day interest rates.

Now, that doesn't mean we would pay that figure once we use that discount number. But we would use that to establish comparability across investment alternatives.

So, if we were looking at 50 companies and making the sort of calculation that you just talked about, we would use a — we would probably use the long-term government rate to discount it back.

But we wouldn't pay that number after we discounted it back. We would look for appropriate discounts from that figure.

But it doesn't really make any difference whether you use a higher figure and then look across them or use our figure and look for the biggest discount.

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

And you mentioned, in terms of our clues, we try to give you all of information that we would find useful, ourselves, in evaluating Berkshire's intrinsic value.

In our reports, you know, I can't think of anything we leave out that, if Charlie and I had been away for a year and we were trying to figure out — look at the situation fresh, evaluate things — there's, you know, there's nothing, in my view, left out of our published materials.

Now, one important element in Berkshire, which is a secondary factor that gets into what you're talking about there, is that because we retain all earnings and because we have a growth of float over time, we have a considerable amount of money to invest.

And it really is the success with which we invest those retained earnings and growth and float that will have an important fact — that will be an important factor — in how fast our intrinsic value grows.

And to an important extent, the — what happens there is out of our control. I mean, it does depend on the markets in which we operate.

So, if our earnings, plus float, growth equals $3 billion, or something like that, in a current year — whether that $3 billion gets put to terrific use, satisfactory use, or no use at all, virtually, really depends, to a big extent, on external factors.

It also depends, to some extent, on our energy and insights and so on. But the external world makes a big difference in the reinvestment rate. And, you know, your guess is as good as ours on that.

But if we run into favorable external circumstances, your calculation of intrinsic value should — would — result in a higher number than if we run into the kind of circumstances that we've had the last 12 months.

Charlie?

CHARLIE MUNGER: Yeah. For many decades around here, we've had roughly a hundred percent — more than a hundred percent — of book net worth in marketable securities and had a lot of wonderful wholly-owned subsidiaries, to boot.

And then we've always had a very attractive place to put new money in as we generate it.

Well, we still got the wonderful businesses. But we're having trouble with the new money.

But it's not trouble, really, to have a pile of lovely money. (Laughter) This is not — I don't think there should be tears in the house. (Laughter)

WARREN BUFFETT: Have you ever run into any unlovely money, Charlie? (Laughter)

12. Internet will have a huge impact, but hard to predict winners

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Good morning. My name is Ronald Towell (PH). I'm from Brooklyn, New York, and very appreciative of your graciousness as a host for this wonderful weekend.

My question has to do with the — (Applause)

My question has to do with the retailing industry, particularly the department stores and mass merchants. My question has two parts.

Without resorting to comments about specific companies, may I ask your opinion as to the long-term prospects for growth and profitability of this industry group?

The second part of my question is, given the fact that it is difficult to pick up a newspaper or to be an investor without being bombarded by what is purported to be the potential for exponential growth in the internet e-business, particularly directly to consumers, which could possibly eat into the revenues of these retailers —

And even if we assume a relatively low impact of, say, 5 to 10 percent revenue reductions, and given the fact that top-line growth is critical to any business, especially the bricks and mortar retailers, with their high proportions of fixed overhead, what advice could you give to a CEO of such a company?

And in turn, based on the proceeding scenario, what would be your opinion of the medium and long-term prospects for this industry?

WARREN BUFFETT: Well, that's a good question, too.

And obviously, the internet is going to have an important impact on retailing. It will have a huge impact on some forms of retailing. Change them and maybe revolutionize them.

I think there's some other areas where it'll — the impact will be less. But anytime we buy into a business, and anytime that we've bought in for some time, we have tried to think of what that business is going to look like in five, or 10, or 15 years.

And we recognize that the internet, in many forms of retailing, is likely to pose such a threat that we simply wouldn't want to get into the business. I mean, it — not that we can measure it perfectly.

But there are a number of retailing operations that we think are threatened. And we do not think that's the case in furniture retailing. And we have three very important operations there.

We could be wrong. But so far, that, you know, that would be my judgment, that furniture retailing will not be hurt.

You've seen other forms of retailing where you're already starting to see some inroads being made. But it's just started. The internet is going to be a huge force in many arenas. But it'll certainly be a huge force in retailing.

Now, it may benefit us in certain areas. I would expect the internet to benefit Borsheims in a very big way. And you noticed in the movie that we talked about borsheims.com coming online in May. There's something up there now. But you'll see a new format within a month or so.

Now, you might say in jewelry retailing, you know, with millions of things that you can click onto, 10 years from now, you know, who is going to be important in terms of online retailing of jewelry? I would argue that two firms have an enormous advantage going in.

I would argue that Tiffany has such an advantage. We don't own any Tiffany. But I would say that because of their name — brand names are going to mean very, very much when you have literally, you know, thousands and thousands of choices.

People can't — they have to trust somebody. And I think that Tiffany has a name that people would trust.

And I think Borsheims has a name that people would trust. And Borsheims sells jewelry a whole lot cheaper than Tiffany's.

So I would say that people who are price conscious, but also want to deal with a jeweler that they trust implicitly, will find their way to Borsheims in increasing numbers, over the internet.

And I would say that people that like the blue box, you know, are going to find their way to Tiffany's, over time. And they'll pay more money.

But I don't see them going for Brand X and buying fine jewelry over the internet.

So, I think that, with the brand that Borsheims has, and with careful nurturing of that brand, I would say that the internet offers Borsheims a chance to have the advantage in cost that comes from a huge one store location. And yet, also go into the homes of people in every part of the world. And that kind of a company should prosper.

There are other of our companies, I worry about. You know, I can worry about them being hurt in various ways.

GEICO is going to be a big beneficiary of the internet. We already are developing substantial business through it.

But I — if I were to buy into any retailing business, whether I was buying a stock of it or buying a whole business, I would think very hard about what people are going to be trying to do to that business through the internet.

And you know, it affects real estate that is dedicated to retailing. If you substitute 5 percent of the retail volume via the internet, where real estate is essentially free, you know, you can have a store in every town in the world through the internet without having any rental expense.

So, I would be — I would give a lot of thought to that if I were owning a lot of retail rental space.

Charlie?

CHARLIE MUNGER: Well, I think it is tricky predicting the technological change. Either it will or won't destroy some business.

When I was young, the department stores had a bunch of, sort of, monopolistic advantages. A, they were downtown where the streetcar lines met. B, they had sort of a monopoly on extending revolving credit. And D, they had one-stop shopping in all kinds of weather. And nobody else did. And they lost all three of those advantages.

And yet, they've done well, a lot of them, for many decades since. At other times, you get a change and you just get destroyed.

Our trading stamp business was destroyed by changes in the economic world. And our World Book business has been seriously hurt by the personal computer, and the CD-ROM, and so forth.

WARREN BUFFETT: I —

CHARLIE MUNGER: We agree, it's a big risk. But it's not easy to make predictions in which you have great confidence.

WARREN BUFFETT: Yeah, if you go down to 16th and Farnam, where the streetcar tracks used to cross, that was the best real estate in town. And people signed 100-year, 50-year leases on it. And it looked like there was nothing more safe, because they weren't going to move the streetcar lines.

The only thing was that they moved the streetcars. They just took and converted them into junk. And it seemed very permanent.

The advantage of the big department store, the Marshall Field in Chicago or the Macy's in New York, was this incredible breadth of merchandise. You could go and you could find 300 different types of spools of thread, or 500 — you could see 500 different wedding dresses, or whatever.

And you had these million square-foot, and even two million square-foot, downtown stores. And they were these huge emporiums.

And then the shopping center came along. And of course, the shopping center created, in effect, a store of many stores. And so, you had millions of square feet now, but you still had this incredible variety being offered.

The internet becomes a store in your, you know, computer, and it has an incredible variety of offerings, too.

Some of them don't lend themselves very well, it seems to me, to the retailing. And, you know, and others do.

But Charlie's right. It's hard to predict exactly how it will turn out.

I would expect, you know, automobile retailing to change in some important ways. And in part — in very significant part, influenced by the internet.

But, I wouldn't — you know, I can't predict exactly how that'll happen. But I don't think it'll look the same 10 or 15 years from now.

13. Buffett praises analyst Alice Schroeder

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Ben Knoll, and I'm from Minneapolis. Although I'd like to enhance my status by noting that I was born and raised in Lincoln. (Laughter)

WARREN BUFFETT: You just moved up. (Laughter)

AUDIENCE MEMBER: Like, many others, I read Alice Schroeder's analysis of Berkshire Hathaway with great interest this last year. And she described her analysis as a toolkit for investors.

And I'm wondering if you see any substantial flaws in any of her toolkit. And in particular, the float-based valuation model that she put together. What are your views on that?

WARREN BUFFETT: Well, I don't want to comment on valuation.

But I can tell you that Alice is a first-class and serious analyst who spent a lot of time on Berkshire, and probably produced the first comprehensive report, at least that's been widely circulated, in the history of Berkshire.

It's kind of interesting that we got to a hundred billion dollars of market value before anybody really published a report about the company, but —

Alice understands the insurance business very well. She's an accountant, by background. So, she understands numbers. And she did a lot of work on the report. And I do recommend it to you as a toolkit. I make no comment at all about valuation.

Charlie?

CHARLIE MUNGER: Nothing to add.

14. Different compensation plans with the same goal

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: Hello. I'm Martin Wiegand from Chevy Chase, Maryland. I want to thank you for the hospitality this weekend and the wisdom you share with us each year in your annual reports.

As a small businessman, one of trickiest jobs I have is dividing up the profits of our business between the employees who generate them.

Would you comment and share your thoughts on how you divide up the profits of the Berkshire Hathaway subsidiaries with the employees who generate them.

And the follow-up is, Mr. Munger, do you have any suggested reading on that subject?

WARREN BUFFETT: Yeah, we're glad to have you here, Martin. I went to high school and to the first couple years of college with Martin's father, who's also here today. And so, if you get a chance to meet Marty, Janie, and younger Martin, say hello to them.

In terms of the arrangements we have with compensation, they vary to an extraordinary degree among the various subsidiaries we have.

Because we have bought existing businesses. And we have tampered as little as possible with their cultures after we buy them. And some of those cultures are very different than others.

I mean, you know, you saw [Nebraska Furniture Mart's] Mrs. B earlier. You know, as you can imagine, she would leave a very strong imprint on any business with which she was involved.

And we have a number of very talented managers who have worked out the systems that they believe to be best for their companies.

Now, it is true that if we — if there's a stock option plan at a company, we will substitute a plan that is performance-based, which ties much more clearly to the performance of the business than any option plan could.

And we will have a — we will design one that has an expectable cost that's equal to the expectable cost of the option plan. So, we try to equate the cost.

And we try to make it even more — much more sensible from both the owner's standpoint and the employees' standpoint, in terms of the way it pays off based on how that business performs.

You probably read in our annual report how we put an across the board plan at GEICO that ties with our objectives. But basically, that was [CEO] Tony Nicely's work in terms of developing that plan.

I mean, he and I thought alike about what counted. And he developed a compensation grid that applied to everybody in the whole place, based on achieving the objectives that he felt were important and that we felt were important.

You will find — if you go to any Berkshire subsidiary — you will probably find that they have a compensation plan that's quite similar, with exception of options, to the plan that they had before we bought the operation. They have successful businesses.

And people get there different ways. Some people bat left-handed. Some people bat right-handed. You know, some people stand deep in the batter's box. Some crowd the plate. They all have different styles.

And the styles of our managers have proven successful in their own businesses. We keep the same managers. So, we don't try to superimpose any system from above, with the exception of what I've mentioned.

We do like the idea of paying for performance. I mean, that is kind of a fundamental tenant. Everybody says they like that. But then they design systems that payoff no matter what happens, in many cases. And we've been reluctant to do that.

Charlie?

CHARLIE MUNGER: Yeah, I think it's important for the shareholders to realize that we are probably more decentralized, in terms of personnel practices, than any company of our size, or bigger, in America. We don't have a headquarters culture that's forced on the operating businesses.

The operating businesses have their own cultures. And I think in every case I can think of, it's a wonderful culture. And we just leave them alone. It's — comes naturally to me. (Laughter)

WARREN BUFFETT: Charlie says we don't have a headquarters culture. Sometimes people think we don't have a headquarters. (Laughter)

We have no human relations department at Berkshire. We have no legal department. We have no investor relations. We have no public relations. We don't have any of that sort of thing.

We've got a bunch of all-stars, as we've put on the screen, out there running businesses. We ask them to mail the money to Omaha, but — (Laughter)

We'll even give them a stamp if they request it. (Laughter)

But beyond that, we don't really go. It would be foolish.

And what is interesting to me is how — I had a lot of preconceived ideas of what motivates people when I started out in business — but you can find certain organizations that resist paying stars on an individual basis. They like to think of themselves as a team and they'd rather have a team concept of payment.

And you can see others where they're much more individually oriented. Actually, Charlie can probably tell you that in terms of law firms. I mean, some law firms have a culture that is much more star-oriented than others. And, you know, you've seen successes in both places, haven't you, Charlie?

CHARLIE MUNGER: Absolutely.

WARREN BUFFETT: OK. (Laughter)

CHARLIE MUNGER: I can't remember a case when anybody has transferred from one operating Berkshire subsidiary to another. It's very rare.

WARREN BUFFETT: Yeah, we don't try and cross-fertilize. We just — we think we've got a good thing going in, you know, in every plot of ground and we just assume they'll do best if left to their own initiative.

15. Low-cost float generates money for investing

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: I'm Brian Phillips (PH) from Chickamauga, Georgia.

And my question is, with regards to an insurance company, if you can use the float for cheap financing, why would you issue a fairly-priced bond?

WARREN BUFFETT: Why would we do what?

AUDIENCE MEMBER: Issue a fairly-priced bond.

WARREN BUFFETT: Yeah, well, the best form of financing for us is cheap float. Now, most insurance companies don't generate cheap float. So, I mean, there are plenty of companies in the insurance business who have a cost of float that makes it unattractive, actually, to expand their businesses.

Our insurance companies have had a terrific experience on cost of float. And we would develop it just as fast as we can.

Right now, we would have no interest in issuing a bond because we have more money around than we know what to do with. And it comes from low-cost float.

But if there came a time when things were very attractive and we had utilized all the money from our float and from retained earnings and all of that to invest, and we still saw opportunities, we might very well borrow moderate amounts of money in the market.

It would cost us more than our float was costing us. But it still, incrementally, would provide earnings.

Now, we would try to gain more float under those circumstances as well. But we would not just quit when we ran out of money from float. We would go ahead and borrow moderate amounts of money. We would never borrow huge amounts of money, though.

Charlie?

CHARLIE MUNGER: Well, I agree.

WARREN BUFFETT: OK. You can see why we've been partners a long time. (Laughter)

16. Big returns are easier with small amounts of money

WARREN BUFFETT: Now, we go to some off — some sites away from this main hall. And not sure how exactly we're going to do this. But we'll go to zone 9 and see if zone 9 comes in.

AUDIENCE MEMBER: Hello. My name is Howard Love. I'm from San Francisco. Thank you very much for this weekend in general and this meeting in particular.

Recently, at a talk at the Wharton Business School, Mr. Buffett, you indicated that — you were talking about the problems of compounding large size, which I appreciate and understand.

But you indicated — you're quoted in the local paper as saying that you are confident that if you were working with a sum closer to a million dollars, that you could compound that at a 50 percent rate.

For those of us who aren't saddled with the $100 billion problem — (laughter) — could you talk about what types of investments you'd be looking at and where in today's market you think significant inefficiencies exist? Thank you.

WARREN BUFFETT: Yeah. I think I may have been very slightly misquoted. But I certainly said something to the effect that working —

I think I talked about this group I get together every two years and how I poll that group as to what they think they can compound money at with a hundred thousand, a million, a hundred million, a billion, and other types of sums.

And I pointed out how this group of 60 or so people that I get together with every couple years — how their expectations of return would go very rapidly down this slope.

It is true. I think I can name a half a dozen people that I think could compound a million dollars — or at least they could earn 50 percent a year on a million dollars — have that as expectation, if they needed it.

I mean, they'd have to give their full attention to be working on the sum. And those people could not compound money, a hundred million or a billion, at anything remotely like that rate.

I mean, there are little tiny areas which, if you follow what I said on the screen there, on that Adam Smith's interview a few years ago.

If you start with A and you go through and you look at everything and you find small securities in your area of competence that you can understand the business, I think you — and occasionally find little arbitrage situations or little wrinkles here and there in the market —

I think, working with a very small sum, that there is an opportunity to earn very high returns. But that advantage disappears very rapidly as the money compounds. Because I, you know, from a million to 10 million, I would say it would fall off dramatically, in terms of the expectable rate.

Because there are little — you find very small things that, you know, you can make — you are almost certain to make high returns on. But you don't find very big things in that category today.

I'll leave to you the fun of finding them yourselves. Terrible to spoil the treasure hunt.

And the truth is, I don't look for them anymore. Every now and then, I'll stumble into something just by accident. But I'm not in the business of looking for them. I'm looking for things that Berkshire could put its money in, and that rules out all of that sort of thing.

Charlie?

CHARLIE MUNGER: Well, I would agree. But I would also say that what we did 40 or so years ago was, in some respects, more simple than what you're going to have to do.

WARREN BUFFETT: Right.

CHARLIE MUNGER: We had it very easy, compared to you. It can still be done. But it's harder now.

You have to know more. I mean, just sifting through the manuals until you find something that's selling at two times earnings, that won't work for you.

WARREN BUFFETT: It'll work. It's just you won't find any. (Laughter)

CHARLIE MUNGER: Yeah.

17. "Surprisingly high" return on equity

WARREN BUFFETT: Zone 10, please?

AUDIENCE MEMBER: My name is Jonathan Brandt. I'm from New York City.

Warren, you wrote in 1977 that the return on equity and growth of book value for corporate America tended towards, and averaged, about 13 percent, no matter the inflation environment.

After properly expensing options and so-called non-recurring charges and taking into account the high price-earnings ratio paid for increasingly frequent acquisitions, do you think that 13 percent figure is still roughly correct?

Also, what quantitative method would you suggest that investors use for expensing the option grants of publicly traded firms where there is no realistic prospect for the substitution of such an options program with a cash-based performance incentive plan?

In other words, how do you derive the five to 10 percent earnings dilution referred to in this year's Berkshire's annual report? And is it possible that the dilution figure could be even higher than that? Thank you.

WARREN BUFFETT: OK. Thanks, John. Just like Martin Wiegand, Jon Brandt is the son of a very good friend of mine, where we worked together for decades. And Jon is now an analyst with Ruane Cunniff and a very good one.

He also — he says it didn't happen this way. But when he was about four years old, I was at his house for dinner with the parents. And he suggested to me, after dinner, he said, "How about a game of chess?"

I looked at this four-year-old. I thought, you know, "This is the kind of guy —"

I said, "Should we play for money?" (Laughter)

And he said, "Name your stakes." So, I backed off, and — (laughter) — we sat down.

And after about 12 moves, I could see I was in mortal trouble. So, I suggested it was time for him to get to bed. (Laughter)

The question about return on equity, it's true. Back in 1977, I believe, I wrote an article for Fortune and talked about this, more or less, this figure of 12 or 13 percent that return on equity kept coming back to, and explained why I didn't think it was affected by inflation, which was a hot topic of the day very much.

And it wasn't. But in recent — in the last few years, earnings have been reported at very high figures on the S&P, although you've had these very substantial restructuring charges, which every management likes to tell you doesn't count.

I love that, when they, you know, they say, "Well, you know, we earned a dollar a share in total last year, but look at the two dollars a share that we tell you we really earned. The other dollar a share doesn't count." And then they throw in mistakes of the past or mistakes of the future. And every three or four years, ask you to forget this as if it doesn't mean anything.

We've never had a charge like that that we've set forth in Berkshire and we never will.

It isn't that we don't have things we do that cost us money in moving around. But we do not ask you to forget about those costs.

The report — even allowing for options costs and restructuring charge and everything, return on equity has been surprisingly — to me — surprisingly high in the last few years.

And there's a real question in a capitalistic society whether if long-term rates are 5 1/2 percent, whether return on equity can be, across the board, some number like 18 or 20 percent.

There're an awful lot of companies out there that are implicitly promising you, either by what they say their growth in earnings will be, or various other ways, that they're going to earn at these rates of 20 percent-plus. And, you know, I'm dubious about those claims. But we will see.

18. Corporations hooked on "corrupt" stock option accounting

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

But we try to figure out what the average option issuance is going to be. And then we say to ourselves, "How much could the company have received for those options if they'd sold them as warrants to the public?"

I mean, they can sell me options on any company in the world. I'll pay some price for an option on anything.

And we would look at what the fair market value of those options would be that day if they were transferable options. Now, they aren't transferable. But they also — employees sometimes get their options repriced downward, which you don't get if you have public options.

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

And that's the cost. I mean, it's a compensation cost.

And just try going to a company that's had a lot of options grants every year and tell them you're going to quit giving the options and pay people the same amount of money. They'll say, "You took away part of my earnings."

And we say, if you've taken away part of the earnings, then let's show it in the income account and show it as a cost. Because it is a cost.

And I think, actually, a number of auditors agreed to that position many years ago. And they started receiving pressure from their clients who said, "Gee, you know, that might hurt our earnings if we reported that cost."

And the auditors caved. And they put pressure on Congress when it came up a few years ago. And I think it's a scandal. But it's happened.

We are going to — in evaluating a business, whether we're going to buy the entire business or whether we're going to buy part of it — we're going to figure out how much it's costing us to issue — and when the company issues those options every year.

And if they reprice them, we're going to figure how much that particular policy costs us. And that is coming out of our pocket as investors. And I think people are quite foolish if they ignore that.

I don't think it's going to change. It's too much in corporate America's interest to keep it out of the income account and keep issuing more and more options percentage-wise, and not have it hit the income account, and to reprice when stocks go down. But that doesn't make it right.

Charlie?

CHARLIE MUNGER: Yeah, I go so far as to say it's fundamentally wrong not to have rational, honest accounting in big American corporations.

And it's very important not to let little corruptions start, because they become big corruptions. And then you have vested interest that fight to perpetuate them.

Surely, there are a lot of wonderful companies that issue stock options. And that stock options go to a lot of wonderful employees that are really earning them. But all that said, the accounting in America is corrupt. And it is not a good idea to have corrupt accounting.

WARREN BUFFETT: You can see the problem of the creep in it, once it starts.

It's much like campaign finance reform. I mean, if you let it go for a long time, the system becomes so embedded and the participants become so dependent upon it, that there becomes a huge constituency that will fight like the very devil to prevent any change, regardless of the logic of the situation.

I mean, once you get a significant number of important players benefiting from any kind of corruption in any kind of system, you're going to have a terrible time changing it. That's why, you know, it should be changed early.

And it would've been easier to change the accounting for stock options some decades back when it was first proposed, than now. Because, you know, basically corporate America's hooked on it.

This does not mean that we are against options, per se. If Charlie and I die tonight and you had two new faces up here who didn't have the benefit of having bought a lot of Berkshire a long time ago, and they had responsibility for the whole enterprise, it would not be inappropriate to pay them in some way that was reflective of the prosperity of the whole enterprise.

I mean, they would — it would be crazy to pay the people at Dairy Queen in options of Berkshire Hathaway or pay the people at Star Furniture or any one of our operations, because they have responsibility for a given unit. And what the price of Coca-Cola stock does could swamp their efforts in either direction. It just would be inappropriate.

But it would not be inappropriate to pay somebody that's got the responsibility for all of Berkshire in a way that reflected the prosperity of all of Berkshire.

And a properly designed option system, which would be much different than the ones you see, because it'd be much more rational, could well make sense for one or two people that had the responsibility for this whole place.

Charlie and I aren't interested in that. But I think that you may be looking at two people up here, 50 years from now, I hope, where it would be appropriate.

But any option system, A, should not involve giving an option of less than the place could be sold for today, regardless of the market price. Because once management's in control, they can make that decision. And it should reflect the cost of capital. And very, very few systems reflect the cost of capital.

But if we're going to sit here and plow all the money back every year into the business and, in effect, use your earnings, interest-free, to increase our own earnings in the future, we think there has to be a cost of capital to have a properly designed option system.

People aren't interested in that. The option consultants aren't interested in that, because that isn't what their clientele wants.

Charlie, you're probably wound up a little more now on this, too?

CHARLIE MUNGER: No, I've wound up enough.

WARREN BUFFETT: OK. (Laughter)

19. Why Buffett dissolved his partnership in 1969

WARREN BUFFETT: We'll go to zone 11.

AUDIENCE MEMBER: Warren and Charlie, good morning.

WARREN BUFFETT: Good morning.

AUDIENCE MEMBER: My name is Maurus Spence from Waterloo, Nebraska.

Some 30 years ago, you disbanded your Buffett partnership saying that you felt out of step with the market and you feared a permanent loss of capital.

Given today's market and current valuations, if Berkshire Hathaway was a partnership of 100 partners, instead of a corporation, would you consider disbanding it as you did 30 years ago? And if not, why not? And was that the right decision back then?

WARREN BUFFETT: Well, if our activities were limited to marketable securities, and I had less than a hundred partners, and we were operating with this kind of money, so that there was a real limitation on what we could do, I would simply tell the partners and let them make the decision. That would be easy enough.

We're not in that position. A, we've got a number of wonderful businesses. And those businesses will grow in value. And in some cases, very significantly, in value.

And it's not a feasible way. People have their own way, if they decide that — since we're unable to find things, that they'd rather go on to something else — they have their own way of getting out. And they can get out at, certainly, a premium to the amount of money they put into the business over the years.

So, if I were running a marketable securities portfolio now and were limited to that, I would explain very carefully to my partners how limited my ability to make money in this market would be. And then I would ask them to do whatever they wish to do. Some of them might want to pull out and others might want to stay.

In the 1969 period when I closed up, A, I had a somewhat similar situation in terms of finding things.

And B, I really felt that the expectations of people had been so raised by the experience we'd had over the previous 13 years, that it made me very uncomfortable. And I felt unable to dampen those expectations.

And I really just didn't find it comfortable to operate where my partners, even though they might nod their heads understandingly and say that, "You know, we really know why you aren't making any money while everybody else is."

I didn't think I wanted to face the internal pressure that would come from that. I don't feel any such internal pressure in running Berkshire.

Charlie?

CHARLIE MUNGER: Yeah, that — I think there are some similarities between 1969-70 and the present time. But I don't think that means that 1973-4 lies right ahead of us. We can't predict that.

You can argue it worked out wonderfully for Warren to quit in '69. And then have '73-4 to come into with his powder dry. I don't think we're likely to be that quite that fortunate again.

WARREN BUFFETT: Yeah, it was a long time from '69, though, to '73. I mean, it sounds easy, looking back. But the Nifty Fifties, you may remember, sort of hit their peak in '72. So, although there was a sinking spell for a while in that '69 -70 period, the market came back very strong.

But you know, that's part of the game. I mean, it stayed cheap a long time from the '73 period on.

And you will find waves of optimism and pessimism. And they'll never be exactly like they were before. But they will come in some form or other.

That does not mean we're sitting around with a bunch of cash because we expect stocks to go down, though.

We keep looking for things. We're looking for things right now. We're talking to people right now about things where we could expend substantial sums of money. But it's much more difficult in this period.

20. Buffett's musical family

WARREN BUFFETT: Zone 12?

AUDIENCE MEMBER: Good morning. My name is Jenna (PH). I'm from Long Island, New York.

And I was reading through your annual report.

You made reference to Wagner and some country western song I never heard of.

I was just wondering what kind of music influences you. And are you planning on doing, like, a musical video? (Laughter)

WARREN BUFFETT: Well, I think with the performance I gave earlier in the movie, I don't think there's any future for me. But I do have a very musical family.

And since you asked, I will point out that my son Peter's recent CD is available at the Disney booth outside. And Peter had a very successful experience here on public television in March and will be on tour later on. And my wife is extremely musical.

But I don't think I've got much of a future in it. So far, I get — no one ever asks me to come back. (Laughter)

I mean, I've had a lot of introductory appearances, but very few encores.

I like all kinds of music. You know, I really — I've always liked music. We started out around the house singing church hymns. And in 1942, my two sisters who are here today, joined me in a 15-minute program on WOW, then the leading radio station in Omaha. And we sang "America the Beautiful."

And my dad got elected to Congress on the back of that program. (Laughter)

We liked to take credit for it. And you — see my sisters at the end of the meeting.

Charlie, what kind of music do you like?

CHARLIE MUNGER: Well, the one thing I agree with is that if we're going to star Warren, it should be in a musical. The straight acting won't do. (Laughter)

WARREN BUFFETT: It took me an hour to get that bald for "Annie," incidentally. It takes a long time to get bald — dressing room.

21. Spotting a great industry doesn't guarantee you'll make money

WARREN BUFFETT: Zone 13, please.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Jack Sutton (PH) from Brooklyn, New York. Thank you for hosting today's meeting.

With reference to communication stocks, because of the growth of cellular communications and the internet, certain stocks hold the prospect of substantially above-average revenue and earnings growth.

AT&T and Nokia, as an example, earn respectable margins and return on common equity and would seem to fit Berkshire's criteria from a financial perspective.

Has Berkshire reviewed stocks in the area of communications? And would you consider an investment in this area at some time in the future?

WARREN BUFFETT: Yeah, there's certainly no question amazing things have happened in communications.

It's interesting that you mention AT&T. Because AT&T's return on equity over the last 15 years has been, you know, has been very, very poor. Now, they've had special charges time after time and said, "Don't count this."

But the overall return on equity, if you calculate it for AT&T for the last 15 years, it's not been good at all. They were the, you know, they were the leader in the field. But so far, what has happened has hurt them, at least relative to their competition, far more than it's helped them.

We have a fellow on our board, Walter Scott, who's right here in the front row — I can't quite see him — who knows a lot more about this.

He used to try to explain to me these changes that were taking place. We'd ride down to football games on Saturday and Walter would patiently explain to me like he was talking to a sixth grader, what was going to happen in communications. And the problem was that he had a fourth grader in the car with him, namely me. (Laughter)

So, I never got it. But Walter did. And he's done very well in MFS and Level 3.

And I think for people who understand it, and are reasonably early, you know, they could very well be substantial money to be made. There's been an awful lot of money made in this town of Omaha by people who've participated in this. But I'm not one of them.

And I have no insights that I bring to that game that I think are in any way superior, and — in, probably, many cases, not even equal to those of other participants.

There's a lot of difference between making money and spotting a wonderful industry. You know, the two most important industries in the first half of this century in the United States — in the world, probably — were the auto industry and the airplane industry.

Here you had these two discoveries, both in the first decade — essentially in the first decade — of the century. And if you'd foreseen, in 1905 or thereabouts, what the auto would do to the world, let alone this country, or what the airplane would do, you might have thought that it was a great way to get rich.

But very, very few people got rich by being — by riding the back of that auto industry. And probably even fewer got rich by participating in the airline industry over that time.

I mean, millions of people are flying around every day. But the number of people who've made money carrying them around is very limited.

And the capital has been lost in that business, the bankruptcies. It's been a terrible business. It's been a marvelous industry.

So you do not want to necessarily equate the prospects of growth for an industry with the prospects for growth in your own net worth by participating in it.

Charlie?

CHARLIE MUNGER: Well, it reminds me of a time in World War II when — where these two aircraft officers I knew, and they didn't have anything to do at the time. And some general came in to visit. And he said to one of them, he says, "Lieutenant Jones, what do you do?" He says, "I don't do anything."

And he turned to the second one. And he says, "What do you do?" And he says, "I help Lieutenant Jones." (Laughter)

That's been my contribution on communications investments. (Laughter and applause)

WARREN BUFFETT: You can address me as Lieutenant Jones for the rest of the meeting. (Laughter)

22. Thank you, shareholders

WARREN BUFFETT: Yeah, incidentally, some people have thanked us for providing this meeting. I want to thank you because the quality — I think we have the best shareholders meeting in the country.

And the quality of the meeting is absolutely — (applause) — in direct proportion to the quality of the shareholders.

We would have nothing without this participation. And I really thank you. It's a big effort to come here for a lot of you. And I thank you for that.

Our plan, incidentally, will be to take a break at noon. They have a lot of food outside that they will sell you. (Laughter)

And then we'll come back in 30 minutes or thereabouts or 45 minutes, depending on how the lines are out there.

And then we'll reconvene for the afternoon. And those of you who are not in this main hall, if you want to come over and join the main hall, there will be enough seats for everybody in the afternoon. And then Charlie and I will continue till about 3:30.

23. Do you ever get tired of being Warren Buffett?

WARREN BUFFETT: Let's go back to zone 1, please.

AUDIENCE MEMBER: Mr. Buffett, over here. Good morning. I'm Allan Maxwell. I live in Omaha.

When you walk down the street, heads turn to watch you. Do you ever get tired of being Warren Buffett? If you could come back again, would you want to be Warren Buffett? (Laughter)

WARREN BUFFETT: I think I'd probably want to be Mrs. B. She made it to 104, so I — (Laughter)

And incidentally, I think there were three siblings at her funeral. Now, that some set of genes. You don't have to worry about the Furniture Mart.

No, you see a lot of the publicity bit here for a couple of days around the time of the meeting. But life goes on in a very normal way.

And I've had a lot fun. I have fun every day of my life. I had a lot of fun when I was 25. But I have just as much fun now. And I think, you know, if my health stays good, it'll keep being the same way.

Because, you know, I get to do what I want to do. And I get to do it with people I like and admire and trust. And it doesn't get any better than that.

Charlie? Do you want to come back as Lieutenant Jones? (Laughter)

CHARLIE MUNGER: I think there are very few people who would change their skin for somebody else's. I think we all want to play our own games.

24. Goodwill costs should stay on the books

WARREN BUFFETT: We'll go to zone 2 with those remarks. (Laughter)

AUDIENCE MEMBER: Hi.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: I'm Liam O'Connor (PH). I come from County Kerry in Ireland. And I must admit the sun shines a little bit more over here than it does on the other side of the world.

I was wondering, today, if you could shed some light on accounting for goodwill.

You reference in your report, in several aspects, including your principles — owner principles — and as well as the fact — with the current merger of General Re.

It seems to me there are several different methods that are used worldwide, through amortization, to direct write-off.

And the fact, when a merger like this is taken, it kind of skews the balance sheet. And I was wondering, in your view, what would you recommend as a more appropriate method for accounting for goodwill?

And secondly, if I could direct it to Charlie, one of the ideas — why not tie goodwill to the share price and have an intangible and a tangible part of shareholder's equity, the intangible piece being the difference between the book value and the share value of a company?

WARREN BUFFETT: OK, I'll take the first part. And it's a good question about goodwill and the treatment of goodwill for accounting purposes.

I actually wrote on that subject. I think it was in 1983 in the annual report. And if you click onto to the berkshirehathaway.com you can look at the older letters. And you will see a discussion of what I think should be the way goodwill is handled. And then we've discussed it at various other times in the Owner's Manual.

To give it to you briefly, in the U.K., for example, goodwill is written off instantly so it never appears in book value. And there's no subsequent charge for it.

If I were setting the accounting rules, I would treat all acquisitions as purchases — which is what we've done, virtually, without exception at Berkshire — I would treat all acquisitions as purchases.

I would set up the economic goodwill, because we are paying for goodwill when we buy a General Re. I mean, we are playing billions and billions of dollars for it. Or when we buy a GEICO or when we buy an Executive Jet. That is what we are buying, is economic — what I call economic goodwill.

I believe it should stay on the balance sheet as reflective of the money you've laid out to buy it. But I don't think it should be amortized. I think in cases where it is permanently impaired and clear that it's lost its value, it should be charged off at that time.

But generally speaking — in our own case, the economic goodwill that we now have far exceeds the amount that we put on the books originally. And therefore, even by a great amount, exceeds the amount that remains on the books after amortization.

I do not think an amortization charge is inappropriate — is appropriate — at Berkshire for the goodwill that we have attached to the — our businesses. Most of those businesses have increased their economic goodwill — in some cases, by dramatic amounts — since we've purchased them.

But I think the cost ought to be on the balance sheet. It's what we — it shows what we paid for them. I think it should be recorded there.

I don't think that the coming change in accounting is likely to be along the lines that I've suggested here. But I do think it's the most rational way to approach the problem.

And I think that because there is this great difference between purchase and pooling accounting, that some really stupid things are done in the corporate world.

And I have talked to managers who deplored the fact that they were using their stock in a deal and going through some — various maneuvers to get pooling accounting because they thought it was economically a dumb thing to do.

But they did it, rather than record amortization charges that would result from purchase accounting. And, you know, they're very frank about that in private. They don't say as much as about it in public.

Charlie?

CHARLIE MUNGER: Yeah, generally speaking, I think that what Warren argues for would be the best system.

Namely, set up the goodwill as an asset and don't amortize it in the ordinary case.

Or there would be plenty of cases when — the cases wouldn't be ordinary cases when amortization would be rational and, in fact, should be required.

So, I don't think there is any one easy answer to this one. And there's a lot of crazy distortion in corporate practice because of all the changes.

I mean, Australia has cowboy accounting. And Europe has this write-it-all-off-immediately accounting, which is — what would you call it? — half-cowboy accounting. And maybe mining promoter accounting.

We think the system should be better than that.

25. "We are not in the business of being white knights"

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: Good morning.

WARREN BUFFETT: Morning.

AUDIENCE MEMBER: My name is Mike, from Omaha.

And it's been said that you're the white knight of the investment world because you rescue companies from hostile takeovers. Are there any companies you are now trying to help out? And would you please name those companies? (Laughter)

WARREN BUFFETT: You have a cell phone that you're going to place orders with? (Laughter)

No, we — what we really want to buy into are wonderful businesses, or at least extremely good businesses. And we want them to have managements we like. And we want the price to be attractive.

And we are not in the business of being white knights. We're in the business of being investors in things that look sensible to us. And I don't think I've been approached by anybody in connection with that.

We do get approached occasionally. I should say, we get approached when somebody, occasionally, when somebody has a takeover bid. And they say, "Would you like to top it or something?" To which our answer, invariably, is no.

Charlie?

CHARLIE MUNGER: Well, we're very good at saying no. (Laughter)

WARREN BUFFETT: Charlie's better than I am, even.

26. China offers opportunities, but hard to pick winners

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Good morning. My name is Matt Haverty (PH). I'm from Kansas City.

Twenty years ago, China unleashed capitalism within its borders. Since then, I believe it has benefited more from that economic system than any major country in history.

I also believe that this momentum, combined with China's size and demographics, will make it the most fertile economic environment in the world during the next few decades.

Nonetheless, there are many Chinese companies with easy-to-understand businesses and 20 percent per annum sales growth this decade, trading at five times or less last year's earnings.

What is your assessment of the risk/reward of investing directly in Chinese companies?

WARREN BUFFETT: Well, I don't know that much about them. But I — certainly if I could buy companies that were earning 20 percent on equity and had promises — gave promise — of being able to continue to do that while reemploying most of the capital, and they were selling at five times earnings, and I felt good about the quality of the earnings, you know, I would say that would have to be an interesting field.

My guess is that it's not a large enough field, in terms of the ones that meet those tests you named, for Berkshire to profitably participate. And whether you could buy all of those companies from the U.S., I think there'd be a lot of — there could well be a lot of problems in that.

But I would say, any time you can buy good businesses — really good businesses — which we define as businesses who earn high returns on capital at five times earnings — and you believe in the quality of the earnings, and they can reemploy a significant portion of those earnings, additionally, at the 20 percent rate, you know, you will make a lot of money if you're right in your assessment on that.

Charlie?

CHARLIE MUNGER: Yeah, I don't know much about China. (Laughter)

WARREN BUFFETT: But that is not to knock it in any way, shape or form. Because I mean, in terms of — there could well be opportunities in areas like that, if you can identify those kind of businesses. We would have trouble identifying those businesses, ourselves.

But that doesn't mean that, you know, you will have trouble or other people who are much more familiar with the economy there, would have trouble.

So, I encourage you to look at your own area of expertise in something like that. And you'll do much better.

If the conditions you describe exist and you can identify the right company, you will do much better in that than you will in American markets, in my view.

27. We prefer to buy companies, but stocks offer more bargains

WARREN BUFFETT: Zone 5.

AUDIENCE MEMBER: Good morning. My name is Fred Castano (PH), from East Point, Michigan. And I appreciate this opportunity.

With Berkshire's size becoming very large, are we to expect major future investments to be in the form of complete buyouts, such as the General Re acquisition? Or would you still consider nibbling in the stock market?

WARREN BUFFETT: Well, we don't want to nibble. But we would like to take big gulps in the stock market from time to time.

But we've always wanted to acquire entire businesses. People never seem to really believe that, back when we were buying See's Candy or the Buffalo News or National Indemnity. But that's been our number one preference right along.

It's just that we've found that much of the time we could get far for more our money, in terms of wonderful businesses, by buying pieces in the stock market, than we could by negotiated purchase.

There may have been — there may be some movement, in terms of the availability of the two, toward the negotiated purchase, although you — it's almost impossible to make a wonderful buy in a negotiated purchase.

I mean, you will never make the kind of buy in a negotiated purchase that you can in a bad — that you can make via stocks in a stock — in a weak stock market. It just isn't going to happen.

The person on the other side cares too much. Whereas, in the stock market, in a 1973 or 1974, you were dealing with the marginal seller. And whatever price they establish for the business, you could buy it.

I couldn't have bought the entire Washington Post Company for $80 million in 1974. But I could buy 10 percent of it from a bunch of people who were just operating, you know, based on calculating betas or doing something of the sort. And they were in a terrible market. And it was possible to buy a piece of it on that valuation. You never get that kind of buy in a negotiated purchase.

We always are more interested in a negotiated — large negotiated — deals than we are in stock purchases. But we are not going to find a way, probably, to use all the money that way.

And we occasionally may get chances to put big chunks of money into attractive businesses that are — which we buy through the stock market, five, 10 percent of company or something of that sort.

Charlie?

CHARLIE MUNGER: My guess is over the next five years, we'll do some of both. Both the entire business and the big gulps in the stock market.

WARREN BUFFETT: Yeah, I agree with that.

We'll keep working at both. We're not finding a lot in either arena. We might be a little more likely to find it in the negotiated business. It won't be any huge bargain. We're not going to get any huge bargain in the — in a negotiated purchase.

We are more likely to find what I would call a fair deal there under today's circumstances, than we will in the market. But I agree with Charlie. Over the next five years, I think you'll see us do both.

28. Being "wealthy" without having a lot of money

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Jane Bell (PH) from Des Moines, Iowa. (Mild applause)

In response to an earlier question, you spoke of people being rich and very, very rich.

It seems to me there's a difference between being rich and being wealthy. I assume you consider yourself to be both. Which is the more important to you?

WARREN BUFFETT: Well, I think we may ask you to define. I don't want to sound like President Clinton here, too much, but we may ask you — (Laughter)

I might want — if you'd really define the "rich" and "wealthy," so that I get the distinction, then I think we can give you a better answer on it.

AUDIENCE MEMBER: Well, in my mind, being rich is having an awful lot of money. Being very, very rich is having even more. And being wealthy doesn't necessarily equate to having a lot of money.

WARREN BUFFETT: What does it equate to, then? I just want — (Laughter)

I think I know what you mean. But I still want you to clear it up before I give you an answer on it.

AUDIENCE MEMBER: Well, this, of course, is my opinion.

WARREN BUFFETT: I mean, you could be wealthy in health, for example. And I agree with you, that certainly, there'd be nothing you'd value more than good health for you, you know, yourself and your family. But I — you go ahead.

AUDIENCE MEMBER: Well, I believe you're starting to get it. (Laughter)

WARREN BUFFETT: Have patience. (Laughter)

No, there's no question about it. I mean, being — the money makes very little difference after a moderate level. I tell this to college students that I talk to.

I mean, they are basically living about the same life I'm living. (Laughter)

You know, we eat the same foods. I mean, that I can guarantee you. (Laughter)

And, you know, there's no important difference in our dress. There's no important difference at all in the car we drive. There's no difference in the television set that we sit there and, you know, watch the Super Bowl on or anything of the sort.

There's really no difference in — you know, they've got air-conditioning in summer. And I got air-conditioning and I got heat in winter. Almost everything of any importance in daily life, we equate on.

The one thing I do is I travel a lot better than they do, you know, NetJets. (Laughter)

So the travel is — travel I do a lot easier than they do.

Everything else in their lives, it just — you know, I'll switch places any time. It doesn't make any difference.

So, the — then you get down to the things of health and who loves you. I mean, that's — you know, there's nothing — if you have a minimum level of — I mean, you want to have enough so that you eat three times a day, and that you sleep in reasonably comfortable surroundings, and so on.

But everybody in this room has that. And yet, some of the people, by the definition that you've given, are obviously much more wealthy than others. And it's not measured by their net worth, if you define it that way.

I don’t disagree with that definition. I might not use the term, wealth, in describing it. But I’d certainly maybe call it well-being or something of the sort.

Charlie? (Laughter)

He’s thinking.

CHARLIE MUNGER: Sure, there are a lot of things in life way more important than wealth. All that said, some people do get confused. I play golf with a man. He says, “What good is health? You can’t buy money with it.” (Laughter)

WARREN BUFFETT: Did I ever tell you about Charlie’s twin brother that he golfs a lot with? (Laughter)

No, I’ll take health any time, incidentally.

CHARLIE MUNGER: So will I.

WARREN BUFFETT: The important thing, even in your work, I mean, is — to an extreme extent, it seems to me, is who you do it with.

I mean, it — you can have — if you’re going to spend eight hours a day working, the most important isn’t how much money you make, it’s how you feel during those eight hours, in terms of the people you’re interacting with, and how interesting what you’re doing is, and all of that.

Well, you know, I consider myself incredibly lucky in that respect. I can’t think of anything I’d rather do. And I can’t think of any group of people I’d rather do it with.

And if you asked me to trade away a very significant percentage of my net worth, either for some extra years in life, or being able to do, during those years, what I want to do, you know, I’d do it in a second.

29. “We blew it” on pharmaceutical stocks

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: Hi, my name is McCall Bang (PH). I’m from central Florida. It’s nice and sunny there.

WARREN BUFFETT: Not so bad here either, now. (Laughs)

AUDIENCE MEMBER: My question was, last year somebody asked about the pharmaceutical companies and the aging baby boomers, et cetera. And you said it was difficult to single out individual companies. And I believe Mr. Munger succinctly said that we blew it on that one.

I was wondering, however, if the idea of regulation and, you know, the specter of what happened in '92, '93 with an unelected politician kind of dampered the whole industry for a period, there — if that plays a part in giving you a little ambivalence about investing in that area for the future.

Is that simply an unknowable? Or with all the, you know, a lot of the political — the things we see here today — if that causes you some concern about, you know, the future of that area?

I know that you're concerned about the growth of — in companies having to spend money, in Washington with regulation, et cetera. So, I'd like to know your thoughts, specifically if you have some ambivalence because of future regulation with pharmaceutical companies?

WARREN BUFFETT: Well, if we could buy a group of leading pharmaceutical companies at a below-market multiple, I think we'd do it in a second. And we had the opportunity to do that in that 1993 period, as you mentioned. And we didn't do it. So, we did blow it.

Because clearly, the pharmaceutical industry, as a whole, has done very well. And it has some of the threats that you enumerated, in terms of regulation and so on.

But, you know, every industry has some problems. And the pharmaceutical industry has enough going for it that the threats you named should not cause, in my view, should not cause the securities to sell at a depressed multiple, which they did.

Now, that's no longer the circumstance. We don't like — you know, we're not going to buy them at present prices. But, we — at least I think they're, you know, as a group, they're good businesses.

I do think it's very hard to pick out the winner. You know, so if I did buy them, I would buy them — I would buy a group of the leading companies. But I wouldn't be buying them at these prices.

Charlie?

30. Munger defends "almost obscene amounts of money" for drug companies

CHARLIE MUNGER: Yeah. I would argue that the pharmaceutical industry has done more good for the customers than almost any other industry in America. It's just fabulous what's been invented in my lifetime, starting with all the antibiotics that have prevented so much death and so much family tragedy.

And I think the country has been very wise to have a system where the pharmaceutical companies can make almost obscene amounts of money. I think we've all been well-served by the large profits in the pharmaceutical industry.

31. Why Buffett buys small amounts of some stocks

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: Good morning Mr. Buffett, Mr. Munger. My name is Gary Rastrum (PH) from right here in Omaha.

My question is, somewhere I thought I'd read that you buy at least one share of every company on the New York — or on the exchanges — to get the annual report. Is that true or is that a thing of the past? And if it is true, how do you keep track of all that information?

WARREN BUFFETT: Well, it's got an element of truth in it. Many years ago, I did buy one share of a great many companies. And I'd get these dividend checks for eight cents and 10 cents. (Laughter)

And I used to pay my bridge losses by endorsing these checks by the hundreds and giving them to the people who'd just won a dollar. And they — and then no one asked me to bridge games anymore. (Laughter)

So I have adopted a new program where I buy a hundred shares of a great many companies. Actually, I buy them in my foundation so I don't go crazy at income tax time. And I probably, just as a guess, would have a couple hundred companies. So, it isn't every company, by a long shot.

But there are at least several hundred companies where I want to be a registered shareholder, and — to make sure I get the mailings promptly. And I do keep those around. And I very — even after I lose interest, I very seldom sell one. So, I'll just keep buying more.

And I'll only buy a hundred shares in something I might want to keep track of, but I'll probably buy a hundred shares in all of their competitors and — so that I keep reading about those companies as well.

It does pay to have a flow of information come in over the desk.

32. Why some shareholders get the annual report sooner

And the answer to that question reminds me of a point which I'd like to bring up, briefly, here.

And that is that our shareholders — unfortunately there's no way around this — unless they go to the internet on the Saturday that we designate to read the annual report, and where it's up on our home site, berkshirehathaway.com, are going to receive their reports at significantly different times.

And the ones who have their shares in their own names are very likely to get those reports faster than the ones that have it — have their shares held in street names. And from our standpoint, unfortunately, probably 90 percent of the shareholders we have, have their name — have their stock held in street names.

Now, what happens on that, is we print the reports up. We mail the ones to the shareholders who are of record, who have the stock in their own names. We send the balance to where their brokers or bankers tell us to send them.

About 90 percent go to one place in New Jersey, but that's out of our control. I mean, if Merrill Lynch or Charles Schwab or whomever, Fidelity, turns their list over to that firm, they are the ones that mail the reports. We truck those reports back to them.

We may, next year, try to figure out a way to get them printed closer. But it's out of our control when those reports go out. So our shareholders receive their reports on widely varying dates, which like I say, you know, I would rather not have that happen.

It means that in terms of sending in your request for tickets to this meeting, many people we had this year as late as maybe the 10th of April, still hadn't gotten their reports. And they wondered about their tickets.

So if it's convenient for you, you will — you know, it's better to have your stock in your own name. Now, that isn't convenient for many people. I understand that. But you will get our reports on a more reliable basis and a more prompt basis if you do it that way.

If you have your stock in street name, you know, I urge you to look on those dates we've laid out in the report for next year, to click onto our homepage. Because then you will have the information just as quickly as everybody — as your fellow shareholder does.

We want very much to have a level playing field. And we want everyone to have access to the information as close to simultaneously as possible and during a time when the market is not open.

We think that just makes sense. That's the way we'd do it if we were running a partnership.

But there is this problem with street name holdings of somewhat erratic distribution. And that's the reason why, when I want to keep track of, say, all of the companies in the pharmaceutical industry, I'll buy a hundred shares of each one and I'll stick them in the name of the foundation. And that mailing comes directly to me in Omaha.

33. "Deceptive accounting" at many companies

WARREN BUFFETT: So let's go onto zone 9.

AUDIENCE MEMBER: I'm Lola Wells (PH) from Florida.

You have been recently quoted in the newspapers as saying that some major corporations have used questionable practices to make their operations seem more favorable. Would you be willing to be more specific about these practices?

WARREN BUFFETT: Not until I'm on my deathbed. The — no, I have followed a policy of criticizing by practice and praising by name, and we will not —

You know, we do — Charlie and I both find certain practices very deplorable. And they aren't limited to a single, or a few, large corporations. But it would — we would probably be less effective in arguing for change if we went to a few specific examples.

A, they would not be that much different, probably, than hundreds of other, or at least dozens of other companies. And secondly, those who get critical of the world, find the world gets very critical of them, promptly.

And I think we do more good by, in a sense, hating the sin and loving the sinner. So, we will continue to point out the sin. But we will not name the sinners.

Charlie?

CHARLIE MUNGER: Warren, I think she wants you to name the practices.

WARREN BUFFETT: Oh, the practices?

CHARLIE MUNGER: Not the miscreants.

WARREN BUFFETT: Oh, well, the practices are some — (laughter) — the practices are some of the things of the things we've said.

They relate to accounting charges that are designed to throw, into a given period, a whole lot of things that should've been covered in subsequent periods in the earnings account. Or to smooth out or to inflate earnings in future accounts.

There's a lot of that being done. There's a lot that's been done. The SEC, under Arthur Levitt, who I admire enormously for his efforts on this, is making a concerted attempt to get corporate America to clean up its act on that.

But it'll only be because somebody hits them over the head. I mean, it has become totally fashionable to play games with the timing of expenses and revenues. And frankly, until the SEC got tougher, in my view, the auditors were not doing enough about it.

I think that, in terms of hiding compensation expense and not recording it, in the case of options and all of that, I think —

Companies now have the option of recording option costs in the income account. But you have not seen any great flood of people doing it.

And actually, the way they show it in the footnotes is quite deceptive, in my view, because they try to make assumptions that minimize what the income account impact would be.

But the cost to the shareholder is what counts. I mean, that is the compensation cost, as far as we're concerned. And that's been minimized.

The whole effort to engage in pooling rather than purchase accounting, I've seen a lot of — there's been a lot of deceptive accounting, in that respect. There's been deceptive accounting on purchase accounting adjustments. So those are the kind of things we're talking about.

Charlie?

CHARLIE MUNGER: Yeah, it's the big bath accounting, and the subsequent release back into earnings of taking an overly large bath, that create a lot of the abuse.

WARREN BUFFETT: We could name names. We won't. But I mean, we have seen, firsthand, managements who think they are doing — they say they're doing what everybody else does. The truth is, they are now because everybody else is doing it.

And it takes some outside force, in this case, probably the SEC — it should've been the auditors and — to clean up the act. Because once it becomes prevalent, the fellow who is — who says, "I'm going to do it fair and square," all of a sudden becomes at a disadvantage in capital markets.

He's penalized. And he says, "Why should I penalize my shareholders by doing something when, legally I can get away with doing something else?"

Charlie?

CHARLIE MUNGER: Nothing more.

34. Financial strength of our insurers is a big advantage

WARREN BUFFETT: Zone 10.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Robert McClure (PH), and my wife and I live in Singapore. My question concerns insurance.

In the 1994 annual report, you made the following remarks. And I quote, "A prudent insurer will want its protection against true mega-catastrophes — such as a $50 billion windstorm loss on Long Island or an earthquake of similar cost in California — to be absolutely certain.

"That same insurer knows that the disaster making it dependent on a large super-cat recovery is also the disaster that could cause many reinsurers to default. There's not much sense in paying premiums for coverages that will evaporate precisely when they are needed.

"So the certainty that Berkshire will be both solvent and liquid after a catastrophe of unthinkable proportions is a major competitive advantage for us." End quote. As I said, that was in the 1994 annual report. Please give us an update on those remarks.

Would you say that that competitive advantage you described is intact? Or would you go so far to say that it has been enhanced over the past five years with the merger of General Re and with what's happened in the super-cat insurance industry?

WARREN BUFFETT: Yeah, I would say that that reputation — certainly the reputation is a stronger — oh, it's stronger than ever.

I mean, Berkshire's preeminent position as the reinsurer most certain to pay after any conceivable natural disaster — that reputation is stronger today than it's ever been, and General Re's reputation right along with it.

I would say the commercial advantage inherent in that reputation is very important. I can't tell you exactly how it rates compared to 1994. But I can tell you that it's important.

It tends to be more important when we're reinsuring other very large entities, either primary insurers or large reinsurers, than it is with the smaller company. The smaller company probably focuses on that less.

But we are writing, probably this week, a very large cover for a very important reinsurer. I don't think they'd want to buy that from almost anyone else. I mean, a couple of people, maybe, but —

They may — they could decide not to buy it from us because they might not feel they wanted to buy it. I think in this case, they will. But I don't think they would have a list of 10 people from whom they'd buy it. They're too smart for that. Because it's a very high-level cover. And if that is called upon, there will be a number of people whose checks will not clear. And Berkshire's check, undoubtedly, will clear.

So, it is a big — the reputation has never been better. The commercial advantage is significant. How much it translates into — you know, it — that can vary from year to year. But I think it's a permanent advantage that Berkshire will have.

I mean, I think five years from now and 10 years from now and particularly after there has been a huge super-cat, it will be a great asset to Berkshire to be thought of as, essentially, as I've described it, as Fort Knox.

And we will pay under any circumstances. And there aren't many people in the insurance or reinsurance business that can truly say that. And when the very big cover comes along, we should have very few competitors.

Charlie?

CHARLIE MUNGER: Well, I think that's exactly right.

35. GEICO and Executive Jet boosted intrinsic value

WARREN BUFFETT: OK. Zone 11.

AUDIENCE MEMBER: Good morning.

WARREN BUFFETT: Morning.

AUDIENCE MEMBER: Richard Corry (PH) from England.

Could you please say what was the main factor which produced the very substantial gain in intrinsic value mentioned in your report?

I ask this because per share gains in portfolio and operating profits were modest. And you said that there was no (inaudible) gain from issuing shares for acquisitions.

WARREN BUFFETT: Well, we did increase the float per share very significantly last year, I mean, invested assets per share. And I would say that, in the — GEICO's business was worth far more at the end of the year than at the start of the year. And that was our largest subsidiary at the start of the year. And if anything, GEICO's competitive position continues to improve.

I would say that Executive Jet is a natural fit into Berkshire. And we paid a significant sum for it. But that it will be a very, very big company 10 or 15 years from now.

And perhaps — well, I'm almost sure it'll get there sooner as part of Berkshire, than it wouldn't gotten there otherwise. And its dominance may be even greater over the years as part of the Berkshire family than it would have independently. Although it would've done very well independently.

I mean, it had a terrific management. It had — it started early, and they had the most service-oriented company you could imagine. So, it would've done fine without us, but I think it will do even considerably better and get there faster with us.

So, I think there — I think in the aviation field, certainly in the primary insurance field, we had large gains in intrinsic value. And I think that, additionally, we had a significantly greater amount of invested asset per share to work with.

So, I feel good about what happened with intrinsic value last year. The problem is doing it year after year after year.

Charlie?

CHARLIE MUNGER: Just basically, we have a wonderful bunch of businesses. And we have a float that keeps increasing and a pretty good record of doing pretty well in marketable securities. None of that has gone away.

36. No need to "groom" potential Buffett successors

WARREN BUFFETT: Zone 12?

AUDIENCE MEMBER: Hello. My name is Elias Kanner (PH). And I am from New York City.

Mr. Buffett, thank you for this entire weekend. I met you at the ballgame on Saturday and at Gorat's yesterday. It was a great honor for me each time.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: My question is this: Mr. Buffett, will you groom a younger man or woman as your heir apparent? If so, when might you do this?

When I say younger, I mean a person 15 to 20 years younger than yourself. Of course, I'm not complaining. You're the best in the world.

WARREN BUFFETT: Well, 15 or 20 years younger is a lot easier to do than it used to be. (Laughter)

A large percentage of the world's population is now eligible.

The — we have, today, the people to take over Berkshire. There's no problem about that at all. They have been named in letters that the directors have. And they are in place.

Exactly who will be the two people will of course — or it could be one person — will depend on when Charlie and I are out of the picture.

I mean, if we'd written the letter 10 years ago, it might have been different than today. It might be different 15 years from now.

So, our death or incapacity, the timing of it, will determine exactly who will be the current person in that letter. But we have those people in place. They don't need to be groomed from this point forward.

They exist. They're ready. They'd be ready to run Berkshire tomorrow morning.

And I think you'd be quite pleased with the job they did. And that's why I don't worry about having — I've got 99 3/4 percent of my net worth in Berkshire. And, you know, I don't want any of it sold. If I knew I was going to die next week, I would not want it sold in the coming week. And I don't want it sold after I die.

I feel comfortable with the businesses and the managers and the successor top management that we have at Berkshire. But I just don't want them to take over too early. (Laughter)

Charlie?

CHARLIE MUNGER: Yeah. I actually think that the prospects for continuity of corporate culture, to the extent we have one at Berkshire, is higher than prospects for continuity of corporate culture at most other large public companies.

I don't see Berkshire changing its way of operating, even if Warren were to expire tonight. And I think that the capital, the fresh cash, would be allocated less well. But as I've said at past shareholder meetings, well, that's too damn bad. (Laughter)

WARREN BUFFETT: That's why we don't have a public relations department.

CHARLIE MUNGER: By the way — (Laughter)

I don't think the job would be ill done, I just don't think it would be done quite as well as Warren does it.

37. One way to add Berkshire to S&P 500 without market disruption

WARREN BUFFETT: OK, Zone 13. (Laughter and applause)

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. I'm Cary Flecker (PH) from Wellington, Florida. Thank you for stopping by the convention center before, Mr. Buffett. It's nice to see you again.

WARREN BUFFETT: My pleasure.

AUDIENCE MEMBER: Recently, much has been made of the fact that Berkshire is the largest company to not be included in the S&P 500.

Do you gentleman have an opinion as — or what is your opinion — as to whether Berkshire should be included and why? Thank you.

WARREN BUFFETT: Yeah, that's a question we've gotten asked quite often since the General Re deal was announced.

Berkshire, if you talk to the S&P people, I think they would say — I think they've even said it publicly, or at least a representative has — that we certainly qualify in every way that — except from what they might term the liquidity standpoint.

It's probable that maybe it's 6 percent, maybe 7 percent of the investment funds, the equity funds in the United States are indexed. And the number, or the amount, is going up somewhat as we go along. I saw an article to the contrary on that. But I think they had it wrong. The amount of index money is, in my view, rising month by month.

So, if you were to put Berkshire into the index tomorrow, in effect, you'd have a market order to buy 6 to 7 percent of the company, or roughly 100,000 shares a day.

That would not be good, you know, if the stock would obviously spike up dramatically as some stocks already have when they've been added. I mean, there've been some — I've looked at the list of all the companies that have been added and some have moved up substantially.

And we would have even — there'd be even more impact at Berkshire than the typical stock because our stock is fairly tightly held. Most people don't want to sell it.

There are two solutions to that. Three solutions, one of them being not to put us in the index.

But we are the most — I think, probably the most significant in the United States that isn't in the index, in terms of market value and a lot of other factors.

So, if you want to put Berkshire or a company like it in the index and not have some crazy market aberration, you could have one of two things happen. And this would be true, I think, more and more of other companies, as well, as they add them to the index and there's more money against index.

One, you could have the company agree that at the time it was added to the index that simultaneously, the company, itself, would sell an amount of stock that was about equal to the index buying that would be generated.

In other words, if we were to offer 100,000 shares, roughly, of A stock at the same as being added to the index, that would neutralize the index buying.

The only problem with that is we don't want to sell 100,000 shares or 10,000 shares or 100 shares of A stock at Berkshire unless we had some very good use for the money. It isn't going to happen. (Applause)

So we are not going to do something like that just because we want to be in an index.

The other possibility, and I believe this was used in Australia, when a very large mutual life company converted to stock. I think it was the largest company in Australia — AMP. And that would be to phase in the weighting of a stock like Berkshire.

And I think later on, I think they may have to do it for all stocks. But phase in the weighting, say, over a 12-month period. So that I was 1/12th weighted the first month, 1/12th weighted the second month and so on. That means, in effect, there would have to be a market order once a month for a half of 1 percent, roughly, of Berkshire.

Well, I don't think that would be very particularly disruptive. And I think there'd be a — once you knew that phase in was coming, there would be some anticipation so that you would not get big spikes in the stock and dips, subsequently.

I think that would be a logical way, but Standard and Poor's, to date, has not had to do that sort of thing. And they may have various reasons, and various good reasons for not wanting to do that.

Now, if indexation continues to grow as it has and you get a situation where 15 percent of the money becomes indexed, you know, I think they're going to have to come up with some approach similar to one of these two that I've named, or it will simply get too disruptive to the market.

It would be interesting. I know America Online has behaved very well since it was introduced to the S&P some time back.

But I would think that it might get to be the case that, if you simply shorted the companies that got added to the S&P after the S&P effect had been felt, that that might — you might find that those stocks would tend to underperform, as that one artificial buy order, in effect, its impact wore off.

So, I think something is going to happen. I think indexation has far exceeded what anybody anticipated, including S&P or including me or Charlie. And I think there's been a good reason for it to develop.

I think as it continues to develop it will have more and more impact on the market in ways that, probably, S&P is not that excited about, nor would the index funds be excited about.

So, there's likely to come a solution to the liquidity problem that might be particularly acute at Berkshire, but that prevails throughout the market, that occurs when stocks are added.

And I would think if they adopt some solution, that certainly, if they adopt a solution of gradual weighting, that Berkshire would be a very logical candidate for the S&P.

It really makes no difference to us what is done along that line. We would not unhappy being in the S&P, as long as it didn't have some huge market impact at the moment of putting it in.

On the other hand, you know, we love the owners we've got. And I don't see how we could improve on this group much by having the index funds.

So, it — we'll see what happens on it. It is not a big deal to us. And we want to be sure if we're ever added, it isn't too big a deal to the market.

Because I would not like — you know, the people who sold that day, might like it — but I would not like the stock to jump up, you know, $20,000 a share on one day because there's some market order for 100,000 shares, and then gradually work its way back down to where it should've been in the first place.

No one benefits from that except the people who sell in the very short-term. And that is not the group that I primarily worry about.

Charlie?

CHARLIE MUNGER: My guess is that Berkshire will eventually be in the S&P index. Somebody will figure out how to do that, sensibly. Maybe not soon. But someday.

38. What we'd need to make an international acquisition

WARREN BUFFETT: OK. Zone 1.

AUDIENCE MEMBER: My name is James Claus (PH), and I'm here from New York City.

Mr. Buffett and Mr. Munger, today we've already heard you talk about a few countries outside of the U.S., here.

And my question is, if you're directly investing in equities outside the United States, what would be your requirements for the market as a whole?

And by this, I mean things like the transparency of the accounting system, the breadth and liquidity in the market, the rights of shareholders, the stability of the currency. And it'd be nice if you'd mention a few of these countries.

Kind of just a little addendum, there, is — for the companies in these countries, how relevant do you believe the reconciliation to U.S. GAAP contained in Form 20F really is?

WARREN BUFFETT: Well, the answer is most of those points you mentioned would be of interest to us.

We'd have to rule out anything where the markets aren't big enough. I mean, we are looking to put hundreds of millions of dollars into any single investment, at a minimum. Certainly, we think in terms of 500 million as being a minimum. We make exceptions to that. And that's going to rule out a great many companies.

Transparency of accounting and accounting rules: we care about that but we can make adjustments mentally. In some respects, we may think, in certain countries, accounting is better than here.

And so, as long as we understand the accounting system, we will be looking toward the same kind of a discount model in our mind of how much cash is this business going to generate over years and how much is going to have to be put into it.

And it's the same sort of calculation that goes into our thinking here. And here, we don't follow strictly GAAP accounting in our thinking. So we don't — the accounting differences would not bother us, as long as we understood those accounting differences.

The nuances of taxes, the corporate governance that you mentioned could make a difference. If we thought corporate governance was far inferior to here, we'd have to make an adjustment for that fact.

But I would say that in most of the major countries, the countries that have stock markets that are big enough so we could take a real position, it's a possibility that we would invest in any of them.

We don't — we wouldn't rule out, you know, Japan, Germany, France, England, the major markets.

Now, it's important to recognize that in all the world's stock markets, something like 53 percent of the value is in the U.S. market. I mean, here we have 4 1/2 percent of the world's population. But 53 percent of the value of all publicly held companies in the world is represented in — with companies in the U.S. market. So, we are a big part of the pie.

But we're very willing to look at almost all of the rest of the pie as long as we're talking about markets that are big enough to let us put real money into them.

Charlie?

CHARLIE MUNGER: Well, so far, we haven't done much, as Warren has said. But we don't have a rule against it. What more can we say? (Laughter)

39. Bullish on Coca-Cola despite high P/E and dollar strength

WARREN BUFFETT: We can say, "Zone 2." (Laughter)

AUDIENCE MEMBER: Good morning, Mr. Buffett. My name is Jean-Philippe Cramers (PH), and I'm coming from London, England. I have a question regarding Coca-Cola.

The first part is, are you worried that the earnings of Coca-Cola might continue to be affected by the weakness in the emerging markets and the strength of the dollar over the next few years?

And the second part is on the P/E ratio of Coca-Cola at 35 times earnings. Are you worried about the potential rise in interest rates? And is it linked to your views on inflation that you are not worried about the rise in interest rate? Thank you.

WARREN BUFFETT: Well, in relation to the strength of the dollar, which means that profits in foreign currencies don't translate into as many dollars, we — I — we don't have any big feeling on that.

I mean, if I — if we had strong feelings about the dollar's behavior, vis-à-vis the yen, or the euro, or the pound, or whatever it might be — you know, we could give vent to those views by actually buying or selling large amounts of foreign exchange.

We don't know what — which way the dollar's going to go. So, I have no — I have nothing in my mind, in regard to any decision on buying or selling Coke, that would relate to any prediction in my mind about the course of the dollar.

The earnings of Coke have been affected by the strength of the dollar in the last few years, particularly the strength against the yen when, you know, when it went from 80-odd to 140-odd. That was a huge hit, in terms of what the — in terms of the yen translation into dollars from those profits. And the strength of the dollar generally would hurt.

But looking forward, I don't have any prediction on that.

It's in Coke's interest to have countries around the world prosperous. I mean, they will benefit from increased prosperity, increased standards of living, throughout the world. I think we'll see that over any 10 or 20-year period. I think people's preference for Coke will do nothing but grow Coca-Cola products.

So, what I am concerned about is share of market and then, what I call share of mind. In other words, what do people think about Coca-Cola now, compared to 10 years ago or 20 years ago? What are they going to think about it 10 years from now?

Coca-Cola has a marvelous share of mind around the world. Everybody in the world, almost, has something in their mind about Coca-Cola products and overwhelmingly, it's favorable.

You can't — you know, try to think of three other companies like it. I can't do it, in terms of that ubiquity of good feeling, essentially, about the product.

We measure it by unit cases sold and by shares outstanding. And we want a lot more unit cases sold. And we like the idea of fewer shares outstanding over time.

I'll give you — I'll be giving that same answer 10, or 15, or 20 years from now. And I think they'll be a lot more unit cases sold then.

It is true that the case growth slowed starting in the second half of last year and continuing through the first quarter of this year. But that's happened from time to time in the past.

In my view, you know, that is not — it's not an important item. It may be an important item in what the stock does, you know, in a six-month period or a one-year period. But we'll be around 10 years from now, and Coca-Cola will be around 10 years from now.

And right now, we own eight-point-one or two percent of Coca-Cola. And we'll probably own a larger percentage 10 years from now, because they'll have probably repurchased some stock.

The P/E ratio of Coke, like virtually every other leading company in the world strikes us as, you know, they all strike us as being quite full.

That doesn't mean they're going to go down. But it does mean that our enthusiasm for buying more of these wonderful companies is less than it was when the P/E ratios were substantially less.

Ideally, those are the kind of companies we want to buy more of over time. We understand their businesses.

And my guess is that there's a reasonable chance, at least, that sometime in the next 10 years, we buy more shares of either Coke or Gillette or American Express or some of those other wonderful companies we own.

We do not like the P/E ratios, generally. But, again, I stress that does not mean they're going down. It just means that we got spoiled in terms of how much we got for our money in the past. And we hope that we get spoiled again.

Charlie?

CHARLIE MUNGER: Yeah, I — if what matters to you is what you think Coke is going to look like 10 years out or even further out, you don't really pay much attention to short-term economic developments in this country or that, or currency rates, or any other such things.

They don't really help you in making the 10 or 15-year projection. And that's the one we're making. So, we have tuned out all this noise, as it's called and what —

WARREN BUFFETT: Sometimes.

CHARLIE MUNGER: — communication networks — tune out the noise. And if you look at the big picture, we think Coke is fine.

WARREN BUFFETT: It's hard to think of a better business in the world, among big businesses. You know, there's obviously companies that are starting from much smaller bases that could grow faster. But it's hard to think of a much more solid business.

40. Nothing to say about Berkshire's investment in silver

WARREN BUFFETT: Zone 3?

AUDIENCE MEMBER: — Newport Beach, California, Bruce Lindsay. And formerly from Omaha, Nebraska. And I have a question.

Some time ago I read that you were buying silver. I never knew the reason why you were buying silver.

WARREN BUFFETT: Well, we covered silver purchase in the 1997 annual report for a special reason. A, it was part of a group of three unconventional investments we made. And one of those investments was of sufficient size so we felt people ought to know about it, specifically.

And then we felt our shareholders ought to know that we sometimes do things that they might not have guessed that we would do, from reading past annual reports. So we named the three unconventional investments.

But in this year's report, we have stated we will not be naming those investments unless one of two things happened: one is that they become of a size that you should know about them specifically, in order to evaluate the kind of thing we do in Berkshire and the commitment of resources that has been made, or two, if regulatory authorities either — obviously, if they require us to report it, we'll report it immediately.

Or in the case of silver, a year-plus ago, an important regulatory authority indicated they would've — that they'd prefer if we report it. We weren't required to do so. But — and our desire is to cooperate on that, anyway. So, we did report it.

But we stated in this year's report that absent those factors, we will not be giving details on unconventional investments any more than we give any more details on our regular equity holdings, than we're, more or less, required to do.

We did say that we had changed certain of the unconventional investments that were described in the previous year's report. And we stated that we'd entered into several new ones.

So, we are in some things that most of you or maybe all of you don't know about. But they aren't of sufficient size so that they're going to, in any material way at all, affect your investment.

Charlie?

CHARLIE MUNGER: Nothing to add.

41. Year 2000 computer problem won't be a "big deal"

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Morning, Mr. Buffett. Wayne Lang (PH) from Toronto, Canada.

Last year, when you were asked about the Year 2000 computer issue, you expressed some concerns about the cost overruns and the federal government readiness.

Our two countries are in much better shape this year. But could you update us on your current thinking and what concerns you may have about the impact of the lesser readiness, internationally, on our company's revenues, supply chain, or on the stock market?

WARREN BUFFETT: Yeah, last year I think I also told you I didn't really consider myself an expert on this. And what I tell you is just what I pick up from being on audit committees or talking to people who are a lot smarter than I am in this sort of area.

But that doesn't mean they're right on it. Because they weren't talking about it 15 years ago, when they should have been talking about it.

So I — my general feeling — and all secondhand — my general feeling is that the part of the world that we have to worry about is in pretty good shape.

It's cost a lot of money in various places. It's cost us a fair amount of money. But it's — some companies, it's cost a terrific amount of money.

But I do not think it's going to be a big deal. And, I — you know, I could be wrong. And I'm less worried about it being a big deal today than I was a year ago.

You know, and Charlie, do you have anything to add?

CHARLIE MUNGER: No.

WARREN BUFFETT: Does that mean you think it's going to be less of a big deal than you thought a year ago?

CHARLIE MUNGER: No, it means I have nothing to add.

WARREN BUFFETT: OK. (Laughter)

That's probably what I should have said in the first place.

42. Japan's economic slump doesn't affect Berkshire

WARREN BUFFETT: Zone 5. (Laughter)

AUDIENCE MEMBER: Good morning. My name is Bob Brewer (PH). And I'm from down the road in Lincoln, Nebraska.

I just wanted to ask you how you think the continuing economic turmoil in Japan is likely to affect the global economy and the U.S. stock market over the next five to 10 years?

WARREN BUFFETT: Well, Charlie and I are no good on those macro questions.

But I would say this: I mean, the Japan problem has been around, now — in financial markets and banking systems — has been around for some time now. So, I see no reason why it should have more impact on the rest of world now than it has had in the last few years. And I would say it's had certainly very little effect on the U.S. in the last few years.

It's not — it's no factor in our thinking at all, in terms of what we would buy or sell tomorrow morning. I mean, if we got offered a good business tomorrow — unless it was directly involved and its primary business was in Japan — but if it was a business in this country, that's not something that we would be thinking about. We would be thinking about the specifics of that business.

We don't really get too concerned about the things that come and go. I mean, in the end, if we're right about a business over a 10 or 20-year period — take See's Candy.

We bought it in 1972. Look what happened in 1973 and 4, you know, and all the oil shocks and what this country was going through and inflation, all that sort of thing.

For us to — and let's say in 1972 somebody laid out a roadmap from 1972 to 1982, with the prime rate going to 21 1/2 percent, long-term rates going to 15 percent. And all of the things happening, the Dow going to 570 or what — or 560.

That wasn't the important thing. The important thing was that this peanut brittle tastes like it does, which is terrific. (Laughter)

And that over time, we could get a little more money for it. So, you know. See's made $4 million, pretax, in 1972, when we bought it. It made 62 million last year.

It doesn't — we don't want to be thinking about the wrong things when we're buying businesses. And that applies to marketable securities, just as much as it does as when we're buying 100 percent of the business.

If we're right about the business, the macro factors aren't going to make any difference, you know. And if we're wrong about the business, macro factors are not going to bail us out.

Charlie?

43. Munger's lesson on not allowing accounting "slop"

CHARLIE MUNGER: Yeah, what I think is interesting in Japan is interesting to one, as a citizen.

Here's a major industrial country. And we understand all about Keynesian economics and everything else. And when it starts sliding down into a big recession, it just keeps going and going, and floundering, and staying down. And year follows year, and you take the interest rates down to practically zero, and you run a big budget deficit. The economy still stays down.

I think this has been very interesting to the economists of the world. I don't think any of them would've predicted that as modern a country as Japan could contract for as long as it did.

And I think the cause is related to the extremeness of its booms in both land prices and security prices, and the corruption in its accounting practices and in its regulation of financial system, including banks.

I think it's an interesting lesson for the world, of how important it is not to let a lot of slop get into the accounting and regulatory systems. And how a lot of folly in markets doesn't help, either.

WARREN BUFFETT: Sort of fascinating to, you know — people keep saying, "Why doesn't Japan stimulate?" Well, they got short-term rates down to zero. And long-term rates at 2 percent. Well, that should stimulate me. But — (laughter) — it doesn't —

As Charlie says, it sort of defied, a little bit, some of the classical Keynesian theory on that. But in the '30s, we had the same problem in this country. We drove interest rates way down towards the latter half of the '30s, and —

CHARLIE MUNGER: And I would argue that probably the extreme prosperity in America is related to this so-called wealth effect, with stock markets going up and up. And I think people thought that was a smaller factor than maybe it is.

44. Analyst coverage won't affect Berkshire's stock

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Jeff Lilly (PH) from Denver, Colorado.

My question is as follows: over the last couple of years, I've read both of you quoted as not following the stock price on a day-to-day basis, not being terribly concerned about whether Berkshire is up or down.

You now have analyst coverage. Perhaps you requested it, or perhaps you acquiesced to it.

But my question is whether this reflects any change in your attention paid to the stock price or your philosophy about investor relations, and whether you think the analyst coverage is going to have any impact on the stock price going forward?

WARREN BUFFETT: Yeah, no. It reflects no change in our attitude toward stock price. I mean, we are concerned about building the intrinsic value per share of Berkshire at the highest rate we can, consistent with a couple of other principles that we've set forth.

And we hope very much that the stock price stays in a zone that is not too wide around intrinsic value — that there's is going to be some zone of some sort, because intrinsic value itself is not precisely calculable. And in addition, you wouldn't expect it to track it penny for penny.

But we don't want it to go crazy in either direction in relation to intrinsic value.

When we made the deal with General Re, that attracted more analyst attention and institutional investor attention because General Re's shareholder base was overwhelmingly institutional.

So, institutions had to decide whether they were going to continue with their investment or clean it out. And we knew we would end up with more institutional ownership, subsequently.

Alice Schroeder asked me, prior to the merger meeting, she said there were a group of institutions that were coming to the meeting, which I liked. I mean, the fact that they were serious enough about their investment to come and see what Berkshire was all about.

And a few of them even had a requirement, I think, from their own boards that they, at least, have sat down with management. So, we spent — or I spent an hour or so with a group that she had put together and they came to Omaha.

But that's the last contact I've had with any institutional investor. And we will have no special meetings with institutional investors or anything. I mean, they are absolutely welcome to attend this meeting to get all of the information that's dispensed.

I think it's very useful, frankly, to have an analyst or two that is well-versed in Berkshire and that thinks straight and does their homework. And that's a plus, because it means we don't have to do it.

And in effect, that if institutions want to talk to somebody about it, they don't call me. Because they're not going to have much luck calling me. And they can call Alice or some other analyst that wants to do it.

And that's perfect. We have a non-paid — it is not investor relations because that's thought of somebody as sort of pumping your stock — but at least we have a information office now — a non-paid information office.

And you know, that goes along the grain of my nature. (Laughter)

And we — people say, "Do you want individual owners? You want institutional owners?" What we want are informed owners who are in sync with our objectives, our measurements, our time horizons, all of that sort of thing.

I mean, we want people that are going to be comfortable owning Berkshire, and we don't want people who are owning it for reasons different — in a way different — that are different from our reasons for owning.

We don't want people that are concerned about quarterly earnings. We don't want people who are concerned about stock splits. We don't, you know — we don't want people that need to be pumped up about the stock, periodically.

It's just not of interest to us. Because it just means we have to keep living that way in the future. And it's not the way we want to live now, it's not the way we want to live in the future.

What we really want are a bunch of people, like we have in this audience, who sit down and read, and think and understand that they're making an investment. It's not just a little ticker symbol. They're buying part of a business. They know what the business is all about.

They know how we think, they know how we measure ourselves. They're comfortable with that.

And they can come in individual or institutional form. And when we get them, we like to keep them.

So there's no change in our attitude about that. There is a change in coverage, in that we — there is some limited amount of coverage in Wall Street, which I guess for a company with a 110 or 20 billion of market value, there should be.

45. Executive Jet's advantage

WARREN BUFFETT: We'll have one more question then we'll break for lunch. We'll go to zone 7. And after this question, we'll break. We'll come back in about 45 minutes or so, and those of you — as long as we see that everybody's gotten served with food in that time — and we'll — any of those who are offsite or over at the Holiday, I think, there are buses to bring you over, you can drive over, and there'll be plenty of room here. You can also go out and tour the Boeing business jet. We'll sell you as little as 50 hours a year, I believe, on it. So, take your wallets at lunch time. Yep?

AUDIENCE MEMBER: Good morning. My name's Marc Rabinov from Melbourne, Australia.

I was wondering if you could help us out with the flight operations, which are now a large part of Berkshire. I think we're still putting a lot of capital into them.

I was wondering, you've pooled both of them together in the annual report. And I was hoping, perhaps, you could help us out with what return on equity you're expecting for each of those divisions.

WARREN BUFFETT: Yeah, the more capital intensive is the flight safety operation. Because every simulator costs real money. And we will add a number of simulators each year.

So, flight safety — you can look at their figures before we acquired them, and it's reasonable to extrapolate those numbers out on a larger basis — base as we go along.

But flight safety's return on equity is not going to move up or down by a dramatic amount. I mean, our simulator training prices are related to the cost of the simulator. And so, there's not going to be way higher returns on equity, nor should there be way lower returns on equity.

There is a growth on the equity employed in the business, because it is a growing business and we're training more and more pilots every year. But that'll be a fairly steady thing.

The Executive Jet business is in an earlier part of its development, although it's the leader in its field, by far. But we're doing substantial investment spending in a place like Europe. And we'll be doing that on an accelerated pace, if anything.

In the end, though, our customers end up owning the plane. So, we have an investment in a core fleet of planes, which supplements the customer's planes.

But by its nature, it's not a capital-intensive business. We are moving around a lot of capital every day. We'll have 140 or so customer planes now and an aggregate, you know, just to pick a figure, that those planes are certainly worth a billion and a half or more.

And we've got 7 billion of planes on order, or some number like that. But we will sell those planes to our customers. So it could be, down the line, that it will be a business with a very good return on capital.

We’ll still have an investment in the core fleet and we’ll have some facilities — hanger facilities and that sort of thing. But our customers will have the big capital investment.

I should point out, they’ll have a whole lot less capital investment if they own their entire plane themselves. So, they will be getting a bargain as well.

Let’s take off for lunch. And I’ll see you back here in about 45 minutes, those of you who wish to rejoin us. Thank you. (Applause)

Afternoon Session - 1999 Meeting

1. General Re benefits won't be felt for several years

WARREN BUFFETT: OK, we're going to be ready to go in just a minute if everybody gets their seats.

VOICE: Warren? Just want to double check something. We're just going to stick in —

WARREN BUFFETT: One through eight.

VOICE: (Inaudible)

WARREN BUFFETT: One through eight.

VOICE: (inaudible)

WARREN BUFFETT: Yeah.

We've got 6 or 7000, anyway, sticking around, I think.

OK. If anyone who has questions wants to go to the microphone, we're going to start here in just a minute. And we will start — there will only be eight zones from this point forward, because we have everyone in attendance in the main hall. So we will rotate around eight zones. We'll stay until about 3:30. And we'll start in zone 1.

AUDIENCE MEMBER: My name is Charlie Sink (PH). I'm from Lexington, North Carolina, as you can tell by the accent.

My question relates to the General Re purchase. I wondered — I've read your letters through the years and I've been trying to learn a little bit investing in insurance companies.

Did you buy General Re, mostly because — I know mostly because of the float — because you think you can grow the float? I know it's not growing significantly now. Or did you buy it because you felt like you could do better with the investments?

I've read, also, that companies who seem to be trying to follow the Berkshire model are trying to get a certain amount of investments to equity — is that something that you focus on? That's my question.

WARREN BUFFETT: Yeah. The first two parts are correct. We certainly — we don't think the float will grow rapidly in the near-term future at all. The float changed, it actually declined very slightly in the first quarter.

And, at a level of 6 billion or so of premiums, the paid losses are likely to run at a rate that would cause the float to remain more or less steady. So it will take a period when premiums grow, for the float to grow.

And the premiums would have to grow fairly substantially to have any significant impact on the float. And like I say, that will not happen in the short term. We expect the float to grow over the longer term.

We expect that General Re will probably grow considerably faster in international markets than the domestic market.

We think that their reputation, which was a good as could be found, from an operational standpoint, from a technical standpoint, a managerial standpoint, will be further enhanced by Berkshire's capital strength.

So we think their reputation is likely to grow over the years and we think the premium volume will follow, but not in any major way at all for a few years, at least.

And then we addressed earlier in the meeting, we think there is the opportunity to do better with that float from time to time in the future.

But right now that is not a plus that it's in our hands, and it may not be a plus a year from now. We think at some point it will be a plus. We also pointed out in — that there are some — there could be some tax advantages to be included as part of Berkshire as well. So there's some things going for it.

But none of them will have — they will not have an impact in 1999, and they may well not have an impact in 2000.

We obviously think Berkshire, 10 years from now, will be worth more on a per share basis with General Re included than if it were — than if we had not made the deal.

We don't necessarily think that's the case on a one-year or two-year basis. But it is our judgment on a 10-year basis.

Charlie? (Laughter)

CHARLIE MUNGER: I would say that if we, in the future, do as — one-third as well with the new float that came to us with General Re as we've done on average in the past, it will work wonderfully.

If you take our past use of float in the history of this company, it would be an interesting study if anybody ever stretched it out.

2. Technological change is bad for investments

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Good afternoon. My name is Greg Kaza (PH) from Oakland County, Michigan. I'd like to thank both of you gentleman for your hospitality this weekend.

My question deals with price deflation. Could you please explain how technological advances and productivity increases are affecting our non-fixed income holdings, especially insurance?

WARREN BUFFETT: Well I think that, to the extent your question implies — the question, how has technology affected the inflation rate, the advances in technology? I've heard Alan Greenspan make a lot of interesting comments on that.

I think it baffles him to some extent, but he also recognizes that there's some important, very hard-to-measure factor that has caused inflation not to behave in the way that most people expected, with this drop of employment, general prosperity, et cetera.

And I think he attributes it, in some part — but again, immeasurable — to what has been happening in the information technology world.

Obviously, low inflation is good for fixed-income investments, but that's been reflected to a significant degree in a long-term rate that's at about 5 1/2 percent now.

You know, it is — it does look, at the moment, like an almost perfect world, in terms of the macroeconomic factors. And that probably is a reason why people are enthused about stocks.

And it's a reason — and it's a good reason, in terms of price inflation — it's a good reason why bonds have behaved well over the last, really, since 1982.

I don't know the answers to what it means for the future. I have to believe that it's very good for this country to have the lead in information technology that it does on the rest of the world. I mean, we —

It seems to me, as a non-expert, that we are so far ahead of the rest of the world, in terms of the leading — having the leading companies and the money flowing into it, the brainpower flowing into it, that it's hard to think of it — who's in second place.

And I think that's helped this country in some very significant way. But I don't know how to measure it.

Charlie?

CHARLIE MUNGER: Well I would say that Berkshire's businesses, on average, are less likely to be obsoleted by new technology than businesses generally. New steel-toed work shoes? I do not anticipate a significant change in the technology. (Laughter)

And I think we have more of the stuff that's sort of basic and hard to obsolete than many other corporations do.

WARREN BUFFETT: Yeah. As we mentioned in the report, we think all of that activity is very beneficial from a societal standpoint. Our own emphasis is on trying to find businesses that are predicable in a general way, as to where they'll be in 10 or 15 or 20 years.

And that means we're looking for businesses that, in general, are not going to be susceptible to very much change.

We view change as more of a threat into the investment process than an opportunity. That's quite contrary to the way most people are looking at equities now.

But we do not get enthused about — with a few exceptions — we do not get enthused about change as a way to make a lot of money.

We try to look at — we're looking for the absence of change to protect ways that are already making a lot of money and allow them to make even more in the future.

So we look at change as a threat. And whenever we look at a business and we see lots of change coming, 9 times out of 10, we're going to pass on that.

And when we see something we think is very likely to look the same 10 years from now, or 20 years from now, as it does now, we feel much more confident about predicting it.

I mean, Coca-Cola is still selling a product that is very, very similar to one that was sold 110-plus years ago. And the fundamentals of distribution and talking to the consumer, and all of that sort of thing, really haven't changed at all.

Your analysis of Coca-Cola 50 years ago can pretty well serve as an analysis now. We're more comfortable in those kind of business.

It means we miss some — a lot — of very big winners, but we would not have picked those out anyway.

It does mean also that we have very few big losers and that's quite helpful over time.

CHARLIE MUNGER: Yeah, the peanut brittle has very little technological change, too. (Laughter)

WARREN BUFFETT: They better not change it. (Laughs) We like it just the way it is.

3. Stocks can’t keep growing at the same rate

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: My name is Esther Wilson. I live in South Sioux City, Nebraska.

My husband and I will have some new money in the early 80s of our lifehood. We have a daughter, 50 years old, who will inherent anything we have.

My question is — I also have a four percent interest on a mutual fund that is non-taxable. Are there any better ways to invest our money? (Laughter)

WARREN BUFFETT: Well, those are tough questions. I mean, I — you know, I run into friends of mine all the time where they come into a lump sum at a given time.

And, you know, Charlie and I do not have great answers about investing sums of money for people who are not really active in the process.

I mean, if, as we said earlier, if we were working with small sums now, we would start looking at a whole bunch of very small situations and some things that we might know how to do on a small scale.

But for the average investor who wants to own equities over a 20 or 30-year period, we think regular investment in some kind of very low-cost pool of money, which might well be an index fund, probably makes as much sense as anything. But it’s important to keep the cost down.

You know, I have close to a hundred percent of my net worth in Berkshire. I’m comfortable with it because I like the businesses we own. And — but, you know, I didn’t buy it at this price either.

So I don’t like to go — I never recommend anybody buy or sell it. And, Charlie, do you recommend anything?

CHARLIE MUNGER: I think it’s — if there’s anybody in the room who thinks it would be very easy to come up with a one-liner for a great no-brainer investment tomorrow with a great slug of new money, I wish they’d come up and tell me what it is. (Laughter)

We don’t have any solution to that one. It’s harder for us now than it has been at other times.

WARREN BUFFETT: Yeah, there’s been a couple of times — in 1974 there was something in Forbes — in ’69, the reverse of that situation. And then, I think, I wrote an article for Forbes — I can’t remember exactly when it was — about how equities almost had to be more attractive than bonds at that time. And bonds weren’t that unattractive.

I mean, every now and then you can say you're getting a great deal for your money in equities. Or sometimes you can say you're getting a great deal for your money in fixed-income investments.

You can't say that now, so what do you do? You know? In terms of new money, we find ourselves sitting and waiting for something and we continue to look.

But we are forced to look at bigger ideas. So if we were working with smaller funds we'd be much more likely to find something than we are in our present situation.

As Charlie says, we really don't have any great one-line advice on it. I wish we did for you. Zone 4 —

CHARLIE MUNGER: I —

WARREN BUFFETT: Go ahead.

CHARLIE MUNGER: The real long-term rate of return from saving money and investing it has to go down, from recent experience in America, particularly equity-related recent experience.

The wealth of the world can't increase at the kind of rates that people are used to in the American equity markets. And the American equity markets can't hugely outperform the growth of the wealth of the world forever.

WARREN BUFFETT: Well, you —

CHARLIE MUNGER: We ought to have reduced expectations regarding the future, generally.

WARREN BUFFETT: Yeah, dramatically reduce them, because, you know — we mentioned earlier, 53 percent of the world stock market value is in the U.S.

Well, if U.S. GDP grows at four percent, five percent a year, with one or two percent inflation, which would be a pretty — would be a very good result — I think it's very unlikely that corporate profits are going to grow at a greater rate than that.

Corporate profits, as a percent of GDP, are on the high side already and you can't constantly have corporate profits grow at a faster rate than GDP. Obviously, in the end, they'd be greater than GDP.

And that's like somebody said that New York has more lawyers than people. I mean — (laughter) — there's certain — you run into certain conflicts with terminology as you go along if you say profits can get bigger than GDP.

So, if you really have a situation where the best you can hope for in corporate profit growth over the years is four or five percent, how can it be reasonable to think that equities, which are a capitalization of that corporate — of corporate profits — can grow at 15 percent a year?

I mean, it is nonsense, frankly. And people are not going to average 15 percent or anything like it in equities. And I would almost defy them to show me, mathematically, how it can be done in aggregate.

I looked the other day at the Fortune 500. They earned $334 billion on — and had a market cap of 9.9 trillion at the end of the year, which would probably be at least 10 1/2 trillion now.

Well, the only money investors are going to make, in the long run, are what the businesses make. I mean, there is nothing added. The government doesn't throw in anything. You know, nobody's adding to the pot. People are taking out from the pot, in terms of frictional cost, investment management fees, brokerage commissions and all of that.

But the 334 million [billion] is all that — is all the investment earns. I mean, if you want to farm, the — what the farm produces is all you're going to get from the farm.

If it produces, you know, $50 an acre of net profit, you get $50 an acre of net profit. And there's nothing about it that transforms that in some miraculous form.

If you own all of American — if you own all of the Fortune 500 now, if you owned a hundred percent of it, you would be making 334 billion. And if you paid 10 1/2 trillion for that, that is not a great return on investment.

And then you say to yourself, "Can that double in 5 years?" It can't — the 334 billion — it can't double in 5 years with GDP growing at 4 percent a year, or some number like that. It would just produce things that are so out of whack, in terms of experience in the American economy, it won't happen.

So any time you get involved in these things where if you trace out the mathematics of it, you bump into absurdities, then you better change expectations somewhat.

Charlie?

CHARLIE MUNGER: There are two great sayings. One is, "If a thing can't go on forever, it will eventually stop." (Laughter)

And the other I borrow from my friend, Fred Stanback, who I think is here. "People who expect perpetual growth in real wealth in a finite earth are either mad men or economists." (Laughter)

4. "Best contribution" is low-cost goods and services

WARREN BUFFETT: Zone 4, please.

AUDIENCE MEMBER: Good evening. My name is Sharukoi Chin (PH). I'm from Des Moines, Iowa.

While we have been discussing of how much return that a company has helped us to get in the past few years, and for the future, too, though, I believe there are many people who are concerned about how much have we given to the society in return.

And gentlemen, would you please share with us about your philosophy and the company policies and how much the Berkshire has done in terms of philanthropy and charities? Thank you.

WARREN BUFFETT: Yes. There are figures in the annual report that bear on that.

One thing we did wasn't entirely voluntary, is that I think we gave about 2.6 billion to the federal government last year in — (laughter) — in income taxes. (Applause)

I'm not sure. I looked at General Electric and Microsoft and a couple of large — we may have paid more in federal income tax than any other U.S. company. I'm not — don't take my word for that, because it could be Walmart paid more. I wouldn't be surprised if Walmart paid more.

But there's — I did look at a couple of the biggest ones and we did pay more than GE or Microsoft, both of which have market caps that are three times our size.

And the shareholder-designated contribution program was 18-or-so million, as I remember, and then we detailed the contributions in the report made by the other companies.

But I would argue that to the extent that GEICO, for example, is a more efficient way of delivering personal auto insurance than, overwhelmingly, than its competitors are, and that, if 15 percent is a fair indication of how much it is saving people, that — and then, on a $4 billion of premium volume — that there is something more than $600 million that consumers save by a more efficient way of distribution, which has been honed to a fine art by the GEICO management.

Really, delivering the goods and services that people want in an economical way is a very important part, I think, of the contribution that any company makes to society, as well as the taxes they pay and their actual corporate philanthropy.

We are not big believers in giving away the money of the owner — of Berkshire acting as their representatives and giving away their money to philanthropy. We think that the shareholder should — it's their money.

And if we had a partnership of 10 people, if I were the managing partner, I would not feel I should make the decisions on philanthropy for the other 9 people. I would let them all make their own decisions.

We do not think that corporations, generally, should be passing out money to the pet charities of the CEO. And we don't do it at Berkshire.

But we do let the shareholders make those designations. And, as I say, I think our primary — (applause) — thank you.

I think that the best contribution actually we can make, this is ideal, over 10 or 15 years, is find a — is finding ways to deliver goods and services, that people want, to them at lower cost than the alternatives that were previously available to them.

Charlie?

CHARLIE MUNGER: Yeah. Well, I applaud the questioner's yearning for an answer to the question of, "Isn't there something more in this game than making and piling up money?" and "Shouldn't we be thinking about what we owe in return and what's going to go back in return?"

In the Munger case, I think a hundred percent is going to go back in return, for a reason different from that of the Buffett case. You know, there's an old saying: "How much did old Charlie leave?" And the answer is, "I believe he left it all." (Laughter)

And in essence, the — it all has to go back one way or another. You can't take it with you, that's the iron rule of the game. And I do think it's important to think about what you do for other people and what example do you set with your own life or your own corporate life.

And I do think that Berkshire stacks up pretty well in that respect. And in due course, when we get into gargantuan charities bearing the name Buffett, my guess is that'll be done pretty well, too. This is likely to be a pretty good run.

5. No "insight" on oil or silver

WARREN BUFFETT: Zone 5. (Applause)

AUDIENCE MEMBER: Hi, my name is Michael from New York. First, I'd like to address Mr. Munger.

Mr. Munger, it's so — it's such a pleasure to be here with you, as well as Mr. Buffett. And if you could just say hi —

CHARLIE MUNGER: You got those in the right order.

AUDIENCE MEMBER: — to my — (laughter) — wife for a second, her name is Jane.

Next, I understand your secrecy on unconventional investments. But Mr. Buffett and Mr. Munger, could you please tell me your insight on market conditions for oil and silver? (Laughter)

WARREN BUFFETT: He asked you, Charlie. (Laughter)

CHARLIE MUNGER: But we've already said that we're not going to comment about commodity investments.

I will cheat a little on that. Eventually the price of oil has to go way up. (Laughter)

That does not mean you can make any money from buying it now, counting the interest factor.

WARREN BUFFETT: (Laughs) Zone 6. (Laughter)

Fortunately, I don't know whether — I listened carefully when he phrased his question. He said "insights" and — (laughs) — I don't have any insights, so —

6. Cable TV systems: more promise than results so far

WARREN BUFFETT: We'll go to zone 6.

AUDIENCE MEMBER: My name is Merritt Belisle from Austin, Texas.

And the company has a large investment in the Washington Post Company, which has many cable television systems serving non-major metropolitan areas, as well as a recent investment in TCA Cable.

And so, I was hoping to get a comment about the cable television business generally.

And the other question is about your philosophy of children handling money and inheriting money.

WARREN BUFFETT: The first question about cable, the Washington Post Company does have — and we own about 17, or so, percent of the Washington Post Company, and I believe they have 700,000-plus homes. And as you say, they're in largely — in smaller areas.

It's been a good business. And as you know, cable prices have been galloping here in the last year, or thereabouts. From the standpoint of the Post that's bad news, because the Post would have been a net buyer of cable and will not be a seller.

And it's very, very much like our attitude towards stocks and stock prices. It is not good news for the Washington Post Company when cable prices go up, because the Washington Post Company's going to be investing funds. It's going to be a generator of funds over time. And if it wants to put money in cable, it's way better off if cable prices go down than up.

The TCA is not — Lou Simpson runs a separate portfolio at GEICO — equity portfolio — so I've never read an annual report of TCA Cable. I know nothing about it.

If he still has it, it's an investment of Lou's at GEICO, for GEICO, and it's not something that falls under my management at all.

It's a point I should mention, because, periodically, the press picks up some item that says that Berkshire — or sometimes it says that I am buying X, Y or Z.

And sometimes that's true, but sometimes it isn't true, because filings are made on behalf of various other entities that are associated with us, and I don't know anything about them.

I saw one here a couple of weeks ago reporting that I was — I don't know if it was me or Berkshire — I think it was me personally — it was buying some real estate investment trust with the name Omega in it. I'd never heard of it. But that story appeared various places.

Well, I can assure you, I filed no form with the federal government that said that I was buying that stock, although you would have deduced that from certain press accounts.

But various other entities, I think that there may be a subsidiary of General Re, New England Asset Management, that may have to report periodically on what they do.

And since General Re is owned by Berkshire, and New England Asset Management's a part of General Re, you know, who knows what they pick up on that.

So I do caution you, generally, to be a little careful about reports as to what is being bought or sold by me or by Berkshire Hathaway.

Now, as I remember, there was second question that I didn't like quite as well to answer. (Laughs)

Charlie, you want to tackle that one?

CHARLIE MUNGER: Well, I think there was more interest in the future of cable. (Laughter)

That is, we have demonstrated a signal lack of aptitude in correctly diagnosing the future of cable in a way that made us a lot of money.

And we've done that in spite of the fact that in retrospect it seems like a lot that was perfectly obvious was lying around.

WARREN BUFFETT: Today cable is not, I mean, cable has been here for what, 30 years or so. Cable has not made extraordinary returns on invested capital, at all.

But it's always had the promise of greater returns and it's had the promise that you wouldn't have to keep investing money in it the way that you've had to date.

But currently, people think that unusual returns will be made in cable, relative to invested capital, not relative to the purchase price of them, but relative to the invested capital in the property itself. And, as I say, that has not really been the case as — it's been the case with cable programming. Cable programming, there's been a lot of money made in relation to capital investment.

But in terms of the actual investment in cable facilities, the capital investment has been such, the expenditures in developing systems have been such, that the returns so far have not been great.

But the prices for cable systems now would indicate that people think that those returns are finally going to start flowing in, in a big way.

7. Buffett and Munger differ on influence of inherited wealth

WARREN BUFFETT: What was the second part of that question that you had?

VOICE: Children and wealth.

WARREN BUFFETT: Oh, inherited wealth and children —

AUDIENCE MEMBER: It was about kids inheriting money.

WARREN BUFFETT: Yeah. Well — (laughter) — we have a minority viewpoint down here in the front row. (Laughter and applause).

I think my views on that subject changed when I was about 18. (Laughs)

Until that point I thought it would be a great idea.

No, I am quite a believer in a meritocracy and I think a part of that is not having people start way, way ahead of other people in life, based on whether they were lucky enough to come from the right womb or not.

So I've never been big on the idea that either society benefited or, in many cases, the kids — although I think that's much more problematic, but — by the fact that great transfers of wealth will go from one generation to another, I —

You know, I would rather see the degree of talent possessed by individuals determine the resources they command in this world, and their ability to influence other people's lives and command the labor of other people, and all of that, than any divine right of the womb.

So that's — and Charlie has a somewhat different view on that.

CHARLIE MUNGER: Yeah. I am a little more willing to let the world take the succeeding generations down. It's — (Laughter)

WARREN BUFFETT: He believes in crossing it —

CHARLIE MUNGER: I don't think they need much help. (Laughter)

WARREN BUFFETT: Charlie believes in passing it along, as long as you're sure they're going to blow it. (Laughter)

OK. Zone —

CHARLIE MUNGER: If you stop —

WARREN BUFFETT: Go ahead.

CHARLIE MUNGER: If you stop to think, Warren, of the great fortunes of yore — if you go back to 1900, 1870 and, you know — name me the people that have vast power because they are in the fourth generation in that family. Some of them are living awfully well, but they are not running the world.

WARREN BUFFETT: I would say the Rockefeller family had considerably more influence than if their name had been, you know, just plain Rock. (Laughter)

CHARLIE MUNGER: Well, I think that's true, but you're picking probably the strongest, single family of the piece. And now that it's dispersed among 60 or 70 or 80 Rockefeller, it —

I think it's true there were four or five brothers there that had an unusual share of worldly influence. I must say, in that case I think they handled it very well.

8. Avoiding tech: we're "willing to trade away a big payoff for a certain payoff"

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: My name is Alan Negan (PH) from Reston, Virginia.

I know you like to buy into success stories but you don't like to buy high tech. And it seems to me, say in the case of Microsoft, that 10 years from now they'll be doing software development, just like 10 years from now Coke will be selling sugared water.

And what I'm wondering is why you feel that way when it seems certain companies, high-tech companies, are predictable.

And it also seems that in the early '90s you were — you mentioned you were going to buy a pharmaceutical company, which also seems like high tech to me. So that's my question.

WARREN BUFFETT: Yeah. Well, we — I think we said that with the pharmaceutical companies we wouldn't have known how to pick out which one. We would have thought the industry as a group would do well.

From those levels of 1993, you cannot buy high tech companies at anything like — at levels that are commensurate with the levels that the pharmaceutical companies were selling at in '93.

You know, I would — and getting to the first part of your question, I think it's much easier to predict the relative strength that Coke will enjoy in the soft drink world than the strength — the amount of strength — that Microsoft will possess in the software world.

That's not to knock Microsoft at all. If I had to bet on anybody, I'd certainly bet on Microsoft, bet heavily if I had to bet. But I don't have to bet. And I don't see that world as clearly as I see the soft drink world.

Now somebody that has a lot of familiarity with software may very well see it that way and they're entitled to — if it's true they have superior knowledge and they act on it, they're entitled to make money from that superior knowledge. There's nothing wrong with that.

I know I don't have that kind of knowledge, and I simply — and I do think that it's — that if you have a general knowledge of business over decades, that you would regard the industry they're in as less predictable than the soft drink industry.

Now it may also be that even though it's less predictable that there's a whole lot more money to be made, so that if you're right, that the payoff is much larger.

But we are perfectly willing to trade away a big payoff for a certain payoff. And that's the way we're put together.

It does not knock the ability of other people to make those decisions. I mean, I asked — first time I met Bill Gates in 1991, I said, "If you're going to go away on a desert island for 10 years, you had to put your stock in two companies in the high-tech business, which would they be?"

And he named two very good stocks. And if I'd bought both of them, we'd have made a lot more money than we made, even buying Coca-Cola.

But he also would have said at the same time that if he went away he'd rather buy Coca-Cola, because he would have felt sure about that happening.

It's — you know, different people understand different businesses. And the important thing is to know which ones you do understand and when you're operating within what I call your "circle of competence."

And the software business is not within my circle of competence, and I don't think it's within in Charlie's.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that. I think there are interesting questions, too, about how far the whole field can go.

Take jet airplane travel below the speed of sound. It's been pretty static in terms of the technology for a long, long time. You know, the big Boeing airliner is much the same as it was 20 or 30 years ago.

And I think it's — a lot of these businesses are quite dependent on the technology continuing to gallop and do more and more for people.

Take pharmaceuticals, if they had never invented any more pharmaceuticals, it would be a terrible business.

I don't know what happens once you get unlimited bandwidth into the house and way more options, and —

Beyond a certain point, it strikes me that there might be a surfeit of anybody's interest in the field. I don't know where that point is, whether it's 20 years out or 30 years out, but it would affect me a little.

WARREN BUFFETT: The Dilly Bar is more certain — (Laughter)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — to be here in 10 years than any software application that we know. But that's, maybe, because we understand Dilly Bars and not software.

In the whole United States, which is, you know, is by far the most prosperous country in the world — the whole United States, there are probably around 400 companies, 400 total companies, that are earning $200 million a year, after-tax.

Of those 400, you could name them. I mean, you could start, you know — if you say "bank," you can say Citigroup and Chase and Wells Fargo, and you name 10 or 15 of them. And if you name consumer goods, you're going to say Procter & Gamble and Coca-Cola and Gillette, and you can name a whole bunch of them.

You can almost, of those 400, you can probably name 350. If, five years from now, instead of 400 being on that list, there'll probably 450 on the list, maybe 475.

A lot of those will be companies that are earning between 150 and $200 million now. So there'll probably be 20 — some number like 20 — that, call it, come from nowhere.

Now if you look at the number of companies that are selling today at a price which implies 200 million or more of earnings right today, you will find dozens and dozens in the high-tech arena. And, you know, a very large percentage of those companies are not going to fulfill people's expectations.

I can't tell you which ones, but I know there won't be dozens and dozens and dozens of those companies making a couple hundred million dollars a year. And I know they are now selling at prices that require them to be making that much money or more. It just doesn't happen that often.

You know, biotech was all the rage some years back. How many of those companies are making a couple hundred million dollars a year? It just doesn't happen.

It's not that easy to make lots of money in a business in a capitalistic society.

People that are looking at what you're doing every day and trying to figure out a way to do it better and to, you know, underprice you or bring out a better product, or whatever it may be. And a few companies make it.

But here in the United States, after all of these decades and decades and decades of wonderful economic development, we've got about 400 companies that have hit the level that would be required of a company that would have a market cap of $3 billion.

And some companies are getting $3 billion of market cap the day they come out, virtually, — so.

There's some — you want to think about the math of all this.

9. Don't "dance in and out of the companies you really love"

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: Hello. My name is Larry Whitman (PH) from Minot, North Dakota.

You've already hinted about Coke and Gillette's current valuations, and also about their great prospects for the future. But in the past year, both stocks have been down 30 to 50 percent from their highs.

How much farther would they have had to fall before your criteria of margin of safety had been satisfied and allowed you to purchase more shares?

And two, has the Disney/Cap Cities merger gone as well as you would have hoped, and has the future prospects of Disney changed in your opinion?

WARREN BUFFETT: First question, that's a good question on Coke and Gillette, because obviously, we think about the businesses that we're the most familiar with and where we're committed.

But neither one of those businesses got to the price that left us happy putting new money in. But we're quite happy, very happy, owning those businesses and will be happy owning them for a very long time to come. But they —

It's some evidence of where the market has been and is, that, even when they ran into some tougher business conditions than they anticipated, that their stocks did not go down to the prices that cause us to get excited about them.

Charlie, you want to comment on that or the second part?

CHARLIE MUNGER: No. But I do want to remind people that the Dilly Bar is a Dairy Queen product. (Laughter)

WARREN BUFFETT: And they are good. I can tell you that. (Laughter)

CHARLIE MUNGER: I wouldn't want the shareholders to believe that the commercial standards of this operation are faltering. (Laughter)

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

WARREN BUFFETT: People have tried to do that with Berkshire over the years. And I've had some friends that thought it was getting a little ahead of itself from time to time. And they thought they'd sell and buy it back cheaper and everything.

It's pretty tough to do. You have to make two decisions right. You know, you have to buy — you have to sell it right first, and then you have to buy it right later on. And usually you have to pay some tax in-between.

It's — if you get into a wonderful business, best thing to do is usually is to stick with it.

Coke and Gillette both experienced disappointments to their management, below what they anticipated a year, a year and a half ago, or whenever it was, and below what we anticipated. But that will happen over time.

It happens with some of our wholly-owned business from time to time. Sometimes they do better than we anticipate, too.

But it's not the nature that everything — that things that — everything goes in a nice, straight, smooth line upward.

You mentioned Cap Cities. Parts of Cap Cities have done extraordinarily well, for example. But in the network business, if you go back 30 years and look at what network has been on top, you find that no one stays on top, or on the bottom, indefinitely there.

It's a competitive world, as I mentioned earlier. And sometimes your competitors' correct moves, your own incorrect moves, the world environment — all of those things can interrupt trend lines.

I see nothing that's happened in the last year, in terms of the long-term trend line, of the blade and razor business, which is the one I've referred to as "inevitables" at Gillette. I mean, they are in other businesses that are not in the same category as the blade and razor business.

Coke, fortunately, has virtually its entire business in soft drinks. And so it comprises almost a hundred percent of the whole there.

But I see nothing that would change my thinking about the long-term future of either the blade or — blade and razor business — or Coke's position in the soft drink business.

10. Deflation unlikely, but would be good for bondholders

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Steve Cohn (PH) from Peoria, Illinois.

First of all, I just had my first Dilly Bar a half an hour ago, and thank you for introducing me to that.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: You spoke —

WARREN BUFFETT: I'll sell you a second, too if — (Laughter)

AUDIENCE MEMBER: You spoke earlier about the threat of change. Can you comment on the threat of deflation and, if it were to occur, what its likely impact would be on the economy, Berkshire Hathaway, and personal investment decisions?

WARREN BUFFETT: Well now, displacement in what respect? I didn't —

AUDIENCE MEMBER: -flation.

WARREN BUFFETT: Oh, inflation.

AUDIENCE MEMBER and CHARLIE MUNGER: Deflation.

WARREN BUFFETT: Oh, deflation.

CHARLIE MUNGER: Deflation.

WARREN BUFFETT: Oh, I'm over — I'm getting there. (Laughter)

Well I think it's very, very unlikely, but I would — I have been wrong consistently now for a decade or more about the degree to which inflation has at least been tamed for that period.

I would have expected — if you'd showed me all the other things that were going to happen in the world in the last — if I'd seen that ahead of time 10 or 15 years ago — I would have thought we would have had more inflation, so —

I have trouble envisioning a world of — where the U.S. experiences deflation. But, you know, my record is not great on that.

And again, we don't — we do not spend a lot of time thinking about macro factors.

I mean, if you ran into deflation that means, you know, capital is appreciating, so you need much lower nominal rates of return on capital to be in the same place under deflation as would be the case if you had inflationary conditions.

So deflation, everything being equal — and it isn't equal — is good for investors because it — you know, the value of money appreciates. The buying power of money appreciates. But it would have other consequences, too.

I don't think it's likely. I'm not — I have no great record at all in macro forecasting and I — if it does happen, the truth is, I don't know what the effects would be.

Charlie.

CHARLIE MUNGER: Well, you've seen what deflation is doing in Japan, and it's been quite unpleasant for the people there. On the other hand, it hasn't been a catastrophe. I mean, nothing like the '30s in the United States.

WARREN BUFFETT: No, and actually, in Japan, if you had owned long bonds, you would have had a tremendous bonanza from deflation, because your — the value of your bonds would have gone up dramatically as interest rates came down. And then that money, in turn, would buy more.

So it would — it was a very — if you happened to be the person that owned longer bonds issued at higher coupons some years back, that's worked to your advantage.

But — and presumably that would work in this country. If we actually ran into consistent deflation, my guess is that people who owned long bonds, even bought at 5 1/2 percent, would find their position in the world dramatically improved compared to people who owned most other asset classes.

11. Markets are "fairly" efficient, but efficient market theory is "silly"

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Hello. I'm Murray Cass from Markham, Ontario. First off, Mr. Buffett, Mr. Munger, I'd like to thank you for being so generous with your time every year at these meetings.

Mr. Buffett, many in the academic community call you lucky, or a statistical outlier. Mr. Munger, I'm not sure what they call you. (Laughter)

WARREN BUFFETT: Well, you're free to speculate on what they call him. (Laughter)

AUDIENCE MEMBER: I know you don't like to forecast the equity markets, but maybe you would dare to forecast the evolution of the debate between proponents of the efficient market theory and value investors.

Do you think there will ever be a reconciliation? And I'm talking especially about what's taught at the business schools.

And as an addendum, are your designated successors, are they outliers as well?

WARREN BUFFETT: (Laughter) Well, we like to think they are. And then, they may be more outliers than we are.

The market is generally — you know, I — to me, it's almost self-evident if you've been around markets for any length of time, that the market is generally fairly efficient.

It's fairly efficient at pricing between asset classes, it's fairly efficient in terms of evaluating specific businesses.

But being fairly efficient does not make — does not suffice to support an efficient market theory approach to investing or to all of the offshoots that have come off of that in the academic world.

So, if you'd believed in efficient market theory, and been taught that and adapted — adopted it for your own 20 or 30 years ago, or 10 years ago — I think it probably hit its peak about 20 years ago — you know, it would have been a terrible, terrible mistake.

It would have been like learning the earth is flat. It just — you would have had the wrong start in life.

Now, it became terribly popular in the academic world. It almost became a required belief in order to hold a position.

It was what was taught in all the advanced courses. And a mathematical theory that involved other investment questions was built around it, so that, if you went to the center of it and destroyed that part of it, it really meant that people who'd spent years and years and years getting Ph.D.s found their whole world crashing around them.

I would say that it's been discredited in a fairly significant way, over the last decade or two. I mean, you don't hear people talking the same way about it as you did 15 or 20 years ago.

But the market generally is fairly efficient in most ways. I mean, it is hard to find securities that are inefficiently priced. There are times when it's relatively easy. But right now, for example, it's difficult.

There — I don't know exactly how much it's holy writ, still, in business schools.

I certainly get the impression, as I go around talking to business schools, that it is far less regarded as, you know, sort of unquestioned dogma that it — like it was 15 or 20 years ago.

The University of Florida now has some courses in valuing businesses. University of Missouri's putting in one.

And I think the high priests of efficient market theory are probably not in the same demand for speaking engagements and seminars and all of that as they were a decade or two ago.

It’s hard, though — it’s very interesting. It’s hard to dislodge a belief that becomes sort of — becomes the dogma of a finance department.

It’s so challenging to them and, you know, they have to, at age 30 or 40, to go back and say, “What I’ve learned up to this point, and what I’ve been teaching students and all of that, is silly,” that doesn’t come easy to people.

Charlie?

CHARLIE MUNGER: Well, you know, Max Planck, the great physicist, said that even in physics, the old guard really didn’t accept the new ideas. The new ideas prevail, in due course, because the old guard fades away, clinging to the asininities of the past.

And that’s what’s happened to the hard-form efficient market theorists. They’re an embarrassment to the scene and they will soon be gone. On the — (Laughter)

People who think the market is reasonably efficient, or roughly efficient, of course, are absolutely correct and that will stay with us for the long pull.

WARREN BUFFETT: Thinking it’s roughly efficient, though, does nothing for you in academia. You can’t build anything around it. I mean, that — what people want are what they call elegant theories. And it just — it doesn’t work.

You know, what investment is about is valuing businesses. I mean, that is all there is to investment. You sit around and you try to figure out what a business is worth. And if it’s selling below that figure you buy it.

That, to my — you can’t find a course virtually in the country on how to value businesses. You can find all kinds of courses on how to, you know, how to compute beta, or whatever it may be, because that’s something the instructor knows how to do. But he doesn’t know how to value a business. So, the important subject doesn’t get taught. And it’s tough to teach.

I think Ben Graham did a good job of teaching it at Columbia, and I was very fortunate to run into him many decades ago.

But if you take the average Ph.D. in finance and ask him to value a business, he’s got a problem.

And if he can’t value it, I don’t know how he can invest in it, so therefore, he — it’s much easier to take up efficient market theory and say it doesn’t make any difference because everybody knows everything about it, anyway.

And there’s no sense in trying to think about valuing businesses. If the market’s efficient, it’s valued them all perfectly.

I never known what you talk about on the second day in that course. I mean — (Laughter)

The first — you walk in, you say, you know, “Everything’s valued perfectly, and class dismissed.” So, it puzzles me. But I encourage you to look for the inefficiently priced.

WARREN BUFFETT: Zone 3. Berkshire, incidentally, was inefficiently priced for a long time. And it wasn’t on the radar screen of — if you asked an academic how to value it, they wouldn’t have known what to look at exactly. Yep.

12. We try to grow cheap float quickly

AUDIENCE MEMBER: My name is Ken Shuvenstein (PH). I’m from New York City. First, thank you very much for this great, educational forum.

You’ve taught us that a key concept of Berkshire is the amount of float it has, the cost of the float, and how fast it grows.

Can you please help us understand, currently, what amount of float Berkshire has and what the goals are in the future for that growth rate over a sort of one to two-decade period, understanding that it will be a lumpy advance?

Because, looking at the historical data you’ve provided us for Gen Re and Berkshire, regarding the amount of float and its cost, it’s grown at a great rate — high teens, lows 20s. And if you could please comment on the future expectations we should have, that would be great.

WARREN BUFFETT: Yeah. Well, it’s an important question. It — but I don’t know how to give you a good answer.

The — it’s grown at a much faster rate, since 1967 when we went into the insurance business, than I thought it would.

I mean, I did not — I didn’t anticipate it would grow that way. I didn’t anticipate necessarily we would get a chance to buy GEICO. I didn’t necessarily know we’d ever acquire a General Re or — so it’s been very hard to forecast.

What we’ve tried to do is grow cheap float as fast as we could. And sometimes it’s been easy, sometimes it’s been impossible.

But I don’t know — if you had asked me that question 30 years ago, I’d have given you an answer that really hasn’t proven out very well. And I —

So, I don’t know how to give you the answer now, except to tell you this: it’s very much a goal of Berkshire to grow that float at as fast as it can, while maintaining a very low cost to it.

And again, you mentioned it'd be lumpy. Well, it'll be lumpy on cost. It'll be lumpy on growth rate. But, I mean, we are — it's something we think about all of the time, in both our operating decisions and perhaps some big capital commitment decision.

It's — we know that if we can solve that problem of how to grow it at — with it costing us relatively little, that we will make Berkshire a whole lot more valuable in the process.

And people, I mean — we always laid out the facts as to what we were doing, but people basically seem to ignore that.

And we have had this growth rate, which we can't maintain, the numbers are too big. But it's something that Charlie and I think about all the time.

We've got some good vehicles for growing it. But we don't have any vehicles that will grow it in aggregate at anything like the rate it's been grown in the past.

So we may have to — we may get a chance to do something that adds to our ability to do it. If we get a chance and it's at the right price, we'll add it. If we won't, we'll do as much as we can internally.

But the question you ask, the growth in intrinsic value of Berkshire over the next 10 years, will be determined, in a very significant way, by the rate at which we do grow it and if — and also the added fact of what it costs us to achieve that float.

Charlie?

CHARLIE MUNGER: Yeah. If we grow very low-cost float at the same rate that it's grown in the past for another 30 years, you can be confident of one thing: if you look to the heavens there will be a star in the east. (Laughter and applause)

13. Two reasons Berkshire isn't selling life insurance

WARREN BUFFETT: Zone 4. (Laughter)

AUDIENCE MEMBER: I'm David Levy (PH) from Newport Beach, California.

Berkshire has been investing in the property and casualty and reinsurance business.

I notice, except for annuities, you've been avoiding the life insurance business. Do you have — do you anticipate investing in the life insurance business?

Also, I have a second question, and that is the relationship of Berkshire A and Berkshire B. Last year there was a slight premium for Berkshire B over Berkshire A.

About now, Berkshire B is selling at about a 3 to 4 percent discount. I also notice that certain people are shorting Berkshire A and Berkshire B. I wonder if you could comment on that.

WARREN BUFFETT: Sure. On the life business, we have no bias against the life business, we just — we are in the life reinsurance business in a fairly significant way through General Re. As you mentioned, we've done a little on annuities.

The problem with the life business is that it isn't very profitable — and you can look at the records of the big companies on that — and that a lot of the activity in the area is, in some way, equity-related.

And Charlie and I have never wanted to get in the business of managing equities for other people. I mean, we want our sole interest on equities to be Berkshire Hathaway itself. So, we do not want to wear two hats.

We would never go into the mutual fund management business or any kind of investment management business because, if we were to be managing 20 or $30 billion in the investment management business, and we get a good idea that we can put a billion dollars in, you know, whose money do we put in it?

So, we'd rather just be wearing one hat. And that we want that hat to be Berkshire Hathaway. And we don't want to be promising other people that for, you know, half of one percent or one percent fee that they're going to get our best ideas, because those ideas belong to Berkshire and we'd be misleading people if we promised otherwise.

So, anything that involves an equity component to it — and that's a big part of what's going on in the life business now — it's just something we wouldn't be comfortable being involved with.

If you look at term life insurance, we've looked at that, in terms of putting it on the internet. It's — it is priced at rates that we find very hard, even with the absence of commissions, to make sense.

But it's a business we understand. So, we're — we'd be perfectly willing to be in the life insurance business if we thought there was — if we had a way of doing it where we thought there was reasonable profitability attached to it.

Charlie, do you want to comment on the life business before I get to the A versus B thing, or —

CHARLIE MUNGER: No.

We do those structured settlements. That is sort of like the annuity business. And the life business we're doing is mostly annuities and on a very low-cost basis.

WARREN BUFFETT: Yeah. Anyone that wants to buy a non-equity-related annuity should go to our website and find, in terms of the — weighting for the safety of the product and everything, you'll find a very, very competitive product because we —

It's a low-cost operation. And if you're buying it to get paid 30 years from now, you are certain to get paid from Berkshire and you're not necessarily certain to get paid from various other entities. So, we've got a very competitive product there, but it's not a big business.

14. Price differences between Class A and B shares

WARREN BUFFETT: On the question of A versus B, I've written something — I wrote it some months ago and stuck it up on the website — regarding my own thoughts on that.

Obviously, the most the B can be worth is 1/30th of the A, because you can always convert an A into 30 shares of B.

The B may sell a slight bit above that 1/30th price before it gets to a level where it induces arbitrage between the two. So, it can theoretically sell, and it will sell, a fraction of a percent above 1/30th of the price of the A. But if it gets above that, you know, I'll buy the A and sell you the B.

There's an arbitrage profit to be made, and probably the way markets work, most of that profit will be captured by the specialist, because he's in the best position to effectuate trades of that sort.

But the B can never be worth more than a thirtieth of the A, and it can never sell for more than slightly above 1/30th of the A.

On the other hand, B is not convertible into A stock, so it can sell at a discount.

I put on the web some months ago that I thought — just my opinion — but I thought that when the B is selling for less — selling for more — than a two percent discount, I personally would rather buy B than A under those circumstances.

If it's selling for the same price as the A — 1/30th the price of the A, but it's selling on a parity basis — and I were buying 30 shares or more of B, I would rather buy A, because you can always go one direction and you can't go the other direction.

I think, if you take the next 10 years — I would think that a fair percentage of the time, it's going to be selling right about 1/30th of the price of the A, and there will be periods of time when it sells it at a modest discount.

And I would say that when it gets in the 3 to 4 percent range, I regard that as quite a wide discount. If I didn't have a tax to pay myself, I might sell A and buy B if I was getting four percent more in the — in economic equivalent on B. It's not practical for me to do it.

Some — I know of some tax-exempt investors that have actually done that sort of thing, and —

Long range, we will always treat the B exactly as we laid it out in the prospectus. There are two differences between the A and B. One is in the voting power, relatively. And the other is in the shareholder-designated contributions program. And otherwise, in all respects, B will be treated on the same basis as the A.

We have no — even though Charlie and I own a lot of A and we don't own any B to speak of, we regard the B shareholders as being 100 percent on a parity, except for those two differences we laid out at the time of issuance, with A shareholders.

We would never — there won't be a deal ever made for Berkshire anyway — but if there would be we would always treat the A and B on a 1-for-30 basis.

We would not — we've been in situations where people haven't done that and we've never been very happy with it. So we would always treat people proportionally.

Charlie.

CHARLIE MUNGER: Well, I certainly agree with all of that.

WARREN BUFFETT: The question about shorting, it doesn't make a difference whether anybody shorts any stock or not, really.

I mean, if you were arbitraging between A and B, and the B was selling a little higher than the A, you might be buying some A and shorting some B, and you might delay conversion because you might figure the B might go to a discount. And then you'd unwind the whole transaction rather than convert.

I mean, there's a lot of techniques that Charlie and I have engaged in over the years, and other securities that apply to that sort of thing.

But shorting doesn't hurt us in any way, shape or form. I mean, it doesn't make any difference.

I don't care whether the short interest in the A is a thousand shares or 100,000 shares. You know, somebody sells it at one point and somebody buys at another point, and whether you reverse the buying and selling doesn't make any difference.

What counts is the intrinsic value of Berkshire. And if we increase the value of Berkshire at a reasonable rate, you know, the shorts will have to figure out how to eat three times a day. (Laughter)

15. Investing advice: start early and think for yourself

WARREN BUFFETT: OK. Zone 5, please.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Grant Morgan (PH), I'm here from New York City.

Earlier, you had acknowledged that it is a more difficult investment and business environment today than it was when you first started out.

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

WARREN BUFFETT: Start young. (Laughter)

Charlie's always said that the big thing about it is we started building this little snowball on top of a very long hill. So we started at a very early age in rolling the snowball down.

And, of course, the snowball — the nature of compound interest is it behaves like a snowball of sticky snow. And the trick is to have a very long hill, which means either starting very young or living very — to be very old.

The — you know, I would do it exactly the same way if I were doing it in the investment world. I mean, if I were getting out of school today and I had $10,000 to invest, I'd start with the As.

I would start going right through companies. And I probably would focus on smaller companies, because that would be working with smaller sums and there's more chance that something is overlooked in that arena.

And, as Charlie has said earlier, it won't be like doing that in 1951 when you could leaf through and find all kinds of things that just leapt off the page at you. But that's the only way to do it.

I mean, you have to buy businesses and you — or little pieces of businesses called stocks — and you have to buy them at attractive prices, and you have to buy into good businesses.

And that advice will be the same a hundred years from now, in terms of investing. That's what it's all about.

And you can't expect anybody else to do it for you. I mean, people will not tell — they will not tell you about wonderful little investments. There's — it's not the way the investment business is set up.

When I first visited GEICO in January of 1951, I went back to Columbia. And I — that rest of that year, I subsequently went down to Blythe and Company and, actually, to one other firm that was a leading — Geyer & Co. — that was a leading analyst in insurance.

And, you know, I thought I'd discovered this wonderful thing and I'd see what these great investment houses that specialized in insurance stocks said. And they said I didn't know what I was talking about. You know, they — it wasn't of any interest to them.

You've got to follow your own — you know, you've got to learn what you know and what you don't know. Within the arena of what you know, you have to just — you have to pursue it very vigorously and act on it when you find it.

And you can't look around for people to agree with you. You can't look around for people to even know what you're talking about. You know, you have to think for yourself. And if you do, you'll find things.

Charlie?

CHARLIE MUNGER: Yeah. The hard part of the process for most people is the first $100,000. If you have a standing start at zero, getting together $100,000 is a long struggle for most people.

And I would argue that the people who get there relatively quickly are helped if they're passionate about being rational, very eager and opportunistic, and steadily underspend their income grossly. I think those three factors are very helpful.

16. How Buffett learned the insurance business

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, thank you very much for your hospitality. Excuse me, my name is Yvonne Edmonds (PH) and I'm from St. Petersburg, Florida. And thank you also for being so kind as to spend all this time answering our questions.

I have two related questions regarding insurance. The first is, I suspect that many of us know less about insurance than about equities and I wonder if you could please put some references for us on the Berkshire Hathaway website that might help us increase our knowledge about insurance.

The second question is, perhaps, related to the first, I just — the fact that I don't understand it, but The Wall Street Journal, on March 19, published an article entitled, "When Insurers Pass Trash, Some Are Left Holding the Bag." And that "some" included Berkshire Hathaway.

It focused on passing the workers comp trash to, among other groups, to Cologne Re.

And to make a long story short, the assistant general counsel for General Re, which, as I understand, now owns most of Cologne Re, said this is a classic example of an insurance company seeking growth in a very competitive market by writing business outside its area of expertise — namely within workers' comp — when their area of expertise is life reinsurance.

Mr. Graham went on to say, and then I'll stop, "Don't write business you don't understand. Second, proper controls are critical in the insurance business. Lastly, if a business opportunity appears to be too good to be true, it probably is."

If this is true, could you tell us how this came about? What measures are being taken to see that it won't happen again? And what might be the ultimate cost to Berkshire Hathaway shareholders? Because I gather that the — only the tip of the iceberg has been represented in the charge to Cologne Re.

WARREN BUFFETT: OK. Those are good questions.

And let's take the first one first about the website and having a list of reference documents, or something that would help you understand insurance. You sound like you understand it pretty well already. The — (Laughter)

I can't think of a good book that I've read on the subject. I got my knowledge of insurance by reading — well I got this huge head start by having a fellow named Lorimer Davidson, who is now 96, spend four hours or so with me one Saturday morning in January 1951, explaining to me how GEICO worked.

And I — it was a marvelous education, and it got me so interested, in not only how GEICO worked, but how its competitors worked, how the industry worked, that I just started reading a lot of other reports.

I never — I guess I took one course in school on insurance. I don't remember a thing from it. I have no idea what the text book was or anything. It had no value to me.

So I never really had any background in insurance. My — you know, nobody in the family was in the insurance business.

And until I talked to Davy, I really — it just hadn't been something that crossed my mind. The only reason I was down there was because I'd — my hero, Ben Graham, was listed in "Who's Who" as being the chairman of Government Employees Insurance. That's —

If he had been the chairman of, you know — he was also the chairman of the Market Street Railway Company in San Francisco.

Fortunately, I went down to GEICO instead of out to see the Market Street Railway Company. (Laughter) It was closer.

But I — my own education about insurance came from just reading lots of, lots of reports.

I mean, I would say that if I started the day fresh and I didn't know anything about the insurance industry to speak of, and I wanted to develop some expertise, I would probably read the reports of every property-casualty company around.

And I would go back some time and I would read — I would probably get the best manuals and look at them.

I would just do a lot of reading. I used to go down to the Department of Insurance in Lincoln and go through the convention reports and the examination reports.

I'd — they'd give me some little table someplace and I'd keep asking them — (laughs) — for these reports and they'd have to go way down in the bottom of the Capitol to get them out for me. But they didn't have much else to do so they were always happy to do it.

And that's the way I learned about it. And it happened to be a productive field to learn about it that way. And I really think that something akin to that is the best way now. I can't think of — you know, you can read some analyst reports.

I think you can learn something, frankly, by reading the Berkshire Hathaway annuals for 20 years and reading the insurance section. I think it'll teach you something about the economics of insurance. So, I would do it by reading.

And if you can find somebody that knows the business well, who's willing to spend some time talking to you about it, they can probably shorten the educational period and give you some help on that.

17. Unicover losses are "rare lapse" for General Re

WARREN BUFFETT: The second question about what's been called — what's the Unicover [Managers Inc.] affair that Cologne Re set up a 275 million — Cologne Life, I should say — set up a $275 million reserve against.

First of all, I would say for the losses to be incurred on that business, the 275 still represents the best estimate.

In other words, it may be the tip of the iceberg in terms of the loss to the industry, because no one else has acknowledged any losses. This is amazing. I mean, believe me, there are plenty of other losses out there.

We said we were going to lose 275 million. I think that's a good estimate. But I think a lot of other people are going to lose very — they have to lose significant money. Somebody has to lose some significant money besides us on that.

And so what we have reported may be the tip of the industry iceberg. I don't think it's the tip of the General Re or Berkshire Hathaway iceberg.

It's our best estimate today of what that loss will be. If that estimate changes, I will let you know through the quarterly reports or, if it was really material, we'd have some announcement. But I don't anticipate that.

But we'll report to you faithfully, I promise to you, as to how that loss develops over time.

The — what you read makes a great deal of sense about when something's too good to be true, it usually is and that sort of thing.

The distribution of the losses in the Unicover affair will, probably, not be fully settled 10 years from now.

I mean, I have seen these things before in insurance and in other areas, but particularly in insurance, where there are multitudes of parties, and there are allegations of stupidity, there's allegations of fraud, there's allegations of misrepresentation, there's allegations of everything.

There are so many people involved, there are so many factual matters to be determined. There will be lots of litigation. It will take a long, long time to sort out the litigation. In the end, the losses will get paid by somebody. Our best estimate we've put up is 275 million.

But we may find out far more in coming months and years, as to the involvement of other parties or — we can find out a great many things, because there will be lots of litigation, not necessarily involving us, but that we will, as a — even as a viewer of — we will be learning things about what took place.

Unfortunately, there have been some similar things in insurance. We were involved in something that had some similarities to this at National Indemnity, 20-odd years ago. And it was very expensive to us.

It didn't cost us that many millions of dollars, but it happened at exactly at the time that the stock market was down around the 600 on the Dow, and we did not know how big the losses would be. And therefore, it caused us to have to be more conservative in investing in equities than would have otherwise been the case, if this hadn't been hanging over our head.

So conventional accounting will never pick up the loss that we suffered in that.

It was called the Omni affair. And like I said, it had some — I'm sure it had many differences, too, but it had some similarities. And, you know, it can — it's distracting to have something like this that obviously — there was some mix of mistakes, there's some mix of misinformation. All of that will have to get sorted out.

Our best guess right now is that, when it's all done — 10 years from now, 15 years from now — the 275 million will be our loss. That most certainly won't be the exact figure. But like I say, if there's any reason to revise that number upward, we'll let you know promptly.

It is the nature of insurance that you get unpleasant surprises from time to time.

Loews Corp. bought CNA in the early 1970s. And just in the last few years, there was a fiberboard settlement on a policy, I believe, that was written in the late '50s. And there was a, as I remember, a billion and a half dollar loss on something where the premiums were a few thousand dollars.

GEICO has lost, as I remember, $60 million on a book of business that was written in the early 1980s, where the total premium was less than $200,000. You know, how much of that is stupidity, how much of it is fraud, or who knows exactly? But you can get some very unpleasant surprises in insurance.

And unfortunately, this will not be the last one. It won't occur in the same place, it won't occur exactly the same way. But the nature of insurance is that the surprises are on the unpleasant side.

It's not the kind of thing that happens when you're writing personal auto insurance or anything of the sort. But when you write business where the claims pop up 10 or 20 or 30 years later — I think we've got a claim, a small workers' comp company that we have, that goes back 20-odd years, 25 years or so, and it's just popped up to life in the last year or so. And it costs real money.

So it's a business where the surprises can come big and they can come late. And that will happen even with good management. But with good managements, you'll have fewer such surprises.

Charlie?

CHARLIE MUNGER: Well, that was a marvelous question. And imagine anybody asking a question of how to get educated — who knows how to educate people? It's the same way you educate the dog by rubbing his nose in it. (Laughter)

And generally speaking, that was a dumb error. That was an amateur's mistake.

It doesn't mean that General Re is suddenly full of amateurs. It was a rare lapse, just as at Berkshire, we think the Omni affair was a rare lapse. I don't think we've repeated it since. Have we, Warren? I can't think of a single one.

WARREN BUFFETT: But again, you know, we don't know that we've repeated it.

CHARLIE MUNGER: Well but —

WARREN BUFFETT: These things pop up later. No. No, the answer is we haven't repeated it. (Laughter)

CHARLIE MUNGER: So yes, it was a dumb, amateurish error. These things do happen. We don't think it reflects a sudden lowering of the intellectual standards of General Re, which are probably the best in the world. It's just one of those things that does happen once in a while.

And there's one good side to these things, it does make you more careful. It really refreshes your attention to get banged on the nose like that.

WARREN BUFFETT: Yeah, and it remains to be seen where the costs of that will be born. Because the entire set of facts, in terms of what was committed to and all of that, it has not been resolved yet.

In the Omni situation, we had significant disputes on the facts for some time, and we eventually recovered a fair amount of money that, for a time, it didn't look like we would recover.

So, you know, the final chapter on this is not going to be written for some time, but it was appropriate to set up $275 million as a reserve, in terms of what we know at this time. And that number could go up. It could also go down, depending on the facts that we discover.

18. Berkshire buyback unlikely

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: My name is Mike Seeley (PH) from Summit, New Jersey.

Would you please revisit the question of share repurchase for Berkshire Hathaway?

We have heard, today, your comment about the price of Berkshire having been inefficiently priced from time to time in the past. We know that there are now more shares outstanding.

And I'm curious as to whether the buildup of cash is causing you to spend more time looking for investment situations where you're more comfortable on the 10-year outlook. Thank you.

WARREN BUFFETT: The question of repurchasing shares — and I made that comment about it being inefficiently priced at times — at those times it always seemed to us — and we were incorrect in some cases — it always seemed to us that there were other securities that were even less efficiently priced.

When Berkshire in 1974 sold at $50 a share, I might have thought it was cheap. But I also was looking at the whole Washington Post Company selling for 80 million when I thought it was clearly worth 400 million. And I did not think that Berkshire was underpriced then as the Washington Post Company was.

And that has been true at various times when — there have been times when I thought Berkshire has been underpriced, or even significantly underpriced, but at the same time I was finding other things which I felt were even more attractive.

And like I said, many times I was wrong. We would have been better off buying our own stock instead of buying the things that I was buying.

But the — if we have money around, and we think Berkshire is significantly underpriced, and we're not finding other things to do with money, it obviously makes sense for us to repurchase Berkshire shares.

I think it's difficult for most companies in this market, even though repurchases are probably at close to an all-time high, if not at an all-time high, I think it's difficult for most companies to be repurchasing — have a repurchase of shares make a whole lot of sense these days.

I mean, I do not think they're getting much for their money, because we don't want to buy those shares ourselves. And it's — and I'm talking about the stock of various companies in America.

And yet, companies are much more enthusiastic about repurchasing shares now than they were 20 years ago when they were getting far, far greater returns from repurchasing.

We will always — it's an option that we will always think about. And we're unlikely to do it unless we think it's fairly dramatically underpriced because it's simply — we would want a big margin for error in making that kind of a decision that — not want to — we would not want to buy a dollar bill for 95 cents, or 94 cents, or 93 cents.

But there is some level where we would start getting excited, if we didn't have other uses for the money. Charlie.

CHARLIE MUNGER: I've got nothing to add to that.

19. Strong reputation will help us with internet commerce

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: Good afternoon. Wes Thurman from Stanford, California.

You mentioned earlier about the power of the brands on the internet. And I really can't think of a better brand, at least in my name, as the Berkshire Hathaway brand.

And, I guess, going forward, have you thought about ways to use that Berkshire Hathaway name, you know, further on the internet to capitalize on the reputation you've built over the past decades as a —

WARREN BUFFETT: Yeah. That's a very good point and it is something that could be of real value. It's already probably of some value to us with the brands that we're associated with.

I mean, I do think that Executive Jet or the NetJets program associated with Berkshire Hathaway, that — Borsheims associated with Berkshire Hathaway, Berkshire Hathaway Life associated with Berkshire Hathaway — I think those brands are enhanced by the association with Berkshire, as some other brands would be.

But I think that's got a long way to go. I think you're dead right on that, that the internet reinforces the necessity for trust in dealing with people.

I mean, you are getting further and further removed from the face-to-face dealing where you can go back to the store the next day or look at the person who sold it to you the next day and get an adjustment or something of the sort.

You're really having to place more and more trust in somebody you're never going to see. And I think you're right that Berkshire Hathaway, if it behaves itself properly, can get a reputation for trust that will be far greater than that possessed by the average company.

And that when we properly associate that with some of our brands that those brands will be enhanced by the association.

So I — no, I've thought a lot about what you're talking about there and so have our managers. And it's something that we intend to capitalize on in the future.

It's rather interesting, I mean, if you look at the companies that do business with people where there's no face-to-face interaction, either with the company itself or some intermediary like a retailer or anything of the sort, I mean, you've got Dell Computer, now you have Amazon.com.

But GEICO is doing business with, now, 3.7 million policy holders and it'll do — before the year is out — it'll be close to 4 1/2 million, and probably 4 billion-8 or so of business with people that have never met anyone from GEICO, they've talked to someone on the phone.

But we are one of the largest companies in the United States, in terms of doing business on a direct-to-consumer basis. We're doing it with people who on average are paying us $1,200 a year or thereabouts for a promise.

So we have a connection that people that talk about the Amazons of the world, where people are buying X dollars' worth of books, we're — have a much more direct connection with people who tend to renew with us year after year.

That is based on trust. I mean, it's not based on the neighbor next door who is — who they can go to if they have a problem. It's based on the fact they trust this company that's in — back in the District of Columbia, Washington, to perform in the future.

And that's a huge asset. And it's growing daily. I mean, we are adding policy holders every day who are signing up with us, who have never met anybody from the company. And that, already, I mean, it's a very big asset. It will be many times bigger, in my view, 10 years from now.

The Berkshire Hathaway umbrella that gets involved in one company after another like that, that people trust, I mean, we can be in an awful lot of homes over the years.

And as more and more business becomes done on an indirect basis, or a direct basis with the consumer, the power of that, in my view, should grow. And we just have to be very smart about how we maximize that growth.

Charlie?

CHARLIE MUNGER: Nothing to add.

20. Management, moats, and the certainty of future earnings

WARREN BUFFETT: OK. Zone 1.

AUDIENCE MEMBER: Hi. My name is David Zelker (PH) and I currently live in Redmond, Washington where I work for one of your good friends. So if I get into trouble for having taken a busy Monday off work, maybe if I give you a call you could put in a word for me.

WARREN BUFFETT: If it's without pay, we won't complain. (Laughter)

AUDIENCE MEMBER: It's vacation, yeah.

My question is about how you two assign value to certain intangibles that I know you look at when you value companies.

Anyone who's read your writings knows that you look for great management and economic moats, as you call them, that enable companies to raise prices and margins.

I'd like you to drill down with us and tell us what, to you, are the signs of great management and economic moats.

And furthermore, do you try to put a dollar value on those management and moats and other intangibles when you value companies? And if so, can you guide us through your thinking there?

And lastly, I'm interested in how you pick your discount rate. I'm actually a — an alma mater of yours from business school and I learned a bunch of junk about beta, too.

I read that you just assign the Treasury rate. And I'm not sure if that's right, but I'd love for you to talk about your discount rate. And I'd really appreciate as much detail about your thinking as you can give us, please.

WARREN BUFFETT: Yeah. We do — we think, in terms of the Treasury rate, but as I said earlier, that doesn't mean we think once we've discounted something at the Treasury rate, that that's the right price to pay. We use the Treasury rate just to get comparability across time and across companies.

But a dollar earned from a horseshoe company is the same as a dollar earned from an internet company, in terms of the dollar.

So it is not worth more, based on whether somebody — it comes from somebody named dot-com, you know, or somebody that — named, you know, the Old-Fashioned Horseshoe Company. The dollars are equal.

And our discount rates, they reflect different expectations about future streams of income, but they don't reflect any difference in terms of whether it comes from something that the market is all enthused about or otherwise.

The moat and the management are part of the valuation process, in that they enter into our thinking as to the degree of certainty that we attribute to the stream of income — stream of cash, actually — that we expect in the future and the amount of it.

I mean it is, you know, it is — it's an art, in terms of valuation of businesses. The formulas get simple at the end.

But if you and I were each looking at the chewing gum business — we own no Wrigley, so I use Wrigley fairly often in class — pick a figure that you would expect unit growth of chewing gum, you know, to grow in the next 10 or 20 years.

Give me your expectations on how much pricing flexibility you have, how much danger there is that Wrigley's share of market is dramatically reduced. You can go through all of that. That's what we go through.

That is — and in the — in that case, we are evaluating the moat. We are evaluating the price elasticity, which interacts with the moat in certain ways. We're evaluating the likelihood of unit demand changing in the future. We're evaluating the likelihood of the management being either very bright with the cash that they develop, or being very stupid with it.

And all of that gets into our evaluation of what that stream of money looks like over the years.

But the value of — how the investment will — works out depends on how that stream develops over the next 10 or 20 years.

We had a question earlier today that made certain suppositions about what could happen at Berkshire. And the formulation was exactly right. The question of what numbers to use is another question, but the formulation was proper. And that formulation — the moat enters into that. If you have a big enough moat, you don't need as much management.

You know, it gets back to Peter Lynch's remark that he likes to buy a business that's so good that an idiot can run it, because sooner or later one will. Well — (Laughter)

That's — I mean, he was saying the same thing. I mean, he was saying that what he really likes is a business with a terrific moat where nothing can happen to the moat. And there aren't very many businesses like that. But then — so you get involved in evaluating all these shadings.

This [a can of Coca-Cola], not the cherry version, but the regular version — this one, has a terrific moat around it. There's a moat even in this, you know, in the container.

You know, I — there was some study made as to what percentage of the people could identify blindfolded what product they were holding just by grabbing the container. And there aren't many that could score like Coca-Cola in that respect.

So here you've got a case where that product has a share of mind. If there's 6 billion people in the world — I don't know what percentage of them have something in their mind that's favorable about Coca-Cola, but it would be a huge number.

And the question is, 10 years from now is that number even larger, and is the impression just a slight bit more favorable, on average, for those billions of people that have it? And that's what the business is all about.

If that develops in that manner, you've got a great business. I think it's very likely to develop in that manner, but that's my own judgment.

I think it is a huge moat at Coca-Cola. I think it varies by different parts of the world and all of that. And I think, on top of it, it has a terrific management.

But that — there's no formula that gives you that precisely, you know, that says that the moat is 28 feet wide and 16 feet deep, you know, or anything of the sort. You have to understand the businesses.

And that's what drives the academics crazy, because they know how to calculate standard deviations and all kinds of things, but that doesn't tell them anything. And that what really tells you something is if you know how to figure out how wide the moat is and whether it's likely to widen further or shrink on you.

Charlie?

CHARLIE MUNGER: Well, you aren't sufficiently critical of the academic approach. (Laughter)

The academic approach to portfolio management, corporate finance, et cetera, et cetera, is very interesting. It's a lot like Long-Term Capital Management. How can people so smart do such silly things? And yet, that's the way it is.

WARREN BUFFETT: That's the great book that needs to be written, really, is, you know, why do smart people do dumb things?

And it's terribly important, because we've got a lot of smart people working with us and, you know, if we can just exorcise all the dumb things, you know, it's just amazing what'll happen.

And to some extent, the record of Berkshire, to the extent it's been good, has been because we — not because we've done brilliant things, but we've probably done fewer dumb things than most people.

But why smart people do things that are against their self-interest is really puzzling. Charlie, tell me why. (Laughs)

CHARLIE MUNGER: Well the — you can argue that the very worst of the academic inanity is in the liberal arts departments of the great universities.

And there, if you ask the question, what one frame of mind is likely to do an individual the most damage to his happiness, to his contribution to others — what one frame of mind will be the worst?

And the answer would be some sort of paranoid self-pity. Couldn't imagine a more destructive frame of mind. Now you have whole departments that want everyone to feel a victim. And you pay money to send your children to places where this is what they teach them.

It's amazing how these pockets of irrationality creep into these eminent places.

One of the reasons I like the Berkshire meetings is I find fewer of those silly people. (Laughter and applause)

WARREN BUFFETT: He excluded the head table from (inaudible). (Laughs)

21. Berkshire B can sell at a discount to the A shares

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: My name is Gaylord Hanson. I'm from Santa Barbara, California.

And I'm a rookie as an investor with Berkshire Hathaway, because I only started investing last November. And if this is a typical annual meeting, I will be here every first Monday of May the rest of my life. (Laughter)

WARREN BUFFETT: And we'll be glad to have you. Thanks. (Applause)

AUDIENCE MEMBER: Now I'm very proud to have finally uncovered Berkshire Hathaway and am an investor. But I may have made a slight error in which issue to buy, A or B.

I watch my investments rather closely, and I do believe in buying and holding. I don't buy and trade at all. I buy — I've got things I bought 10, 15 years ago, and I still have them, and I've made a lot of money.

But I made an — I make an analysis, every December 31st, on my portfolio. And I looked at Hathaway A and I looked at Hathaway B on January 1st, and again on the 23rd of April. Hathaway A was up 10 percent since January 1st. Hathaway B was 5.3 percent. Now I don't like that.

Now, I must confess that I'm not inclined to buy a $77,000 stock and buy one of your 5 or 10 shares. But in this instance, because I bought a fair little bit of it, I bought the B and my increase in value, per share, is 4.7 percent less in B than in A. And I got to have that explained to me — (laughter) — by Mr. Buffett.

WARREN BUFFETT: OK. (Applause)

AUDIENCE MEMBER: Have one other — one further comment. (Laughter)

You mentioned the 30 times the B being an A value. Well, if I multiply the value on the 23rd of May — of April — of $2,474 per share by 30, I come up with 74,220 but the price of A was 77,000.

Now I want to know whether I'm stupid or some good intelligent answer from Mr. Buffett.

WARREN BUFFETT: OK. The — (Laughter)

If you read what we've got, both in the original offering on the B, as well as on the website, explaining everything, the A can always be converted into 30 shares of B.

So, it can't sell for anything other than a very tiny amount less than 30 shares of B. And if it went below that, arbitrage would occur. But it doesn't convert the other way.

So there's no question that, whereas a share of B can never be worth more than about 1/30th of A, it can be worth less, because the conversion doesn't run the other way.

Now at year-end, I didn't look at the prices, but obviously the A and B were at almost parity, or probably at parity from what you say.

And at that level we say that if you're buying at least 30 shares of B, you're better off buying the A because you can always go — you can always convert it into 30 shares of B. And without having paid any premium, you can't lose money and you can gain money if the B goes to a discount.

The B will periodically go to a discount against the A. It depends on the supply and demand of the two securities. The B will not go to a premium above the A of any significant amount because then conversion occurs. And we've had a lot of conversion occur.

I have personally said on the website, for example, that I think when the B is at more than a two percent I would rather buy the B, if it was me.

But if it's at less than a two percent discount, I'd probably buy the A, because I just think that you've always got the right to go one direction and you don't have the right to go the other direction.

I would predict, as I think I did just a little earlier, that if you take the next 10 years, you're going to find a significant number of months when the two stocks trade at parity, at 30-to-1 relationship, and you're going to find a significant number of months when the B sells at a discount.

When people who are buying smaller amounts are the more aggressive buyers of the stock, they will push the B up to the point where A gets converted into B. And that means that the B is selling at a slight, very slight, premium over the A.

And when you find times when people are, on balance, preferring their larger buyers, maybe institutional buyers, then the A will tend to sell at some premium.

I think that — you may have picked on April 23rd. My guess is it's narrowed a little bit, because I think it's a 3-and-a-fraction percent discount at the moment.

But I would sort of use that guideline I stuck on the website, although there's nothing magical about it. Those will be the prevailing facts.

I mean, if the B is selling at 2,500 and the A is selling at 75,000, a 30-to-1 relationship, and you were buying at least $75,000 worth of stock, I'd advise you to buy the A because you — the next day, if you wanted to you could convert it into 30 shares of B. And —

But you can't buy 30 shares of B and convert it into one share of A.

So, I'm not sure on the day you actually bought — if you bought B, it sounds as if you did — on the day that you actually bought B, I don't whether you were buying it at a discount or not. Most of the time last year it did not sell at a discount.

Most of the time this year it has sold at a discount. There will be times when it will sell at parity and there will be times when it sells at a discount.

Charlie?

CHARLIE MUNGER: Yeah. When you made your original decision to buy the lower priced of the two stocks, you made a mistake. (Laughter)

WARREN BUFFETT: Well, if he was buying at least 30 shares —

CHARLIE MUNGER: Yeah. Yeah. If you were buying at least 30 shares.

And now that the stock, the B stock, is down to such a discount versus the A, Warren is saying he would hold the B. What could be simpler? (Applause and laughter)

WARREN BUFFETT: We'll try and make both the A and B work out fine. (Laughs)

But it — there — you should understand the relationship of the two. And we tried to be extremely clear about that when we brought up — we had a page that — which we devoted precisely to that point.

And we have put — I put this thing up on the website because I was getting some mail that was questioning this. People clearly didn't understand it, so I put this up on the website.

And if you click on the — our homepage, you will see some reference to something else you can click that says the relative situation on the A and B. And I hope it's clear.

22. "The average insurance company is going to remain very average"

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Hi, my name is John Loo (PH) from New York City.

First, let me start out by thanking both of you for the incredible education that you've provided me through your annual reports and various presentations that you've given in public and in publication.

I was about to send you my tuition check last week, but instead I decided to buy more shares of your company. I hope you'll forgive me.

WARREN BUFFETT: No, you learned well. (Laughter)

AUDIENCE MEMBER: My question basically centers around the insurance industry at present.

Right now, there's excess capacity, which comes and goes, typically speaking. But there seems to be a trend towards international consolidation. And also, there seems to be a trend towards demutualization in the life insurance companies in the U.S.

I was wondering if you could give us your thoughts on what the future face of the insurance industry will look like.

WARREN BUFFETT: Yeah, I — both of those trends do exist, that you talked about.

I don't think that consolidation usually solves many problems. I mean, if you have two lousy businesses and you put them together, you've got a big, lousy business, usually. (Laughter)

And I am not a big fan of consolidation where the theory is that you're going to — you really have two very mediocre businesses and you're going to wring the costs out of one. And it doesn't — it just doesn't work that way in my experience.

But the consolidation will go on, and the demutualization of life companies will go on.

It's not inconceivable that we would play some part in one or the other in some way, although it's not high on our list. But I've learned in this business never to say never because things do happen that have caused me to want to retract some earlier statements.

The winners are going to be the people that have some franchise based on specialized talents, on terrific distribution systems, managerial know-how, even the ability to use the float effectively.

And in the case of something like GEICO, on the superior — it's combined with a franchise — a superior distribution system. We have the low-cost method of distributing personal auto insurance on a — on an all-comers basis.

USAA does a terrific job of delivering low-cost insurance to a specialized group.

GEICO actually came — in a sense — came out of USAA. Leo Goodwin and his wife, Lillian, who founded the company in 1936, were both employed by USAA. And I — Leo, as I remember, was an officer of the company.

So the idea of GEICO came out of a USAA, but they've limited it to a given class. We offer it to everybody in the country, except we can't offer it in New Jersey or Massachusetts because we can't figure out any way to make any money there.

Twentieth Century has done a terrific job of becoming a low-cost operator in a given urban area, in the greater Los Angeles area.

But in terms of an all-comers, all-geography, all-occupation-type operation, in my view, GEICO is the best operation in the United States. And better yet, consumers around the world are agreeing — around the country — are agreeing with that view.

GEICO gained, last year, 20.8 percent policy holders. This year, in the 12 months ended March 31st, it's up 22.5 percent policy owners.

These are on big numbers. The base and the growth has accelerated. So that kind of — that sort of advantage will make for a good insurance — a very good insurance business over time.

I think the average insurance company is going to remain very average, and there is a lot of capital in the industry, as you pointed out. There's more capital in the industry than there is opportunity to use it intelligently.

And nevertheless, it doesn't go away. You are not seeing consolidation that takes away a lot of the capital of the industry, you're not seeing massive repurchases or anything of the sort.

So the capital is there. It's seeking an outlet in premium volume. That actually hurts a General Re to an extent because it means that the primary companies want to retain more of the premium they generate, just so they can show some kind of growth against this capital base.

I think generally, we're very well positioned in the industry. I think the industry will be tougher in the next few years by a significant margin in the personal auto business. But frankly, I look forward to it because I think we — it may offer us the opportunity to grow even faster.

We — you know, we have the best vehicle in a very, very big industry, the auto insurance business. And we've got incredibly good management to take advantage of that. And we've got policies available as you leave at the door. (Laughter)

Charlie?

CHARLIE MUNGER: Nothing to add.

23. China: huge growth potential for Coca-Cola and Gillette

WARREN BUFFETT: Zone 4.

AUDIENCE MEMBER: Good afternoon and thank you. My name is Paul Worth. I'm from Wichita, Kansas. And my question is as follows.

For the consumer franchise companies that Berkshire owns, Coca-Cola and Gillette in particular, in which emerging markets do you see the greatest 10-year potential for unit sales growth? And what economic, political, or social changes are precipitating that growth?

Secondly, do you believe that the U.S. market cap, as a percent of the world's, at 53 percent, is near its zenith? And which countries do you believe will likely show the greatest percent growth in total market cap?

WARREN BUFFETT: Well, I wish I had the answers. The first question, though — obviously, when you're dealing with something like Coke, is raw numbers. I mean, there's huge potential in a country, you know — with the largest country in the world, and in China, where the per capita consumption is very, low but is growing very fast.

So it's very easy for me to predict, and probably be right, absent some tremendous upheaval or some real surprise, that China would be the fastest growth market among countries of any size in the world for Coke from this level.

But that's based on the fact that you've just got a huge number of people that clearly like the product, that are starting from a very low base, and where a lot more bottling infrastructure is going to be needed, but which will be supplied to facilitate that growth.

With Gillette, it's a little different. People are already shaving. What you do is you upgrade the shaving experience that they have. So you have great differences in the quality of the blades available throughout the world. They call them shaving systems when you get into the more advanced ones.

And what happens is that, as people's disposable income grows, they are — they trade up. And they get a much more enjoyable shaving experience, and they get better shaves than was the case when they were forced to rely on the lowest-priced product.

But both of those companies have tremendous opportunities as the prosperity around the world — as the standard of living grows.

And there's just no doubt in my mind that in the blade and razor business for Gillette, which is only a third of their business, but — and in the soft drink business for Coke, they're going to share in it. It'll be uneven in the years that it happens and all of that sort of thing.

But I would almost guarantee you that 10 or 20 years from now, both of those companies will be doing a lot more business in their — in those areas I named than currently.

And, you know, it — we don't fine tune it a lot more than that. I mean, I do not sit and work out — try and work out — country by country, what's going to happen with a Gillette or Coke. It would be a waste of time. I wouldn't know the answer anyway.

But I'm pretty sure the conclusion that both of them will prosper a great deal — and I would hate to be competing with either one of them — here or anywhere else in the world. I mean, they have the winning hand.

Charlie?

CHARLIE MUNGER: Well, I agree with everything you said. And I'd like to add that, if I knew for sure that the United States share of worldwide market capitalization was going to go from 53 percent down to 40 percent, I wouldn't know how to make money out of that insight by running around buying foreign securities.

WARREN BUFFETT: Yeah, we just don't operate on that basis. And, I mean, you know, a few years ago emerging markets were all the rage.

And every institution in the country was getting promoted by somebody who said, "I'm going to run an emerging markets fund." And they felt they had to participate in it and their advisors told them they had to participate.

We regard that all as nonsense. You know, in the end, you've just got to think for yourself about what you know and what you don't know and go where that leads you.

And you don't do it by buying into things with names on them, or sectors, or country funds, or that stuff. You know, that's merchandise that's designed to sell to people and it's usually sold to people at the wrong time.

CHARLIE MUNGER: Yeah. Our game is to find a few intelligent things to do. It's not to stay up on every damn thing that's going on in the whole world.

WARREN BUFFETT: Yeah.

24. Munger recommends a book about Buffett

WARREN BUFFETT: Zone 5. (Applause)

AUDIENCE MEMBER: Hello, my name is Everett Puri. I'm from Atlanta, Georgia and I've two questions.

One is for Mr. Munger in our never-ending effort to have the Munger Book Club surpass the Oprah Book Club. I was wondering if you could make some recommendations.

CHARLIE MUNGER: Yeah.

AUDIENCE MEMBER: The second is, it seems that with the pharmaceutical industry earlier, that the threat of government regulation or government appropriation of those cash flows led to a reasonable market opportunity, and the same thing with Sallie Mae.

And I'm wondering if you feel that that's going on with the tobacco industry now or if that is a larger threat to that industry, larger and permanent threat.

CHARLIE MUNGER: Well, number one, the books.

[Robert] Hagstrom sent me chapters of his latest book on Warren Buffett called, "The Buffett Portfolio." And I didn't read them because I thought his first book was a respectable book, but didn't contribute too much to human knowledge, and — (Laughter)

(Inaudible) sent me the second book, a full version, and I read it and I was flabbergasted to find it not only very well written, but a considerable contribution to the synthesis of human thought on the investment process. And I would recommend that all of you buy a copy of Hagstrom's second Buffett book.

I notice the airport was heavily promoting it. It's called, "The Warren Buffett Portfolio." It doesn't pick any stocks for you, but it does illuminate how the investment process really works, if you think about it rationally.

Another book that I liked very much this year was "Titan", the biography of the original John D. Rockefeller. That's one of the best business biographies I have ever read. And it's a very interesting family story, too.

That is was just a wonderful, wonderful book. And I don't know anybody who's read it who hasn't enjoyed it. So I would certainly recommend that latest biography of John D. Rockefeller the first.

The third book is sort of a revisitation of the subject matter of the book I recommended a year or two ago called "Guns, Germs, and Steel," which was a physiologist's view of the economic history of man. And it was a wonderful book.

And much of that same territory has now been covered by an emeritus history professor from Harvard, who just knows way more economics and science than is common for a history professor. And that gives him better insight.

And his book is a takeoff in title on Adam Smith, and the title is, “The Wealth and Poverty of Nations.” And the guy’s name is [David] Landes. So I would heartily recommend those 3 books.

25. Tobacco far more threatened than pharmaceuticals

CHARLIE MUNGER: Now what was the third question?

WARREN BUFFETT: The other question was about tobacco and pharmaceutical —

CHARLIE MUNGER: Oh, tobacco.

I don’t know about Warren, but I think the legislative threat to tobacco is serious, and I haven’t the faintest idea of how to predict it.

WARREN BUFFETT: Yeah. I would say that there’s no comparison between the threat to tobacco, currently, with the threat to pharmaceuticals in 1993 — that the problems of the tobacco companies are of a far different order than the problems of the pharmaceutical companies.

Nobody was against pharmaceuticals. They were just — had different ideas about maybe pricing, and distribution, and all of that. But tobacco’s a different story. I mean, tobacco companies — well, you can figure it out for yourself.

26. Buffett’s book recommendations

WARREN BUFFETT: The — in terms of books, I would recommend — many of you have may have read it, but this goes back more than a year, but I would — if you haven’t read Katharine Graham’s autobiography [“Personal History”], it is one terrific book.

It’s a very incredibly honest book. And it’s a fascinating story. I mean, it’s a life that’s seen all kinds of things in politics and in business and in government. So I — it’s a great read.

A book that came out just in the last few months in the investment world that I would certainly recommend to everybody is “Common Sense on Mutual Funds,” by Jack Bogle.

Jack is an honest guy, and he knows the business. And if mutual fund investors listen to him, they would save billions and billions of dollars a year. And he tells it exactly like it is. So I — he asked me for a blurb on the book, and I was delighted to provide it.

27. Expect “huge impact” from internet, but too hard to pick winners

WARREN BUFFETT: Let’s go to zone 6, please.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and good afternoon, Mr. Munger. My name is Mohnish Pabrai and I'm from the Chicago area.

Mr. Buffett, I'd like to thank you for all your insights over the years. I'm especially amazed at the pace of which you answer my letters, point by point.

I have a question for you related to circle of competence. I have a notion that both Mr. Munger and yourself understand the Kleiner Perkins model of early-stage venture capital investing and, currently, their focus in the internet space, extremely well.

My notion is that I think it is well within your circle of competence to understand what they do, just like you understand what your managers at See's Candy or Executive Jets do.

So the question is, that with the internet, I think we're seeing a change that has not been seen in the last 500 years as humans. We haven't seen something that is as dramatic and as profound that's going to come upon us.

If, let's say, a John Doerr at Kleiner Perkins approached you and said that they were starting, let's say, a billion-dollar early-stage or later-stage internet investment fund that Kleiner would manage, would you consider that — would you consider participating in that investment to be within your circle of competence, if it were offered at terms that looked attractive?

WARREN BUFFETT: I agree with the first part of what you said. I mean, I'm not sure that it'll, necessarily, will be the most important in the last 500 years in the commercial world. But it could well be. And if it isn't, it's right up there.

I mean, it is — and we talked about this last year and maybe even the year before — I mean, it is a huge development. But — and I would say that Charlie and I both understand the process of early investment/promotion probably as well as anyone.

We haven't participated in it. There are certain things we don't even like about it. But we do understand it. Right, Charlie? (Laughs)

And I would say that no, we would not have an interest in investing in the fund. It — we do not necessarily regard the internet —

There's no question, if you're in the early stages of promotion, and you — particularly if you've got a reputation as a successful in that — but in this case, it wouldn't make much difference, because the whole field has gone wild — you will make a lot of money selling to the next stage, and the next stage, and the next stage.

But, in terms of picking out businesses that are going to do wonderfully as businesses — not as stocks for a while, but as businesses — I don't think it's necessarily so easy in the internet world.

And I would say that, if you were to ask some very top names in the field to name the next five companies out of the chute, or the next 10 companies out of the chute, and predict that one of them will earn, say, the $200 million I used as a threshold, six or seven years from now, I'm not so sure, if they gave you a list, that they would name a single one.

That doesn't mean they might not make a lot of money by being early investors in them because they sell out to the next group and so on.

But in the end, they have to succeed as businesses. And a few will succeed as businesses. The internet will have a huge impact on the world. But I'm not so sure that makes it an easy investment decision.

Charlie?

CHARLIE MUNGER: Well, at least it's not an easy investment decision for us. And that's what we're looking for.

28. "We will never turn our money over to somebody else"

WARREN BUFFETT: Yeah. We will never turn our money over to somebody else. You know, if we're going to lose your money as Berkshire shareholders, we're going to lose it ourselves and we're going to come back and look you in the eye and tell you how we lost it.

We are not going to say this game is too tough, so we'll give our money to somebody else. You can give your money to somebody else, and you don't need the intermediaries of me and Charlie to do it for you.

So, we get approached all the time. I had a call, you know, within the last couple of days, on something you would know very well about participating in some fund or — they always have — it's always stage one, stage two, stage three.

And the idea is we get some more people to come in later at twice the price, and maybe the fact that our name is involved, and it will cause people to pay even more, and all of that sort of thing. We're not in that game.

And we're not going to turn the money over to someone else to manage. It's your money. You gave it to us to manage. We'll manage it. If you decide you don't want us to manage it, you decide who you give it to. We're not going to be intermediaries on it.

And if we don't understand something ourselves, we're not looking for anybody else to do it for us. It — the world doesn't work very well that way, anyway.

I mean, it — usually you end up in the hands of the promoters and not the hands of the people who really know how to make money.

Charlie? You want to? He said it.

29. Selling McDonald's was bad; postmortems are good

WARREN BUFFETT: OK. Zone 7.

AUDIENCE MEMBER: Peter Kenner from New York City. Good afternoon, Warren, Charlie.

WARREN BUFFETT: Hi, Peter.

AUDIENCE MEMBER: Good to see you. I'd like to ask you what your thought process was when you, or share with us your thoughts, when you decided to sell McDonald's.

WARREN BUFFETT: That must have been Charlie's idea, Peter. (Laughter)

Peter, incidentally, is in a family that four generations have essentially invested with us. And they're all terrific people, I might add. His dad was a wonderful guy.

The — you know, I said it was a mistake to sell it, and it was a mistake. And I just reported that in the interest of candor. And there were some reasons why I thought it was something we — I didn't think it was, obviously, that it was any great short sale, or even a great sale.

But I didn't think it belonged in the list of eight or 10 of the businesses, of the very few businesses, that we want to own in the world. And I would say that that particular decision has cost you, hmm, in the area of a billion dollars-plus.

Charlie?

CHARLIE MUNGER: You want me to rub your nose in it? You're doing a — (Laughter)

You're doing a pretty good job by yourself. (Laughter)

By the way, that's a good practice around Berkshire. We do rub our own noses in it. We don't even need the help of the Kenners. (Laughter)

WARREN BUFFETT: We believe in postmortems at Berkshire. I mean, we really do believe — one of the things I used to do when I ran the partnership is I contrasted all sale decisions versus all purchase decisions.

It wasn't enough that the purchase decisions worked out well, they had to work out better than the sale decisions. And managers tend to be reluctant to look at the results of the capital projects or the acquisitions that they proposed with great detail a year or two earlier to a board.

And they don't want to actually stick the figures up there as to how the reality worked out against the projections. And that's human nature.

But, I think you're a better doctor if you drop by the pathology department, occasionally. And I think you're a better manager or investor if you look at every one of the decisions you've made, of importance, and see which ones worked out and which ones didn't and, you know, what is your batting average.

And if your batting average gets too bad, you better hand the decision making over to someone else.

Charlie, want to rub my nose anymore?

CHARLIE MUNGER: No.

WARREN BUFFETT: No, that's OK. OK. We're —

30. Looked "a little" at health insurance partners

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: Good afternoon. Ian Sacks from New York City.

This afternoon, through various questions and comments, we've mentioned the fact that the word "trust," which Berkshire Hathaway and the brand has. We've mentioned, basically, health, and the importance of health, and that being above everything else.

With Berkshire's competencies in the insurance industry and with the health care services sector being relatively depressed, is — although the dynamics would be different in the industry how risk is managed on an overall basis — has Berkshire looked at all, in terms of taking a position or buying a health insurance business?

WARREN BUFFETT: Charlie runs a hospital so I'm going to let him talk about this.

CHARLIE MUNGER: Sure. We've looked a little. We've looked at everything in turmoil that's important in the world. But so far it hasn't seemed to yield our particular mental approach.

WARREN BUFFETT: Yeah. I don't know who I would want to get in with in that business at the moment. That's not — I'm not condemning the people in the business, it just means I don't know. I'm not — I haven't been able to evaluate that.

And I think it would make an enormous difference, in terms of wanting to get in with a quality operation and quality people and at a sensible price. And we haven't seen that, but that doesn't mean we've canvassed the whole field either.

CHARLIE MUNGER: There is a significant percentage of schlock operators in the field who are painting the reality different than it is. That makes it harder.

31. "Journalistic process" good for learning about companies

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: Eric Tweedie from Shavertown, Pennsylvania.

I just wanted to express our appreciation of — regarding all the operating businesses that we've visited. They've been very warm and hospitable.

In fact, when we visited Executive Jets at the airport, the tour was so impressive my wife wanted to buy an airplane. (Laughter)

WARREN BUFFETT: What's her name? What's her name? (Laughter)

AUDIENCE MEMBER: Well, I won't say that —

CHARLIE MUNGER: Spell it out!

AUDIENCE MEMBER: American Express declined the $500,000 we tried to put on my card. (Buffett laughs)

But you can thank the chairman for me next time you see him. Just kidding, but —

My question regards, basically, approach to investing. I've been investing my own money in equities for about 10 years. And my results, overall, have been relatively good.

In the process, however, I've taught myself some very painful and costly lessons. For instance, my first equity ever purchased was a share of Berkshire Hathaway for $5,500 in 1990 and I sold it 3 months later for something over $8,000 and congratulated myself for the rapid and shrewd profit. (Laughter)

And earlier this year, I repurchased the same share for $70,000. (Laughter) And I intend to own it for the rest of my life. (Laughter) So you can see I'm growing. (Laughter)

My question is, I have no formal education in accounting and finance. And I would just like some advice from you regarding an approach to educate myself and a reading list of basic texts, obviously, starting with the Berkshire Hathaway annual reports. Thank you.

WARREN BUFFETT: Thank you, particularly for your comments about the people from our operating companies, because they have just been terrific. They come out here — (Applause)

They are here at five in the morning. They — I mean, they do a tremendous amount of work over this weekend. They're cheerful. I've met with them all on Saturday at lunch and, I mean, they're just one sensational group of people, and —

You know, I'm very proud of them. And the managers should be very proud of the people they brought with us. And I hope you get a chance to thank as many of them as possible personally.

Incidentally, at the See's counter you'll find Angelica Stoner, who's been with us for 50 years and, you know — here she comes from California to help us out and sell peanut brittle, and she's having a good time doing it. (Applause)

And the question you ask is a very good one about — you know, in terms of accounting and finance — what's the best way to teach yourself?

I was always so interested in it from such a young age, that I — my approach was go to the Omaha — originally, was to go to the Omaha Public Library and just take out every book there was on the subject. And I learned a lot — (laughs) — I learned a lot that wasn't true in the process, too. I got very interested in charting and all that sort of thing and buying stocks.

But I did it by just a tremendous amount of reading, but it was easy for me because, you know, it was like going to baseball games or something of the sort.

And in terms of naming specific texts in accounting, you know, I think you may want to read some of the better, even, magazine articles that have appeared. I mean, there've been - or newspaper articles.

There have been some good commentary about accounting there.

I don't have — can you think, Charlie, of any specific texts or anything that we could recommend?

CHARLIE MUNGER: I think both of us learned more from the great business magazines than we do anywhere else. It's such an easy, shorthand way of getting a vast variety of business experience, just to riffle through issue after issue after issue, covering a great variety of businesses.

And if you get the mental habit of relating what you're reading to the basic structure of the underlying ideas being demonstrated, you gradually accumulate some wisdom about investing.

I don't think you can get to be a really good investor over a broad range without doing a massive amount of reading. I don't think there's any one book that will do it for you.

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

But pick out something, so at least you understand what — if you understand their products, you know what's going on in the business itself. And then, you know, get lots of annual reports. And, through the internet or something else, get all the magazine articles that have been written on it — on those companies for five or 10 years.

Just sort of immerse yourself as if you were either going to work for the company, or they'd hired you as the CEO, or you're going to buy the whole business. I mean, you could look at it in any those ways.

And when you get all through, ask yourself, "What do I not know that I need to know?"

And back many years ago, I would go around and I would talk to — I would talk to competitors, always. Talk to employees of the company, and ask those kinds of questions. That's, in effect, what I did with my friend Lorimer Davidson when I first met him at GEICO, except I started from ground zero. But I just kept asking him questions.

And that's what it really is. You know, one of the questions I would ask if I were interested in the ABC Company, I would go to the XYZ Company and try and learn a lot about it. Now, you know, there's spin on what you get, but you learn to discern it.

Essentially, you're being a reporter. I mean, it's very much like journalism. And if you ask enough questions — Andy Grove has in his book — he talks about the silver bullet, you know.

You talk to the competitor and you say, "If you had a silver bullet and you could only put it through the head of one of your competitors, which one would it be and why?" Well, you learn a lot if you ask questions like that over time.

And you ask somebody in the XYZ industry and you say, "If you were going to go away for 10 years and you had to put all of your money into one of your competitors — the stock of one of your competitors, not your own — which one would it be and why?" Just keep asking, and asking, and asking.

And you'll have to discount the answers you get in certain ways, but you will be getting things poured into your head that then you can use to reformulate and do your own thinking about why you evaluate this business at this or that.

The accounting, you know, you just sort of have to labor your way through that. Might — I mean, you may be able to take some courses, even, in that. But the biggest thing is to find out how businesses operate.

And, you know, who am I afraid of? If we're running GEICO, you know, who do we worry about? Why do we worry about them? Who would we like to put that silver bullet through? I'm not going to tell you. (Laughter) That the —

You know, it's — you keep asking those questions. And then you go to the guy they want to put the silver bullet through and find out who he wants to put the silver bullet through. It's like who wakes up the bugler, you know, in the Irving Berlin song?

And that's the way you approach it. You — and you'll be learning all the time.

You can talk to current employees, ex-employees, vendors, supplies, distributors, retailers, I mean, there's customers, all kinds of people and you'll learn.

But it is a — it's an investigative process. It's a journalistic process. And in the end, you want to write the story. I mean, you're doing a journalistic enterprise. And six months later, you want to say the XYZ Company is worth this amount because, and you just start in and write the story.

And some companies are easy to write stories about, and other companies are much tougher to write stories about. We try to look for the ones that are easy.

Charlie?

CHARLIE MUNGER: Yeah. For the histories of the thousand biggest corporations laid out in digest form, I think Value Line is in a class by itself. That one volume really tells a lot about the histories of our best companies.

WARREN BUFFETT: Yeah. If you just look, there's 1,700 of them. If you look at each page and you look at sort of what's happened in terms of return on equity, in terms of sales growth, (inaudible), all kinds of things.

And then you say, "Why did this happen? Who let it happen?" You know, "What's that chart going to look the next 10 years?" Because that's what you're really trying to figure out, not the price chart, but the chart about business operation.

You're trying to print the next 10 years of Value Line in your head. And there's some companies that you can do a reasonable job with, and there's others that are just too tough. But that's what the game is about.

And it can be a lot of — I mean, if you have some predilection toward it, it can be a lot of fun. I mean, the process is as much fun as the conclusion that you come to.

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

If you want to get smart, the question you've got to keep asking is: Why? Why? Why? Why?

And you have to relate the answers to a structure of deep theory. And you've got to know the main theories. And it's mildly laborious, but it's also a lot of fun.

32. Creating value for subsidiaries by leaving them alone

WARREN BUFFETT: Zone 2.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I'm Patrick Wolff, formerly from Cambridge, Massachusetts and soon to be from the San Francisco area.

Like many people around the world who want to learn about business, I've read all of your letters to the shareholders. And like many people here in this room, I was so impressed that I bought a piece of the company.

But I must admit that, in studying Berkshire Hathaway, there's one element that I didn't quite understand, and I'd love it if you could please explain it. And that is the following.

How does Berkshire Hathaway add value to the various wholly-owned companies in the manufacturing services and retail division?

And the reason I ask this question is, as you yourself said earlier this morning, it's very difficult in negotiated purchase agreement to buy a company for anything other than what it's truly worth.

So if Berkshire Hathaway is going to create value by buying such fantastic companies as the Nebraska Furniture Mart, or See's Candies, or any of the other fantastic businesses we have, there must be some way in which Berkshire Hathaway adds to that value. Could you please explain how we do that?

WARREN BUFFETT: In certain specific cases, the case of General Re being the most recent example, we actually laid out in the proxy material why we thought there was at least a reasonable chance that the ownership by Berkshire would add value.

And we got into various reasons about the ability to use the float, and tax advantages, and the ability to move faster around the world, and that sort of thing. So we've actually spelled that out in that case.

I think in the case of something like Executive Jet, you might well figure that there are some reasons why association with Berkshire would put Executive Jet on the map and in the minds of people who could afford to buy fractional ownerships of planes, faster than might otherwise be the case.

But usually the situation — so there are specific cases where we bring something to the party. But the biggest thing we bring to the party on a generalized basis is what I spelled out a little bit in the annual report this year in talking about GEICO.

We enable terrific managers to spend, in many cases, to spend a greater percentage of their time and energies on what they do best, and what they like to do best, and what is the most productive for owners than would be the case without our ownership.

In other words, we give them a very rational owner who expects them to spend all of their time focused on what counts for the business and eliminates the distractions that often come with running a business, particularly a publicly-owned business.

I would guess that the CEOs of most public companies waste a third of their time, at least, in all kinds of things they do that really don't add a thing to the business — in many cases subtract, because they're trying to please various constituencies and waste their time with them, that take the company backwards.

But we eliminate all of that. So, we simply can create an ownership — we think we can create the best ownership environment, frankly, that can exist — other than maybe owning it a hundred percent yourself — for any business.

And that happens to also go along with how we like to lead our lives, because we don't want to run around and attend a lot of meetings and do all of these things that people do. And that's — that can be a significant plus.

I think that GEICO has probably grown a fair amount faster as a subsidiary of Berkshire than it would have if it had remained an independent company, although it was a hell of an independent company and would have continued to be one.

But I think billions and billions of dollars will be added to the value of GEICO, over and above what would have happened if it had reminded a public company. Not because, as I put in the report —

Now we haven't taught the management one thing about the classification of insurance risk, or how to run better ads, or anything of the sort. We've just let them spend a hundred percent of their time focused on what counts. And that is a rare occurrence in American business.

Charlie?

CHARLIE MUNGER: Yeah. Just not having a vast headquarters staff to tell the subsidiaries what to do — that helps most of the kind of subsidiaries that we buy. They are not looking for a lot of people looking over their shoulder from headquarters, and a lot of unnecessary flights back and forth, and so on.

So, I would say most of what we do, or at least a great part of what we do, is just not interfere in a counterproductive way. And that non-interference has enormous value, at least with the kind of managers and the kind of businesses that have joined us.

WARREN BUFFETT: And a great many — you have to see it to believe it — but in a great many corporate operations, the importance of a large group of people is tied to how much they meddle in the affairs of other people who are out there doing the work.

And, you know, we stay out of the way. And we're appreciative owners and we're knowledgeable owners. We know when somebody has done a good job and we know when they've done a good job when industry conditions are terribly tough.

So, we can look at our shoe operations, for example. And, you know, they are in tough industry conditions now. We've got some absolutely terrific people. And we are knowledgeable enough about that, so we don't go simply by a bunch of figures and make a determination whether people are doing the right thing.

So, we've got — we're knowledgeable owners and we have no one whose job at headquarters is to go around and tell our managers how to run their human relations departments, or how to run their legal departments, or a dozen other things.

And not only do people have more time to work on the productive things, but I think they probably actually appreciate the fact that they're left alone.

So, I think you even get more than the proportional amount of effort out of them than would be indicated simply by the amount of time you free up, because I think you get even an added enthusiasm for the job.

And I think having people in a large organization that truly are enthusiastic about what they're doing, that doesn't happen all the time. But I think it does happen to a pretty good degree at Berkshire.

Charlie?

CHARLIE MUNGER: No more.

33. Intrinsic value of marketable securities

WARREN BUFFETT: OK. Zone 3.

AUDIENCE MEMBER: Gentlemen, hi, I'm David Butler from here in Omaha. A comment and then two quick questions. Comment is regarding the annual reports.

I read a lot of annual reports for a living, and I sort of start off with the assumption that I'm going to have to spend 20 to 30 hours looking at 5 years of 10-Ks and 5 years of annuals, probably some 10-Qs and going through a lot of numbers to have any kind of idea how the company really is working.

And comparing that to Berkshire, which has basically crystal-clear clarity, it's quite refreshing to read honesty, and it's quite refreshing to see accounting that's actually presented in a clear fashion and that doesn't try to hide facts.

So as a shareholder and as an investor, I'm very grateful for the effort and for the high quality of your annual report. And I think we ought to give Mr. Buffett and Mr. Munger a hand — (applause) — for that.

OK, now that I've brown-nosed a little bit. (Laughter)

WARREN BUFFETT: Here comes the zinger, huh? (Laughter)

AUDIENCE MEMBER: Yeah. I'm nervous about the derivative operations that General Re has. Now, right now the balance sheet figure says that there's a $400 million net asset position, but there are also some really hairy derivatives, the swaps and the floors and caps.

And knowing that, in the past, you haven't used those types of leveraged derivatives, I'm wondering if that's going to change now.

And then secondly, in terms of going through an intrinsic value calculation, when you and Mr. Munger think about intrinsic value, obviously, a big part of that is the marketable securities portfolio.

Do you think of intrinsic value, in terms of the marketable securities, as what their market value is, in terms of their look-through earnings, or is there a separate intrinsic value calculation that you sort of roll into the overall Berkshire intrinsic calculation?

WARREN BUFFETT: Yeah. I'll answer the second part first. On the intrinsic value, we tend to use the market prices in the way we think about things, although there are times when we feel that we own securities that are worth far more than they're carried for.

And we've mentioned that once or twice. There was a time in the mid-1970s, if you'd look back at our 1975 annual report — I may be off by a year, one direction or other — probably 1974, because I — we valued the securities at market.

But I — in the body of the report, I said we really think these things are going to worth — be worth a hell of a lot more than they're selling for currently. That was an unusual remark for somebody, if you knew me, that would be an unusual remark for me.

And at that time, I would have said that, in looking at the intrinsic value of Berkshire, I would have said that I was quite comfortable marking these things up in my mind. I wouldn't have done it with the public, but I would have done it in my mind.

But under most circumstances, we tend to think of the market value as being representative of it, that that is the price at which we could buy or sell that day.

And if we thought they were ridiculously high in relation to intrinsic value, we'd probably do something about it. And they certainly haven't been so low that we've ever felt like marking them up in recent — in our own minds — in recent years.

34. Must look "very carefully" at derivatives accounting

WARREN BUFFETT: The question about the derivatives business, it's a good business — it's a good question — because it involves big balance sheet numbers and big off-balance sheet numbers in relation to the amount of money made, and particularly in terms — in relation to the amount of money made in terms of the capital employed.

And the credit guarantees, the long-term nature, all of that makes that something that we will want — we do want to look at always very hard.

It's a business that people can get in trouble in and they can get in trouble while the accounting sails along merrily.

I remember when Charlie and I were at Salomon, we found — we didn't find it, other people found it finally, but — mismarked derivative positions that were very substantial that had gone on for a long period of time.

And this was with paying a lot of money to auditors to look at them.

Am I right about that, Charlie, on that? Charlie was on the audit committee.

CHARLIE MUNGER: The worst glitches were that the books just got so out of control, not in the derivative department, but there were just multimillion dollar errors.

WARREN BUFFETT: But we found mismarks, as I remember —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: — in the 20-odd millions on —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: — positions —

CHARLIE MUNGER: Yes. Both.

WARREN BUFFETT: In some cases, because the contracts got so complicated that the people that were valuing them didn't understand them, and — at least partially didn't understand them.

There's a lot of potential for mischief when people can write down a few numbers on a piece of paper and nothing changes hands for a long time and their compensation, you know, next month and this year, depends on what numbers are attached to a bunch of things that are not really — where they don't come to fruition for a long time. And particularly when you're guaranteeing credit or anything of the sort.

So, you're very correct in observing that, when the numbers are big in relation to the amount of profits, you want to look very carefully, because if anything goes wrong, it could go wrong on a fairly big scale, and you're not getting paid a lot for running that type of risk.

35. "We don't sugarcoat things"

WARREN BUFFETT: I very much appreciate what you said about the annual reports, though. We may disappoint you in how the business performs over time. I mean, that is not totally within our control. We'll try hard, but we can make no promises.

But we shouldn't ever disappoint you in either our accounting or in the candor of the reporting. I mean, that is in our control. We may not like what we have to tell you, but there's no reason for failure — there can be no reason for failure in the accounting or candor.

I mean, that is — there's — if we fail there it's because we set out to fail.

We can fail in terms of operating performance for a lot of reasons, some within our control and some without our control. But — and that can happen. And if so, we'll tell you about it.

But we're going to try very hard to make sure that you see the business in a form exactly like we see the business, and that we don't sugarcoat things, and we don't put spin on things.

And we'll judge ourselves in a — to a significant degree by how we handle that particular part of the problem. We'll also try to do a good job in operations.

Charlie, do you have anything to add on that?

CHARLIE MUNGER: No.

Morning Session - 2000 Meeting

1. Meeting introduction and welcome

WARREN BUFFETT: Good morning.

Well, first thing I'd like to do is to thank everybody that's helped us put this on.

As you saw in the movie, I think, at the time, we may have had 45,000 or so people working with Berkshire, with 12.8 at headquarters.

We're probably up to about 60,000 now, and we still have 12.8, and they take care of putting on this whole meeting.

We get help from people in internal audit, and we get terrific help from the people at all of our companies who work very hard to put on the exhibits. And we hope that you not only visit them, but patronize them, and we'll give you ample time to do that.

As you can see, I enlisted my family for the movie, and I want to thank them. I want to particularly thank Kelly Muchemore and Marc Hamburg for their work in putting this on. It's a real project to — (Applause)

A lot of companies have a whole department that does this and, at Berkshire, Kelly processes 25,000 requests for tickets, and coordinates everything with the exhibitors, and it's a fabulous job.

Now, we'll follow our usual routine. We do have a surprise at — a small surprise — at 11:45. It's not that Charlie's going to say anything — that would be a big surprise, but — (laughter) — we'll — well, we'll have this small surprise for you at 11:45.

The plan is to go through the business part of the meeting here in just a second, and we'll run from 9:30 to 12:00. Then, after conducting the business meeting, we'll take your questions. We'll go around the room. We have 10 stations. I guess we'll probably only be using eight stations in this room.

And we have microphones everyplace that the eight stations — that you'll see, and you can step up to those. And we'll just keep answering questions.

And we'll break at 12 o'clock, and there will be food available down below, where you can also purchase things from us.

And we'll reconvene about 12:45, and then we'll stay until 3:30 and we'll try and answer whatever questions you have. And then we will have to cut it off at 3:30.

We have — we had about the same number of ticket requests as in the past, but we had a different mix this year. We — as most of you know — we had change the venue, and the time, because Ak-Sar-Ben is winding down.

And so, there's a little different rhythm to this meeting. A much higher percentage of our tickets than usual were requested by people from Omaha.

And, of course, you've heard me say before that we're a little suspicious of these figures because we know that a lot of people claim to be from Omaha that aren't, for status reasons, and so — (laughter) — we can't really give you the geographical breakdown we normally would.

2. Introduction and election of BH directors

WARREN BUFFETT: I'd like to introduce, first, our directors, and then we'll proceed into the formal business of the meeting. On my left here is the ever-animated Charlie Munger, our vice chairman. (Applause)

And if the other directors will stand up as I announce their names. We have the better voice in the movie, my wife, Susan Buffett. Susie? (Applause)

We have Howard Buffett. (Applause)

You can see we find these names in the phone book, I mean —

And Kim Chace. Kim? (Applause)

Walter Scott, the star of "How to be a Gillionaire." (Applause)

And Ron Olson. Ron? (Applause)

OK, we'll now take on the formal part of the meeting.

We're going to try to set a new record, I think, 5:38.4, but the four-minute mile has always been our ambition on this. So I will go through this and then we'll get to the questions.

The meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of this company.

I welcome you to this 2000 annual meeting of shareholders. I've introduced the directors. Also with us today are partners in the firm of Deloitte & Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings. Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: I do. Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent by first-class mail to all shareholders of record on March, 3, 2000, being the record date for this meeting, there are 1,341,174 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 5,385,320 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,116,151 Class A shares and 4,342,959 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 27th.

WARREN BUFFETT: Thank you. That number represents a quorum and we will therefore directly proceed with the meeting.

The first order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott Jr., who will place a motion before the meeting.

WALTER SCOTT JR: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: The motion has moved and seconded. Are there any comments or questions? We will vote on this question by voice vote. All those in favor say, “Aye.”

VOICES: Aye.

WARREN BUFFETT: Opposed? You can signify by saying, “I’m leaving.” The motion is carried. (Laughter)

The one item of business of this meeting is to elect directors. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy, and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to the meeting officials in the aisles who will furnish a ballot for you. Would those persons desiring ballots please identify themselves, so that we may distribute them?

I now recognize Mr. Walter Scott Jr. to place a motion before the meeting, with respect to election of directors.

WALTER SCOTT JR.: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: I second the vote.

WARREN BUFFETT: It's been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. be elected as directors.

Are there any other nominations? Is there any discussion? The nominations are ready to be acted upon. If there are any shareholders voting in person that should — they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of election.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors voting the proxies, in accordance with instructions they have received? Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders, in response to proxies that were received through last Thursday evening, cast not less than 1,136,497 votes for each nominee.

That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as those cast in person at this meeting, if any, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Becki. Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. have been elected as directors.

Does anyone have any further business to come before this meeting before we adjourn? If not, I recognize Mr. Walter Scott Jr. to place a motion before the meeting.

WALTER SCOTT JR: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second? A motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say, "Aye."

VOICES: Aye.

WARREN BUFFETT: All opposed, "No." This meeting's adjourned. Thank you. (Applause)

We will advise Guinness of those results, and maybe we'll get in the book.

Just want to make one more announcement and then we'll start in the questions with area 1, which I believe will be right over here.

About — I think about 3,500 of you are attending the ballgame tonight. You know what you're supposed to do, incidentally.

And we — in the past, we've had some traffic jams at — where the interstate goes off into 13th Street. So, the police, who are wonderfully cooperative throughout this whole weekend, in many ways, are going to do their darnedest to make sure that we don't have much of a jam.

But if those of you who are attending the game would like to go a little early, that will probably be quite helpful.

And I might say that we have probably got — well, we think it's probably the best zoo in the world here, thanks in very large part to our director, Walter Scott, and his wife Sue, who have really turned our zoo into a huge attraction, draws well over a million people a year.

It's right adjacent to the ballpark. So if you get out a little early, and you want to go to the zoo, and then you won't even have to move your car. You can come over to the ballpark, and then there's also food there. And we have a — we serve Coca-Cola products.

And if you don't all try to come at 6:45, it will be a help to us.

I will be pitching at 7:05, but my fastball will arrive at the plate almost instantaneously with the moment that it leaves my hand, so unless you're there, you'll miss it. And — (Laughter)

3. Aesop's investing primer: Birds in hands and bushes

WARREN BUFFETT: So look with that, let's start in area 1, and we will go around. And feel free to ask any questions. You might identify yourself and where you're from before asking your question. Area 1?

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger.

My name is Steve Yates (PH), I'm from Chicago. I'm a Berkshire shareholder and this is my sixth year coming to this meeting. I'd like to thank you for all your time and advice through the years. It's been great.

I'd also like to thank all those wonderful people who sold Berkshire this year for giving us an opportunity to purchase more of the world's greatest company for dirt-cheap prices. (Applause)

WARREN BUFFETT: We will convey your thanks. (Laughter)

AUDIENCE MEMBER: I own another stock, which sells for four times current trailing earnings. Every quarter we get a report. Earnings go up, sales go up, cash flow goes up, the equity base expands, they gain market share, and the stock goes down.

The company has a 60 percent five-year annualized growth rate and sells at four times earnings. I have two related questions.

First, is this is a growth stock or a value stock, and could you please give us your definitions of these terms?

Second, the company sells recreational vehicles. Demographic trends in the recreation and leisure areas, RVs, cruise lines, golf equipment, et cetera, seem to be quite good. Do you see any opportunities for Berkshire here? Thanks.

WARREN BUFFETT: Well, the question about growth and value, we've addressed in past annual reports. But they are not two distinct categories of business. Every business is worth the present —

If you knew what it was going to be able to disgorge in cash between now and Judgment Day, you could come to a precise figure as to what it is worth today.

Now, elements of that can be the ability to use additional capital at good rates, and most growth companies that are characterized as growth companies have that as a characteristic.

But there is no distinction in our minds between growth and value. Every business we look at as being a value proposition. The potential for growth and the likelihood of good economics being attached to that growth are part of the equation in evaluation.

But they're all value decisions. A company that pays no dividends growing a hundred percent a year, you know, is losing money. Now, that's a value decision. You have to decide how much value you're going to get.

Actually, it's very simple. The first investment primer, when would you guess it was written?

The first investment primer that I know of, and it was pretty good advice, was delivered in about 600 B.C. by Aesop. And Aesop, you'll remember, said, "A bird in the hand is worth two in the bush."

Now incidentally, Aesop did not know it was 600 BC. He was smart, but he wasn't that smart. (Laughter)

Now, Aesop was onto something, but he didn't finish it, because there's a couple of other questions that go along with that.

But it is an investment equation, a bird in the hand is worth two in the bush. He forgot to say exactly when you were going to get the two in the — from the bush — and he forgot to say what interest rates were that you had to measure this against.

But if he'd given those two factors, he would have defined investment for the next 2,600 years. Because a bird in the hand is — you know, you will trade a bird in the hand, which is investing. You lay out cash today.

And then the question is, as an investment decision, you have to evaluate how many birds are in the bush. You may think there are two birds in the bush, or three birds in the bush, and you have to decide when they're going to come out, and when you're going to acquire them.

Now, if interest rates are five percent, and you're going to get two birds from the bush in five years, we'll say, versus one now, two birds in the bush are much better than a bird in the hand now.

So you want to trade your bird in the hand and say, "I'll take two birds in the bush," because if you're going to get them in five years, that's roughly 14 percent compounded annually and interest rates are only five percent.

But if interest rates were 20 percent, you would decline to take two birds in the bush five years from now. You would say that's not good enough, because at 20 percent, if I just keep this bird in my hand and compound it, I'll have more birds than two birds in the bush in five years.

Now, what's all that got to do with growth? Well, usually growth, people associate with a lot more birds in the bush, but you still have to decide when you're going to get them.

And you have to measure that against interest rates, and you have to measure it against other bushes, and other, you know, other equations.

And that’s all investing is. It’s a value decision based on, you know, what it is worth, how many birds are in that bush, when you’re going to get them, and what interest rates are.

Now, if you pay $500 billion — and when we buy a stock, we always think in terms of buying the whole enterprise, because it enables us to think as businessmen, rather than as stock speculators.

So let’s just take a company that has marvelous prospects, is paying you nothing now, and you buy it at a valuation of 500 billion.

Now, if you feel that 10 percent is the appropriate rate of return — and you can pick your figure — that means that if it pays you nothing this year, but starts paying next year, it has to be able to pay you 55 billion in perpetuity, each year.

But if it’s not going to pay until the third year, then it has to pay you 60.5 billion in perpetuity — in perpetuity — to justify the present price.

Every year that you wait to take a bird out of the bush means that you have to take out more birds. It’s that simple.

And I question, in my mind, whether — sometimes, whether people who pay $500 billion implicitly for a business by buying 10 shares of stock at some price, are really thinking of the mathematical — the mathematics — implicit in what they are doing.

To deliver, let’s just assume that’s — there’s only going to be a one-year delay before the business starts paying out to you, and you want to get a 10 percent return and you pay 500 billion. That means 55 billion of cash that they have to be able to disgorge to you year, after year, after year.

To do that, they have to make perhaps $80 billion, or close to it, pretax.

Now, you might look around at the universe of businesses in this world and see how many are earning 80 billion pretax, or 70, or 60, or 50, or 40, or 30. And you won’t find any.

So it requires a rather extraordinary change in profitability to give you enough birds out of that particular bush to make it worthwhile to give up the one that you have in your hand.

Second part of your question, about whether we’d be willing to buy a wonderful business at four times earnings, I think I could get even Charlie interested in that. But let’s hear it from Charlie.

CHARLIE MUNGER: I'd like to know what that is. (Laughter)

WARREN BUFFETT: He was hoping you would ask that. That fellow that's got all his net worth in this stock — (laughter) — and who has a captive audience.

Tell us what it is. You've got to tell us. We're begging you. (Laughter)

AUDIENCE MEMBER: You want the name of the company?

WARREN BUFFETT: We want the name of the company. We're dying to get the name. Wait till I get my pencil out. (Laughter)

AUDIENCE MEMBER: It's called National RV, and it's based in California, and they sell recreational vehicles.

WARREN BUFFETT: OK, well, you've got a crowd of people with — who have birds in the hand, and we will see what they do — (laughter) — in terms of National RV.

Charlie, do you have anything further on growth and value, et cetera?

Watch him carefully, folks. (Laughter)

CHARLIE MUNGER: Well, I agree that all intelligent investing is value investing. You have to acquire more than you really pay for, and that's a value judgment. But you can look for more than you're paying for in a lot of different ways.

You can use filters to sift the investment universe. And if you stick with stocks that can't possibly be wonderful to just put away in your safe deposit box for 40 years, but are underpriced, then you have to keep moving around all the time.

As they get closer to what you think the real value is, you have to sell them, and then find others. And so, it's an active kind of investing.

The investing where you find a few great companies and just sit on your ass because you've correctly predicted the future, that is what it's very nice to be good at.

WARREN BUFFETT: The movie was G-rated even though — (Laughter)

Is that it, Charlie? (Laughter)

4. Munger on internet stocks: "If you mix raisins with turds, they're still turds"

WARREN BUFFETT: OK. We will move to area 2.

AUDIENCE MEMBER: Good morning, gentlemen. Wayne Peters. And where I come from our ladies are referred to as birds. (Laughter)

And I'm sure I know a lot that would trade one in the hand for two in the bush — (laughter) — irrespective of the interest rate. (Laughter)

I have two small questions.

Firstly, with the speculation, and some would say rampant speculation, in the high tech and internet arenas, could you share your views on the potential fallout from the speculation for the general economy?

And secondly, how long did it actually take you to perfect that curveball, and are we going to see it tonight?

WARREN BUFFETT: The — I don't think I want to give anything away about my pitches tonight. (Laughter)

Ernie Banks may be in the audience, I know he's in town, and I just can't afford to do that. But you'll see it tonight, and you can describe it anyway you'd like.

The question about the high tech stocks and possible fallout, any time there have been real bursts of speculation in the market, you know that — it does get corrected, eventually.

Ben Graham was right when he said that in the short run it's a voting machine, and the long run it's a weighing machine. Sooner or later, the amount of cash that a business can disgorge in the future governs the value it has — that the stock commands — in the market. But it can take a long time.

And, I mean, it's a very interesting proposition. For example, if you take a company that, in the end, never makes any money, but trades — changes hands — representing a valuation of 10 or $20 billion for some time, there's no wealth created. There's a tremendous amount of wealth transferred.

And I think you will see, when we look back on this era, you will see this as a period of enormous amounts of wealth transfer, but in the end the only wealth creation comes about through what the business creates.

There's no magic to it. If a company that's not worth anything sells for 20 billion and 5 percent of it changes hands, somebody takes a billion dollars from somebody else. But investors as whole gain nothing.

They all feel richer. It's a very interesting phenomenon. But they can't be richer except — as a group — unless the company makes them richer.

And it's the same principle as a chain letter. If you're very early on a chain letter you can make money. There's no money created by chain letters. In fact, there's the frictional cost of envelopes, and postage, and that sort of thing.

So the net, there's some money destroyed a little bit. And there's money destroyed by the frictional cost of trading and investing, and that comes out of investor's pockets.

But the manias that periodically take place — and not just in stocks. We had a similar mania — not necessarily similar — we certainly had a mania in farmland here in Nebraska 20 years ago.

And land which couldn't produce, we'll say, more than 70 or $80 an acre would sell for 2,000 an acre at times when interest rates were 10 percent.

Well, that math will kill you. And it killed the people who bought it at those prices, and it killed a great many banks here in Nebraska who lent based on that sort of thing.

But while it was going on everybody thought it was wonderful, because every farm was selling for more than the similar farm had sold for a month earlier. And it was momentum investing in farmland.

And, in the end, valuation does count. But it can go on a long time, and when you get a huge number of participants playing with ever increasing sums, you know, it creates its own apparent truth for a — what can be for a very considerable period of time.

It doesn't go on forever. And whether it has fallout to the whole economy, like it probably did in the late '20s, or whether it's just an isolated industry where the — or sector — where the bubble bursts and it really doesn't affect other values, who knows? But five or 10 years from now, you will know.

Charlie?

CHARLIE MUNGER: Well, I think the reason we use the phrase "wretched excess" is that there are wretched consequences.

If you mix the mathematics of the chain letter or the Ponzi scheme with some legitimate development, like the development of the internet, you are mixing something which is wretched and irrational, and has bad consequences, with something that has very good consequences.

But, you know, if you mix raisins with turds, they're still turds. (Laughter)

WARREN BUFFETT: That's why they have me write the annual report. (Laughter)

5. Evaluating the internet's threat to Berkshire's businesses

WARREN BUFFETT: So, I think we better move on to sector 3. (Laughter)

Way back there.

AUDIENCE MEMBER: My name —

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: My name is Thomas Kamay (PH). I am 10 years old and I go to Bacich School in Kentfield, California. I have been a shareholder for two years. This is my third annual meeting. Here's my question.

I know you won't invest in technology companies, but are you afraid that the internet will hurt some of the companies that you do invest in, such as The Washington Post or Wells Fargo? Thank you.

WARREN BUFFETT: Well, that's an absolutely terrific question. You know, I may turn my money over to you. (Laughter and applause)

There's probably no better question we'll get.

And I hope Charlie answers in an appropriate vein considering your age. (Laughter)

We do not — we have no — you know, it's no religious belief that we don't buy into tech companies.

We just don't — we have never found one — as conventionally defined — we've never found one where we think we know enough about what the business will look like in 10 years that we can make a rational decision as to how much we pay now for that business.

In other words, we have not been able to find a business where we think we know what that bush will look like in 10 years, and how many birds will be in it, so that we know how many birds we can give up today to participate in that future.

Not any — there will be wonderful things, as Charlie so colorfully explained, that will evolve from many of these companies, but we don't know how to make that decision.

And you're absolutely right that we should be thinking all of the time about whether developments in that tech area threaten the businesses that we're in now, how you might counter those threats, how we might capitalize in opportunities because of it.

It's a very, very, very important part of business now and will become more important in the years to come, including many of our businesses.

For example, you mentioned The Washington Post. Even closer to home, we own a newspaper called The Buffalo News in Buffalo, New York. We own all of that. So we're in a position to make our own decisions of an operating nature as to what we should do in respect to the internet.

And believe me, Stan Lipsey, who's here today, who runs that paper, and I have talked many, many hours, including considerable time yesterday about what we are doing on the internet, what we should be doing, what other people are doing, how it threatens us, how we can counter those threats, all of that sort of thing.

And newspapers are a category that, in my view, are very threatened by the internet because we had an example —

The internet is terrific for delivering information. We have a product, World Book, that's terrific for delivering information. And 15 years ago, print encyclopedias were the best tool, probably, for educating not only young children, but for educating me or Charlie when we wanted to look up something on a subject.

And the World Book is a marvelous product. But it requires chopping down trees, and it requires operating paper mills, and it requires binding it and printing, and it requires a delivery of a 70 pound, you know, UPS package. And it's a —

It was put together in a way that was, for 4- or 500 years, the best technique for taking that information and moving it from those who assembled it to those who wanted to use it. And then the internet changed that in a very major way.

So we have seen firsthand, and experienced the business consequences of the improvement offered by the internet and the delivery of information.

And newspapers, although not as immediately susceptible to that problem, still face that overpowering factor.

When you eliminate the delivery cost — I mean, we pay a significant percentage of our circulation revenue to our carriers, and we pay additional money to the district managers, and we pay for the trucks to deliver the product out, and we pay for huge printing presses, and all of that sort of thing.

And people do chop down trees in order to give us the raw material to transmit information in Buffalo, you know, about what the Buffalo Bills did yesterday, on Sunday, with all the details.

And now you have the internet that has virtually no incremental unit cost to anything and can deliver the information instantaneously. So it's a big factor for newspapers.

And the newspaper world in my view will look very, very, very different in not that many years.

And I find it kind of interesting, because the people in the newspaper business are a little schizophrenic about this. They see this. They're afraid of it. They're, in almost all cases, trying to combat it on some way operationally.

But some of them, at least, continue to go out and buy papers at a price that sort of reflects the economics that used to exist 20 years ago, when it's — to me it's very clear that it doesn't exist anymore.

So they sort of have their billfold, you know, in the past, even though they see the future. And, you know, I think, probably, they're making mistakes in many cases.

All of our businesses, virtually — Coca-Cola will not be affected in any significant way by the internet, you know? The razor and blade business won't be. Although you could dream up things about distribution or so on, but I think that it's very unlikely.

But other businesses we have — our insurance business, particularly at GEICO, will be very affected by the internet. Now, that may turn out to be a big advantage to us over time. I wouldn't be surprised if it is.

But our retailing businesses are all threatened in one way or another by internet developments, and there may be some opportunities there, too. But it's a change.

It's a change in — it's going to be change in the world — how the world gets entertainment. It's going to be a change in the world — how the world gets information. And it is incredibly low cost compared to the — most of the methods of conveying entertainment and information now.

Charlie?

CHARLIE MUNGER: Well, he asked if we were afraid that the internet would hurt some of our business and I think the answer is yes. (Laughter)

WARREN BUFFETT: I'm learning to appreciate these short answers, though, more as the day goes by. (Laughter)

I want to thank you for coming to our meeting, incidentally. You're way ahead of me. I didn't buy my first stock until I was 11, and so you've got a real jump on me. And I wish you well.

6. "There's nothing magic about a one-year period"

WARREN BUFFETT: OK. Area 4.

AUDIENCE MEMBER: Warren and Charlie, good morning. This is Mo Spence (PH), Waterloo, Nebraska.

In 1999, Berkshire Hathaway managed to produce a positive gain in net worth of one-half of one percent.

That means that since present management took over 35 years ago, Berkshire Hathaway has realized a positive gain each and every year, and produced an average annual gain of 24 percent.

Including the years you ran the Buffett Limited Partnership, you have had a run of 48 consecutive years of positive gains and net worth without one single down year, producing a compounded rate of return of almost 26 percent annually.

On behalf of the long-term shareholders of Berkshire Hathaway, we want to thank you from the bottom of our pocketbooks. (Applause)

WARREN BUFFETT: Well, thank you. I hope your question isn't going to be whether we can continue that, but go — you have a question?

AUDIENCE MEMBER: My question is, don't you think you could have ended the millennium with a bigger bang than one-half of one percent? (Laughter)

WARREN BUFFETT: Well, I certainly wish we could have. But the interesting thing about those figures — and, actually, the figures go back before that, because the very best period was pre-the partnership days, because the amount I was working with was so small.

But the — there's nothing magic about a one-year period. I mean, it's the way the measurements come out. We've — if you took all the half-year periods, for example, I'm sure — well, I know that there were a number that were down, you know —

There're going to be lots of years in the future — assuming I live long enough, that — we will have plenty of down years. It's been a fluke, to some degree, that we have not had any down years in terms of underlying value.

The stock has gone up and down in ways that are not related to intrinsic value a few times, but that is totally a fluke. I mean, we're not going to be up every day. We're not going to be up every week. We're not going to be up every month, or even every year.

And it's — the fact that, you know, the Earth revolves around the sun really is not totally connected to most business activities, or the fruition of most investment ideas, or anything of the sort.

So we have to report every year, and, you know, I care about the yearly figures in that sense. I don't really care about them, totally, as a measure of what we're doing.

And, like I say, if we could've — we were — the capital allocation job that I did in 1999 was very, very poor. And it was partly because some of our main businesses did poorly.

I mean, Coca-Cola and Gillette had bad years last year. They'll have good years over time.

I wrote a few years ago — it's interesting, I called their soft drink business and their razor and blade business as "Inevitables."

And the truth is they've got a higher market share now than they've ever had in history. They're selling more units than any year in history. But certain other factors hurt their business and therefore hurt their stock performance.

But I would still call the soft drink — Coca-Cola's position in the soft drink business, and Gillette's position in the razor and blade business — I would characterize them as "inevitable," that they will gain share over time.

Gillette has over 70 percent of the blade and razor business in the world, which is — measured by value. And that's an extraordinary share.

Coke has 50 percent of the soft drink business in the world. That's well over a billion eight-ounce servings per day. A billion per day.

Eight percent of those are for the account of Berkshire, so over 80 million eight-ounce servings of soft drinks per day are being consumed by people for — where the economic benefit comes to Berkshire Hathaway.

In effect, we have over six percent of the — for Berkshire Hathaway's account — of the blade and razor business in the world. And it'll go up.

So I don't worry about the businesses in the least, long term. They will have bad years from time to time. And when they do, our performance will not look good in those years.

Charlie?

CHARLIE MUNGER: Well, it's been a very interesting stretch. One of the most interesting things about the stretch is that, during pretty much the whole period, the company has owned marketable securities in excess of its net worth.

And so you have this extraordinary liquidity in a company that has performed very well, to boot. That advantage has not gone away and, in fact, it's been augmented.

Give us reasonable opportunities and we are prepared.

WARREN BUFFETT: Well you've heard what you're supposed to do, now we'll do the rest. Just give us the opportunities.

7. We want a "mathematical edge in every transaction"

WARREN BUFFETT: Area 5.

AUDIENCE MEMBER: My name is Greg Blevins (PH) from Bargetown, Kentucky.

I have a question about intrinsic value. It comes from comments that you made in your annual report this year. In there, you describe the extraordinary skills of [Berkshire reinsurance chief] Ajit Jain in judging risk.

When I think about Berkshire and its ability to increase intrinsic value, it seems to me that judging risk has been at least as important as an ability to calculate a net present value.

So my question to each of you is, would you give us some comments on how you think about risk?

WARREN BUFFETT: Well, we think of business risk in terms of what can happen — say five, 10, 15 years from now — that will destroy, or modify, or reduce the economic strengths that we perceive currently exist in a business.

In some businesses that's very — it's impossible — to figure — at least it's impossible for us to figure — and then we just — we don't even think about it then.

We are enormously risk averse. We are not risk adverse, in terms of losing a billion dollars if there were an earthquake in California today. And we're thinking of writing a policy, for example, in the next week or so, on a primary insurance risk of over a billion dollars.

That doesn't bother us as long as the math is in our favor. But in terms of doing a group of transactions like that, we are very risk averse. In other words, we want to think that we've got a mathematical edge in every transaction.

And we think that we'll do enough transactions over a lifetime so that, no matter what the result of any single one, that the group expectancy would — gets almost to certainty.

When we look at businesses, we try to think of what can go wrong with them. We try to look [for] businesses that are good businesses now, and we think about what can go wrong with them.

If we can think of very much that can go wrong with them, we just forget it. We are not in the business of assuming a lot of risk in businesses.

That doesn't mean we don't do it inadvertently and make mistakes, because we do. But we don't intentionally, or willingly, voluntarily, go into situations where we perceive really significant risk that the business is going to change in a major way.

And that gets down to what you probably heard me talk about before, is, what kind of a moat is around the business?

Every business that we look at we think of as an economic castle. And castles are subject to marauders. And in capitalism, any castle you have, whether it's razor blades, or soft drinks, or whatever, you have to expect the —

And you want the capitalistic system to work in a way that millions of people are out there with capital thinking about ways to take your castle away from you, and appropriate it for their own use. And then the question is, what kind of a moat do you have around that castle that protects it?

See's Candy has a wonderful moat around its castle. And Chuck Huggins has taken that moat, which he took charge of in 1972, and he has widened that moat every year. He throws crocodiles, and sharks, and piranhas in the moat, and it gets harder and harder for people to swim across and attack the castle. So they don't do it.

If you look, since 1972, Forrest Mars tried with Ethel M — I don't know, 20 years ago. And I hate to think of how much money it cost him to try that. And he was a very experienced businessman.

So we think of the — we think in terms of that moat and the ability to keep its width and its impossibility of being crossed as the primary criterion of a great business.

And to our managers, we say we want the moat widened every year. You know, that does not necessarily mean that the profit is more this year than last year, because it won't be sometimes. But if the moat is widened every year, the business will do very well.

When we don't have a — when we see a moat that's tenuous in any way — getting back to your question — it's just too risky. We don't know how to valuate that, and therefore we leave it alone.

We think all of our businesses — virtually all of our businesses — have pretty darn good moats, and we think the managers are widening them.

Charlie?

CHARLIE MUNGER: How could you say it better? (Laughter)

WARREN BUFFETT: Here, have a — have some peanut brittle on that one. (Laughter)

8. Insurance “attracts chicanery” and we’ll have surprises

WARREN BUFFETT: OK, 6.

AUDIENCE MEMBER: Good morning.

WARREN BUFFETT: Good mrning.

AUDIENCE MEMBER: My name is Hugh Stevenson (PH). I’m a shareholder from Atlanta.

WARREN BUFFETT (to Munger): Why don’t you open that?

AUDIENCE MEMBER: My question involves the company’s activities before and shortly after the Gen Re acquisition.

I remember you saying once that, in insurance, virtually all surprises are negative ones. And I’m wondering, given the company’s operating experience in insurance over long period of time, could you tell us what happened in the Unicover situation?

How come in Gen — with Gen Re’s experience and the company’s experience, that it happened, they didn’t foresee it, we didn’t foresee it? What has the company done? I know they’ve taken a large reserve for the situation.

And how do they plan to operate in the future to prevent these things, find them out, and strengthen the company from these kind of situations in the future?

WARREN BUFFETT: Yeah, the Unicover situation was discovered in about, I don’t know, February of last year, or thereabouts. And it was a mistake, I mean, it should not have been made. A lot of other people made the same mistake, but that still didn’t mean that we should have made that mistake.

We set up a reserve of $275 million when the mistake was discovered, and that reserve looks like it’s about right still. There have been quite a few developments at Unicover that have defined the limits of it better and resulted in the resolutions of many of the issues attached to it. Still looks like about a $275 million mistake.

Now, that’s a big mistake, but we’ve made bigger ones. We had one in the mid-’70s that probably cost Berkshire, measuring opportunity cost and everything, because we didn’t know how bad it was going to be —

I would say that Berkshire would now be worth at least 10 percent more if that mistake hadn’t occurred. Wouldn’t you say so, Charlie? The Omni situation?

CHARLIE MUNGER: Absolutely.

WARREN BUFFETT: Yeah, so we had a mistake whose present value would be 8 or $9 billion. It cost us at least that.

CHARLIE MUNGER: Yeah, it cost us less than 4 million at the time.

WARREN BUFFETT: Yeah. Though, it — but we didn't know it for sure it was 4 million, so it tied our hands in other respects, too.

In insurance you will get surprises. Now, the test of good management is how many surprises you get. But there's no way you'll get no surprises.

And if you look at our history, you will see some years when our float cost us a lot of money. You will also see a history where over 33 or so years that it's been a very, very attractive business.

But we have had cases, I mean, our name causes problems. I think National Indemnity — we had a fraud, as I remember, down in Texas where an agent was using our paper, which incidentally was the same problem we had, the one that cost us so much.

And some guy is out there writing bonds on — surety bonds — on construction of schools. And he says he represents National Indemnity and the contract proceeds, and of course, we've never heard of the guy.

But if you get a school district in Texas with a half-finished school, and the choice is whether the taxpayers ante up more or whether you find that this guy had apparent authority as an agent, and so on, and therefore we should pay on a policy we never heard of, written by a guy we never heard of, you know, on a school we never heard of. You know, we'll end up paying.

So the surprises are unpleasant nine times out of 10. We'll have more. We had another one last year that shouldn't have happened. But they do happen.

And General Re has a terrific record over time.

We knew last year would not be a good business in the reinsurance business. It was worse than we thought it would be. But that had nothing to do — if you told me the figures that General Re would have at the end of the year, we would have made the same deal in a moment.

And, you know, we didn't do so well with Coke and Gillette ourselves. So that the ratio of mistakes was probably fairly equal between the two organizations with me contributing our — my share.

I think insurance, which will continue to have surprises in it, will turn out to be a very, very good business for Berkshire over time. It's the best one I know about that we can do in increasing scale over time.

As a matter of fact, some of you may not have noticed but we announced another small insurance acquisition just last week.

It's a tough field. The average company is going to do poorly. We think we have some very special companies, and we really do think, over time, we will acquire and utilize float at a cost that's very, very attractive.

It won't be zero like it's been in the past. I mean, we are in some lines of business where intentionally — I mean, we would be crazy to try to hold it to zero, because it's way better to have twice as much money at one or two percent as have half as much money at 0 percent.

But we will fully acknowledge that — I mean, Unicover was a surprise. But I don't know how many surprises I've had in insurance over the 33 years or so we've been in it.

One of the surprises, incidentally, you know, worked to our incredible benefit.

GEICO has been a great, great company since I first went down to Washington, and even before that, and met Lorimer Davidson almost 50 years ago. But they made a mistake in the early '70s that really did bankrupt the company.

But fortunately, there was an insurance commissioner named Max Wallach in the District of Columbia, who saw that it could be resuscitated, and that mistake enabled us to make many, many billions of dollars. So mistakes can be useful on occasion, too.

Charlie?

CHARLIE MUNGER: All that said, it is perhaps the most irritating way to lose money there is, is to be taken by a sort of obvious lie. And — but it happens.

I don't think it's likely to happen again on that scale.

WARREN BUFFETT: Well, I wouldn't say that. (Laughs)

I would say that it's unlikely that — in any 20 year period, or anything like that, we will get a big surprise. And it will come about, very often, through one form or another of three or four methods of obvious fraud that we've observed in the past.

But they spring up again. And there are plenty of people that are, I'd have to say, "crooked," in insurance because it's a product where you deliver a piece of paper and somebody hands you money.

And that intrigues people. You know, you don't even hand them a Dilly bar, you know, or — (laughter) — or anything in exchange. They hand you a lot of money and you give them a little piece of paper.

And of course, when you get into reinsurance and all that, then you hand that little piece of paper to somebody else and try and get them to hand you money.

And all the way along the line you have brokers who are getting big chunks of money for sort of papering over some of the weaknesses in the project, and sometimes they may even be in on it.

So it's a field that attracts chicanery. And often they — the same people — come back again and again. It's amazing to me.

So, I would say that we will get a surprise or two over any 10-year period in insurance. It's almost impossible to avoid.

We should try to minimize it. We do try to minimize it, but I would not want to bet my life that we've seen the last of a Unicover-type situation.

They're always just a little bit different enough so that it doesn't get spotted, or somebody down the line doesn't get the message, but —

I don't know. Don't you think, Charlie, we'll see another one? (Laughs)

CHARLIE MUNGER: Well, perhaps so, but it was a long time from one to the other, and maybe I'll be able to get through without another. (Laughter)

One of these fraud artists, Warren caused me to meet years ago, and his proposition was that he had this perfectly marvelous business.

He says, "I — we only write fire insurance on concrete bridges that are under water." He says, — (laughter) — "It's like taking candy from babies." And —

WARREN BUFFETT: We were the babies. (Laughter)

CHARLIE MUNGER: I looked in his eye. I thought he was kidding or something. He wasn't kidding. I mean, these people believe this kind of stuff.

WARREN BUFFETT: The truth is Charlie — if Charlie and I could see everybody we dealt with, we would screen out some perfectly honest people, too. I think we could probably screen out the crooked propositions. I mean, they do have similar characteristics to them.

And what happens is you get somebody out in the field who is eager to write business or is being wooed by producers, and the intermediaries get very good at it. It's the same way lousy stocks get sold.

I mean, you'll get people who are getting paid very well to part, you know, separate you from your money. And that's worked over the years. The good salesmen find out they can make more money, you know, selling phony products with big tickets attached to them than they can selling lollipops.

9. Rules and fees for Buffett's 1950's partnerships

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good morning Mr. Buffett, and good morning Mr. Munger. My name is Monish Pabrai (PH) and I'm from Long Grove, Illinois.

I have been a student and disciple of yourself, Mr. Buffett, for some time, and especially Mr. Munger. And I have adopted, quite intensely, your theories of capital allocation, in the manner in which I run my business, as well as my portfolio, and quite pleased with the results so far.

My question has to do with the original 1950s Buffett partnerships. There is some conflicting data in the various books about you pertaining to the rules of the partnership and the fees of the partnership.

What I wanted to understand is, I think some of the books allude to the principle being guaranteed — I think six percent a year being guaranteed — and then you took a fourth, and the partners got three-fourths.

In some cases they talk about four percent, and some cases they say there was no guarantee. I would just appreciate a clarification on that.

WARREN BUFFETT: OK, we'll make it short because I'm not sure how much general interest there is to that. But there was never any guarantee.

There was a guarantee that I wouldn't get a penny myself — there was none of this one percent fee and all that sort of thing that hedge funds now normally have. After a short period of time I told people I'd have all my capital in it, basically.

So there was a guarantee I would follow — have a common destiny. There was never any guarantee of principle of any sort.

Originally, the thing started by accident, so that there 11 different partnerships before they all got put together on January 1st, 1962, into Buffett Partnerships.

So with the 11 different partnerships, they had different — some different arrangements — based on the preferences of the limited partners. I offered them an option of three or four different choices, and different families made different choices.

When we put them together we settled on the 6 percent preferential with a quarter of the profits over that, with a carry forward of all deficiencies. Nobody was guaranteed anything on them.

Charlie had a much better partnership. His was a third, as I remember, wasn't it Charlie? (Laughter) ?

CHARLIE MUNGER: Yes, but we were smaller and operating specialist posts on the stock exchange. (Buffett laughs)

The facts were different.

WARREN BUFFETT: Yeah.

10. American Express isn't "inevitable" but has "huge value"

WARREN BUFFETT: OK. Let's go to 8.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, good morning. My name is Pete Banner (PH), and I'm from Boulder, Colorado.

In the 1996 annual report, Mr. Buffett, you stated companies such as Coca-Cola and Gillette might well be labeled "The Inevitables," and you just reaffirmed your view of Coca-Cola and Gillette.

My question to you is, do you have the same view of American Express? That is, do you view American Express as, quote, "The Inevitable"?

WARREN BUFFETT: Yeah. I would like to clarify one point, too. I didn't really say I regard the companies as "Inevitables." I regarded the businesses, their dominance of soft drinks, or their competitive strength in soft drinks and in razors and blades.

And as a matter of fact, I actually pointed out in talking about that — a few paragraphs later, I pointed out the danger of having a wonderful business is the temptation to go into less wonderful businesses.

And to some extent, for example, Gillette's stumble in the last year or two has not been the product of their razor and blade business, but it has been some other businesses, which are not at all inevitable.

And that, you know, that is always a risk. And it's a risk I pointed out, that when a company with a wonderful business gets into a mediocre business, that usually the reputation of the mediocre business prevails over the supposed invincibility of the management of the wonderful business.

American Express, an interesting case study, because it does have a — we always think in terms of share of mind versus share of market because, if share of mind is there, market will follow.

People — virtually — probably 75 percent of the people in the world — have something in their mind about Coca-Cola. And overwhelmingly it's favorable. Everybody in California has something in their mind about See's Candy, and overwhelmingly it's favorable.

The job is to have it in a few more California minds — or world minds in the case of Coke — over the years, and have it even be a little more favorable as the years go by. If we have that, everything else follows. And consumer product organizations understand that.

American Express was — had a very special position in people's mind about financial integrity over the years, and ubiquity of acceptance. When the banks closed in the early '30s, American Express traveler's checks actually substituted, to some extent, for bank activity during that period.

The worldwide acceptance of this name meant that when American Express sold traveler's checks — for many years, their two primary competitors were what are now Citicorp — First National City — and the Bank of America.

And, despite the fact that American Express charged you one percent when you bought your traveler's checks, and you had two other premier organizations, Citicorp, imagine, and BofA, and — actually, Barclays had one and Thomas Cook had one.

And American Express still had two-thirds of the market after 60 or 70 years — two-thirds of the worldwide market — while charging more for the product than these other very well-known competitors charged.

Anytime you can charge more for a product and maintain or increase market share against well-entrenched, well-known competitors, you have something very special in people's minds. Same thing came about when the credit card came around.

Originally, American Express wanted the credit card because they thought they were going to get killed on traveler's checks. And they thought it was going to be a substitute, and therefore, they had to go into — it was a defensive move.

It came about because a fellow named Ralph Schneider, and Al Bloomingdale, and a couple people came up with the Diners Club idea. And the Diners Club idea was sweeping, well, initially New York, and then the country in the mid-'50s.

And American Express got very worried because they thought, you know, people are going to use these cards. Nobody had ever heard of Visa at that point, or anything of the sort.

But people were going to use these cards instead of traveler's checks. So they backed into the traveler's check business — I mean, it backed into the credit card business.

Immediately, despite the jump the Diners Club had on the — on this business — because Diners Club had the restaurants signed up already, and they already had the high rollers carrying around their card, and nobody had an American Express card.

But American Express went in and they started charging more than Diners Club for the card, and they kept taking market share away.

Well, that is a great position to be in people's minds where they are willing to — when faced with a choice — they're willing to go with the newer product, at a higher price, and leave behind the entrenched product.

And it just showed the power of American Express. American Express had a special cache. It identified you as something special.

When you pulled out your American Express, as opposed to your Diner's Club card, and as opposed to the Carte Blanche card, which was the third main competitor at the time. Visa still did not exist. And you could see this dominance prevail.

That told you what was in people's minds. It's why I bought into the stock in 1964. We bought 5 percent of the company for — a huge investment at the time for us. I was only managing $20 million at the time.

But you could see that this share of mind, this consumer franchise had not been lost.

In the — considerable period of time, American Express got into other businesses, they got into — Fireman's Fund Insurance was a very big acquisition. And, to some extent, they let the Visas of the world and all of those get established. They still had this preeminent cache position, but it was eroding.

But I would say that Harvey Golub, along with a lot of other people in the management, have done an extremely good job of reaffirming — intensifying — the cache. There will be probably $300 billion worth of charges, something in that area, put on American Express this year.

The — 300 billion, those are big numbers, even in today's world. The average discount fee is about 2.73 percent. If you look at the average discount fee on Visa, MasterCharge, you know, it's going to be a —probably, a full percentage point beneath that.

So you've got a percentage point on $300 billion, which is $3 billion of revenue that your competitor doesn't get. You can do a lot of things for your clientele.

And they've segmented the card, as you know. They've even recently gone to this black card, and — which sells for a thousand dollars. It's got a very special cache.

I would say that — I wouldn't use the word "inevitable," but I would say that nourished properly, that the American Express name has had — excuse me — has huge value and is very, very likely to get stronger and stronger as the years go by.

But I don't — I think that what they went through showed that it could take quite a beating and come back. But I don't want to — I don't think you'd want to test it that way indefinitely.

Incidentally, that's one of the things we look for in businesses, is how — you know, if you see a business take a lot of adversity and still do well, that tells you something about the underlying strength of the business.

The classic case was on that was — to me, is AOL. Four or five years ago — you know, I'm no expert on this, but I got the impression there for a period of time when they were having a lot of problems, that a very significant percentage of AOL's customers were mad at them.

But the number of customers went up every month. And that's a terrific business. I mean, if you have a business where your customers are mad at you and you're growing, you know, that has met a certain test, in my mind, of utility.

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

Coca-Cola had some problems, you know, in Europe. But it comes back stronger than ever. They certainly had problems with New Coke, and they came back stronger than ever.

So you do see that underlying strength. And that's very impressive as a way of evaluating the depth and impenetrability of the moat that we talked about earlier.

Charlie?

CHARLIE MUNGER: Well, I think it would be easier to screw up American Express than it would Coke or Gillette. But it's an immensely strong business, and it's wonderful to have it.

WARREN BUFFETT: We own about 11 percent of American Express. So when there are 300 billion of charges, we're getting 33 billion of those for the account of Berkshire, and it's growing at a pretty good clip. The first quarter, it grew very substantially in both cardholders and charges.

My guess is that our 11 percent becomes more valuable over time. It's hard to think of anything that would destroy it.

CHARLIE MUNGER: The business is very interesting. They made a deal to put American Express cards into Costco. I think that is a very intelligent thing for American Express to have done. And it's a very aggressive place that does a lot of interesting things.

WARREN BUFFETT: Charlie is a director of Costco, so he's a — Costco is an absolutely fabulous organization. We should have owned a lot of Costco over the years and we — I blew it. Charlie was for it, but I blew it.

11. "We don't think in terms of absolutes"

WARREN BUFFETT: OK, we'll go to number 1 again.

AUDIENCE MEMBER: My name is Jin Xi Wan (PH) from San Diego, California.

First, I would thank both of you. My question is also about growth and value.

If you look at the business in this country, most of them, if not all of them, are cyclical to various degrees. Certain businesses are, of course, more cyclical than other businesses.

So when you buy a business or make a investment in a new stock, do you ever cut off — like if a business lose money in a downturn, we are not going to buy.

If its earning begin to decline or downturn, we're not going to buy. But if the earning growth slows down, then we can look at a business and make an investment. So do you have a cutoff, in terms of this cyclical factor?

And also, when you buy a business — in terms of the current P/E ratio, also do you have a cutoff? Let's say, if it's P/E ratio is more than 15, 16, we are not going to buy the business, no matter how much the earning will grow in the future. So basically, it's about the growth and the value.

WARREN BUFFETT: Yeah, we have — to answer your question directly — we have no cutoff, whatsoever.

We don't think in terms of absolutes that way because, again, we are trying to think of how many birds are in the bush. And sometimes the number that are currently being shown could be negative.

One of the best buys we ever made was in 1976 when we bought a significant percentage — what became through repurchases — 50 percent of GEICO at a time when the company was losing a lot of money and was destined to lose a lot of money in the immediate future.

And, you know, the fact they were losing money was not lost on us, but we thought we saw a future there that was significantly different than the current situation.

So it would not bother us in the least to buy into a business that currently was losing money for some reason that we understood, and where we thought that the future was going to be significantly different.

Similarly, if a business is making some money — there's no P/E ratio that we have in mind as being a cutoff point at all. There are businesses — I mean, you could have some business making a sliver of money on which you would pay a very, very high P/E ratio. But it's basically —

We look at all of these as businesses. We're, for example, in — at Executive Jet — NetJets — we're losing money in Europe. Well, we expect to lose money in Europe getting established.

So does that mean it's a bad thing to buy a hundred percent of, if you own the whole company, or three percent of, if Executive Jet was a public company and you were buying into? No. I mean, it —

There are all kinds of decisions that involve the future looking different, in some important way, than the present. Most of our decisions relate to things where we expect the future not to change much.

But you get this — well, American Express was a good example. And when we bought it in 1964, a fellow named Tino DeAngelis had caused them incredible trouble. You know, it was one of those decisions that looked, for a time, as if it could break the company.

So, we knew — if you'd been charging for what Tino had stolen from the company against the income account that year, or the legal costs that were going to be attached to it, you were looking at a significant loss.

But the question was, what was American Express going to look like 10 or 20 years later? And we felt very good about that.

So there are no arbitrary cutoff points. But there is that focus on, how much cash will this business deliver, you know, between now and Kingdom Come? Now as a practical matter, if you estimate it for 20 years or so, the terminal values get less important.

So — but you do want to have, in your mind, a stream of cash that will be thrown off over, say, a 20-year period, that makes sense discounted at a proper interest rate, compared to what you're paying today. And that's what investment's all about.

Charlie?

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

WARREN BUFFETT: And we've had a couple of those in our history that have made us a lot of money. I mean, we don't want to wish anybody ill, but —

CHARLIE MUNGER: Oh, I wouldn't go that far —

WARREN BUFFETT: OK, well Charlie — (Laughter)

I think he's speaking for both of us. (Laughter)

12. Speculate a bit in tech? Not if we don't understand it

WARREN BUFFETT: OK, we'll move on to number 2.

AUDIENCE MEMBER: Mr. Buffett, I would like to start my question by giving you and Charlie 10 lashes with a wet noodle, not because of 1999 and what happened to your net worth or our net worth, but because you have spoiled your shareholders into expecting 25 percent growth every year, since 1965.

And then comes the bad, bad 199[9] and it hits all of us. But by my calculations, you personally, Mr. Buffett, have lost over 10 billion dollar — not million — billion dollars during 1999.

So I don't think we should get too mad at you because probably all of us have, at this point in our life, increased our net worth and made a lot of money. So you don't get a wet noodle today. (Laughter)

WARREN BUFFETT: Hmm.

AUDIENCE MEMBER: And the shareholders have, I'm sure, lost thousands. And some have lost millions of dollars during the year 1999.

Now after reading your biography in November of 1998 — unfortunately I didn't know about you earlier — I started investing on November the 24th of '98. And of course, I'm a poor little investor, so I bought your B stock at 23.08.

Then, because the market dropped, I bought some more on the 4th of December at 22.29. And then I bought, on January the 24th of 2000 at 16.89, so I do believe in dollar-cost averaging and I've been doing that for probably 30 years of my life.

My January investment, I'm happy to say, is up 15 percent, so the worst may be over.

Now, I read your annual report and I want to compliment you that that is the easiest and most entertaining annual report I think created in the whole world. And your — and I hope you continue that kind of a report. (Applause)

WARREN BUFFETT: Thank you.

VOICE: (Inaudible) Your name and —

AUDIENCE MEMBER: Oh!

VOICE: — where you're from

AUDIENCE MEMBER: I'm sorry. I was just told that I should have said who I am. My name is Gaylord Hanson and I'm from Santa Barbara, California — where investor Munger puts his big, multimillion-dollar boat in the water. (Laughter)

WARREN BUFFETT: I'm not going to make any comment on that.

AUDIENCE MEMBER: Please don't. (Laughter)

Now, with technology, computers, electronics, and software transforming our entire world — not just here — the world, I must admit that I personally invested in four technology computer software and aggressive growth mutual funds and made up all of my 1999 losses on Berkshire Hathaway. (Laughter and applause)

Are we asking too much as shareholders of Berkshire Hathaway for you men to put your brains to work and possibly speculate a little bit, maybe 10 percent of our money, into the only play in town, which seems to be technology, electronic?

And I read your report, and I understand a lot of your reasoning that it's difficult — and it is difficult — to project earnings of a lot — people are going to be a little bankrupt. Are they going to out of business?

But isn't there enough left in your brainpower to maybe pick a few and — (laughter) — see what's going on? Because I made over a hundred percent profit in 1999 on my aggressive position in the technology field, so that's —

WARREN BUFFETT: OK, well —

AUDIENCE MEMBER: — my question.

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

But, you know, we'd be delighted — we have a man here who's done very well. And if he has any business cards, you know, you could always invest with him, and — (Laughter)

And we'd welcome — you know — you can — we'll give you a booth in our exhibitor's section. And anybody that wants to do that is perfectly — obviously — free to do it with you or through any other — through anybody else that they select.

Now, you have a whole bunch of people out there that say they can do this. And maybe they can and maybe they can't and maybe you can spot which ones can and can't. The only way we know how to make money is to try and evaluate businesses.

And if we can't evaluate a carbon steel company, we don't buy it. It doesn't mean it isn't a good buy. It doesn't mean it isn't selling for a fraction of its worth. It just means that we don't know how to evaluate it.

If we can't evaluate the sensibilities of putting in a chemical plant or something in Brazil, we don't do it. If somebody else knows how to do it, you know, more power to them.

There are all kinds of people that know how to make money in ways that we don't. But, you know, it's a free world and everybody can invest in those sort of things. But they would be making a mistake, a big mistake, to do it through us.

I mean, why pick a couple of guys like Charlie and me to do something like that with — when you can pick all kinds of other people that say they know how to do it.

I would say this. Incidentally, you mentioned a point earlier, which is how the popular press tends to think of things. But we don't consider ourselves — Charlie and I don't — richer or poorer based on what the stock does. We do feel richer or poorer based on what the business does.

So we look at the business as to how much we're worth. And we do not look at the stock price, because the stock price doesn't mean a thing to us. I mean, it doesn't for a variety of reasons, but beyond that, imagine trying to sell hundreds of thousands of shares at the stock price.

We can always sell the business — we're not going to do it — but we could always sell it for what the business is worth. We can't sell our stock for what the — necessarily — what the stock price is. So we look at the business, entirely, in terms of evaluating our net worth.

We figure our net worth went up very, very, slightly — very slightly — in 1999. And we would figure that no matter what the stock was selling for — it just doesn't make any difference — because we do look at the businesses.

We really look at it as if there wasn't any quote on the stock. Because we don't know what the stock is going to do.

If we do — if the business gets worth more at a reasonable rate, the stock will follow, over time. But it won't necessarily follow week by week, or month by month, or year by year.

We had a lousy year in 1999, but the stock price did not calibrate with that in any perfect, or close to perfect, manner.

And we've had good years other times, when the stock price is way overpriced or over-described what happened during the year.

So we really measure all the time by the business. We think of it as a private business, basically, for which there's a quotation. And if it's handy to use that quotation, either in buying more stock or something of the sort, we may do it. But it does not govern our ideas of value.

Charlie?

CHARLIE MUNGER: Yeah. Generally, I would say that if you have a lot of lovely wealth in a form that makes you comfortable, and somebody down the street has found a way to make money a lot faster, in a way you don't understand, you should not be made miserable by that process.

There are worse things in life than being left behind in possession of a lot of lovely money. I mean — (Laughter)

WARREN BUFFETT: Would you want to name a couple? (Laughter)

No, Charlie made — I mean, when farmland was — went from — farmland probably tripled here in the late '70s, without any real change in yields per acre or the price of the commodity.

You know, are we going to sit around and stew because, you know, they — we didn't buy farmland at the start?

You know, are we going to stew because all kinds of stuff — uranium stocks in the '50s — or you can go back — all kinds of things that have — the conglomerates in the late '60s, the leasing companies, I mean, you can just go down the line.

And it just doesn't make any — we're not in that game.

We would know how to create a chain letter, believe me. I mean, we've seen it down some many times. You know, we know the game. But it just isn't our game.

Charlie? (Applause)

13. Currencies are "important but not knowable"

WARREN BUFFETT: Number 3?

AUDIENCE MEMBER: Good morning Mr. Buffett, Mr. Munger. My name is Stacey Braverman (PH). I'm 15 years old, and I'm from South Setauket, New York. It was very nice meeting you Mr. Buffett, yesterday.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: I especially appreciated your internet stock tips. (Laughter)

WARREN BUFFETT: (Laughs) Yeah, keep it — keep it to yourself now, Stacey. That's our deal. (Laughs)

AUDIENCE MEMBER: I bought the B shares two years ago, when I decided that I needed to save some money for college. When the share price dipped below 1,500 I decided to investigate correspondence courses. (Laughter)

WARREN BUFFETT: Maybe you can get a scholarship. (Laughs)

AUDIENCE MEMBER: So I'm glad to see that things are back on track now.

My question is, a lot of the companies that you invest in, like Coca-Cola and Gillette, seem to do better when the dollar is weak and interest rates are falling. That seems to be the opposite of what's happening now.

So how is Berkshire positioning itself to take advantage of the current economic position, with that assessment in mind?

WARREN BUFFETT: Yeah, well, that's a good question. But if we thought we knew what the dollar was going to do, or interest rates were going to do, we would — we won't do it — but we would just engage in transactions involving those commodities, in effect, or futures directly.

In other words, it would not be — if we thought that the dollar was going to weaken dramatically — and we won't get those kind of thoughts — but if we did, you know, we would buy other currencies.

And it would be — it might benefit Coke, in dollar terms, if that happened.

But it would be so much more efficient, directly, to pursue a currency play or an interest rate play than an indirect way through companies that have big international exposure. We would probably do it directly.

We don't really think much about that. Because — just take currency. If you look at what the yen has traded at, you know over the last — well, since World War II, you know. From — what was it? Three-sixty down to — what? Seventy-some, Charlie? At lowest?

CHARLIE MUNGER: Uh-huh.

WARREN BUFFETT: And, you know, back up to 140-some. And now, I don't know, 105, or wherever it may be. I mean, those moves are huge.

But, in the end, we're really more interested in whether more people in Japan are going to drink Coca-Cola. And, over time, we're better at predicting that than we are at predicting what the yen will do.

And if Coca-Cola satisfies people's needs — liquid needs — for more and more people, we will probably get a reasonable percentage of their purchasing power of those people around the world for their right to drink Coca-Cola, or for shaving, or whatever it may be.

So, if the world's standard of living improves, bit by bit over time, in an irregular fashion, and we supply something the world wants, we will get our share in dollars, eventually.

And what it — quarter-to-quarter or year-to-year — how that moves around, because of currency moves, really doesn't make any difference to us.

It makes a difference to reported earnings in that quarter or — but in terms of where Coca-Cola's going to be 10 or 20 years from now, it would be a big mistake, I think, to focus on currency moves as opposed to focusing on the product itself.

And Japan offers a good example of that because you had this — I mean, you really had a move from 360, or whatever it was, to the high 70s or thereabouts. I mean, that is an incredible move in currency, and it can overshadow in the short run, even, what's happening in the business.

But long-range, what's really made Coca-Cola strong in Japan is the fact that the Japanese people have accepted their products in a big way. And Coca-Cola's built this tremendous, for example, vending machine presence.

And the Japanese market is very different than all the rest of the markets in the world, virtually, in that such a high percentage flows through vending machines.

And my memory is that, you know, we may have something like 900-and-some thousand, out of something over 2 million, vending machines in the country.

So we've got this tremendously dominant position. It's a little like billboards might be in this country. Plus, we have this terrific product, Georgia Coffee, which is huge over there.

And that's the sort of thing we focus on, because that's something we understand.

We don't understand what currencies are going to do week-to-week or month-to-month or year-to-year. And we always try to figure on what — focus on what's knowable and what's important.

Now, currency might be important, but we don't think it's knowable. Other things are unimportant, but knowable. But what really counts is what's knowable and important.

And what's knowable and important about Coca-Cola is the fact that more and more people are going to consume soft drinks around the world, and have been doing so year after year after year, and that Coca-Cola's going to gain share, and that the product is extraordinarily inexpensive relative to the pleasure it brings to people.

Coca-Cola — in the '30s, when I was kid, I bought, you know, for — six for a quarter and sold them for a nickel each. That was a 6 1/2 ounce bottle for a nickel, at Coke.

And you can buy a 12-ounce can now at — pick a supermarket sale — for not much more than twice per ounce what it was selling for in the '30s. You won't find many products where that kind of value proposition has developed over the years.

So that's the kind of thing we focus on. And interest rates and foreign exchange rates, important as they may be in the short term, really are not going to determine whether we get rich over time.

The best time to buy stocks, actually was, in recent years, you know, has been when interest rates were sky high and it looked like a very safe thing to do to put your money into Treasury bills at — well, actually the primary got up to 21 1/2 percent — but you could put out money at huge rates in the early '80s.

And, as attractive as that appeared, it was exactly the wrong thing to be doing. It was better to be buying equities at that time, because when interest rates changed, their values changed even much more.

Charlie?

CHARLIE MUNGER: Yeah, we have a willful agnosticism on all kinds of things. And that makes us concentrate on certain other things. This is a very good way to think, if you're as lazy as we are. (Laughter)

14. We'll "probably" own M&T Bank stock 10 years from now

WARREN BUFFETT: We'll go to 4, please.

AUDIENCE MEMBER: Jerry Zucker, Los Angeles, California. Good morning, boss. (Laughter)

Calling your attention to the annual report and major investments, I'd appreciate your comments on two companies.

Number one, M&T Bank, a new name to that list, but not exactly a household name, at least on the West Coast.

And company number two, definitely a household name, but missing from the list this year, the Walt Disney Corporation.

WARREN BUFFETT: Well, we don't comment much on our holdings, particularly as to purchases or sales, but we do have the CEO — longtime CEO — of M&T here today, Bob Wilmers. Bob, would you stand up? He should be up here somewhere. There he is. (Applause)

Bob is a terrific businessman, a terrific banker, and a terrific citizen. I've known him a long time. A good friend of Stan Lipsey, our publisher in Buffalo. Bob runs the kind of a bank that allows Charlie and me to sleep very comfortably.

Someone once said there are more banks than bankers, which is something worth thinking about a little bit. But believe me, Bob is a banker and he's done a lot for Buffalo.

And he runs — he's got a — he has a very big ownership position, which he achieved, at least in very large part, through purchase with his own money, as opposed to having options.

He's got one of the largest ownership positions, probably, among the hundred largest banks in the United States.

And it's just a very attractive business for us to be in, and we're very comfortable with it. And 10 years from now, Bob will be here, and I hope I'm here. We will — we'll probably own M&T.

The Disney Company, our ownership in that fell below the threshold level which we used, although we had ownership. And we think Disney is a terrific business. Michael Eisner's done a great job there.

We have — as we put in the annual report — we have mildly reduced equities as prices began to — generally — began to get more and more full.

We do not think the general ownership of equities is going to be very exciting over the next 10 or 15 years, so we would like to buy businesses.

We bought a few last year. We had this one we announced last week in the insurance field. We got another small acquisition where we've got an agreement with somebody. It's very small.

But we would love it if those were 10 times that size or 20 times that size, because — you will see more of that, relative to marketable securities, as we go along.

Charlie?

CHARLIE MUNGER: Yeah, regarding equities generally, I think that Fortune article, which was sent out to the Berkshire shareholders this year, should be absolutely must-reading for everybody. In fact, it would be a good thing to read two or three times.

The ideas there sound so simple, that — you know, people have the theory that they must understand it. But I think the world is more complicated than that. I think we are in for reduced expectations eventually, with respect to the kind of returns people have had from investing in stocks.

WARREN BUFFETT: You want to offer any thoughts as to what — that might — what the corollary might be?

CHARLIE MUNGER: Well, I think if you have very unreasonable expectations of life, it makes life much more miserable. Much better to get your expectations within reason.

It's much easier to reduce expectations to some reasonable level than it is to get superhuman achievements.

WARREN BUFFETT: That's why my kids were almost delirious when they heard that announcement I was going to give them $300 each and they — (Laughter)

How to be — do you want to be a zillionaire, or whatever it was.

Incidentally, that was terrific of Regis Philbin to do something like that. I mean, all of those appearances [in the video shown to shareholders] are nonpaid, I can assure you. (Laughter)

And those people are good — very, very, good sports. And I thank them.

15. We'll "never have a conventional dividend policy"

WARREN BUFFETT: OK, we'll go to zone 5.

AUDIENCE MEMBER: My name is Monty Leffoltz (PH) from Omaha, Nebraska.

I have a two-part question. What is Berkshire's philosophy on paying dividends and under what circumstances would Berkshire pay a dividend in the future?

WARREN BUFFETT: Well, that's a good question. We paid a dividend in — what, 1969, Charlie? At 10 cents a share. The — I can't remember it, but it's in the records.

We would pay — we would be very likely to pay either very large dividends or none at all, because our test is whether we think we can use money at a rate — in a way — that it creates more than a dollar of market value for every dollar we retain.

Obviously, if we can keep a dollar and it becomes, on a present-value basis, worth more than a dollar, it's foolish to pay it out.

Forget all about taxes. Assume it's a tax-free society. We would have exactly the same dividend policy up to this point, whether there was any tax on dividends, capital gains, or anything else, or whether we were entirely tax-free.

Because we have retained money because, to date, we have felt that if we keep a dollar and use it in buying other businesses, or whatever it may be, that it becomes worth more than a dollar on a present-value basis — I mean, not that it's going to be worth a dollar-ten four years from now — but that it's worth more than a dollar when we look at what it'll be four years from now.

That's subjective, but any given decision like that is subjective. Over time, you get an objective test as whether that's met by — whether we do indeed create more value than — each dollar retained earnings, we create an extra dollar-plus of value.

If that changed — and it could change — then we would give the money to the shareholders. And it might be done through repurchases or it might be done through dividends, but we would — there's no reason to keep a dollar in the business that's worth 90 cents if you keep it in the business.

And there are companies that do that, but they don't — they're not necessarily intentionally doing it. They may have higher aspirations as they go along, but they're not realized.

We, I think, would be fairly objective about trying to figure out whether we are indeed creating value or destroying value by retaining earnings.

We would never have a conventional dividend policy. I mean, the idea of paying out 20 percent of your earnings, or 10 percent, or 30 percent of earnings in dividends strikes us as nuts. I mean, you may get yourself in a position where you have to do it because you build these expectations in people's minds, but it is — there is no logic to it whatsoever.

The logic is basic. If you create more than a dollar value for a dollar retained, why in the world would you pay it out, because the people who want to get that dollar as a dividend can instead get a dollar-ten by selling the stock for — or whatever it may be — a dollar-twenty— for the value that was maintained — or retained.

So, that — it's a very simple dividend philosophy, and one, I think, that's in one of the past annual reports. We explain the logic of it. And I see no — nothing that would change, in terms of the principles of it.

Evaluating whether that's the case — I mean, obviously we aren't going to make a decision every week based on whether we can employ money that week at a higher rate of return, or every month.

But in terms of a reasonable expectancy over a couple-year period, whether we think we can use retained earnings advantageously, that's our yardstick.

Charlie?

CHARLIE MUNGER: Yeah, what's interesting about what Warren is saying about logical dividend policy is that if you went to all the leading business schools of the United States, all the leading economics departments, all the professors of corporate finance — this wasn't — wouldn't be the way they teach the subject.

In other words, we're basically saying we're right and all the rest of academia is wrong. (Laughter)

WARREN BUFFETT: We love it when we do that. (Laughter)

16. We never sell a business and rarely sell a stock

WARREN BUFFETT: OK, we'll go to 6.

AUDIENCE MEMBER: I'm Mark Chere (PH) from Hong Kong.

And Mr. Buffett, I'd like to ask you a couple of questions. The first one is how many insurance companies does Berkshire Hathaway own?

WARREN BUFFETT: Let me —

AUDIENCE MEMBER: I can't figure out the total.

WARREN BUFFETT: Let me answer that and then you go on to your second one.

We have a great number of companies because, in many cases, a given strategy or a given operation operates through multiple companies.

The company we announced the purchase of the other day is really one business, but it has three companies.

I wouldn't be surprised — I've never looked at the number — but it wouldn't surprise me if we have 20 insurance companies or something. Maybe 25 or 30, who knows?

We have about nine or 10 basic insurance operations for which a given management has responsibility, but there's a lot of state laws applicable to insurance companies and different regulations.

It's often advantageous to have a number of companies operating under one management to achieve one operational goal.

The big operations are General Re, and GEICO, and the National Indemnity reinsurance operation run by Ajit [Jain].

And then we have a group of about five different operations that are all very decent businesses, but are not as big as the three I mentioned. Go ahead.

AUDIENCE MEMBER: Thank you. Yeah, my main question is this. Much has been written by you, and a lot more by other people, about your criteria, or the criteria you use when you make a purchase of a company, either in full or in part.

But almost nothing has been written by you, at any rate as far as I can tell, on your criteria for selling a company that you have already — you have previously purchased.

And I wonder if you could outline the criteria you might apply today to a sale of a company, and whether you would go — well, the simplest way to put it is this: Would you agree with Philip Fisher, who said there were two reasons to sell a company — or a stock?

One was when you'd discovered you've made a mistake in your analysis and the company was not what you thought it was.

And the second when — was when the — something within the company had changed, the management had changed or so on, so it no longer met your original criteria.

Would you — are those the principles that you apply or would you say there are different ones or others? Thank you.

WARREN BUFFETT: I'm glad you brought up Phil Fisher, because he is a terrific mind and investor. He's probably in his 90s now, and — but his —

A couple of books he wrote in the early '60s are classics and I advise everybody here who's really interested in investments to read those two books from the earlier '60s.

And he's a nice man. I went out to — 40 years ago, I dropped into his office in San Francisco, a tiny office. And he was kind enough to spend some time with me. And I'm a huge admirer of his.

The criteria that we use for selling a business that we own control of are articulated in the annual report, under the ground rules.

So in terms of businesses that we own, we have set forth — and I direct you there — we've written those same ground rules every year since 1983. And actually, we had those in our head for decades before that.

And we have this quirk, which you should understand, and we want our shareholders to understand it, that even though we got offered a price that was far above its economic value, as we might calculate it going in — but if we got offered a price for that for a business that we have now, we have no interest in selling it.

You know, we just — we don't break off the relationships that we develop simply because we get offered a fancy price for something. And we've had a chance to do that sometimes.

That may help us, actually, in acquiring businesses, because both of the companies that I've committed to buy in the last few weeks, both of them are very concerned about whether they have found a permanent home or not.

And people who build their businesses lovingly over 30, or 40, or 50 years, frequently care about that. A lot of people don't care about that.

And that's one of the things we evaluate when buying a business. We look at the owner, and we say, "Do you love the — " in effect, we ask ourselves, "Does he love the business or does he love the money?"

Nothing wrong with liking the money. In fact, we'd be a little disappointed if most of them didn't like the money. But in terms of whether the primacy is loving the money or loving the business, that's very important to us.

And when we find somebody that loves their business — and likes the money — but loves their business, we are a very, very desirable home for them, because we're just about the only people that they can deal with, of size, where we can commit that they are going to be part of this operation, really, forever, and be able to deliver on that promise.

I tell sellers that the only person that can double-cross them is me. I can double-cross them. But there's never going to be a takeover of Berkshire. There's never going to be a management consultant come in and say, "I think you'd better do this."

There's never going to be a response to Wall Street saying, "Why aren't you a pure play on this or that and therefore you ought to spin this off the—?" None of that's going to happen.

And we can tell them, with a hundred percent assuredness, that for a very long time — that if they make a decision to come with Berkshire, they — that decision will be the final decision as to where their company resides.

So, unless those couple conditions, which are extremely unusual, that are described in the ground rules prevail, we will not be selling operating businesses, even though someone might offer us far more than, logically, they're worth.

The question about stocks is, we're not quite with Phil Fisher on that, but we're very close. We love buying stocks where we think the businesses are so solid, have such economic advantage, that we can essentially ride with them forever.

But you've heard me talk about newspapers earlier today. We would have thought newspapers — 20, 25 years ago, I think Charlie and I probably thought a daily newspaper, you know, in a single newspaper town — which practically all are — is probably about the solidest investment you could find.

We might have thought a network TV-affiliated station was about as solid as you could find. And they were very solid.

But events have, over the last 20 or 25 years, have certainly changed that to some degree and maybe to a very, very big degree.

So we will occasionally reevaluate the economic characteristics that we see 10 years out from the ones that we saw 10 years ago and maybe come to a somewhat different conclusion.

The first 20 years of investing for me — or maybe more — my decision to sell almost always was based on the fact that I found something else I was dying to buy.

I mean, I sold stocks at — you know, at three times earnings to buy stocks at two times earnings 45 years ago, because I was always running out of money. Now, I run out of ideas. I've got a lot of money but no ideas, and —. (Laughter)

You know, I'd — I'm not sure which is better. What do you think, Charlie? (Laughter)

CHARLIE MUNGER: I think you were way better off when you had 50 years ahead of you — (laughter) — and less money.

WARREN BUFFETT: I still think I have 50 years ahead of me, Charlie. (Laughter)

You want to elaborate any more on selling?

CHARLIE MUNGER: Yeah. We almost never sell an operating business. And when it does happen, it's usually because we've got some trouble we can't fix.

17. Compensation based on stock price is a "lottery ticket"

WARREN BUFFETT: OK, number 7.

AUDIENCE MEMBER: Hello, I'm Martin Wiegand from Chevy Chase, Maryland.

And, though you've given yourself a D in capital allocation, on behalf of the shareholders, we would like to give you an A-plus in honesty and accounting, temperament for a long-term investing view, and hosting an annual meeting.

WARREN BUFFETT: Thanks. (Applause)

I went to school with Martin's father. Good to see you here.

AUDIENCE MEMBER: Thank you. Now my question. Do General Re's competitors pay their employees with a rational incentive plan aimed at growing float and reducing its cost, or do they use something similar to General Re's old plan, and is this a new, sustainable, competitive advantage for General Re?

WARREN BUFFETT: Well, I think a rational compensation plan — and I think we have rational compensation plans — we certainly aim at that, and we don't care what convention is.

Over time, we'll select for people who are rational themselves, who have confidence in their abilities to deliver under a rational plan, and who really appreciate operating in that kind of an environment.

Now, who wouldn't want a lottery ticket, you know? I mean, if anybody here wants to buy a few lottery tickets at the lunch break and come up and present them to me, I'll be glad to take them.

I don't think it will have anything to do with, you know, my performance at Berkshire Hathaway or anything in the future.

And so, we try to make plans that are very rational. And incidentally, we've never had any real problems at all in working with managements to do just that.

The two operations that I've just recently agreed to buy, we will have rational compensation plans at those places. And they'll be somewhat different, perhaps, than the ones they've had in the past, although not much different, as I think about it.

I think it’s been a huge advantage at GEICO to have a plan that is far more rational than the one that preceded it. And I think that advantage will do nothing but grow stronger over time because, in effect, compensation is our way of speaking to employees, generally.

And with a place as large as GEICO, you can’t speak to them all directly. But it speaks to them all the time. It says what we think the rational measurement of productivity and performance in the business is.

And over time, that gets absorbed by thousands and thousands of people. And it’s the best way to get them to buy into their goals.

Whereas, if you use as your test what the stock market is going to do, people, I think, inherently know they got a lottery ticket. I mean, you’ve seen that in a lot of tech stocks in the last three or four months.

You will find all kinds of options being repriced, or issued in great abundance at lower prices without repricing them because they don’t want to have the accounting consequences. Those people know they’re getting lottery tickets, basically.

And, you know, the market’s attitude toward tech stocks is what’s going to determine results far more than their own individual results.

So, it’s silly to think of somebody working very hard at some very small job at Berkshire, with our aggregate market value of 90 billion, thinking that their efforts are going to move the stock.

But their efforts may very well move the number of policy holders we gain or the satisfaction of policy holders. And if we can find ways to pay them based on that, we are far more in sync with what they can do. And they know it makes more sense.

So, I hope our competitors do all kinds of crazy things on comp and everything else. I mean, the more dumb things they do, the better life is for us. And I think that —

Well, we’ve had incredible success at keeping managers. I don’t think there’s probably any company in the United States of size that has had better luck on that than Berkshire.

And partly, it’s because we appreciate, in terms of the comp plan, and partly because we just appreciate, generally, managers that do a terrific job for us. And we’ve got the best group in the world.

Charlie?

CHARLIE MUNGER: Yeah, here again, we’re very much out of step with the conventions of the world.

When I read annual reports, and I read a lot of them, I'm very frequently irritated by the presence of things that are totally absent from the Berkshire Hathaway annual report.

I think promising people free medical care forever, between age 60 and the grave, and maybe for a younger spouse after the grave, but the first one, regardless of what's invented and regardless of what it cost, I don't see how anybody who cared about the shareholders would be making promises like that.

There's a lot of insanity in conventional corporate conduct on the pay front. And — but if convention determined what was sane and what was insane, we're the oddballs. I mean, we're the unusual example.

WARREN BUFFETT: I think per — and I think it's very subconscious, but I think, sometimes, that the desires of the top person to get an outrageous amount gets pyramided through the organization.

Because if they're going to have some scheme that rewards them based on a lottery ticket, they feel they have to give lottery tickets to everybody else, although on a much-reduced scale.

And they really do. I mean, it's just — it becomes accepted in the course. And then you hire consultants who come around and say, "Well, you're getting more lottery tickets at someplace else. And we've got some added new schemes." It becomes very, very reinforcing.

But what has happened at the top level is really unbelievable. I mean, it — if an executive said to his company, "I want an option on 300 — just for working here — I want an option on $300 million worth of S&P futures for the next 10 years," you know, people would regard that as outrageous. They'd say, "What have you got to do with that?"

But in effect, if they get one on their own stock and it goes up based on the fact the S&P appreciates over 10 years, they think that that's perfectly acceptable to have that kind of a ride.

So I would say that, you know, there's been a lot of talk about the huge gap between, you know — that exists in pay. But it seems to me that the primary gap that is eating at American CEOs is the gap between the rich and the super-rich. That seems to be motivating the adoption of many plans.

It's really — it's gotten out of hand, but it isn't going to change. The CEO has his hand on the switch as a practical matter. I know people, and I've been on them myself, but on comp committees. And as a practical matter, you don't stand a chance.

CHARLIE MUNGER: Yeah, a lot of the corporate compensation plans of the modern era worked just about the way things would work for a farmer or if you put a rat colony in the grainery. It — (Laughter)

WARREN BUFFETT: Put him down as undecided. (Laughter)

Good to see you, Martin.

18. We ignore book value for our stock investments

WARREN BUFFETT: OK, let's go to 8.

AUDIENCE MEMBER: Good morning Mr. Buffett and Mr. Munger. My name is Ram Tarecard (PH) from Sugar Land, Texas.

I've been a Berkshire shareholder since 1987 and always battling with the idea of what really is the intrinsic value for the company.

We have seen that, over time, a change in book value is a big indicator of the change in intrinsic value of Berkshire. Although in absolute terms, you have said again and again, that intrinsic value far exceeds book value.

In calculating the book value of Berkshire, our partly-owned businesses, like Coke and Gillette, are valued at their market value. This component of book value fluctuates, often irrationally, depending on the mood of the market.

Do you think that using a look-through book value, just like you used look-through earnings, is a superior measure for tracking changes in intrinsic value?

In fact, I had written a letter to you last August and I was very pleased to get a response from you personally saying that this approach makes sense.

My question is, does this approach really give you a better measure for tracking intrinsic value? And if so, would you consider publishing it in the annual report? Thank you.

WARREN BUFFETT: Yeah, thanks for the question. I would say that — I'm not sure how you phrased it when you wrote me and how I phrased it going back, but look-through book value would not mean much, actually.

The very best businesses, the really wonderful businesses, require no book value. They — and we are — we want to buy businesses, really, that will deliver more and more cash and not need to retain cash, which is what builds up book value over time.

Admittedly, the prices of marketable securities, at any given time, are not a great indication of their intrinsic value. They are far better, though, than the book value of those companies in indicating intrinsic value.

Berkshire's book — Berkshire's intrinsic value, in a very general way, and trends in it, are better reflected in book value than is the case at a very high percentage of companies. It's still a very — it's not a great proxy.

It's the best — it's a proxy that is useful in terms of direction, in terms of degree, in a general way over time. But it's not a substitute for intrinsic value.

It — in our case, when we started with Berkshire, intrinsic value was below book value. Our company was not worth book value in early 1965. You could not have sold the assets for that price that they were carried on the books, you could not have — no one could make a calculation, in terms of future cash flows that would indicate that those assets were worth their carrying value.

Now it is true that our businesses are worth a great deal more than book value. And that's occurred gradually over time. So obviously, there are a number of years when our intrinsic value grew greater than our book value to get where we are today.

Book value is not a bad starting point in the case of Berkshire. It's far from the finishing point. It's no starting point at all of any kind in — you know, whether it's The Washington Post or Coca-Cola or Gillette.

It's a factor we ignore. We do look at what a company is able to earn on invested assets and what it can earn on incremental invested assets. But the book value, we do not give a thought to.

Charlie?

CHARLIE MUNGER: Well, I think that's obviously correct. (Laughter)

WARREN BUFFETT: Oh. He'll come back next year.

19. Markets: "Wild things create their own truth for a while"

WARREN BUFFETT: Number 1. (Laughter)

AUDIENCE MEMBER: Hello, gentleman. My name's Dan Sheehan. I'm from Toronto, Canada.

First of all, I'd like to thank you for this weekend. It's become more and more important to me as it's become more and more difficult to find a rational discussion about the stock market. And this weekend really is a breath of fresh air for most of us, I think.

One of the places I refer to a lot is Benjamin Graham. And what worries me now is what he referred to — is a period in 1929, in the early '30s — as a lab experiment that — where normal intrinsic values and margins of safety broke down, or seemed to, anyway.

And I wonder how much you think that might happen now or in the next few years, and how much you worry about that with the investments you're making.

WARREN BUFFETT: Well, we generally believe you can just see anything in markets. I mean, just extraordinary what happens in markets over time. It gets sorted out, you know, eventually.

But, I mean, we have seen companies sell for tens of billion dollars that are worthless. And at times, we have seen things sell for 20 percent — a number of things, not hard to find, perfectly decent running them — sell for literally 20 percent or 25 percent of what they were worth.

So we have seen and will continue to see everything. It's just the nature of markets. They produce wild, wild things over time.

And the trick is, occasionally, to take advantage of one of those wild things and not to get carried away when other wild things happen.

Because the wild things create their own truth for a while and you have to — you know, you — that's the reason they're happening, and people are getting pleasant experiences and all that. You'll see everything if you're around markets for a reasonable period of time.

We don't see any great cases of dramatic undervaluation by this market. So it isn't like we're seeing — because there's this — perhaps this speculative mania in a particular area of the market, we do not see that creating incredible undervaluation other places.

What's happening there may lead to undervaluation, you know, a few years from now. Or it may not, I don't know that, but we're —

It isn't like you can find things that are worth double or thereabouts what you're paying because, frankly, there's so much money sloshing around that if you found such a thing, it would be very likely corrected by some buyout types.

I mean, we would love to find businesses that are selling for half of what they're intrinsically worth. We don't find that. We do find a lot of cases where we think the evaluations on the high side are just — are unbelievable.

We have been in periods in the past where we felt almost everything was being given away, too. So you'll get those extremes. Most of the time the market's in a position where there's a little of both, but every now and then, it gets into a position where there's a lot of one or the other.

And we would — you know, we would love it if we could find a lot of reasonable-sized companies that were selling at what we thought were half of the intrinsic value. We're not finding them.

Charlie?

CHARLIE MUNGER: Well, I do think that the present time is a very unusual period. It's hard to think of a time when residential real estate, and common stocks, and so on, rose so rapidly in price and there was so much easy money floating around. I mean, this is a very unusual period.

WARREN BUFFETT: What's fascinating — and I'm sure you've thought of it — is that you can now have a business — we saw a few of them, you know, earlier this year we'll say — that might've been selling for $10 billion where the business itself could not have borrowed, probably, a hundred million dollars in debt, with an equity evaluation of 10 billion.

But the business itself would not — as a private business — would not have been able to borrow a hundred million. But the owners of that business, because it's public, can borrow many billions of dollars on their little pieces of paper, because they have this market valuation.

If it's a private business, the company itself couldn't borrow one-twentieth or so of what individuals could borrow.

That's happened, to a degree, before. But this has probably been as extreme as anything that's happened, probably, including the '20s. That doesn't mean there's a parallel to it, but it's been pretty extreme.

Charlie?

CHARLIE MUNGER: I think it probably is the most extreme that has happened in modern capitalism. In my lifetime, I would say the '30s were the — it created the worst recession in the English-speaking world in 600 years.

And it was very extreme. You could buy a "all-you-can-eat" in Omaha through the '30s for a quarter from Henderson's Cafeteria.

And now we're seeing the other face of what capitalism can do. And this is almost as extreme as the '30s were, but in a different direction.

It's zero unemployment, rampant speculation, et cetera, et cetera. It's an amazing period.

WARREN BUFFETT: That does not make it easy to predict, however, the outcome.

It says to us, though, certain things we want to stay away from. I mean, basically that's — it's precautionary to us. It does not spell opportunity.

Although, there's no question that the — in the last year, the ability to monetize shareholder ignorance has never been exceeded, I think. Wouldn't you say so, Charlie? (Laughter)

20. “It’s so easy to copy in the internet”

WARREN BUFFETT: OK, number 2.

AUDIENCE MEMBER: Good morning, gentleman. David Winters, Mountain Lakes, New Jersey.

Thanks again for Berkshire Fest 2000 and having it on Saturday, for those of us who tap dance to work on Monday. (Buffett laughs)

You know, over the previous 30 years or so, Berkshire has been a tactical participant in the insurance business. With the acquisition of Gen Re and the broadening of GEICO’s scope, the company’s been transformed into a mainstream activity.

How will this transformation result in growth and low cost float over time? I.e., how do you avoid becoming average?

And to follow on with the very perceptive 10-year-old from California’s question, will Berkshire’s newspaper interest be able to make the successful transformation to the new electronic world, especially the unique content of the Washington Post? Thank you.

WARREN BUFFETT: Those are both good questions. I think, to answer your second one, I think the Buffalo News will do just as well as, if you take the top 50 papers in the country, in making a transition. How well the top 50 will do is really an open question.

And — but there is — you know, the industry factors will, in my view, just overwhelm any specific strategy. Because any strategy is —

It’s so easy to copy in the internet. That’s one of the problems of the internet. It’s one of the problems of capitalism.

I mean, if you open a restaurant that’s successful, somebody’s going to come in and figure out what your menu is and how — you know, the whole thing. And then they’re going to try to do it in a little bit better location, or at a lower price, or whatever. That’s what capitalism’s all about and it’s terrific for consumers.

The internet accentuates that process. I mean, it gives everybody in the world real estate. You know, there are no prime locations to speak of. I mean, I can give you the argument for how you develop one and all of that, but it really changes the world in a big way.

You know, if you were at 16th and Farnam in Omaha in the ’20s, with Woolworth — that’s the place where the streetcar tracks crossed, you know, and a whole bunch of them were going north/south there and east/west — and there wasn’t any better real estate in town.

I'm not sure if that's worth as much now in nominal dollars as it was in the 1920s. But — and that looked permanent, incidentally. Who was going to rip up the streetcar tracks or — in 1910 or whenever it was?

So now, you rip up the tracks every day. You know, and so the fluidity is incredible, in terms of moving economic resources around compared to what it was.

The newspaper industry is going to try and figure out how to be a very important information source in a new medium. And it may solve that problem, to a degree, and still have lousy economics. That's — you know, that's — unfortunately, the newspaper industry's always —

Historically, the way the industry structure worked, once you got into the majority of households and everything, somebody else could bring out a way better paper, but it wasn't going to go any place against you.

I mean, you had such structural advantages that you could, you know — you could put your idiot nephew in and he would do fine — wonderfully — you know. And nothing could happen to him except when this different medium came along.

Now you can put in a genius and whether that will make any difference is an open question. I would say that it's quite doubtful. If you own a newspaper, you want to do everything that you can think of and, fortunately, everything anybody else can think of, because you can copy them so fast.

And it may work in terms of product and it may not work in terms of product. And it may work in terms of product and still not work in terms of economics very well. And I don't know the answer to that question.

I know that we will play it out — at the Buffalo News, for example — as strongly as we can. I don't think other people are going to get way better results than we are. I don't know what the other people are — what their results are going to be and how it will work.

It would be crazy to sit on the sidelines and simply ignore what's going on. So we will do our darnedest to have good economics when this is all through. But nobody knows how it's going to play out, in my view.

21. "Average is going be terrible in insurance"

WARREN BUFFETT: The question about insurance, about whether we become average — average is not going to be good insurance. Average is going be terrible in insurance over time. It's not —

It’s a commodity businesss, in many respects. And if you are average, you’re going to have a very poor business. You may limp along because you got a lot of capital that’s supporting the lousy business, but it’s not — it won’t be a good business, per se.

But I think in GEICO, and in General Re, and some — and our other operations as well — we do not have average businesses, and there is nothing about the way the industry is going that would force us or lead us to have average operations.

I mean, we have special things we bring to the party in both cases I’ve named, and actually, in other cases as well. We have things we bring to the party that should make us considerably better than average.

It’ll show more in some periods than others, and it’ll be different in the way it is applied at GEICO or at General Re or at National Indemnity’s reinsurance operation. But none of those, in my view, will be average.

But average — and there will be a lot of average, by definition — average is not going to be good.

The other problem about it is average is not going to go away, either. So that is an anchoring effect, to some extent, on what even the skillful operator can achieve. I think insurance will be a very good business for us over time.

Charlie?

CHARLIE MUNGER: Yeah. Every once in a while, we have a business sort of die under us. Trading stamps is now off 99 3/4 percent from its peak volume, and we were able to do nothing to prevent that except wring all the money out and multiply it by about 100. (Laughter)

WARREN BUFFETT: We actually did about, what, 120 million, in the late ’60s, per year in trading stamps, far more dominant in our area than S&H was nationally.

And we have — by skillful management, Charlie and my constant attention to detail — have taken that business from 120 million a year down to, what, about 300,000 a year or so?

CHARLIE MUNGER: Oh, way less than that. (Laughter)

WARREN BUFFETT: We thought of having the sales chart here and turning it upside down to impress you, but it wouldn’t have worked very well.

CHARLIE MUNGER: I think it’s the nature of things that some businesses die. It’s also in the nature of things that, in some cases, you shouldn’t fight it. There is no logical answer, in some cases, except to wring the money out and go elsewhere.

WARREN BUFFETT: Yeah, and that's very tough for managements, too. In fact, they almost never face up to that. It's very, very rare.

And it's logical that it'd be rare. In a private business, you can understand why people face up to it. In a public company, if you take the equation of the manager, he or she may be far better off ignoring that reality than accepting it.

22. Competitive advantage is more important than short-term profits

WARREN BUFFETT: Let's go to number 3.

AUDIENCE MEMBER: Good morning, gentleman. My name's Marc Rabinov from Melbourne, Australia.

You've emphasized the importance of the moat around a business, or the sustainable competitive advantage. My question really relates to learning more about that.

Professor Michael Porter at Harvard has made a detailed study of this. Did you find his work useful and can you recommend any other sources of information on this?

WARREN BUFFETT: Yeah, I've never really read Porter, although I've read enough about him to know that we think alike, in a general way. So I can't refer you to specific books or anything. But my guess is that what he writes would be very useful for an investor to read.

I mean, I — again, I've never — I've just seen him referred to in some commentary. But I think he talks about durable or sustainable competitive advantage as being the core of any business. And I can tell you that that is exactly the way we think.

I mean, that — in the end, you — if you are evaluating a business year-to-year, you want to — the number one question you want to ask yourself is whether the — could the competitive advantage have been made stronger and more durable before — and that's more important than the P&L for a given year.

So I would suggest that you read anything that you find that's helpful or —

Actually, the best way to do it is study the people that have achieved that and ask yourself how they did it and why they did it. I mean, why is it that in razor blades, which could —

I mean, everybody grows up in business school hearing that as a great example of a product that's very profitable and why —

With it obvious that there's going to be no reduction in demand for the next hundred years for the product, why are there no new entrants into the field? What it is that gives you that moat around the razor blade business?

Normally, if you've got a profitable business, you know, a dozen people want to go into it. If you've got a dress shop here in town and it looks like it's doing well, you know, a couple of other people are going to want to open up a shop next door to it.

And here's a worldwide business, nothing can go wrong with the demand, to speak of. And yet, people don't go into it.

So, we like to ask ourselves questions like that. We like to ourselves, "Why was State Farm successful, you know, against people that had incredible agency plants and lots of capital?"

And here's some farmer out in Bloomington, Illinois named George Mecherle , you know, who's in his forties. And he sets up a company that defies capitalistic imperatives.

I mean, it has no stock, it has no stock options, it has no big rewards. It's, you know, it's kind of half socialistic. And all it does is take 25 percent of the market away from all of these companies that had all these characteristics.

We believe you should study things like that. We think you should study things like Mrs. B out at the Nebraska Furniture Mart, who takes $500 and turns it, you know, over time, into the largest home furnishing store in the world. There has to be some lessons in things like that. What gives you that kind of a result and that kind of competitive advantage over time?

And that is the key to investing. I mean, if you can spot that — particularly if you can spot it when others don't spot it so well — you're on the — you know, you will do very well. And we focus on that.

Charlie?

CHARLIE MUNGER: Yeah, it — these factors — every business tries to turn this year's success into next year's greater success. And they all use pretty much every advantage they have in every direction from this year to make next year's better.

Microsoft did exactly that, year after year after year and happened to win big.

And it's hard to see — for me at least — to see why Microsoft is sinful because they tried to improve the products all the time and make next year's business position stronger than last year's business position. (Applause)

If that's a sin, every subsidiary at Berkshire is a sinner, I hope. (Laughter)

WARREN BUFFETT: Yeah, yeah, yeah. We declare ourselves for sin. (Laughter)

23. Promo for See's Candies Barbie doll

WARREN BUFFETT: At this moment, I think we have a small interruption in the program here.

Charlie, on your left. (Laughs)

It's just a sample of what it's like to be an officer at Berkshire. (Laughter)

Oh, OK.

This is the new See's Barbie doll. And — never before seen, it will be in the exhibitors section, lower level.

And believe it or not, we've come up with three more just like this young woman. And they will be down there to take your orders. We can't ship them now, we won't charge your credit card until they — until they're available for shipment, which will probably be, I guess, around September or so.

But we wanted our shareholders to be the first ones to have a shot at this new product, and —

The model is not included in the — (laughter) — delivered price.

Afternoon Session - 2000 Meeting

1. Most companies hide the true cost of stock options

WARREN BUFFETT: OK, if area one is ready, we're ready to start answering.

AUDIENCE MEMBER: Hi.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: My name is Steve Check. I'm from Costa Mesa, California.

My question is regarding stock options. I've taken your suggestion and have been attempting to subtract stock option compensation from reported income when evaluating companies. When I read annual reports, I usually find companies estimating option costs using the Black-Scholes model.

However, the assumptions going into the Black-Scholes model seem quite different from company to company. These assumptions, of course, are what is used for risk-free interest rates — quote unquote, "risk-free" interest rates, expected option lives — even though options have stated lives, and expected volatility.

Help me out a little bit. What is the best way to calculate option costs? Do you think Black-Scholes is appropriate? If so, how should we normalize the assumptions?

And just one short follow-up: how can we possibly estimate future earnings for companies, when companies, such as even Microsoft last week, in response to a lower stock price, simply reissue a bunch of new options?

WARREN BUFFETT: Yeah, the — I can tell you, from some personal experience, that companies attempt to use the lowest figure they can, even though it doesn't hit the income account.

So they like to make fairly short assumptions as to the life of the options, even though they're granted on a ten-year basis. Because they'll make certain assumptions about exercise date or forfeiture and so on.

I think the most appropriate way, when you've got a pattern, which you have at many companies, of what they do on options, is simply to make an educated guess as to the average option issuance that they're going to incur, or they're going to elect to do over time.

And, generally, what you really want to — if you were to be precise — you would try to figure out what they could've sold those options for in the open market. Because that's the opportunity cost of giving them to the employees instead of selling the same option in the market.

I think you'll find, generally, that if you take a value of about a third, for a ten-year option, if you take a value of about a third — obviously, it depends on dividend rate and volatility and a whole bunch of things — but about a third of the market value, strike price, at the time they're issued, that's the expectable cost.

We believe in using the expectable cost versus the actual cost. I mean, that is how we would look at it.

If we were issuing options at Berkshire, and we issued options on $100 million worth of stock a year, we would figure it was costing us, probably in our case, with no dividend, at least $35 million a year to issue those options.

And we would figure that if we gave people $35 million in some other form of result-oriented compensation, that it would be a wash. And that is not the way most managements, of course, figure. At least that's my experience.

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

And I think you'll see a lot of option repricing. Everybody says they won't reprice their options, until they do it. And, you'll see that with a lot of schemes.

It would be interesting to see whether CONSICO is willing to bankrupt all the executives who made loans to buy the stock and had those loans guaranteed by the company.

And the company initially said they would enforce those loans. And we'll see whether they do it. I would say, in many cases, they won't. I don't know what CONSICO will do.

But, a lot of things that are said in connection with executive option schemes and that sort of thing are what they'll do if it works in their favor. And then they'll do something else if it doesn't work in their favor. And that's not spelled out in the initial approval that's granted.

Charlie, you have anything to add?

CHARLIE MUNGER: Well, Warren's somewhat critical attitude is very understated compared to mine. (Laughter)

WARREN BUFFETT: We're going to leave raisins out of this particular — (laughter) — analysis. Let's go to area 2.

We do believe, incidentally, if a company is going to end up giving out 10 percent of the, company over a 10-year period or 15 percent on options, that is like buying an apartment house and letting the seller keep a 10 or 15 percent interest in the upside.

Or it's like buying an oil field and giving somebody a 10 or 15 percent interest-free override. It changes the value of the property. Make no mistake about it.

It is a — it has a huge economic impact on the value of a property. And just go out and try and sell your house and say, "I want to keep 15 percent of the appreciation in it," and ask the buyer whether he's going to pay the same price for the house.

Options subtract value the moment they are granted. And, like I say, unless companies — some companies follow a practice of making a mega-grant every three or four or five years. A lot of them just issue a fairly constant amount annually. And you can figure out the cost.

And, you know, they don't want to tell the shareholders there's a cost. And that's why they fought through Congress and everything else in order to prevent it from being the truth. But, you know, Galileo had that problem many years ago and finally won out. So maybe we will, too. (Laughs)

2. Moody's moat has "poisonous characters"

WARREN BUFFETT: Yeah, area 2.

AUDIENCE MEMBER: My name is Dennis Jean-Jacques from Chatham, New Jersey. I first would like to thank you personally for taking the time out of your busy schedule to visit MBA students throughout the country on a regular basis.

In fact, I consider your visit to the Harvard Business School campus many years ago my personal rational awakening.

My question is in regard to Dun & Bradstreet. Many academics would argue that two of the many factors that determine a firm's sustainable competitive advantage are the threat of new interest through imitation, and the threat of substitution through technological advances, such as, you know, the internet and things of that nature.

My question is, how deep is the moat around Moody's and the operating company?

WARREN BUFFETT: Yeah, we don't want to go into too much detail about our marketable investments.

But I would say that the moat is, just in our view, is far wider, deeper, and infested with far more poisonous characters, in the case of Moody's, than in the case of the operating company.

We've had experience — just in terms of making decisions about how you either obtain credit information, in the case of the operating company, or if you want to obtain ratings on securities or something — I think you'd conclude that Moody's is a much stronger franchise than the operating company.

Doesn't mean the operating company can't turn out to be a better business. It might have more upside under certain circumstances, too.

But if you're really thinking of, you know, what bad can happen to you, I think that you would regard Moody's as a considerably stronger franchise than the operating company.

Charlie?

CHARLIE MUNGER: Well, I'd certainly agree. The —

Moody's is a little like Harvard. It's a self-fulfilling prophecy. (Laughter)

You know, I hate to think of how much you could mismanage Harvard now and still have it work out pretty well.

3. Harvard Business School isn't affected by supply and demand

WARREN BUFFETT: If you cut the price of the admission to the Harvard Business School by $10,000 a year, you would have less demand, in all probability, than an increase in demand.

I mean, it's totally counterintuitive in that respect. Because the cachet of the school, in that case, is not only reinforced, it almost makes it necessary, that it be priced toward the top.

So, it — you can throw away the demand and supply curves that they teach you in Economics 101 on something like that.

I — frequently, I have a little fun with — when I attend business schools. Because I ask them, you know, what the definition of a wonderful business is, and we go through all this stuff.

And then I say, you know, I tell them that — really — the best business I've seen is the Harvard Business School or the Stanford Business School, because the more they increase the price, the more people want to get in, and the more people think the product is worth.

And that is a marvelous position to be in. (Laughter)

And I thank you for your comments on the — you know, I was lucky enough to have a great, great teacher in Ben Graham at Columbia. And Ben didn't need to go up to Columbia once a week, on Thursday afternoon, to talk to a bunch of us.

So it — I really feel it's — I enjoy, sort of, passing that along. I haven't had any original ideas in this field at all. But I, you know, I had a terrific teacher. And it's fun to talk to students.

If you talk to a bunch of guys my age, nothing happens. I mean, they just want to be entertained. (Laughter)

But they want predictions always and that sort of thing. So I don't do any of that at all. I'd rather talk to students. And I thank you for coming.

4. Energy and transportation need a lot of capital

WARREN BUFFETT: Let's go to number 3.

AUDIENCE MEMBER: My name's Jared Placeler (PH). I'm 15 from St. Louis.

Are you considering investing in energy and transportation companies, such as ones that deal with fuel cell and environmentally friendly energy resources?

And if you are, will you thus be replacing any other energy-based investments you may currently hold, such as your newly acquired holdings in MidAmerican Energy?

WARREN BUFFETT: Yeah. I would say that energy and transportation, in the very broad sense, are both things that we've at least got a chance of understanding. So those are the kind of areas in which, we would think about making investments.

We would probably think about it less in connection with new technology. We might expect the people who run MidAmerican Energy to be thinking about that all the time.

But Charlie would be better at it than I am, because he has a different background and thinks better about that, anyway, in terms of evaluating newer technologies. I wouldn't be very good at it at all.

But those fields are, they're big, in terms of capital investment, for one thing. So they're very big fields.

And then secondly, we would probably think we were capable of evaluating the potential, some years down the road, of many companies in energy and transportation.

So those would be fields we would consider. And of course, as you mentioned, we made an investment in MidAmerican Energy.

I doubt if the technology changes dramatically in any near term as to the product that they're delivering.

But if there were changes on the horizon, I think we've got the management there that would be very good at spotting that ahead of time and capitalizing on it in a proper way.

I wouldn't take that function on myself.

Charlie?

CHARLIE MUNGER: Well, historically, we've done very little in either field. And mostly, the past is a pretty good guide to the future.

WARREN BUFFETT: Historically, the transportation field, I mean, it's been a terrible place to have money, and, whether it's been in airlines or in the rails. If you — we've mentioned Value Line from here — from time to time.

If you go to the rail transportation section and just run your eye across on the revenues and look at the capital investment, the amount of capital required to produce incremental revenues is just — is horrible.

And on the other hand, there's not much alternative here in the game to doing that. So there — many railroads will spend hundreds and hundreds and hundreds of millions of dollars. And it will not move the top line hardly at all. The ones where the top line has changed is where there's been acquisitions or mergers.

Airlines, you'll see just the opposite. You'll see this great movement in the top line, but again, a disastrous amount of capital investment and very little in the way of returns. So, it hasn't been a great field.

Most fields that require heavy capital investment, most of the time, they don't turn out very well over time. There are plenty of exceptions to that.

But if you find a business that has to keep adding up huge sums of money every year, there always will be a reason why they're doing it. But the net result, after five or 10 or 20 years usually isn't very good.

Charlie, got anything?

5. Buffett defends Coca-Cola CEO Doug Ivester's big exit package

WARREN BUFFETT: Area 4?

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Bob Odem (PH) from Seattle, Washington.

I'd like to say, first of all, how nice it is to come out to Omaha, and how I am made to feel comfortable by its people. I hope you both are as enthusiastic about the meeting as you seem to be in years to come. Mr. Munger, by the way, I am looking forward to your book coming out.

My question has to do with Doug Ivester's severance package and what justifies it, considering he had a very short tenure as CEO and that he took the reins from some very strong performance from Goizueta and to be relieved of his dismal performance by Doug Daft.

My brother, still in the bottling and distribution business of Coke, cut this article from Bottlers' World Magazine concerning the severance package. He said he also would retire, if he were offered this — (laughter) — 97.4 million in stock, 3 million per year for 2000 to 2002, 2 million per year, 2002 to 2007, 1.4 million per year from 2007 for the rest of his life.

Anyway, I don't see how — or here, car and cell phone, he gets that. That's a Mercury Grand Marquis and mobile telephones, laptop computer, and the like. I don't know why he'd need that. (Laughter)

Anyway, I have been wondering how you voted on this, whether you supported it or not, or what degree, considering executive pay at Berkshire hasn't risen except, perhaps, for the CFO who last got a raise, I believe, in 1997.

WARREN BUFFETT: You asked — no, CFO's gotten a raise every year.

But the — you asked whether I supported it. Yeah, I can tell you, I supported it. Because with my 35 percent interest in 8 percent of Coca-Cola, I paid almost 3 percent of it myself, personally.

I probably paid more severance pay than any man in the history of the world, personally. (Laughter)

I was not on the comp committee. But I will say this. Doug Ivester did all kinds of really wonderful things for the Coca-Cola Company, over time.

He was — for many, many years, when Roberto was running things, Doug — working with Don Keough, too, and I had this first hand from both of them. I wasn't in Atlanta. But there was no question that he was a huge, huge asset and conceived and carried out many of the things that other people may have gotten even more credit for.

Most of what you described, not the little things at the end, but most of what you described was contractually in place at the time that he left. I mean, those were deals that were made, restricted stock and all of that, that really occurred, in significant part, when Roberto was the chief executive officer and at Roberto's recommendation.

Doug's devotion to Coke, his knowledge of Coke, I mean, he lived and ate and breathed Coke. But in my opinion, Doug Daft was the man for the job. And a change was made.

But it was not because of any lack of attention by Doug Ivester. It was not because he hadn't done great things as CFO of the company.

But I think he was not the right man at the time he took over as CEO. He took over, as you know, when Roberto died quite suddenly. And there wasn't any real option in terms of the —

He was Roberto's hand-picked successor. It's almost inconceivable that somebody else would've been chosen at that time.

And we made a decision, within a couple of years, that the company would move faster and better with Doug Daft in charge. And we made a deal in severance which was about 80 percent, or some very high percentage, embedded.

And like I say, I paid more of it than anybody else. So it isn't like it was all academic.

And I think, considering some other factors, which maybe I'll put in a book sometime, that entered into it, it was definitely the right decision for the Coca-Cola Company.

Whether the computer should've been included or the car or anything, I can't — I would not want to defend small item by small item. But I can — I think the Coca-Cola shareholders are going to be many billions of dollars ahead over time by what was done then. And it wasn't easy to do.

We'll go to 5 — Charlie, do you have anything to add on that? You paid a fair amount, too.

6. Excessive CEO pay creates "hostility" to corporations

CHARLIE MUNGER: Generally speaking, I think it's a mistake for corporate America to create as much hostility as it does, which is based on the way it compensates principal officers of corporations.

It is simply maddening to add a little clause that the corporation will scratch the guy's back for just tiny, little bits of stuff that looks terrible. To me, that is extremely stupid.

And I see it where the corporation helps him prepare his tax return for 10 years after he leaves and so forth.

I think that makes a terrible impression on shareholders, generally. And I think corporate America's crazy to do it. They get sold this stuff by these damn consultants. (Laughter)

WARREN BUFFETT: I agree with Charlie. And what — it is true — (applause) — what Charlie says.

We don't have a contract, at least that I can think of, at Berkshire. It's perfectly easy to run a company without them.

We've got wonderful managers. You know, we've got things that might be called contracts. I mean, we've got deals with them, in terms of we work out compensation arrangements and all that.

But I can't remember a case of anybody that's been with us that ever has called in a lawyer or anything of the sort, or where we even had to reduce things to writing, basically. And it works fine.

And it is a little maddening, as Charlie says, to have a CEO, you know, show up with a lawyer with a 20-page contract. It's become standard operating procedure.

And once you get a big, public company with committees, consultants to the committees, consultants who, usually, are picked by the officers of the company, they look around at what everybody else is doing and say, "Well, that's the way the other guy does it. So I'll do it."

I think you can — I think the proxy statements of the last 20 years, what that's induced in the way of behavior by people at somewhat comparable companies that look at the proxy statements of their competitors and then say to their lawyer, "Well, Joe Blow got this. Why shouldn't I have it?"

It just escalates and escalates and escalates. And it ratchets. And it won't stop. I have never seen a compensation consultant come into a public company and suggest a plan that, net, reduces the cost of compensation.

At — and I see all kinds of people leave companies with — who have made tremendous amounts of money. And nobody wants to hire them at half the price, or a quarter of the price, or a tenth of the price. I mean, it's not a market system.

CEO compensation is not a market system. And it's not subject to market tests. And I don't know what you do about that, particularly. But I — it doesn't seem to bother shareholders very much. The ones that could change it —

CHARLIE MUNGER: Oh, I think it bothers them a lot, Warren. It's just they feel powerless.

WARREN BUFFETT: Yeah, but institutional shareholders could change that. My guess is that the top 30 institutions, probably, control — what — two-thirds of the big companies in the country. And they don't seem to care that much.

They — actually, they spend their time on what I regard as peripheral issues, usually. They talk about other things. They get involved in rituals of corporate governance that, frankly, don't mean a damn in terms of how the company performs. And they seem to ignore these other issues.

But, you know, there's — we've got enough to do running Berkshire. So we can't reform the world on that.

We will run Berkshire in a rational manner. And we have yet to hire a compensation consultant. And we've yet to lose an important manager.

7. Buffett: Economists aren't needed

WARREN BUFFETT: OK, we'll go to number 5. (Applause)

AUDIENCE MEMBER: Hello.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: I am Diane Ryan (PH) from Prairie Village, Kansas. This is the fourth year I've attended the stockholder meeting. And I'd like to say, every year, I feel like I've learned a little bit more.

This year, my question is, do you see a deflationary trend in the global economy? And if so, what is your investment advice?

WARREN BUFFETT: Well, Diane, I'm no good on the macro questions. And I've proven that by being way too worried about inflation for, probably, the last 20 years. Fortunately, it hasn't made much difference, the fact that I've been wrong on that.

So I don't really think my judgment is any better than yours, at all, in terms of assessing what's going to happen to global prices over time. My opinion would be that the world is not going in a deflationary situation.

But, you know, I've not earned any stars for my past economic predictions. And the good thing about my economic predictions, even if I do make them, is that I pay no attention to them myself, so. (Laughter)

I really — and the way we pick our investments is we just don't get into the macro factors. I can't recall a time when Charlie and I have looked at a business, either buying it in its entirety or buying pieces of it through the stock market.

I just — macro conclusions are — just never enter into the discussion. I mean, I'll pick up the phone. We've had these two in recent months. And I'll tell Charlie about it. And, you know, we talk about a few things. But we don't talk about anything remotely macro. And that's really the way it'll stay.

You know, I've seen a lot of bank mergers recently. And one of the things they do, because they want to cut the costs and justify a merger, which they're dying to do, I mean, that's the reason — so they cut costs they wouldn't have cut if they weren't dying to do the merger in the first place and get bigger.

But frequently — I know one in particular that I'm thinking of — you know, they'll cut out the economics department. You know, I always wondered why the hell they had it in the first place. (Laughter)

You know, because what do they do? You know, I mean —the guy comes in and says, “I think GDP will be 4.6 this year instead of 4.3.” So what?

You know, I mean, you’re still trying to make every good loan you can make. You’re still trying to take in deposits as cheap as you can. And you should be trying to cut costs wherever you can. It’s got nothing to do with running the business.

But, you know, it’s fashionable. And every bank had its economist and economics department. And when a big client would come in, they’d take him to lunch. And it just — it always has struck me as just a lot of nonsense.

So if we ever get an economics department at Berkshire, sell the stock short. (Laughter)

WARREN BUFFETT: Number 6, please. Oh, Charlie, I didn’t —

CHARLIE MUNGER: (Inaudible)

WARREN BUFFETT: Oh, OK. (Laughter) He’d rather eat peanut brittle.

8. “Take on the qualities of other people you admire”

AUDIENCE MEMBER: Hello, Mr. Buffett —

WARREN BUFFETT: Hi.

AUDIENCE MEMBER — Mr. Munger. My name is Aaron Wexler (PH). And I’m from Santa Maria, California.

I have — my question has two parts. The first part is, when you and Bill Gates had a television show some time ago, you were asked about the people who were — had different role models.

And you said, “Well, if I know a person’s role model, I can pretty well tell the kind of a person he is and what kind of a future he has.”

Mr. Buffett, my role model is Warren Buffett. Do you think I have a chance? (Laughter)

WARREN BUFFETT: Well, I hope you’re choosing me on the basis you hope to expect to live to an advanced age. I like to think that that’s what I bring to the party.

It does pay to have the right models. I mean, I was very lucky, early, very early in life, that I had certain heroes — and I’ve continued to develop a few more, as I’ve gone along — and they’ve been terrific. And they never let me down. And it takes you through a lot.

And I think that, you know, it just stands to reason that you copy, very much, the people that you do look up to, and particularly if you do it at an early enough age.

So I think, if you can influence the model — the role models — of a 5-year-old or an 8-year-old or a 10-year-old, you know, it's going to have a huge impact.

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

I think that it beats a whole lot of other things in life to have the right models around. And I have — like I say, even as I've gotten older, I've picked up a few more. And it influences your behavior. I'm convinced of that.

And if you — you will want to be a little more, or a lot more, depending on your personality, like the person that you admire.

And I tell the students in classes, I tell them, you know, "Just pick out the person you admire the most in the class and sit down and write the reasons out why you admire them. And then try and figure out why you can't have those same qualities."

Because they're not the ability to throw a football 60 yards, or run the 100 in ten flat, or something like that. They're qualities of personality, character, temperament, that are — can be emulated. But you've got to start early. It's very tough to change behavior later on.

And you can apply the reverse of it. Following Charlie's theory, you can find the people that you don't like — (laughter) — and say, "What don't I like about these people?"

And then you can look — if, you know, it takes a little strength of character. But you can look inward and say, you know, "Have I got some of that in me?" and —

It's not complicated. Ben Graham did it. Ben Franklin did it.

And it's not complicated. Nothing could be more simple than to try and figure out what you find admirable and then decide, you know, that the person you really would like to admire is yourself. And the only way you're going to do it is take on the qualities of other people you admire.

Anyway, that's a two-minute answer on something Bill and I did talk a little bit about.

Charlie? (Applause)

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

And, if it's a model is all you want, you're really better off not limiting yourself to the living. Some of the very best models are — have been dead for a long time. (Laughter)

WARREN BUFFETT: Charlie has probably read more biography than any three people in this room put together. So he has put this into practice. And, as somebody mentioned earlier, Janet Lowe has a biography of Charlie coming out here in — later this year. So you can read all the secrets of Charlie's life. (Applause)

9. Buffett and Munger have no interest in running the Federal Reserve

WARREN BUFFETT: OK, number 7.

AUDIENCE MEMBER: Good afternoon, gentlemen. My name is Gary Bradstrom (PH) from here in Omaha, Nebraska.

And my question is, if Alan Greenspan just decided to retire, and that job was offered, to either of you, would you take it?

WARREN BUFFETT: Well, I can tell you my answer is no, in a hurry. (Laughter)

I think Charlie will give you his answer.

CHARLIE MUNGER: I would say "no" more quickly. (Laughter)

WARREN BUFFETT: You notice, we gave you very unequivocal answers. And of course, that alone would disqualify us from the job at the Fed. (Laughter)

I think it was Alan that said to one senator, he said, "Since you, you know, since you've seem to have stated my remarks so accurately, you must've misunderstood them." (Laughter)

I don't think you could find a job in public life that would entice either one of us.

And the truth is, we're having too much fun. I mean, this — we've got the best job in the world. We get to work with people we like and admire and trust every day of the year. We get to do what we want to do the way we want to do it.

We should pay, and this is true of some other CEOs, too, but we should pay to have this job.

I mean, it is really interesting. I've often thought, if you could get, you know, you had a sealed envelope, and you got — and you had the compensation committee say what they would pay to have the job filled, but then you had the chief executive also say what he would do before he would leave, there would be a huge, huge gap.

And I mean, it's — there are all kinds of — I mean, it's a lot of fun to start with interesting problems you come up with, interesting things to do, something different every day. You can't beat the job. And to get paid for it is just the frosting on the cake.

And I don't see any jobs like that in public life, myself.

Charlie, have you got anything to add? Charlie takes on these public jobs. He runs a hospital and a few things. And he can tell you the wonders of it. Charlie?

CHARLIE MUNGER: Oh, yeah. There's an old saying that, "He lied like a finance minister on the eve of a devaluation." I never wanted to have a job where lying was a required part of the activity. (Laughter and applause)

10. Berkshire is the "Metropolitan Museum of businesses"

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, my name is Norman Rentrop. I'm from Bonn, Germany. I want to thank you very much for so patiently listening and answering and sharing yesterday and today. And I'm a shareholder since 1992. And this is my first meeting.

I came here being inspired by Robert Miles' book, "101 Reasons to Own Berkshire Hathaway." And I was very careful, listening to you, the reasons how you pick good people, that it's love for the business and not so much love for the money.

And I'd like to hear a little bit more on your philosophies, now that Berkshire Hathaway is more and more buying companies. On this, how you make sure that it's true love and how you pick people.

WARREN BUFFETT: It's a terrific question. I don't know exactly how to answer. Maybe Charlie will think of it while I'm stumbling around, but —

I really — I think I can do that quite well. But I don't know of any way to give somebody else a set of questions to ask, or, you know — I don't know how to tell someone else how to select managers using those criteria: do they love the business or do they love the money?

It's very, very important. I mean, it's crucial. Because it — well, we see it all the time. I mean, you've got people around who love the money. And you see them in public companies and doing things that we wouldn't want to have associated with us.

And on the other hand, if they love the business, and we'll tell — I'll tell an owner this. I will say to them, "You built this business lovingly for 50 years, and maybe your parents before you, maybe even your grandparents." One of these businesses we're buying is fourth generation.

And the clincher, in fact, I used it with Jack Ringwalt back in 1967. I said to Jack, who had built it over a long period of time, “Do you want to sell this? You know, do you want to dispose of this, the most — you know, your creation, your painting? Or do you want some 26-year-old trust officer to do it the day after you die?”

And the thought of who was going to handle this masterpiece, which he’d created himself, was important to him. And I tell him, If they want to put it in our museum, we will make sure, A, it doesn’t get resold, that it gets the proper respect, and that you can keep painting it.

We won’t come in and tell you to use reds instead of yellows or anything like that. So even though it’s a masterpiece now, you can keep adding to it.

So we like to think that we’re the Metropolitan Museum of businesses and that we can get really outstanding creations to reside in our museum. But it — we’ve got to deliver the kind of museum to these painters of businesses, in effect, that we would want, if we were doing the same sort of thing.

To some people, that doesn’t mean a damn thing. I mean, all they want to do is auction their business, you know. And they probably cheat on their figures a little in the last year or two before they sell it to dress it up. And they do all kinds of things.

And they employ some investment banker who pretends that he’s getting bids from other people to jack it up some more. And that’s standard procedure for a lot of people.

We have no interest in buying in with them at any price because we don’t want to be on the other side of the table for the rest of our lives with somebody that’s going to do that.

If somebody loves their business — and I love Berkshire, I mean, you create something over a period of time — it means something to you.

Some people get it out of how they decorate their home, or some people get it out of all kinds of different things, their golf game or whatever. But some of us get it out of building a business. And it has to be enormously important, what kind of a home it finds.

And there comes a time, in many situations, for estate taxes, or because the kids don’t get along, or whatever the hell it may be, why people need to do something with that business. But they don’t want it auctioned off. And we get — we have a good home for that.

I think I can tell pretty well what people’s motivations are when they come in with a business. And so far, we’ve batted pretty well.

We’ve made mistakes. There’s no question about that. But in a sense, I think they’ve gotten fewer over the years.

And we have — our disappointments with people have been very, very few. We've been wrong about the economics of the business sometimes. But that's our mistake, not theirs. We've seldom been wrong about the people.

And I wish I could give you a checklist that you could go down, and you could say, "Well, this guy loves the money. So he's going to be gone in six months. And this one loves the business. So as long as I leave him alone to do his job and appreciate what he does, be fair with him, that he's going to stay around here as long as he can."

Charlie, have you got any thoughts on how you separate these people out?

CHARLIE MUNGER: I think our culture is very old fashioned. In other words, I think it's Ben Franklin and Andrew Carnegie. It's very old fashioned.

And what I think is amazing about Berkshire is how well these very old-fashioned ideas still work.

Can you imagine Andrew Carnegie calling in a compensation consultant or — (laughter) — an investment banker to tell him whether he should buy another steel mill? Or —

We don't get imitated much. We're imitating the behavior of a period that has been gone for a long time. But, I don't see — a lot of the businesses we buy are kind of cranky like us and old fashioned. And I hope we continue it that way.

WARREN BUFFETT: They're sitting out there, Charlie. (Laughter)

CHARLIE MUNGER: Yeah, yeah. Well, but I think the businesses do have standards. See's has standards. It has its own personality. But it's — but maintaining standards is a huge part of it.

WARREN BUFFETT: Charlie hit on one thing. The idea of asking investment bankers or somebody to evaluate the businesses you're going to buy, I mean, that strikes us as idiocy. If you don't know enough about a business to decide whether to buy it yourself, you'd better forget it.

It does not make sense. (Applause) You bring in somebody who's going to get a very large check if you buy it, and a very small check if you don't, that displays a faith in human nature that would strain Charlie and me. (Laughter)

It's a key point, which you raise. And frankly, if I think there's anything we're good at, I think we're pretty good at what you're talking about there.

It's an important part of capital allocation. Because we do not — we are not in a position to manage the businesses ourselves.

And we want management as well as the business. And we've gotten it. And we've gotten it in spades from people that stay on and have done a terrific job for us. And it makes life a lot easier, too.

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

WARREN BUFFETT: Let's go to number 1 again.

AUDIENCE MEMBER: Hello, Warren. Hello, Charlie. My name is Doug Paterson. I'm from here in Omaha.

I teach down the road at the University of Nebraska at Omaha. And I teach in theater, which is also the greatest job in the world. And I have to say that I enjoy the theater that you provide every year. Thanks so much.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Just sitting here, there are so many questions that come to those of us who have been sitting here for three or four hours. I've got three very disconnected questions.

WARREN BUFFETT: OK, we'll do them one at a time.

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

WARREN BUFFETT: Oh, we understand the product. We understand what it does for people. We just don't know the economics of it 10 years from now.

That, I mean, you can understand all kinds — you can understand steel. You can understand home building. But if you look at a home builder and try and think where it's going to be in five or 10 years, the economics of it, that's another question.

I mean, it's not a question of understanding the product they turn out or the means they use to distribute it, all of those sort of things. It's the predictability of the economics of the situation 10 years out. And that — that's our problem.

AUDIENCE MEMBER: Right, and I'm not trying to provoke you into doing it. I'm glad you haven't. Because I probably would've gone into cardiac arrest this last couple of months.

WARREN BUFFETT: Well, so would we.

AUDIENCE MEMBER: Yeah. So your projection is that you are not going to try to make an attempt to understand it. You think it's — is it not comprehensible? Is that it, it's not comprehensible?

WARREN BUFFETT: Yeah. Every business I look at, I think about its economics. It's built into me. It's built into Charlie.

So it isn't like, when some — if I'm with Andy Grove, or actually, I knew Bob Noyce back at Grinnell in 1968 and '69, when they were starting Intel.

I — when he talked to me about starting Intel, or anybody talks to me about a business, I think about its economics. I'll think about the economics of UNO, you know, if we talk for three or four minutes.

But — I — so it isn't that we shut off the valve. It's just that we don't get anyplace. We don't know what it'll look like. And it's, you know, there are a lot of things in life that, you can — they're just beyond comprehension for many of us. And —

AUDIENCE MEMBER: So you'd say that like, nobody, really, probably, can understand this, where it'll be in 10 years. Nobody could understand it.

WARREN BUFFETT: We would be very skeptical about it. I would say that — and incidentally, my friend, Bill Gates, would say the same thing. And actually, Bob Noyce would've, and Bob died some years ago, but — or Andy Grove — they would say the same thing. I've taken long walks with Andy.

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

12. Buffett: Berkshire will be fine if I'm hit by a truck

AUDIENCE MEMBER: Cool. A second question, again, not related. But I've heard this question several times today. And it comes up every year.

I'd like to couch it in sort of a different phrase. Let's say that you stepped outside of this building and were hit by a bus.

WARREN BUFFETT: Yeah. We've got one fellow who objects to that here who's a shareholder. It's normally a truck.

AUDIENCE MEMBER: A truck, OK.

WARREN BUFFETT: And he happened to be in the trucking business, so he —

AUDIENCE MEMBER: Or, given —

WARREN BUFFETT: Just so it isn't a GEICO driver. But — (Laughter)

AUDIENCE MEMBER: Given Omaha, it could be a road grader.

What kind, I mean, that would be a sudden — maybe you'd come out of it with a great fastball. Maybe that's it. But you wouldn't have your facility at stocks.

What kind of advice would you give people that hold Berkshire Hathaway at a moment such as that?

WARREN BUFFETT: Well, it's — I've got the ultimate test on that. Because my estate, at that point, would be 99 3/4 percent invested in Berkshire. And I feel totally comfortable, considering the arrangements that have been made, and the businesses we own, and the managers we have in place, in terms of that.

But no one will be more affected, financially, let alone in other manners, by that truck than me. (Laughter)

So it's a thought that's crossed my mind.

And it's a more important question to me than to anybody else. And I've answered it to my satisfaction. The directors have some of my thoughts on the subject. But the world will go on. The businesses will go on. And I think you'll have terrific management in place.

AUDIENCE MEMBER: Thank you. I appreciate that. And thank you for taking all three of these. They're so disconnected.

WARREN BUFFETT: OK, thank you.

13. Buffett: No interest in buying the Omaha World-Herald newspaper

AUDIENCE MEMBER: Given your comments about newspapers, may we assume that you are probably not going to buy the Omaha World-Herald?

WARREN BUFFETT: I think that's a fair assumption. But that would probably be true regardless of my thoughts about newspapers. Because they're not going to sell.

Charlie, have you got anything to add on any of those?

CHARLIE MUNGER: Well, that story about the World-Herald is interesting. The truth of the matter is that, if Warren had been offered the Omaha World-Herald 20 or 25 years ago, he would've cheerfully bought it. And now he doesn't want it. And that isn't because of the economics.

WARREN BUFFETT: That's true. Yeah, I mean, there's no question — I have not been offered it, never will be offered it. And all — the ownership's all set. But what Charlie said is true.

If it were still owned by an individual, and they offered it to me, for economic reasons, I wouldn't want to buy it. And for other reasons, I wouldn't want to buy it.

CHARLIE MUNGER: But you wouldn't want to buy it now, because your life would be less congenial afterward than before. There'd be more people after you.

WARREN BUFFETT: There'd be no plus in life to owning the World-Herald, at all. Yeah. (Laughter)

And, as Charlie said, that's probably not the way we would've thought 30 years ago.

CHARLIE MUNGER: Not at all.

WARREN BUFFETT: I think we're right now.

14. Internet is good for society, bad for businesses

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Hi, Howard Winston (PH) from Chicago, Illinois. I wanted to thank Charlie and you for your hospitality.

My question is, Berkshire has benefitted enormously over the years from the low cost of its float. Do you think the internet will make the insurance business more competitive and, therefore, raise the cost of your float?

WARREN BUFFETT: Well, that's a good question. I would say that the internet, from what I see now, is unlikely to increase the cost of Berkshire's float.

It will have different effects on different aspects of our insurance business. And it will change the insurance industry in some ways, not — and I can't tell you exactly what. But I —

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

I think in the end, the competitive advantages we have among our group of insurance companies, net, will not be hurt by the internet. But I could be wrong on that. And therefore, I don't think that our cost of float will be changed much.

I don't think industry economics, in aggregate, for insurance companies, are going to be changed very much. The economics haven't been that good. I think they'll be about, you know, in that same range.

And I don't think our competitive advantage will be cut. So therefore, I think our cost of float, in the future, is going to be higher than it has been in the past. But that's for reasons other than the internet. I still think we'll have an attractive cost of funds over time on float.

It's a good business for us. I don't think it's necessarily a good business for the average company.

Charlie?

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

WARREN BUFFETT: Yeah. My guess would be yes, too. I would say that, on balance, for society, the internet is a wonderful thing. And for capitalists, it's probably a net negative.

CHARLIE MUNGER: So all of you can be happy that the progress of the species will affect your economic futures for the worse. (Laughter)

WARREN BUFFETT: A sacrifice, at which our ages, we're willing to do. But we wouldn't be at your age. (Laughter)

That — incidentally, that — there's plenty to think about there.

The internet, I mean, if you analyze it, you have to think it's much more likely that it will reduce the profitability of American business and improve it.

It will improve the efficiency of American business. But all kinds of things improve the efficiency of American business without making it more profitable.

And I think that the internet is likely to fall into that category. So far, it's improved the monetized value of American business.

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

CHARLIE MUNGER: By the way, that's perfectly obvious and very little understood. (Laughter)

WARREN BUFFETT: So there. (Laughter)

15. Egos and proxy statements fuel excessive CEO pay

WARREN BUFFETT: OK, number 3.

AUDIENCE MEMBER: Yes, good afternoon. My name is Tom Gayner from Richmond, Virginia.

And in the current environment, it seems that the attacks on the moats of wonderful businesses are coming from inside the castle, in the form of option-based compensation, just as much as from outside competitors.

One of your role models, Ben Franklin, said, “Even a small hole can sink a great ship.” It seems like the holes are getting bigger.

Can you discuss what, if any, forces may cause this to change? Is it a problem that will get worse or get better?

My second is specifically, in your role as directors of companies like Coke and Gillette, are you seeking to change these practices? And what kinds of success do you expect there? Do they let you on the comp committee?

And three, if these compensation practices are irrational, does Berkshire benefit from this irrationality? Thank you.

WARREN BUFFETT: Well, to carry the castle analogy further, we not only look for a great economic castle, but we look for a great knight in charge of that castle. Because that’s important. He’s the one that throws the crocodiles into the moat and widens the moat over time.

And of course, the question is, you know, how much does the knight get of the castle for doing that? And I think, generally speaking, at Berkshire, you get a very fair deal in terms of the amount that —

We’ve got a lot of castles around. And we try to pay people fairly. But I don’t think that the division of — is unfair between the owners of the castle and the knights that are around there, protecting the moat.

The — it’s hard for me to imagine how the compensation practices — the question of how much the knight gets of the castle — how that changes in favor of the owners of the castle over time. The ratcheting effect is just unbelievable.

No one, no compensation committee in America, will be listening to a consultant who walks in and says, “I think your management should have an arrangement that ends up in them being in the lower half.”

And if no one wants to be in the lower half, believe me, the median is going to move up.

I mean, there is no way around that. I mean, these people meet yearly or more often. And they sit there with a proxy statement of every other company in their business. You know, and they pick out the ones that have the biggest numbers in them.

And they say, “Well, gee, we need a management at least as good as this. And how are we going to attract people?” and all this other stuff.

And it’ll only ratchet upward. And I think that’s a fact of life. And I think that it’s important for shareholders to understand that.

I’ve been on the board of 19 companies, not counting any Berkshire subsidiaries or anything like that. The last comp committee I was on was at Salomon. And I was chairman of the comp committee, I think. I may be wrong on that. There were three of us. And the other two guys were terrific guys.

And the earnings came in one year, $100 million or so — I think it was 1990 — below the previous year. And comp was up a fair amount.

And I’d found that there had been some earlier issues involved and so on. I just said, I couldn’t swallow it anymore. And I voted against it.

I can’t remember whether I was chairman or not. But in any event, it was two to one against me. And I think it would’ve been two to one against me if I’d been chairman.

And the other two fellows were perfectly rational. They said, “How do we keep these people? And, you know, how can we repudiate our management?” All the sort of things you get.

So as a practical — I’ve got one friend, terribly well-regarded businessman — and he’s been — they don’t throw you off the comp committee. They just don’t re-nominate you.

And he’s been bounced from two of them simply by raising some questions that — about things you would find outrageous.

I’m not on the comp committee. I’ve been on only one comp committee. And they saw what I did. So that was the end of it.

People say, “We love your ideas,” And, you know, “You think creatively. We don’t want to hear about your thoughts on compensation.” And that, you know, it’s understandable.

You know, and every — and you run into some terrific cases of people. I mean, the fellow who runs Fastenal, for example, they are just outstanding. And there are a number of cases where people behave very well.

But most of them, I think some — I don't think it's money so much, sometimes. I just think it's ego. They just can't stand to see some guy that they think is batting .280, and they're batting .300, and he's getting paid more money. And, you know, and that process is endless.

And that, I, you know, that's understandable. It's like who gets top billing in a movie or something of the sort. People care about, you know, where their name is compared to somebody else's. And their name, in this case, is compensation. And it — I doubt if it reverses itself.

Charlie?

CHARLIE MUNGER: No, I think we can confidently expect that the situation will get worse. And I think we can confidently expect that that is bad for Berkshire Hathaway to the extent that it's a passive shareholder in big corporations.

There is one place where we get an advantage: our own culture and attitude being so different, it does attract some of these people that own wonderful businesses.

I mean, we literally, on occasion, find people for whom we're the only acceptable buyer. They don't like this culture of other big corporations any better than you do. And that does give us an advantage.

WARREN BUFFETT: Yeah. You asked us a question, also, about the — how active we might be in saying this. We're not going to ever sit here and tell you what we say in other boardrooms, because it would reduce any effectiveness we might have. And we probably don't have that much effectiveness anyway. But —

You can only belch so many times at the dinner table and get invited back. And — (laughter) — we've probably done enough of our share of that. And you — we try to run Berkshire in a way that we find admirable. And we try to spell out our reasoning on it and everything else. And we hope that maybe somebody latches onto that as a model someplace.

But going around condemning people by name does not work. And so we, you know, we hate the sin and love the sinner and all that sort of thing. And it doesn't have much effect.

16. Hard to predict how demographics will affect markets

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Good afternoon, Warren and Charlie. My name is Erras (PH). I'm from Winnipeg, Manitoba, Canada. And my first time in Nebraska, in Omaha, first time hearing you guys live.

And there's a big ice cream man behind you.

WARREN BUFFETT: Hmm. There we go!

FEMALE VOICE: Here you go.

CHARLIE MUNGER: Oh, thank you.

WARREN BUFFETT: And you think there are no management perks at Berkshire.

AUDIENCE MEMBER: Oh, boy. (Laughter) All right, let's get down to business.

WARREN BUFFETT: OK.

AUDIENCE MEMBER: My question is in reference to your article in Fortune magazine last November, where you talked about corporate earnings and what the market — are you guys listening? Or…

WARREN BUFFETT: I'm listening. (Laughter)

We can chew gum and listen at the same time.

AUDIENCE MEMBER: All right, all right, all right. As I was saying —

WARREN BUFFETT: But if we had —

AUDIENCE MEMBER: — the point in your article in Fortune about corporate earnings and what the market is paying for them, painting a pretty gloomy picture for equities and market levels going forward.

Now, as you may know, there exists a very strong trend in demographics. We see, in Canada and the United States, the aging of the population and, more importantly, the bulk of this population reaching their peak savings years, all at the same time.

WARREN BUFFETT: You're getting a little rude. But go ahead. (Laughter)

AUDIENCE MEMBER: I can't believe this. Warren actually called me rude.

WARREN BUFFETT: I wanted to prove to you I was listening. Go ahead. (Laughter)

AUDIENCE MEMBER: Anyways, OK, so there's a major retirement crisis as a majority of Canadians and Americans between the ages of, especially between 22 and 55, are worried that they won't have enough money to fund their retirement or let alone, last.

So for this reason, I mean, this population is expected to invest in equities, as opposed to fixed-income instruments, to get the necessary long-term rates of return to fund their nest egg for retirement.

And therefore, many are calling for massive amounts of money to flow into the markets over the next five, 10, 15 years through stocks and mutual funds and, consequently, fueling market prices and market levels. Many predicting the biggest growth ever in the stock markets.

So what is your opinion on this potential trend, separately or in conjunction with what you said in that article in Fortune? Thanks very much.

WARREN BUFFETT: Good. To be, I'm not being rude here, but we don't think it means a thing, frankly. (Laughter)

The savings rate, the private savings rate, you know, is not high now. It doesn't need to be high.

What really determines how the people who are either aged or very young, because either way, the people who are in their nonproductive years depends, in aggregate, on aggregate production of goods and services, and then the division between those who are in their productive years and in their nonproductive years. And that's what Social Security argument's about and everything.

The biggest single thing working for people in their nonproductive years on both ends, young and old, is the fact that the pie keeps growing. And that makes it easier to attack the problems of the nonproductive.

And when I say, "nonproductive," there's obviously no — nothing derogatory about that term. It just relates to who's in the employable age and who isn't.

And our society is going to do extremely well in terms of being able to take care of the people in their nonproductive years.

If there — there is a shift, obviously, as people live longer. And of course, there should be a shift, perhaps, in defining — I think there should be — in defining what's productive, because 65 was decided back in the '30s. And I think that's changed.

But the fact that the pie keeps growing is what makes it — it makes the problem easy. And — not easy — but it'll be easier 30 or 40 years from now, in my view, you know, than it was 30 or 40 years ago.

Because there'll be so much more in the way of goods and services produced per capita that the productive can take care of the nonproductive and the — or the aged — in a way that will be easier for them to sustain than it was in the past. When —

It's low amounts of output that strains society. I mean, when you get very small amounts of output, or huge disparities in the division of that, that you put real strains on a society.

But a society whose output is growing 3 percent a year and whose population is growing 1 percent a year is going to have way less in the way of strains than existed 20, 30, 50, 100 years ago. The —

But, you know, we will need no big boom in savings or anything of the sort. The present savings rate will do — will just do fine for the world. In the United States, I mean, I'm not speaking to the — I shouldn't speak to the whole world on that.

Charlie?

CHARLIE MUNGER: Well, generally, you can say that stocks are valued in two different ways.

One, they're valued much the way wheat is valued, in terms of its perceived practical utility to the user of the wheat.

And there's a second way that stocks are valued, which is the way Rembrandts are valued.

And to some extent, Rembrandts are valued high, because in the past, they've gone up in price.

And once you get a lot of Rembrandt element into the stock market, and you fuel the stock market with massive retirement system purchases, you can get stocks selling at very high prices by past historical standards. And that can go on for a long, long time.

That's what makes life so interesting. It isn't at all clear how it's going to work out. It isn't even clear what the level of interest rates is going to be.

And nobody in this room ever expects to see 3 percent interest rates continue for a long time again. But that could happen. That would have an enormous effect on the price of equities.

You live in a world where you can't really predict these macroeconomic changes.

WARREN BUFFETT: No, you can argue that increases in savings will drive down the returns on capital. The more capital is around, that the lower the returns will be on capital.

But I don't think you'll — I don't think it will help you make any decisions about businesses, you know, over your lifetime by — actually by thinking about matters like that. We're a little biased on that. But you'll find all kinds of guys that will tell you. I mean, that's what books are written about. Because everybody likes predictions and books. So, you could all —

Go ahead.

CHARLIE MUNGER: In addressing this question, you can see that we have acted much as one of my old Harvard Law professors acted. He used to say, "Let me know what your problem is. And I'll try and make it more difficult for you." (Laughter)

17. Buffett: The best book on how I invest

WARREN BUFFETT: Area 5, please.

AUDIENCE MEMBER: My name is Eric Tweedie from Shavertown, Pennsylvania. Thanks again for another great meeting.

During last year's meeting, my wife picked up a copy of a book called "Buffettology" at one of the shops around town that is written by Mr. Buffett's former daughter-in-law, a very well-written book, very interesting. And it attempts to outline the Warren Buffett approach to investing.

My question is, I don't know if either of you gentlemen are familiar with the content or have read it. And if so, if you could comment on if you think it is a good outline of that type of investing.

My second question related to that, I wonder if you — if Mr. Buffett could comment on why you bought the original textile mill in Massachusetts, and if that represented an earlier phase, when you were more of a strictly Graham-style, value investor, versus your current investing style.

WARREN BUFFETT: Probably the best, I would say, the most representative book on my views is the one that Larry Cunningham has put together, because he essentially has taken my words and rearranged them in a more orderly — he's taken from a number of years. And what he has put together there best represents my views.

We've got 20 years of annual reports or so, or more, on the internet, plus articles in Fortune, all kinds of things.

So it's probably a bias I have. But I would — I like to think that I laid out those views better than somebody who's rewriting them. But that's — I'll let you make that decision.

But I do think Larry's done a very good job of taking a number of those reports and rearranging them by topic in a way that makes it a lot easier to read than trying to go through year after year.

And actually, you'll have this book about Charlie, pretty soon, to read, too.

We've said what — we've said in these meetings, we've said in the annual reports, we've said exactly what we do.

And some of the books, I would say, try to take that and — because people are looking for mechanistic things or formulas or whatever it may be. They try to hold — they may try to hold out that there's some secret beyond that. But I don't think there probably is.

Charlie? You've read the books.

CHARLIE MUNGER: Oh, I skimmed that book. The —

I think what we have done all these years is, it wasn't all that hard to do. And it's not that hard to explain. All that said and done, I think a lot of people just don't get it. (Laughter)

As Samuel Johnson said, famously, "I can give you an argument, but I can't give you an understanding." (Laughter)

18. Buying Berkshire Hathaway was a "terrible mistake"

WARREN BUFFETT: What was the second part again?

AUDIENCE MEMBER: I just asked you if you could maybe comment on why you bought the original —

WARREN BUFFETT: Oh.

AUDIENCE MEMBER: — Berkshire textile mill.

WARREN BUFFETT: That's why I didn't remember. (Laughter)

AUDIENCE MEMBER: If I could say —

WARREN BUFFETT: It was —

AUDIENCE MEMBER: — one of the things, someone tapped me on the shoulder and asked me for you not to forget to give the current year's recommended books.

WARREN BUFFETT: It's — I've got to recommend the book on Charlie. But I'll let Charlie recommend one, too.

The original purchase of Berkshire was a terrible mistake and my mistake. No one pushed me into it.

It was — I bought it, because it was what we used to call the cigar —

It was a cigar butt approach to investing, where we would look around for something with a free puff left in it. You know, it was soggy and kind of disgusting and everything. But it was free. (Laughter)

And Berkshire was selling below working capital, had a history of repurchasing shares periodically on tender offers. And it was selling, the first purchase was, I think, at $7 1/2 a share. In fact, I've got the broker's ticket up in the office, 2,000 shares.

And they — it looked to me like they were going to have a tender offer periodically. And it would probably be at some figure closer to working — net working capital — which might've been 11 or $12 a share, some such number.

And we would sell on the tender. And that was — we had other securities we owned that way. And we bought some that way.

And then, actually, I met Seabury Stanton one time, who was running Berkshire. And he told me and made me an insider, so I couldn't do anything, but he said he was thinking of having a tender. And he wondered what price we'd tender at.

And I — as I remember, I may be wrong on this, I could look back on it, but I think I said, "11 3/8." And he said again to me, "Well, if we have a tender at 11 3/8, will you tender?" And I said, "Yes, I will."

And then I was frozen out, obviously, of doing anything with the stock for a little while. But then he came along with the tender offer.

And as I remember, I opened the envelope, and it was 11 1/4. I may be wrong. It may have been 11 1/2, 11 3/8. But it was 1/8 below what he had said to me and what I had agreed to.

So I found that kind of irritating. And I didn't tender. And then I bought a lot of stock.

Kim Chace was a director. His father had some members of the family, not his direct family, but related family, that wanted to sell a block. And we bought several blocks. And before long, we controlled the company.

So at an eighth of a point difference, we wouldn't have bought it, the company, if they'd actually tendered at that price.

We had a somewhat similar thing happen with Blue Chip, actually, later on, too.

We would've been much better off, if we hadn't bought it. Because then things like National Indemnity and all of that, instead of buying it into a public company with a great many other shareholders, we would've bought it privately in the partnership. And our partners would've had a greater interest.

So Berkshire was exactly the wrong vehicle to use for buying a bunch of wonderful companies over time. But I sort of stumbled into it. And we kept moving along.

And when I disbanded the partnership, I distributed out to Berkshire. Because it seemed like the easiest and best thing to do. And I followed through. And I enjoyed it enormously. I'm glad it all worked out this way.

It did not work out the best way, economically, in all probability. It was the wrong base to use to build an enterprise around. But maybe, in a way, that's made it more fun.

Charlie, do you have anything to add on that? You can tell them about the Blue Chip story. (Laughs)

CHARLIE MUNGER: No, one such story is enough. (Buffett laughs)

But it is interesting that a wrong decision has been made to work out so well.

We've done a lot of that, scrambled out of wrong decisions. I'd argue that's a big part of having a reasonable record in life.

You can't avoid the wrong decisions. But if you recognize them promptly and do something about them, you can frequently turn the lemon into lemonade, which is what happened here.

Warren twisted a lot of capital out of the textile business and invested it wisely. And that's why we're all here.

WARREN BUFFETT: But Berkshire comes from three companies that came together: Diversified Retailing, Blue Chip Stamps, and Berkshire. Those were the three base companies.

And Diversified started when we bought a company called Hochschild Kohn in Baltimore in 1966, a department store. And that company disappeared over time.

Fortunately, in 19 — I think — 70, we sold it to Supermarkets General. Blue Chip, we've told you about the record of that.

So, we started out with three disasters, and put them all together. (Laughter)

And it's worked out pretty well.

But it was a mistake to be working from that kind of a base. Don't follow our example in that respect. Start out with a good business and then keep adding on good businesses.

CHARLIE MUNGER: But the example of quickly identifying the mistakes and taking action, there, our example is a good one.

WARREN BUFFETT: Yeah.

19. Buffett would never trade Berkshire stock for gold

WARREN BUFFETT: OK, number 6.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. Kathleen Lane (PH) from New York.

I have a question out of left field for you. You say you like to be entertained? This question will entertain you. It's also a serious question.

I know you don't like to speculate about the future. You won't do so. I appreciate that.

But some people do. For example, Edgar Cayce was one. He didn't pick stocks or investments. But if he had, he would've probably gone for that farmland that you were talking about earlier this morning.

Because he had a dream that in the year 2158, Omaha would be located on the west coast of the United States. And you know how beachfront property goes. So it would be a good bet.

WARREN BUFFETT: It will be good for our super catastrophe business, if that happens. (Laughter)

AUDIENCE MEMBER: As you both said earlier, we're living in an extraordinary time, financially especially.

You can't help but to hear disaster scenarios concerning the impending collapse of worldwide financial markets, about major physical changes in the world as we know it, about a future when the world's resources will be better measured by their prospects for ensuring our basic survival than their value as speculative commodities. That's where that farmland would come in again.

Nobody does better what you two do. But even if your investment acumen wasn't what it is, I would invest with you, because you're honest.

In short, I came here to ask you, what would you tell a single mother to exchange her Berkshire share hold for gold coins? When, under what circumstances?

WARREN BUFFETT: Well, I can't imagine ever exchanging any of my shares for gold coins. But —

I would rather trust in the intrinsic value of a bunch of really fine businesses run by good managers selling products that people like to buy and have liked to buy for a long time, and then exchanging their future efforts, the money that comes from their wages, for See's Candy or Coca-Cola or whatever, than take some piece of metal that people dig out of the ground in South Africa and then put back in the ground at Fort Knox, you know, after transporting it and insuring it and everything else. (Laughter)

I've never been able to get real excited about gold. Now, my dad was a huge enthusiast for a gold standard. So I grew up in a family where gold was revered, if not possessed. And I would — I gave it its full chance.

But I've never understood what the intrinsic value of gold is. And, you know, we'll sell you some at Borsheims, but I would never exchange —

The idea of exchanging a producing asset for a nonproducing asset would be pretty foreign to me.

20. Why Buffett ignores predictions

WARREN BUFFETT: And I would say this: in terms of the predictions, and I know the spirit in which you asked the question, but in terms — there's a market out there all the time.

And people love to hear predictions. If I said I was going to offer a bunch of predictions today, we would have a million people here. I mean, they're dying to have predictions and speeches at rotary clubs or trade associations or whatever. That's — they just plain love it.

And that's what a whole industry is built upon, you know, the people coming out of Washington to talk about political predictions and the — I don't read those in the paper at all. Because it's just — it's space fillers, basically.

And, you mentioned Edgar Cayce. Ben Graham knew Edgar Cayce pretty well. But I just have never seen any utility to any of that at all.

There will be some huge surprises in the world. There's no question about that. But I don't think that betting on any specific one is a very smart policy.

In fact, our — we usually bet against them, in terms of super catastrophes. We know there will be a 7.0 or greater quake in California in the next 50 years. We don't know where it'll be or when it'll be or anything like that. We are willing to pay out a lot of money if it happens tomorrow.

And because people do worry about catastrophes. And in this case, it's perfectly proper, with insured values. But it just isn't any way, in our view, to get through economic life.

Charlie?

CHARLIE MUNGER: Well, I suppose the one time when a single mother might want to own gold compared to anything else is if she faced conditions like a Jew in Vienna in 1939, or —

I mean, there are conditions you can imagine where some form of transportable wealth would be useful, compared to anything else.

But absent those extreme conditions, I think it's for the birds. Now, silver… (Laughter)

WARREN BUFFETT: It's hard to think of anything other than fleeing the country. And Charlie and I don't give a lot of thought to fleeing the country.

21. Buffett: "I'm a little crazy, I don't mind paying taxes"

WARREN BUFFETT: Although, I must say that the one thing I really find reprehensible is the people that make a lot of money in this country and then leave to, you know, to get another tax jurisdiction or something like this. I really — I don't —

But I'm a little crazy. I don't mind paying taxes. (Applause)

WARREN BUFFETT: Let's go to 7.

There are plenty of reasons, I think, perfectly valid reasons — I mean, people may want to live someplace else — but the ones who carefully arrange it so that they actually live here as much as they can.

I think one of them wanted to be appointed — he wanted to go to some very small entity, where there was no tax. And then he wanted to be appointed an ambassador to the United States, so that he could enjoy living here but enjoy the taxes of something else.

And, you know, that is not my role model. Yup.

22. Costs vary for Berkshire's float

AUDIENCE MEMBER: Hello, Warren. Hi, Charlie. Two questions. First, was anybody dumb enough to sell you Berkshire at less than 45,000 a share?

WARREN BUFFETT: We did not repurchase any shares.

AUDIENCE MEMBER: My second question concerns float. The float has been low cost most years for Berkshire and probably zero cost in many years, except last year, possibly.

When you think about float in terms of intrinsic value, do you have an idea in mind when you add new float for how much it will increase the intrinsic value of Berkshire?

WARREN BUFFETT: Well we add — that's a good question — but we consciously add float sometimes at a given cost. And then we, other times, add float at no cost. So we have different layers of float, if you will, that we've entered into.

We've entered in some transactions in the last month or two, where we will take on some float, which will not have zero cost. But it's acceptable to us. And we couldn't get it at zero cost, although we're also creating float which, I think, will be close to zero cost or better.

So, we would be willing to take on float, obviously, at costs only modestly below the Treasury rate, if that was the only way we could get that float, and it didn't impede our ability to get other float, you know, at zero cost or something.

We don't want to raise the cost overall by a single transaction that would have an effect on other transactions.

But float, if you look at our historical record, and our future record can't be as good, but it's not —it's the cost of float, and it's the amount of growth of float.

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

So there are a lot of different ways, in the insurance business, that we can and will think about developing float.

And usually, one doesn't preclude another. Occasionally, one bumps into another. But usually, one doesn't preclude another.

And believe me, we spend a lot of time thinking about that. And we'll continue to as long as we run Berkshire. It's a big part of our strategy.

Charlie?

CHARLIE MUNGER: Well, I've been amazed how well we've done with the float. And I've been watching it from the inside for a long, long time.

It is a very wonderful thing to generate millions and millions, and then billions and billions, of dollars of float at a cost way below the Treasury rate. There are people who would kill for such opportunities.

WARREN BUFFETT: Yeah. And of course, that makes it competitive. We do — we — there are plenty of other people that are thinking about it in a similar vein and probably observed what we do and all of that. So like everything else in capitalism, it's competitive.

We think we've got an edge in several very important respects. And we think that edge is sustainable for quite a — as far as we can see. And we intend to push it as hard as we can. And then we'll see where it leads.

I would've had no idea, 10 or 20 years ago, that we would have the present situation. But we do find, if you just show up every day, like Woody Allen said, and you answer the phone and read the paper, every now and then, you see something that makes sense to do.

And we do find them occasionally. The hard part is finding them where they are material relative to our present size. If we were running a very small business, we would find plenty of things that would make good sense.

We find a few things that make good sense now, relative to our size. And there's really no answer for that except to shrink dramatically, which is not a action we're contemplating.

23. Munger on Wesco succession

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: James Pan (PH) from New York City.

I really have a question on Wesco, which is your 80 percent-held subsidiary, just a couple questions dealing with that.

First question is, last time I checked, that was trading below intrinsic value.

And given that most of Wesco's assets are tied up in Freddie Mac, and Freddie Mac will arguably grow intrinsic value in the low teens for the next couple of years, how are you guys going to manage the, I guess, how would you manage the gap between intrinsic value, and what — the current price, and what intrinsic value will be two or three years from now?

And also, is there a succession plan at Wesco or some kind of roll-up plan at Wesco eventually?

WARREN BUFFETT: Charlie is the boss at Wesco. So —

CHARLIE MUNGER: Yes. We have paid almost no attention to the price of Wesco stock. So the chance to make any meaningful gain for the Wesco shareholders by buying in a few shares of Wesco stock is so tiny that we don't really bother thinking about it very much. The —

As to succession, we are gradually making me so useless that I won't be missed. (Laughter)

WARREN BUFFETT: Yeah, incidentally, you talked about Wesco being significantly undervalued compared to intrinsic value. I'm not sure that's the case. Charlie, would — you're more of an expert on that than I am.

CHARLIE MUNGER: Well, there's certainly no huge gap.

And, we don't spend a lot of time thinking about things that will make, practically, no money. (Laughter)

24. Munger: EVA valuation is "twaddle" and "medieval theology"

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Hi, my name is Jason Tang (PH) from Traverse City, Michigan. Before I ask my question, I want to know that it's true that you guys are going to be here tomorrow at 9:30 to answer more questions. (Laughter)

My question, I just recently read the book, "Quest for Value," by — I think the author is Bennett Stewart, from Stern Stewart consulting firm.

And I want to talk to you a bit about — just ask you about different valuation methodologies, and EVA in particular, and how that may or may not be more valid than, let's say, other benchmarks of value, like P/E, or price-to-book, or price-to-sales.

Is that something closer? I noticed that the language that was used in this book was real similar to the type of language you guys use in your writings. So I'd like you to talk a little bit about EVA, if you could.

WARREN BUFFETT: Charlie, why don't you take EVA?

CHARLIE MUNGER: I think there's an awful lot of twaddle and bullshit. (Laughter)

WARREN BUFFETT: I knew that's what he was going to say. And I thought it deserved it, so I — and I didn't want to say it myself.

CHARLIE MUNGER: In EVA, we keep stating, over and over again, that the game is to turn the retained dollars into something more than dollars.

And EVA tends to incorporate cost of capital ideas that just make no sense at all. They make it sound very fashionable.

And, God knows, it's correct that a corporation that earns a huge return on capital and keeps retaining it for a long time has a great record in terms of EVA. But the mental system, as a whole, does not work. It's like medieval theology. (Laughter)

WARREN BUFFETT: I like that second term better than the earlier one. (Laughter)

25. How Buffett became friends with Bill Gates

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Good afternoon. My — excuse me — my name is Stewart Hartman from Sioux City, Iowa.

First, I'd like to thank you both for allowing a couple of Berkshire employees to migrate north to Sioux City. I work with Corey Wrenn and Mark Sisley (PH). They're both great guys. You did a terrific job training them.

Mr. Buffett, you've known Bill Gates for several years and probably spent more time with him than any of us in this room. Would you feel —?

WARREN BUFFETT: That isn't the case, if Jeff Raikes is here. I don't know. Is Jeff here?

Anyway, go ahead. But we did have a local fellow who comes from 30 miles from here, Jeff Raikes, who's a key Microsoft employee. And I think he's in town this weekend. I thought he was in the meeting.

AUDIENCE MEMBER: I didn't mean to make the broad generalization to be argumentative. (Laughter)

WARREN BUFFETT: I just didn't want to think Jeff — I was trying to muscle him out.

AUDIENCE MEMBER: Sure, sure. That being said, I guess, here's a way I'll rephrase this. Would you feel comfortable sharing with us how your relationship began and how it evolved with Mr. Gates?

And with regard to his spirit and competitive nature, how vigorous do you expect him to defend his company's position against the government and state's current antitrust suit?

And then for both of you, Mr. Munger included, what, in your opinion, are the odds that the government and the states will prevail and split his company into pieces?

And then since Mr. Munger mentioned, I guess I'd ask, could we have an update on the company's silver position and its future as an investment, as well? (Laughter) Thank you for opening that door.

WARREN BUFFETT: OK, well, he can close them, too. (Laughter)

Yeah, I really don't feel comfortable speaking for Bill at all in terms of what he's going to do. In fact, I think they've been quite outspoken, he and Steve Ballmer both, about what Microsoft will do.

So I don't want to try and rephrase that or modify it or do anything else. Because they know what they're saying when they say it. And I would take them at their word. And I really shouldn't be adding anything to it.

I met Bill, because a very good friend of mine, Meg Greenfield, was the editorial page editor at the Post. She called me one time, 10 or more years ago. And — she said, "Warren," — she loved the state of Washington and had grown up out there. So she said, "Can I afford to buy a second home?"

She was living in Washington, D.C. now. And so she says, "Can I afford to buy a second home in Washington?" And I said — and she said, "I'll send you all my financial information."

I said, "Meg, you don't need to." Anybody that asks me whether they can afford something can afford it. It's the people that don't ask me that never can afford it. So I said, "Just go do it." And, "It'll make you happy." And so she did.

And, then a year or two later, she wanted to have me come out and see what she'd done with my mild encouragement. And so I went out there and visited. It was the July 4th weekend in 1991. And they had this parade on this island and everything she wanted me to see. And she had a few other people out, too.

And then, she was a friend of the — of Bill's parents. And so we went down there, to the Hood Canal, to visit them when I was back there, to meet the parents. And I think Bill didn't want to come. But Kay Graham was coming. And he wanted to meet her. He didn't want to meet me.

And, so he came in. And then we hit it off immediately. We had a great time. And, I mean, he had this chimpanzee, to whom he was going to try and explain this technical stuff. But it was a — I was kind of an interesting chimpanzee to him. So, we — and he's a terrific teacher.

So, we spent a number of hours. And we just plain hit it off. And, I found it very interesting, what he had to say. And, we've had a good time good time ever since.

And we play bridge together and golf together. So I can tell you that he's quite competitive in those games. But I, can't tell you anything about Microsoft or anything. I don't know that much about it. And it wouldn't be right, if I didn't know anything personal, to be talking about it. Charlie, you know Bill.

CHARLIE MUNGER: Yeah. Well, I don't want to speak for anybody else, either. I happen to be quite sympathetic to the Microsoft side of the pending antitrust case. But — (Applause)

And regarding silver, all I can say is, so far, it's been a dull ride. (Laughter)

26. Buffett and Munger on the antitrust case against Microsoft

WARREN BUFFETT: I would say this about the Microsoft case. That — and I've expressed this to a couple news organizations who asked the question earlier.

Twenty years ago, this country really had sort of an inferiority complex about its place in the world economic order.

And we talked about having a country of hamburger flippers. And, we thought we were going to lose our steel industry and our auto industry. And we really didn't quite see how America fit into the world where it looked like the Japanese and the Germans, to some extent, and all those, were eating our lunch.

And that — there are many of you are too young to remember that. But there are many of you in this room who will remember that. And we were very depressed about our economic situation in this country.

And then this, whatever you want to call it, information age or whatever, came along, fueled by technology. And we've just swept the world aside. I mean, it — we are so far number one that it's difficult to think who's number two. So here we have —

And it's changed — in some way, it's contributed to a change, I should say — in the national mood. And it — whether — what part of our prosperity is accounted for by it, no one knows. But I think everybody in the room would agree that it's significant.

And that age is going to get — and that development — is going to get more and more important in the years to come. It's going to be fueling much of what happens in the world and for this country to be the world leader. And like I say, you can't even see who's in second place, and moving faster, even, to increase that lead, with all the benefits that brings, you know, I think that —

I think we've got something working very well that probably doesn't make a lot of sense to tinker with too much. So I would not want to go in with a meat axe into something that is pulling this country along, in my view, in a huge way.

And I just, I don't like to tinker with success. And it's an important success. It's really an important success.

Charlie and I may not understand how to play that, in terms of buying the companies that are going to do well 10 or 15 years from now. But we know some companies will do well. And we certainly know it'll have a huge benefit to society, even if it makes business less profitable but makes the society more efficient.

I mean, that is a huge edge to have. I would love to have the most efficient industry in the world in this country, even though it might pull down returns on capital against the less-efficient system.

So we — I think neither one of us would be inclined to go in there and mess around with something that's working.

CHARLIE MUNGER: I think — (Applause)

If you look at the big picture, in patriotic terms, having lost totally in radios, stereos, television sets, et cetera, and in many other places, and having lost position in other major industries to the Japanese and others, we finally get huge leadership in a new and wonderful field — software — that's needed all over the Earth.

And somebody who's drawing a salary from the United States government gets the bright idea that they should dramatically weaken the one place where we're winning big. (Applause)

And he actually goes home at night and is proud of himself. (Laughter)

27. GEICO benefits from smaller industry-wide profit margins

WARREN BUFFETT: OK, number 3.

AUDIENCE MEMBER: Good afternoon. Joe Levinson (PH) from New York.

You mentioned, in this year's annual report, that the operating environment that GEICO is facing, especially with regard to pricing, is going to get even tougher this year.

I'm wondering if this tough environment that GEICO's been facing over the last few years, is it something cyclical? Or is there something more structural going on here that we should be concerned about?

WARREN BUFFETT: Well, actually, what has happened is that it's been unduly benign the last few years. So I would regard this as much more a return to normalcy, what's happening.

The profits in auto insurance, industrywide, have been far higher than, I think, are sustainable and higher than I would've predicted, five years ago, would've occurred.

So the industry got very, very lucky for a while. That wasn't necessarily good for us, incidentally.

We made more money than we would've otherwise made. But there was a big umbrella over the industry, too, so that less-efficient competitors still did very well.

We do not find the environment, which is going to be lower profits, we do not find that undesirable at all. We do not like having a huge umbrella over an industry. We want the most efficient to be the ones that do well and the less-efficient ones to have plenty of problems.

So, we are not unhappy about the fact that margins in the auto insurance business are going down. We think they should go down.

We will — as long as we feel that we are adding policyholders at a cost that's less than their net value to us over time, we will continue to do it. We'll love to do it.

But we won't be making the kind of money, in the year 2000, that we made in 1999, which was not as good as 1998. But that doesn't — that's — as far as we're concerned, that's fine. Because we will be the low-cost producer, over time or will — that is our goal. And I think we've got a lot of things going in our direction to enable us to do that.

The low-cost producer in a huge industry is going to do very well over time.

And then question is just — is, it costs money to sign up people and bring them into our fold. Then we have to keep them in our fold. And we lose some every year. It's an hourglass problem, to a degree.

But that's all part of the equation. And the GEICO equation is fundamentally good. It's not as good as it was a couple of years ago, just in terms of overall profitability, because there isn't this big umbrella over the whole industry.

But that umbrella was going to go away. And it doesn't hurt us to have it go away at all.

The second thing is that we are, as I pointed out in the report, it is costing us more to develop inquiries than it did a couple of years ago. We knew that would be the case. It's going to cost more three years from now than it costs now.

So we believe in pouring it on. And we think that we can attract business at a lower cost and then run it at a lower cost than most of the competition, if not all. And we intend to plow ahead with that.

We will write — I said, in the annual report, I ventured that the industry might write at three points worse than last year. Well, three points on 120 billion of volume is $3.6 billion difference in the profitability, if that forecast happens to be correct.

That bothers us not at all. In fact, we will not only take that three points of industry worsening, but on top of that, we will spend even more money to bring in business, which will make our figures, specifically, look that much worse in the near term.

But that, you know — in the end, it is so much more attractive to bring in that kind of business, we'll say, than some e-retailer, who is losing cash by the ton, bringing in customers who are spending far, far less than our customers spend with us, and where the retention rate, I would venture to say, will be lower than our kind of retention rate.

We've got a very good business model. It's not as good as it was a couple of years ago. It's probably better than it will be a couple of years from now. But it's still far superior, I think, to the business model of most of the competition.

We've got a great machine at GEICO. And we've got a sensational man running it in Tony Nicely. He is the best in the world at running that business.

And he's been there since he was 18 years old. And he knows it every way from Sunday, in terms of how to run that business.

I've known Tony for a good many years. I've never heard him say anything that didn't make sense. It's really interesting.

If you take a whole bunch of people with 140 IQs, it's a very uneven performance in what they actually do. Some of them say all kinds of things that make a lot of sense about 90 percent of the time. And then 10 percent of the time, they go crazy.

And Tony is — everything Tony says and does makes sense. And he is a huge, huge asset to Berkshire. And he's working with a business model that — that's very, very powerful.

Charlie?

CHARLIE MUNGER: Nothing to add.

28. MidAmerican Energy: "Decent" but not "extraordinary" returns

WARREN BUFFETT: OK, number 4.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. My name is Andrew Sole. And I'm from New York City.

I was hoping, if you wouldn't mind, turning your attention to MidAmerican Energy. You've spoken about how much you respect the management of that company.

But if you could elaborate upon what you see are the long-term competitive advantages of MidAmerican Energy, where you see the company 10 years from now, and is it your hope or your intention to make MidAmerican Energy the lowest-cost provider of electricity in the United States?

WARREN BUFFETT: Well, you — you're not going to do a great deal about the embedded cost that you have in generation. I mean, if you have a group of plants, they are, in the United States, they're relatively low-cost generation.

But if somebody else has a hydro plant or something that has built-in advantages that are going to enable them to turn out electricity cheaper than we can do it in Iowa with coal, so be it. I mean, it —

So it is relatively well positioned as a generator, but we have nothing we could do there to specifically, dramatically change the cost of generation compared to other competitors.

But — and you shouldn't expect to make extraordinary profits in a business that is selling an essential, like electricity, to virtually every consumer in the country.

The whole idea behind the utility industry is not to allow extraordinary profits. But we think it's a very good business.

We do think that Dave Sokol has demonstrated ability, in the time he has been running that, to come up with a lot of ideas about doing various things that have made sense, various projects.

Not everything works. But his batting average is very high. And a good mind like that, we will expect that he'll produce more ideas over time.

But, it's not the sort of thing you get fireworks in. It's conceivable that, you know, we would get a chance to do something very big in that field at some time, just because it's a big field. It is the kind of field where you can write a $5 billion check. So it's not the jelly bean business.

But whether we do or not depends on a lot of things, including regulatory restraints. Because there are a lot of rules in that business, starting with the Public Utility Holding Company Act of 1935.

But there may be ways to do some very big things. And we've got the right management to do it. We've got the financial wherewithal to do it. And we'll see what happens.

I think MidAmerican is a very — we'll get, in my view, we're very likely to get a very decent return on it. But we shouldn't get an extraordinary return, because it isn't that kind of business.

Charlie?

CHARLIE MUNGER: Nothing to add.

29. We can do almost anything with insurance float

WARREN BUFFETT: OK, number 5.

AUDIENCE MEMBER: Mr. Buffett, my name is John Shayne (PH) from Nashville, Tennessee. I want to join the other shareholders and thank you for the results you've achieved, but also for the example that you've set for business, generally.

My question is about float proceeds and whether they can go into common stocks. You've been asked that question before in prior years. Once, I asked you something on that. And I think at least one other shareholder has.

But I'm wondering if you might go into a little more detail. If I've understood you in the past, you've said, "Yes, you can — the float's available to go into common stocks."

I think it's an important question because it affects the intrinsic value of that float. If that float is locked into fixed income, it's worth one thing. If it could go into stocks at one point, it's obviously worth quite a bit more.

What I've had trouble understanding is, I think you must have some way that you can guarantee that the policyholders will be protected. Obviously, you can invest everything in a low market, and the market goes even lower.

Is it simply the size of the capital you've got that you think that'd be extraordinarily unlikely? Or do you use future insurance revenues, premium revenues, to pay off claims? Would you borrow to pay off claims?

If you could give some detail on that, maybe we could get some comfort as to how you're thinking about that.

WARREN BUFFETT: Yeah. The float, in no way, is limited to fixed-income securities. The float is really available for anything that we feel is the most intelligent at any given time.

And the reason we can say that, and other insurance companies can't say that, is because we have an incredible abundance of capital, plus other streams of earning power which are unrelated to the insurance business.

So we could have the float entirely in equities. And we have had that, in the past, or tantamount to that. And we could have a lot of it in operating businesses. We can have it anyplace it makes the most sense.

But the only reason we can do that is because we have extraordinary capital. And we don't have much debt.

We run the business differently than, or think about it differently, than probably 90 percent of managements do.

We look at the assets on a consolidated basis with a few little exceptions. We look at the asset and the liability side — completely absent any linkage for specific assets and liabilities.

So our job at Berkshire is to get the liabilities as cheaply as possible. We want all the liabilities we can get and not have any worries about fulfilling as cheap as we can, plus a lot of capital. And then we want all the assets to be employed as intelligently as possible.

And we don't match up, you know, a billion dollars of assets on the asset side against a billion of specific liabilities on the right-hand side. There's one or two exceptions to that, but that's — where we're required to — but that's the basic approach.

So, when Charlie and I think about Berkshire, we're thinking about, how do we get as much money as we can as cheap as we can without, in any way, endangering our ability, ever, to pay anybody, under any circumstances?

And then, how do we put it out in a way that we feel the most comfortable on the asset side, at the best returns? And frequently, that will be equities. And it has been, over the past. Sometimes, we — it won't be. We can't find them. But that's the goal.

And float is available just like — in virtually all cases — just like common equity. We don't distinguish those in our mind.

And that gives us — that flexibility gives us some edge and, perhaps, quite an edge, at times, over other — over our competitors.

Charlie?

CHARLIE MUNGER: Well, yeah, you can see that in the results to date. We have used that edge in the past. And we hope to use it in the future.

30. Liz Claiborne and Jones Apparel investments

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Hi, I am Kevin Pilon (PH) from Simsbury, Connecticut.

Let me just say, quickly, that I'm really looking forward to Charlie's book. And I hope it expands on the talks he gave that were reported in (inaudible) with regard to having a certain number of models that you need to understand and prosper in life.

I have two questions. And I'll ask them quickly, in succession. Because you may want to punt on the first one.

The first question is, I'm interested in any comments you might have that would expand on your general interest in the branded apparel companies, Liz Claiborne and Jones.

And the second question is, I wonder if you would comment on the future of Freddie Mac with all the current brouhaha.

Every year, there's new brouhaha, as you know, with the buyback of the 30-year bond and the search for a new benchmark and the Treasury saying that, perhaps, the agency securities were not backed by the full faith and credit of the government.

WARREN BUFFETT: Yeah, we — we're not going to be able to help you too much on some of those. Because we may have some views, but they may be things that we don't really want to talk about.

The Liz Claiborne and the Jones Apparel investments you're talking about, the Jones Apparel is a decision that was made by Lou Simpson at GEICO.

Lou runs a separate portfolio of equities for Berkshire. They're held in GEICO. But obviously, they're for the account of Berkshire. And that portfolio is well over 2 billion. And to some extent, it can be expanded or contracted based on what Lou would like to do.

And he runs that 100 percent on his own. And he's compensated based on how that portfolio does. He makes decisions, buying and selling, without talking to me at all, which is the way we like it.

Sometimes, there's an overlap in our decisions. But when I, for example, when I first found out about Jones Apparel, I'd never read an annual report of the company. I didn't know what they did or anything.

But that's Lou's baby. And he's very good at managing money. And he's a fellow that has 100 percent of my trust.

So I know his general criteria for investing, which is quite similar to mine, not identical, but quite similar to mine. And he's got a familiarity with businesses that, again, is quite similar to mine but not identical.

And he runs a good portfolio. And it makes life a little easier for me, not to have that two and a fraction billion added to all the rest that I'm having trouble investing.

Liz Claiborne came about a little differently. I got a call one weekend, actually, on purchasing a large block that someone was going to sell. And we bought that on a Monday morning in London, as I remember.

It was never reported on any exchange. I'm not quite sure even how it happened. But the broker that handled it arranged the trade over there.

And, you know, they've had a very, very decent record. They buy in their shares. I like the business that they run.

It's not a Coca-Cola-type business or a Gillette-type business or even an American Express business. But we were offered that stock at a very attractive price. And it's worked out fine.

The Freddie question, I'd rather not get into it, frankly. Because there's a lot of political overtones to that. But Charlie?

CHARLIE MUNGER: I can pass as well as you can.

WARREN BUFFETT: OK. (Laughter)

31. Berkshire's next CEO won't be a "caretaker"

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Garesh Paku (PH) from Croton, New York. First, regarding — I just have a couple of questions.

First, regarding the succession issue. I just can't imagine that you would allow someone else to paint over your picture afterwards, I guess, post-truck.

So I was wondering, would the — is your — is the nature of your succession plans more of a caretaker role of the museum? Or is it more active? That's the —

WARREN BUFFETT: It would be more active. No, the last thing in the world I would want would be a caretaker. That would be — no, that would not — I would not want that to be my legacy.

32. Potential impacts of inflation on GEICO

AUDIENCE MEMBER: And the second question is regarding inflation. While I appreciate your focus on the specific businesses and your insistence that you not try to predict it, we've been very fortunate by successively lower rates of inflation.

And I'm wondering, with all of the money sloshing around and between real estate and stocks and all the other places, whether you are concerned about inflation, what effect that would have on the insurance businesses at Berkshire, and what you can do to guard against those risks.

WARREN BUFFETT: My record is just terrible, in terms of predicting the inflation rate. So, it is not something that enters into our decision making.

The big danger in — a speed-up of inflation would lead to more dollar volume in the insurance business. And more dollar volume is basically good for us, even though there might be a lag in pricing, that would eventually catch up and all that.

So, absent the next factor I'm going to mention, inflation is not necessarily harmful at all to something like a GEICO.

As you get into longer-tail liability lines, such as a General Re might have, inflation has this effect of hitting liabilities that were created four, five, 10 years earlier, maybe, and they get resettled in current dollars. And obviously, that ratchets up the cost of settling those liabilities, in kind of an unpredictable way.

The danger in inflation to something like GEICO would be that people get, during inflation, they get irritated about the price of everything going up.

And there are some things they can do something about. And there's others they can't. And then there are some they think they can, even though they can't. And one of those might be the cost of insurance.

So the people might get very upset with the system of auto insurance, when they see a very significant part of their annual budget. Because an auto insurance policy, on average, is significant to people, and virtually every consumer in the country.

And there could be a lot of pressure on legislatures to do a variety of things that might change the system in a major way.

It wouldn't reduce the number of cars that crashed into each other or the injuries that were done or anything else. But it would be a way of striking out against higher rates.

And people would be unhappy about those rates. And that also might reflect itself in difficulty getting the increases that were required to take care of the costs that were ratcheting up fast.

So net, I think, inflation is bad for the auto insurance business. Although, you can argue that, you know, GEICO —

I think when I first got interested in GEICO, they had about a — it was in 1951, I wrote it up in "Security I Like Best." I think they had about 175,000 policies. And I think they were writing about 7 million of business, which would be about 40 bucks a policy.

Now, if we were getting $40 a policy now, you know, our premium volume would — the company would be a whole lot less valuable than it is.

And so one way or another, it ended up going from that period of $40 an average policy to 12 — or $1,100 an average policy without the roof caving in on it.

And it has been made more valuable, in dollar terms, by a combination of inflation and a great business model, without it getting destroyed in the process.

Nevertheless, I would prefer a noninflationary environment. It's better for the whole world, over time. And that the way our hope goes.

And then we have this, so far, unwarranted fear that the kind of conditions that have existed over the last 15 years might cause a re-ignition of inflation, which to date, it hasn't.

I don't know any more about what's going to happen than you do on that.

Charlie?

CHARLIE MUNGER: I don't know anything, either. (Laughter)

33. International expansion: interesting but not easy

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Good afternoon, gentlemen. My name is Zeke Turner, and currently finishing up my senior year at Taylor University in Indiana. So four more weeks, and I'm out of there. (Buffett laughs)

As someone studying finance, I do appreciate your comments as to the teaching of investment in academia. It certainly has some development it can make there. I do say that with hope that very few grad school admissions officers are listening right now.

But I do want to say a special thank you quickly, if I could, to all those professors who do have the intelligence and the guts to actually teach value investing on that level and go away from efficient market theories. I do kind of wish Benjamin Graham were still teaching.

Many questions have been asked as far as technology and its development into the business model. I think the greatest effect of this will probably be in the globalization of the economy. This has had, and will continue to have, a significant impact on the business model as we know it today.

Now, except for certain growth opportunities, this may have a smaller effect on companies such as See's Candy or Nebraska Furniture Mart, but has had and probably will continue to have a dramatic effect on companies like Gillette, Coke, who have significant international presence.

My question is, how does your approach change, if at all, in light of the international expansion?

I'm particularly interested in the introduction of greater difficulty in understanding the business models, in the understanding of the economic future and the economic risk associated with the international scene. In addition, do you actively search for a global scene for investment opportunities?

WARREN BUFFETT: Yeah. The answer is that we obviously like businesses that are good businesses at present volume and that have the chances to expand significantly with similar economics.

And with any business that's been around the United States a long time, there's probably more opportunity, potentially anyway, around the rest of the world than here.

And Coke has grown faster. Oh, it's grown well here. But it's grown faster around the world than here. And that's been true at Gillette, also, just because we were a more mature market.

So we love the idea of products that will travel. Some travel well. Some don't. I mean, it's an incredible world that way.

Candy bars don't seem to travel so well, you know. Soft drinks travel terrifically. And razor blades travel terrifically. But the Cadbury bars sell in England. And, you know, and the Hershey bars sell here. And it's very hard, with some items, to try —

In fact, within this country, it's amazing to me. We talk about having a mobile society. And people are moving all the time. And we're all watching the same television and everything else.

And the supermarket share of Dr. Pepper in Dallas is 18 and a fraction percent. And in Boston, it's six-tenths of one percent. I mean, 18 to 0.6, 30 times the market share.

Dr. Pepper's been around forever. You know, people move back and forth and everything. And how can you have that sort of a differential in this country?

Royal Crown Cola, 3 percent in Chicago, one-tenth of a percent, you know, maybe, in Detroit, a couple hundred miles away, same kind of people, all that sort of thing. And Royal Crown's been around for 75 years or whatever it may be, 50 years, at least.

And you get these incredible differences in what people do, even within this country. So it's not easy to predict how — if you can't predict how Dr. Pepper — if you can't figure out how to make Dr. —

If I owned Dr. Pepper and was selling 18 percent of the market in the supermarkets of Dallas, it would drive me crazy, you know, I was getting six-tenths of a percent in Boston. Or, I think it's five-tenths, maybe, in Detroit. That would drive me crazy, although maybe I should just be grateful that I've got 18 percent in Dallas.

It just — it's very hard to predict how products will travel. With See's Candy, you know, we have this incredible penetration in the West and particularly in California. We know it's the best candy.

Now, boxed chocolates just do not sell big in this country. The annual consumption is low. But it still seems that, if we can make a lot of money in California, we ought to be able to make some money in New York or Pennsylvania.

But we haven't figure out how to do it. And we've tried a lot of things.

So, the answer is we're always interested in geographical expansion, whether it's even in the United States or, going beyond that, into other countries.

It's not as easy as it looks. But when the chance to do it comes, then you ought to just pound and pound and pound.

And we occasionally have bought stocks in other countries. I wrote a fellow the other day that I read about in Germany about his business. I've never met him or anything else. But it sounded like he had a pretty good business. And it sounded like he might be my type of guy.

So I just wrote him a letter. Haven't heard back, either. But I may. The odds are against it. But it sounded to me like I'd buy his business, if he chose to write back and wanted to do something.

And we're very willing to do business, you know, in any country in the world, where we think we understand the nuances of the corporate governance system and taxation and that sort of thing.

We don't understand all 200 countries, by a long shot. But there's plenty we'd love to be in business in.

We looked at a very significant company in Japan a couple years ago. And some other fellow I know bought it and has done very well. It would've made sense for us. And we missed it.

We will continue to look at things, internationally. It makes a lot of sense. And we've got a lot of capital to employ.

We're more likely, by some margin, to find things here. But we may find a big one outside of this country.

Charlie?

CHARLIE MUNGER: Nothing to add.

34. Spending to expand GEICO's business

WARREN BUFFETT: OK. Number 1.

AUDIENCE MEMBER: I'm John Bailey (PH) from Boston, Massachusetts.

You commented, in the annual report, that only part of GEICO's marketing expense last year was required to maintain the business.

This seems to get to the heart of owner earnings, where, in the first part, you can value the existing business very well through this observation. And you get a direct measure of the dollars invested in new business.

And it seems that you should be able to make similar observations about other businesses that you may be interested in investing in.

So could you use this as a jumping off point to describe examples, perhaps, of how you contemplate companies' marginal investment opportunities or their return on marginal capital?

And how much weight do you give to the value of the existing business in your investment decisions or the value of the, so to speak, in-force book?

WARREN BUFFETT: Well, we, as we explained earlier, are looking for ways to create more than a dollar of value per dollar we lay out.

We'd love to create $3 of value or $4 of value. But we'll settle for $1.10, if that's all we can get.

We don't consciously make decisions that are 90-cent decisions for a dollar laid out. None of this is that precise, when you get into the application of it.

What we do know, is that there is enough of a margin at, say, a GEICO expansion effort, that it's pretty compelling that it makes sense. Part of the limitation there, as I explained in the report, too, is a question of infrastructure and all of that.

So, it isn't solely a question of saying, you know, "Can we lay out another dollar?" and "Will that have a value of $1.10?" because if we strain the organization beyond its ability to service people, we may be hurting the business already on the books.

I used the GEICO example in the report, because it's big enough, so it's meaningful to shareholders. I mean, we're doing things all the time that cost us money in the short run that we think will more that produce a commensurate value over time, but not on the scale that we're doing it at GEICO currently. And we may step up that scale even.

So, I thought it important to lay out those figures, even though I can't be precise. When I say, you know, that it might be $50 million to maintain, I don't know that figure. It could be 70. It could be 30. Maybe I'm off even more than that.

But that's my best guess. And I think the shareholders are entitled to my best guess. And they're entitled to know how much we are spending, beyond that maintenance cost, to build the business for the future, which we don't, obviously, capitalize on the balance sheet.

So those — GEICO's, by far, the most dramatic. And we don't have comparable expenditures like that going on elsewhere.

But we are spending significant money, for example, to take NetJets to Europe. And we'll be spending it this year and next year.

And then as soon as that starts looking good, we'll be going to Asia and spending more money. I mean, all of those decisions are made that way. They're not on the scale of the GEICO decision, though, at all.

We want to give you the information in the report that, related to the size of the enterprise, would be material to Charlie or me, if we were reading the report and not involved in the business, in trying to figure out what our investment was all about.

That's the goal in what we write and then to keep it to a size that doesn't have to be sent UPS.

35. Problems with Berkshire annual report distribution

WARREN BUFFETT: Incidentally, I'm glad I got wandering along on that line. Because we did have a lot of shareholders this year that got their reports even later than they received them in past years.

Now, they were delivered — the reports that go to registered holders were put in the mail a few days after we go up on the internet here in Omaha. And they seem to get delivered OK.

Street-name holders, which are ten times in number what the registered holders are, so we're really talking about nine out of ten shareholders, get their reports from a firm in New Jersey that is designated, by their broker, to take the reports from us and re-mail them. And we pay those people a fair amount of money to do that.

We know when we deliver those reports to them, which is promptly. And we know when they tell us that they send them out. And we inquire every day, or more than once a day, to find out whether they've gone out.

And we got a lot of complaints this year that people hadn't received them at a time when you would've thought they would've received them.

So, we can either — we know when the designated mailer received them. We don't know for sure when they got them out. And we don't know for sure what happens at the post office.

But we were — the mailing went out about the same as in previous years. But the receipt, apparently, was somewhat later. And all we can say is that we apologize, but we don't have any better system.

The people that have them in their own name will always get them dropped in the mail a couple of days after the report appears on the internet. We can assure you of that.

We can't assure you of when the street-name holders will get their reports, because that is a mailing that we don't handle. And no other companies handle them, to my knowledge.

There is a firm that seems to do about 95 percent of that and is designated by the specific broker with whom you have your shares.

Charlie, you got anything to add?

36. The internet's effect on GEICO and auto insurance pricing

WARREN BUFFETT: OK, number 2.

AUDIENCE MEMBER: Hi, Mr. Buffett and Mr. Munger. My name is Will Obendorf (PH). I'm from San Francisco, California, and I'm 11 years old. I have been a shareholder for six years at Berkshire Hathaway.

My questions are, what are GEICO's sustainable competitive advantages? And my other one is, what are the implications of the internet on pricing for the auto insurance industry?

WARREN BUFFETT: Well, we — we're going to get your name and send it to human relations or whatever they call those departments. We want to hire you. (Laughter)

The sustainable competitive advantage at GEICO is to be the low-cost producer providing very good service.

And there will be a number of companies that provide good services. So that does not distinguish us from a great many competitors.

Having the low cost is crucial. There are companies that specialize in given groups of policyholders, but smaller groups, such as USAA, that have very good costs. So they are very, very competitive with us in their chosen area.

There's another company in Los Angeles that, geographically, called 21st Century Insurance, that has costs like ours. And so they are extremely competitive within that geographic area.

I don't think anybody is any better than us who operates nationwide. We don't operate in Massachusetts or New Jersey. But in the other 48 states, we will have a quote for about anyone.

So, in terms of a broad-based insurance — auto insurance competitor — our competitive advantage has to be low cost over time.

Now, we also have to be as good at distinguishing among the risks posed by different kinds of drivers as other people. In other words, we have to be able to select people who are going to be better-than-average drivers. And we have to be able to understand who is likely to be a poorer-than-average driver.

But — and the ability to do that, to distinguish those people, would be a competitive advantage. I think that many companies tend to be fairly equal on that point. So it's really at this cost level.

And we care very much about cost, the same way that Charlie mentioned a company called Costco does, you know, in terms of retailing. They figure their expense ratios out to hundredths of a percent. And that is important.

So that is the competitive advantage. Now when you get — and we have to sustain and widen that, if possible.

The question of the internet, it's going to be very important. It already is important to GEICO. It will be more and more important. It will be important to the insurance industry.

Because when you have the internet, you have a situation where somebody thinking about insuring a car can click to one place, find out what that rate will be. They can click to someplace else and find out what that rate will be.

So, in effect, they can shop all around without going from place to place to place and driving all over town or calling lots of agencies. They can just do it right there in their den. And that makes it very important, again, that we be the low-cost company.

I think it's going to be an advantage for us, over time. For one thing, I think it makes brand very important. Because we want people to be thinking of GEICO as one of the possibilities to call.

And if you've got the XYZ Company that nobody's ever heard of, nobody's going to think about clicking on them.

And GEICO's brand is becoming extremely familiar to people throughout the country, and we're spending a lot of money to make it even more familiar.

So you've asked two very good questions. And I think we're in pretty good shape on both of them. Thank you.

Charlie?

37. We'll do real estate deals, but only at the right price

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Good afternoon, Mr. Berkshire and Mr. Hathaway. (Laughter)

My name's Anthony Priest. I'm from Washington, D.C.

A couple months ago, I saw an ad in the "Wall Street Journal," where it said, "Berkshire Hathaway wants to see real estate finance opportunities in excess of $100 million."

I was curious about your thoughts in this area, the real estate field, some of your goals, if you can talk about any of the deals you may have made, and if Donald Trump has given you a call yet. (Laughter)

WARREN BUFFETT: I don't think Donald Trump will give us a call.

We have got about, what, three deals that we've put on in the last couple of years in real estate. And they are in this $100-million-and-up category.

And we're willing to put billions and billions of dollars in, if we can find the right sort of opportunities. Or nothing may happen, depending on — just depending on the market. We don't have —

Most — a lot of places have a mortgage department, or they have a real estate department. And they sort of have a budget. And they put money out based on using up the budget. And they have a whole bunch of people that don't have a job, unless they do that.

That's not the way we operate at Berkshire. We're willing — if the deals are right, you know, we'll do many billions. If the deals aren't right, we don't have anybody whose job is dependent on keeping busy in a field like that. So, we look at the deals when they come in.

Mike Goldberg is in charge of that operation. And we kick things around. He's in the office right next to mine. So, if he hears about a deal, you know, we'll discuss it for three minutes. And we'll sort of know whether it passes the first threshold. And then we'll go on to the second and the third.

But we don't waste a lot of time on things. And we don't care whether we make another deal or not. We'd like to, if the terms are right. And that ad produced some inquiries, not from Donald Trump.

And, you know, one or — there's one or two of — a couple of them are alive at the present time. And we'll see whether they work out.

Real estate deals, by their nature, take longer to put to bed than the kind of thing we normally do. In fact, I can buy a business faster than we can make a real estate deal, usually. That's just the way they work. But we could end up with a —

We're very happy with the three deals that we've got. They're good uses of money. And I hope we find a lot more. But if we don't, I won't be upset.

Charlie, do you have anything to add? Charlie's our real estate expert.

CHARLIE MUNGER: Hardly.

WARREN BUFFETT: We are not financing Charlie's boat, incidentally, despite the rumors. (Laughter)

38. Berkshire is not a "fund"

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi, my name is Joel. I'm an undergraduate student at the University of Virginia. Just — I have two questions.

My first question is, how important do you think the structure of your fund is to its long-term success?

And by that, I mean, in the last couple weeks, some other legendary investors, like Julian Robertson, Stanley Druckenmiller, have been forced to either close or restructure their funds as a result of a kind of vicious cycle of underperformance and subsequent redemptions and then even worse performance.

Do you think that the structure of your fund, as a publically-traded company, as opposed to a private partnership, like Tiger and Quantum, has protected your business from a similar fate?

Or phrased a different way, do you think that, if Tiger or Quantum were structured the way that Berkshire Hathaway is, that they might still be in business in the same way today?

WARREN BUFFETT: Yeah, we don't consider ourselves in remotely the same business as Tiger. I mean, they are managing a securities operation. And we aren't doing anything like what they do. So that — they have —

Thirty years ago, when I had the partnership, it was much more along their lines, although still far from what they do. But it was structured much more like what they did.

And I — and, although we had bought control of businesses and all that, we were functioning much more — or, focusing much more on securities.

We don't care whether we own a stock or a bond. We will over the next 20 years. But that's not what we're about. We're not a fund. We are an operating business that generates a lot of capital and uses that to buy other businesses in whole or part.

And we prefer in whole. But we sometimes do it in part.

But I would — I don't consider — which is a reason why I don't consider book value that important, although it — it's got the importance I attributed to it earlier.

But, we could easily have 90 percent of the value of Berkshire, ten years from now, be represented by businesses that we own and 10 percent by securities. Or we could very easily have 60 or 70 percent represented by securities, depending on how markets develop.

I hope it develops in the former way. But I'm perfectly willing to go the other way, too. But it just has no relationship to the kind of funds you talk about. They —

We are structured poorly, from a tax standpoint, compared to those fellows, and compared to what I used to have in the '60s.

But that's, you know, that's a decision we made. And we're stuck with it, more or less.

It's not a great tax structure, if you're going to own securities. But we may not own that many securities over time.

Charlie?

CHARLIE MUNGER: Well, I do think that the people in the relative performance game, who are trying to attract so-called hot money, are living in a totally different world from ours.

I mean, Soros, in the end, was not willing to have a lot of people make a lot of money in high-tech stocks and not be part of that game. And they got killed.

We're perfectly willing to let something we don't understand very well rage on while a lot of other people make a lot of money we don't.

WARREN BUFFETT: Yeah, we — it's just not a securities operation that we have. We own a lot of securities at present. And we'll probably own a lot five or 10 years from now. But it's not what Berkshire is necessarily about.

Ideally, you know, I would love it if we could move all the money in securities into businesses that we liked. But that's — that isn't going to happen, in all probability.

It's too tough, because we can't find multi-billion-dollar businesses to buy right and left. We find a few. But they tend to be small.

39. We wouldn't buy a company that lies to itself

WARREN BUFFETT: Number 5?

AUDIENCE MEMBER: My name is Paul Tomasik from Chicago. My question is about intellectual honesty and your incredible ability of rising intellectual honesty in organizations.

In particular, you look at General Re, a large, well-managed, publically-traded firm. And if you think about it, if you raise the intellectual honesty in an organization like that, initially, you're going to have an aberration, as you called it.

In particular, Berkshire Hathaway was the first company to write-down the Uni — what is it — Unicover write-down, whereas Aon pushed it on into the year 2000.

Can you comment, give us some hints, on how you raise the intellectual honesty in an organization?

And somebody whispered in my ear, they wanted to know Charlie's reading list. I guess they finished "Guns, Germs, and Steel." Thank you.

WARREN BUFFETT: We really don't want to buy into any organization that we felt would be lacking that quality, in the first place. Because we really don't believe in buying into organizations to change them.

We may, you know, we may change the comp system a little or something of the sort.

But, I'm not going to name names, but there are a whole lot of organizations that, if we bought into them, we wouldn't move their needle one point in terms of how they operate. And we wouldn't be comfortable with how they operated.

So, we try to buy into organizations that we think are very much like ours, at bedrock. And General Re would've recognized that Unicover loss just as quickly if we hadn't owned it, as we had.

Now, that was not true of some other people. But they didn't need any prodding from us in order to realize something like that.

We want people joining us who already are the type that face reality and that tell us, basically, tell us the truth but tell themselves the truth, which is even more important.

And once you get an organization that lies to itself, and there are plenty that do, I just think you get into all kinds of problems.

And people know it throughout the organization. And they adopt the norms of what they think is happening up above them.

And particularly in a financial organization — really in any organization — but particularly in a financial organization, you know, that is death over time. And we wouldn't buy into something that we felt had that problem, with the idea that we would correct it. Because we wouldn't.

You know, it — Charlie and I have had a little experience with some organizations that have had that sort of problem. And it's not correctable, at least, you know, based on the lifespan of humans. It's too much to commit to.

Charlie?

CHARLIE MUNGER: Well, I think you're totally right about General Re. We didn't improve behavior at General Re. They already had a behavior just like ours.

And regarding a reading list, by the mischances of life, I didn't read one book last year that I thought was a lollapalooza. Therefore, I didn't make any recommendations to that bookstore at the airport.

WARREN BUFFETT: Charlie, how many books do you think you've read, though? He reads a lot.

CHARLIE MUNGER: Well, I don't count. And some of them, I skim through pretty fast. But there was no lollapalooza. A book like "Guns, Germs, and Steel" doesn't come along every year.

WARREN BUFFET: OK —

CHARLIE MUNGER: And by the way, that guy was a little nuts in one way.

WARREN BUFFETT: It's hard to get an A from Charlie. (Laughter)

40. Berkshire's competitive advantages in reinsurance

WARREN BUFFETT: OK, is it 6 we're going to?

AUDIENCE MEMBER: Hello. My name's James Armstrong (PH) from Pittsburgh, Pennsylvania. Thanks for having us.

I'd like you to comment, please, on the reinsurance business and how it might look over the next 10 or 20 years.

At Berkshire, we've usually bought businesses that are insulated to some degree from easy entry by new competitors and from commodity-type pricing. We want businesses that possess defensible franchises, few substitutes, resistance to cyclical factors, et cetera.

The reinsurance business carries a lot of characteristics that are the opposite of what we usually look for. There's a lot of excess capacity. We're hindered by irrational and unwise pricing decisions by competitors.

For GenRe to prove out as an investment for us, we need better underwriting. And we also need prices to harden.

But in a world with great global liquidity, where capital moves very rapidly from place to place, why wouldn't the reinsurance business gradually evolve into a poor business, where all excess returns are competed away, where price is never firm for very long because a new entrant arises and throws capital at the business?

So I'd like you to comment on how GenRe could be made to work. And also, give us a broad view of how the reinsurance business might unfold in the next 10 or 20 years. Thanks.

WARREN BUFFETT: OK. You made some good points. And, I — we have been, actually, in the reinsurance business, at Berkshire Hathaway, for 30 years.

So it's a business, obviously, that we've paid a lot of attention to. And we've gotten some scars from it at times. But overall, we've done extremely well.

And the reason we've done extremely well is because we've had an absolutely sensational manager in Ajit Jain, who I wrote about, running that business.

But Ajit is a good example of what somebody with brains and energy and discipline and the right temperament and some capital behind him can do in a business.

It's not the world's most efficient business. And it never will be the world's most efficient business, because it's not strictly actuarial. It —

All excess returns will not be competed away. There will be people that will earn very subnormal returns in the business. There will be people who get killed in the business. And that means there will be quite a deviation from the mean in terms of the results of individual insurers.

And we think that both at National Indemnity, under Ajit, and at General Re, that we have advantages, so that our returns will be significantly better than average.

But both of our businesses are subject to getting killed in any single year, will get killed in specific years, but also, in our view, will do better than average and more than satisfactory, in terms of Berkshire Hathaway's results.

You know, I can't prove that to you now. I can show you what's happened over the past years.

I don't think the situation in reinsurance is way different than some years back. There's always dumb competitors. There's always a lot of capital in the business.

In the '85, 1985, 1986 period, people felt very poor. But it wasn't really a lack of financial capital. It was psychological capital that disappeared. People were just plain scared. And that was the best of times to be writing business, obviously. You know we like to —

Prices are somewhat better now. But there are always people that misevaluate risk. And when they misevaluate risk, it's our job to let them have the business.

That's easier to do with Ajit's business in National Indemnity than it is with General Re, because General Re has long-term relationships with many accounts.

And the question of what you do when your competitor offers a price that's a little too low, with somebody you've been doing business with for 50 years, is a very tough decision to make.

And so sometimes, they probably do some business that might be labeled as "necessarily evil." And Charlie always says that he doesn't mind an occasional transaction like that, as long as you underline evil and not necessary.

The nature of people in the business, usually, particularly the frontline guy, who was calling on the account, is to underline necessary. And as owners, our tendency is to underline evil.

GenRe has done a terrific job, over the years, of balancing the necessity of continuing a relationship so long with the discipline of making sure they get paid enough.

That was not done perfectly last year. And the conditions were very difficult for doing it perfectly, I might add, too.

But I think that, both at Ajit's operation and at General Re, we have two businesses that will do very well, in terms of what we get out of them and very well compared to their competition, but occasionally will have a very bad year.

I mean, we could have something happen tomorrow, you know, a Tokyo earthquake. Or, I can name a bunch of them that would result in a very bad year. And that's what we're getting paid for.

And if we price with discipline, our 20-year results can't be bad, no matter what any one year produces. And if we don't price with discipline, we'll get killed over time.

Charlie?

CHARLIE MUNGER: Yeah. I don't think the reinsurance business is quite as much of a commodity business as might first appear. It's not like an execution transaction when you sell government bonds or something, where one broker is roughly just as good as another.

There's such a huge time lag between the time the premium is paid and the time the performance is given that you're making a — the customer is making a big prediction about the insurer's, A, willingness to pay what it really owes and, B, its ability to pay what it really owes.

I think we have a huge edge in reputation and actuality, with reference to both those two factors.

WARREN BUFFETT: Yeah, we have a reputational advantage. And I think that, in actuality, it's even stronger than the reputational advantage. I mean, I can't think of a case where there's been any problem with having Berkshire or General Re write a check very promptly for anything it owed.

I mean, we've, you know, we have never been subject to people suing us and getting money later on or anything like that after fighting us out in courts. It just — it's not the nature, it's not the attitude we bring toward the reinsurance transaction.

And we have a reputational advantage. But like I said, I don't think it's quite as wide as it should be in some cases, even.

And then we have a huge attitudinal advantage in that we have no need, none, to write more business, or the same amount of business, or even something close to the amount of business, next year that we wrote this year.

We — there is no — there are no volume goals at Berkshire Hathaway at all. And that is not true at most insurance organizations.

We report the results as they come in and as we see them, which also, I think, gives us an advantage in being realistic about all aspects of our business.

We have huge amounts of capital behind us. So we can take large pieces of attractive business and keep them all for our own accounts.

So we have a lot of advantages in the business. And they will translate into something better than the rest of the world gets.

I don't know how much better. And I don't know how much the rest of the world will get. But it's not insignificant, the advantages we have in the business.

Morning Session - 2001 Meeting

1. Formal business meeting

(Video recording begins with meeting already in progress)

WARREN BUFFETT: And — (laughter) — Andy [Heyward], if you're here, you could stand up, I think the crowd would like to say thanks. (Applause)

We have one other guest, too. After doing an incredible job for all Berkshire shareholders and particularly for Charlie and me, Ralph Schey retired this year. But Ralph and Luci, I believe, are here. And [if] Ralph and Luci would stand up, the shareholders and I would like to say thanks. (Applause)

Scott Fetzer was one of the best acquisitions we ever made, but the reason it was among the very best was Ralph. And a great many of the other companies that we own now, our ownership was made possible because of the profit that Ralph delivered over the years. So, thanks very much, Ralph.

Now we will come to order. I will go through this fast. I'm Warren Buffett, chairman of the board of directors of the company, and I welcome you to this 2001 annual meeting of shareholders.

I will first introduce the Berkshire Hathaway directors that are present in addition to myself.

First of all, of course, is Charlie, on my left. And if you'll — the directors will stand when I give your name.

Howard Buffett, Susan Buffett — she was the voice on the songs, the ones that were sang — sung well — Malcolm G. Chace, Ronald L. Olson, and Walter Scott Jr.

Also with us today are partners in the firm of Deloitte and Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire, and he will make a written record of the proceedings. Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg. We will conduct the business of the meeting, and then adjourn the formal meeting. After that, we will entertain questions that you might have.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting, that was sent by First-Class Mail to all shareholders of record, on March 2, 2001, being the record date for this meeting, there were 1,343,041 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting and 5,505,791 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,116,384 Class A shares, and 4,507,896 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 26.

WARREN BUFFETT: Thank you. That number represents a quorum, and we will therefore directly proceed with the meeting.

First of order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott Jr. who will place a motion before the meeting.

WALTER SCOTT JR.: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with.

WARREN BUFFETT: Do I hear a second?

VOICES: Aye.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions? We will vote on this motion by voice vote. All those in favor, say, "Aye."

VOICES: Aye.

WARREN BUFFETT: Opposed, say, "Bye, I'm leaving." (Laughter)

The motion is carried. The first item of business of this meeting is to elect directors. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy, and desires a ballot in order to vote in person, you may do so. If you wish to do this, please identify yourself to meeting officials in the aisles, who will furnish a ballot to you. Would those persons desiring ballots please identify themselves, so that we may distribute them?

I now recognize Mr. Walter Scott Jr. to place a motion before the meeting with respect to election of directors.

WALTER SCOTT JR.: I move that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. be elected as directors.

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. be elected as directors. Are there any other nominations? Is there any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of election.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors, voting the proxies in accordance with the instructions they have received?

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders, in response to the proxies that were received through last Thursday evening, cast not less 1,126,480 votes for each nominee.

That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders, in response to proxies delivered at this meeting, as well as those cast in person at this meeting, if any, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. have been elected as directors.

The next item of business was scheduled to be a proposal put forth by Berkshire shareholder Bartlett Naylor. On April 20th, 2001, Mr. Naylor advised us he was withdrawing his proposal. Accordingly, we will not have the proposal presented at this meeting.

At the adjournment of the business meeting, I will respond to questions you may have that relate to the business of Berkshire, but do not call for any action at this meeting.

Does anyone have any further business to come before this meeting, before we adjourn? If not, I recognize Mr. Walter Scott Jr. to place a motion for the meeting.

WALTER SCOTT JR.: I move this meeting be adjourned.

WARREN BUFFETT: Motion to adjourn has made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say, "Aye."

VOICES: Aye.

WARREN BUFFETT: Opposed say, "No." Meeting's adjourned. (Applause)

I ask you, am I getting slower in my old age? No, I'm — (Laughter)

Now, the first — we're going to go —

We have eight microphones strategically placed. We have the first two on my right. Far back, three and four, and over to this back area, over here, and then up front for the seven and eight.

And if you have a question, just go to the microphone, and queue up at the microphone, and we'll keep rotating, like I say, until noon. Then we'll have a break, and then we'll start again around 12:30, or thereabouts, and go until 3:30.

2. Four-year-old and Buffett look ahead to Berkshire's future

WARREN BUFFETT: Now, first question in area 1, we have a special guest.

I received a letter from Mark Perkins on April 5th, telling me about his daughter, who has been a shareholder since she was 6 months old.

And she's going to be 4 in November, and she would like — Marietta would like to ask the first question.

And frankly, I take all the questions from 4-year-olds, and Charlie handles them from anybody — (laughter) — that's been around a little longer.

So Marietta, if you've got the microphone there, would you ask your question, please?

VOICE: Ask him. (Inaudible)

MARIETTA: (Inaudible)

VOICE: I'm Marietta.

MARIETTA: Marietta.

VOICE: I'm three. Speak up.

MARIETTA: I’m three.

VOICE: Berkshire Hathaway fistful of dollars.

MARIETTA: (Inaudible) dollars. (Laughter)

VOICE: Her — actually, her question was, she said she was three, and she says, “Berkshire Hathaway fistful of dollars,” and she says, “What should we invest in now” so that she’ll be ready when she goes to college?

WARREN BUFFETT: What should she invest in, or what should Berkshire invest in?

MOTHER: What should Berkshire invest in?

WARREN BUFFETT: Well, Berkshire would like very much to buy businesses of the same quality, and with managements of the same quality, and at prices consistent with the eight businesses that we’ve bought over the last 16 or 18 months.

Our first preference is, and has been for many decades — although I would say most observers didn’t seem to realize it — but our first preference has always to been — to be buying outstanding operating businesses. And we’ve had a little more luck in that respect lately.

We also own lots of marketable securities. We’ve bought many of those, for example, in the mid-’70s, that did very well for us. But the climate has not been as friendly toward making money out of marketable securities.

And we, frankly, prefer — we prefer the activities associated with owning and operating businesses over time.

So what we hope to do, Marietta, is by the time you’re ready to go to college, I would hope that

well, first of all, I’d hope I’m still around. (Laughter)

But beyond that, I would hope that we would have — you’ll be ready in about 14 years or so. I would hope that we would have another, maybe, 40 businesses or so that would be added. And I would hope that we would have every business that we have now.

And I would hope we would not have more shares outstanding, or any — at least any appreciable number of more shares outstanding.

If we can get all that done, I think you’ll probably be able to afford college.

Charlie, do you have anything to add?

CHARLIE MUNGER: No. (Laughter)

WARREN BUFFETT: And there's some things in life, Marietta, you can really count on. (Laughter)

3. Tech sector not comparable to pharmaceuticals

WARREN BUFFETT: OK, let's go to microphone number 2.

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger.

VOICE: (Inaudible)

AUDIENCE MEMBER: Oh, sorry. OK.

If you want to trade a share of Berkshire A for 30 shares of Berkshire B, as you had mentioned before, a personal stock split, or vice versa, is this considered a wash sale for tax purposes?

Also, I'd like to ask you a question which you've heard before, but in a slightly different context. A few years ago, you said you had made a mistake by not buying shares of the major pharmaceutical companies around 1993.

You cited their value to society, as well as their terrific growth, high profit margins, and great potential. You said that while you didn't know which companies would do the best, you could've made some kind of sector play, because the entire sector had been decimated.

These exact same words, including those about not knowing which businesses will dominate over time, can also be used to describe another industry, which has recently been decimated.

This is industry is, of course, technology. How do you see these two investment ideas, pharmaceuticals in '93 and technology now, and what difference in the two situations makes the first a good opportunity for Berkshire, and the second not one?

WARREN BUFFETT: Well, Charlie answers all the questions about mistakes, so I will turn the second question over to him. (Laughter)

CHARLIE MUNGER: Personally, I think that the future of the pharmaceutical industry was easier to predict than the future of the high-technology sector.

In the pharmaceutical sector, almost everybody did well, and some companies did extremely well. In the other sector, why, there are many permanent casualties in the high-tech sector.

WARREN BUFFETT: Yeah, I would say that there's certainly nothing obvious to us about the fact that the tech sector — as a group — viewed in aggregate — would be a good buy or be undervalued.

Whereas we should have had enough sense to recognize that the pharmaceutical industry, as a group, was undervalued.

But the pharmaceutical industry has a far, far better record of returns on large amounts of equity over time, and with a high percentage of the participants having those returns, than the tech industry. I wouldn't regard those two as comparable at all.

4. Tax implications for exchanging Berkshire share classes

WARREN BUFFETT: Your first question about exchanging and whether you have a wash sale, and I think you indicated exchanging from B into A.

If you actually, physically, have a share of A, and turn it in for 30 shares of B, that is not a taxable transaction, so there is no sale under such a circumstance. If you —

There would be no reason, unless the B was at a significant discount, to actually sell the A and buy the B, but I — and I'm not giving tax advice on this — but I would think that they — I think the tax code refers to "substantially identical" securities when they talk about wash sales.

And I would think that you — that the IRS would be entitled to, at least, raise the question if you had an A share you were selling at a loss, and replacing it with 30 shares of B.

You'd have a better argument than if you bought a share of A back the next day, if you were establishing a loss. If you were establishing a gain, you'd have no reason — you know, they're not worried about wash sales in that respect.

You can't go from B to A by exchange, but you could go by selling 30 shares of B in the market, and buying a share of A.

Again, if that were being done at a loss, I think the IRS could well argue that they were substantially identical, but you could argue otherwise.

Charlie?

CHARLIE MUNGER: No, no, I think the IRS would win.

WARREN BUFFETT: Yeah. (Laughter)

Charlie might even go state's evidence, you know, if there was a (inaudible).

5. Berkshire isn't hindered by state insurance regulators

WARREN BUFFETT: OK, let's go to zone 3.

AUDIENCE MEMBER: I'm Dan Blum (PH) from Seattle, Washington.

As an insurance holding company, Berkshire Hathaway is subject to regulation by insurance departments in every state in which GEICO or your other insurance subsidiaries do business.

Has that handicapped or affected your operations in any way? And do you have any trenchant or wise observations to make about governmental regulation in that context?

WARREN BUFFETT: Yeah, we've really not been impeded in any way by the fact that — Berkshire Hathaway itself is not an insurance company, but it owns various insurance companies. Of course, it owns a lot of other companies, too.

But being the holding company of insurance companies, which indeed are regulated by the states in which they're admitted, it really has not slowed down any acquisition.

They are not — whereas with the Public Utility Holding Company Act, under that statute, the authorities are directed to be concerned with the activities of the holding company. And in the banking business, to some extent, they are.

In the insurance business, there's relatively little in the way of regulation or oversight that extends up to the holding company. So, it has not slowed us down in that business, but it's been reported recently in the electric utility business.

There's a statute from 1935, the Public Utility Holding Company Act, the acronym is that euphonious term, PUHCA. (Laughter)

The Public Utility Holding Company Act has a lot of rules about what the parent company could do. And that act was put on the books because the holding companies of the '20s, most particularly ones held by — formed by — Sam Insull, but there were others.

There were many abuses, and a good many of those abuses involved what took place at the holding company. So it was quite understandable that that act was passed in the '30s. And it achieved a pro-social purpose at the time.

I don't think there's anything, frankly, pro-social about limiting Berkshire's ability to buy into other utilities. We can buy up to five percent of the stock. But we might well, in the last year or two, have bought an entire utility business if it were not — if that statute weren't present.

So we're handicapped by the utility holding company statute, we are not handicapped, in my view, by any state insurance statutes.

Charlie?

CHARLIE MUNGER: Nothing to add. (Laughter)

6. "Pain today, gain tomorrow" insurance transactions

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Good morning.

WARREN BUFFETT: Good morning.

AUDIENCE MEMBER: Steve Bloomberg, from Chicago. I have two questions regarding the insurance operations.

With regard to the reinsurance contracts, which were written at what some consider and call "good losses," you've discussed those insurance contracts in your report, indicating that it's generated 482 million of losses in the year 2000.

Do we need an annual schedule disclosing the aggregate amortized charges of all current and past such deals, to make our adjustments, to reflect economic reality?

WARREN BUFFETT: Well, there are two unusual-type deals, and you referred to one type, what I call the "pain today, gain tomorrow," or good losses-type deals.

And under the deals you're describing, we record a usually quite significant loss in the current year, and then we have the use of float for many years to come, and there are no subsequent charges against that.

So in respect to those contracts, the important thing is that we tell you — and we should tell you — really, every quarter if they're significant, and certainly yearly, any significant items that fall in that category.

And as you mentioned, you know, we had over 400 million last year. We had a significant amount the year before.

We have not had a significant amount this year. I think, in the first quarter, there may have been a 12 million charge for one of those.

If they're significant, we're going to tell you about them.

It's a one-time adjustment in your mind that, in effect, should — you should regard as different than any other type of underwriting loss that we experience, because we willingly enter into these.

We take the hit the first year, and accounting calls for that. And over the life of the contract, we expect to make money. And our experience would be that we do make money.

But we'll tell you about any significant item of that sort, so that you will be able to make an adjusted cost to float. I reported our cost to float last year at 6 percent, which is high. It's not unbearable, but it's high, very high.

And included in that 6 percent cost was — about a quarter of it came from these transactions that distorted the current year figure. And therefore, our cost of float, if we hadn't willingly engaged in those transactions, would've been about 4 1/2 percent.

I should mention to you that I expect that our cost of float — I said in the annual report — that absent a mega-catastrophe — and I might define a mega-catastrophe as insured losses, we'll say, of 20 billion or more, or something on that order — absent a mega-catastrophe, we expected our cost of float to come down this year, and I said perhaps substantially.

In the first quarter, our cost of float will probably run just a touch under 3 percent, and — on an annualized basis.

And I think that — I think the trend is in that direction, absent a mega-catastrophe. I would expect the cost of float, actually, to come down substantially this year.

But if we were to take on some of these "pain today, gain tomorrow" transactions — and we don't have any in the works at the moment — but if we were to take those on, then it would be reflected in our cost of float, and we would lay out the impact of that sort of transaction.

Charlie?

CHARLIE MUNGER: Yeah, I think almost all good businesses have occasions where they're making today look a little worse than today would otherwise be, to help tomorrow. So I regard these transactions as very much the friends of the shareholders.

WARREN BUFFETT: We have a second type of transaction, just to complete, which we also described in the report, which also creates a large amount of float, but where accounting rules spread the cost of that transaction over the life of the float.

And those do not distort the current-year figures, but they do create an annual charge that exists throughout the life of float. And that charge with us is running something over $300 million a year.

But there again, it's a transaction that we willingly and enthusiastically engaged in. And that has this annual cost attached to it.

So when you see our cost to float at 3 percent, annualized, in the first quarter, it includes, probably, a $80 million charge or so, relative to those retroactive insurance contracts, which were the second kind described in the report.

I recognize this accounting is, you know — and even the transactions — are somewhat Greek to some of you. But they are important, in respect to Berkshire, so we do want to lay them out in the annual report for those who want to do their own calculations of intrinsic value.

7. "What really costs … are the blown opportunities"

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Good morning, gentlemen, my name is Jay Parker. I'm from Washington State. And this question regards mistakes. So that being the case, it should probably be directed to Mr. Munger.

Mr. Munger, I know you're fond of evoking humility to promote rational thought. So my question is, what's the most recent business mistake that you've made, Mr. Munger, and why did it occur? (Laughter)

WARREN BUFFETT: I'm going to take notes on this one. (Laughter)

CHARLIE MUNGER: The mistakes that have been most extreme in Berkshire's history are mistakes of omission. They don't show up in our figures. They show up in opportunity costs.

In other words, we have opportunities, we almost do it. In retrospect, we can tell that we were very much mistaken not to do it.

In terms of the shareholders, those are the ones in our history that it really cost the most. And very few managements do much thinking or talking about opportunity costs. But Warren, we have blown —

WARREN BUFFETT: Billions and billions and billions. I might as well say it. (Laughter)

CHARLIE MUNGER: Right, right. And we keep doing it. (Laughter)

WARREN BUFFETT: Some might say we're getting better at it. (Laughter)

CHARLIE MUNGER: I don't like mentioning the specific companies, because the — you know, we may, in due course, want to buy them again and have an opportunity to do so at our price.

But practically everywhere in life, and in corporate life, too, what really costs, in comparison with what easily might have been, are the blown opportunities. I mean, it just — it's an awesome amount of money.

When I was somewhat younger, I was offered 300 shares of Belridge Oil. Any idiot could've told there was no possibility of losing money, and a large possibility of making money. I bought it.

The guy called me back three days later, and offered me 1,500 more shares. But this time, I had to sell something to buy the damn Belridge Oil. That mistake, if you traced it through, has cost me $200 million.

And I — it was all because I had to go to a slight inconvenience and sell something. Berkshire does that kind of thing, too. We never get over it. (Laughter)

WARREN BUFFETT: Yeah. I might add that when we speak of errors of omission, of which we've had plenty, and some very big ones, we don't mean not buying some stock where we — a friend runs it, or we know the name and it went from one to 100. That doesn't mean anything. It's only —

We only regard errors as being things that are within our circle of competence. So if somebody knows how to make money in cocoa beans, or they know how to make money in a software company or anything, and we miss that, that is not an error, as far as we're concerned.

What's an error is when it's something we understand, and we stand there and stare at it, and we don't do anything. Or worse yet, what really gets me is when we do something very small with it. We do an eyedropper's worth of it, when we could do it very big.

Charlie refers to that elegantly when I do that sort of thing as when I'm sucking my thumb. (Laughter)

And there really — I mean, we have been thumbsuckers at times with businesses that we understood well. And it may have been because we started buying, and the price moved up a little, and we waited around hoping we would get more at the price we originally started — there could be a lot of things.

But those are huge mistakes. Conventional accounting, of course, does not pick those up at all. But they're in our scorebook.

8. Not worried "at all" about product liability involving sugar

WARREN BUFFETT: Zone 6, please.

AUDIENCE MEMBER: My name is Joseph Lapray. I'm from Minneapolis, Minnesota.

In recent years, tobacco companies have been compelled to pay large damages for marketing their unhealthy, but discretionary, products. My question has two parts.

First, does the potential for similar damage liabilities reduce the intrinsic value of Coca-Cola, See's Candies, Dairy Queen, or any other business, which sells discretionary products of questionable healthfulness? Not that I don't like these products.

And second, are either of you concerned that a possible erosion in the principle of caveat emptor is undermining the legal basis of contracts, in general? Thank you for taking my question.

WARREN BUFFETT: Well, the products you described, I've been living on for 70 years, so — (laughter) — they'll probably haul me in as a witness if I — that they don't do much damage.

No, I think, if — you know, if you're opposed to sugar and the — I think the average human being eats something like 550 pounds dry weight of food a year. And I think 125 pounds, or thereabouts — I'd have to look at it — it consists of sugar in one form or another.

I mean, it's in practically every product that you have, and happens to be in Coca-Cola, it happens to be in See's Candy, but it's in practically everything you're — I mean, it's over 20 percent of what Americans are consuming, one way or another.

And, you know, the average lifespan of Americans keeps going up. So, I would not be worried at all about product liability in connection with those companies.

But product liability, generally, is an area that is a fertile field for the plaintiff's bar. And it's — we are conscious in buying into businesses, and we have passed up some businesses, because we were worried about the product liability potential.

Unless there is some legislative solution, I think you will see more and more of the GDP going into liability awards. And whether there will be any change by legislation, I don't know. But, you know, it's a big field.

And the lottery ticket aspect of it is so attractive. Because if an attorney can gamble a modest amount of time, or even a reasonable amount of time, and have a potential payoff of 10, or 20, or maybe, in some cases, hundreds of millions of dollars, you know, that's a decent lottery ticket. Who knows what 12 people, you know, are going to be on the jury?

As one of my friends who's a lawyer said, you know, he said, "Lincoln said, 'You can fool all of the people some of the time, and all of the — some of the people all of the time, and all of the people some of the time, but not all of them all the time.'" He says, "I'm just looking for 12 that you can fool all of the time." You know, and — (Laughter)

You know, and all you have to do is get an award. And the odds are fairly favorable in a nation where lots of zeros have sort of lost meaning to people. So it's a very real concern in any business we get into, in terms of trying to evaluate product liability.

Charlie?

CHARLIE MUNGER: What's particularly pernicious is the increasing political power of the plaintiff's contingency, the bar.

If you're on a state Supreme Court, for — in most places, you're on for life. If you — at least, you're on for life if you want to stay for life.

And the one thing that could get you off the court would be to really irritate some important group. And I think that greatly helps a lot of abusive conduct in the courts.

I think the judges of the country haven't been nearly as tough as they should be on junk science, junk economic testimony, trashy lawyers. And I don't see — (applause) — and I don't see many signs that it's getting better.

In Texas, they actually improved the Supreme Court of Texas, which really needed it. So, there are occasional glimmers of life.

WARREN BUFFETT: We make our decisions in insurance and in buying businesses with a very pessimistic attitude toward the chances of that particular ill that Charlie described being even moderated.

I mean, we think if — we would project out that the trend would accelerate, but that's just our natural way of building in a margin of safety in decisions.

Don't worry about eating the See's candy, or the Dairy Queen, or the Coke.

You know, if you read the papers long — I use a lot of salt, and, you know, I was always being warned about that. And then, you know, few years ago they started saying, "You know, you can't get enough salt" and all that. I don't know what the answer is, but I feel terrific. (Laughter)

9. We don't "have cash around just to have cash"

WARREN BUFFETT: Zone 7. (Applause)

AUDIENCE MEMBER: Good morning. I'm Murray Cass from Markham, Ontario.

The financial community relies heavily on the P/E ratio when evaluating prospective investments.

When you buy a company, you must certainly consider not just the future stream of earnings but also the company's financial condition, among other things. By financial condition, I'm speaking mainly of cash and debt.

But the P/E doesn't take into consideration either cash or debt. Occasionally, you see a company with consistently positive free cash flow trading just over cash value, effectively giving away the future earnings. In cases like this, the P/E looks terribly overstated unless adjusted for cash and debt.

I've always preferred companies with oodles of cash to those burdened with lots of debt. And then I read Phil Fisher's book, "Conservative Investors Sleep Well."

Well, I haven't slept well since. He really confused me when he commented that "hoarding cash was evil." He wrote that instead, "Companies should either put the cash to good use or distribute it to shareholders." Can I get your thoughts on this?

WARREN BUFFETT: Well, there are times when we're awash in cash. And there have been plenty of times when we didn't have enough cash.

Charlie and I, I remember in the late '60s, we were — when bank credit was very difficult — we were looking for money over in the Middle East. You remember that, Charlie?

CHARLIE MUNGER: Yes, I do.

WARREN BUFFETT: Yeah, and —

CHARLIE MUNGER: They wanted us to repay it in dinars.

WARREN BUFFETT: Yes, and the guy that wanted us to repaint it — repay him — in dinars — or "deeners," or whatever the hell they call them — (laughter) — was also the guy that determined the value of those things.

So, we — (laughter) — were not terribly excited about meeting up with him on payday and having him decide the exchange rate on that date. (Laughter)

But we, obviously, are looking every day for ways to deploy cash.

And we would never have cash around just to have cash. I mean, we would never think that we should have a cash position of X percent. And I — frankly, I think these asset allocation things that tacticians in Wall Street put out, you know, about 60 percent stocks and 30 — we think that's total nonsense.

So, we want to have all our money — (applause) — working in decent businesses. But sometimes we can't find them, or sometimes cash comes in (un)expectedly, or sometimes we sell something, and we have more cash around than we would like.

And more cash around than we would like means that we have 10 or 15 cents around. Because we want money employed, but we'll never employ it just to employ it. And in recent years, we've tended to be cash heavy, but not because we wanted cash per se.

In the mid-'70s, you know, we were scraping around for every dime we could find to buy things. We don't like lots of leverage, and we never will. We'll never borrow lots of money at Berkshire. It's just not our style.

But you will find us quite unhappy over time if cash just keeps building up. And I think, one way or another, we'll find ways to use it.

Charlie?

CHARLIE MUNGER: I can't add anything to that.

10. Costs vary by type of business

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: Good morning. My name is Mark Dickson (PH) from Sarasota, Florida. And I'd like to thank you for providing this forum for all of us. It's wonderful.

In past years, you've been very specific about some of the numbers related to Coca-Cola, Wells Fargo, Rockwood — specifically like with Coca-Cola — cost of aluminum, and sugar, and all that. It goes into the bottom line of Coca-Cola.

Can you provide some of the specific numbers that go into some of your more recent purchases over the last couple years?

WARREN BUFFETT: Well, they have such different characteristics. That's very difficult. I mean, we have service businesses such as FlightSafety, and Executive Jet is a service business.

And, you know, in many of those companies, the big cost is personnel. I mean, we need people with — at a FlightSafety, we've got a lot of money invested in simulators. We'll put over $200 million into simulators this year, just as we did last year.

So we have a big capital cost in that business, and then we have a big people cost because we are training pilots. And that's very person-on-person intensive. NetJets, part of Executive Jet, very people-intensive. I mean, we are absolutely no better than the people that interact with our clientele.

You get into something like the carpet business, and maybe only 15 percent of your revenues will be accounted for by employment costs. And you're a very heavy raw material buyer. I mean, you're buying lots of fiber.

So it varies enormously by the kind of business you're in.

I mean, when we're in the insurance business, you know, we're in the business of paying future claims. And that's our big cost. And that's — obviously, involves estimates because sometimes we're going to pay the claim five, 10, or 20 years later. We're not going to know about it sometimes till 20 years later.

So, it's very hard to generalize among the businesses.

If you're in the retail business, which we are in the furniture and jewelry in a significant way, purchased goods are very — obviously — very important. We don't manufacture our own goods to any extent in those businesses.

And then, the second cost, of course, is labor in a business like that.

But we don't have any notions as to what we want to buy based on how their costs are segmented. What we really are looking for is an enduring competitive advantage. I mean, that's what's going through our mind all the time.

And then we want, obviously, top-notch people running the place, because we're not going to run them ourselves. So those are the two factors we look at.

We want to understand the cost structure, but Charlie and I can understand the cost structure of many companies — there's many we can't — but we can understand a good many companies.

And we don't really care whether we're buying into a people-intensive business, a raw material-intensive business, a rent-intensive business. We do want to understand it and understand why it's got an edge against its competitors.

Charlie?

CHARLIE MUNGER: Yeah, basically, to some extent we're like the hedgehog that knows one big thing. If you generate float at 3 percent per annum and buy businesses that earn 13 percent per annum with the proceeds of the float, we have actually figured out that that's a pretty good position to be in. (Laughter)

WARREN BUFFETT: It took us a long time. (Laughter)

Incidentally, I would hope that we would — and actually expect that — absent a mega-catastrophe — that 3 percent figure will come down over the next, well, in the near future.

But a mega-catastrophe could change all of that. I mean, if you had a $50 billion insured catastrophe — Tokyo earthquake, California earthquake, Florida hurricane — I mean, those — we're in the business of taking those risks.

We're the largest insurer, as you may know, of the California Earthquake Authority. I have a sister here who is from Carmel, and she used to call me when the dogs and cats start running in circles. (Laughter)

So we're exposed to some things that could change.

But absent a mega-catastrophe, experience is going in the right way at both — at really at all of our insurance companies. And I would expect that to continue for a while. And then at some point I'd expect it to reverse itself. Isn't that helpful? (Laughter)

11. Airlines must keep costs in line with competitors

WARREN BUFFETT: Area 1, please.

AUDIENCE MEMBER: Good morning. I'm Martin Wiegand from Chevy Chase, Maryland.

WARREN BUFFETT: Good to have you here, Martin. (Laughs)

AUDIENCE MEMBER: Thank you. Thank you for the wonderful shareholder weekend, and thank you for the leadership and education you give your shareholders and the general public.

My question. Large airlines are in the news negotiating labor contracts. They claim they can't pass along rising labor costs to their customers.

In the annual report, you say Executive Jet is growing fast and doing great. Executive Jet seems to be able to pass along its rising labor cost to its customers.

Is this because Executive Jet has a rational compensation plan that keeps employee salaries in line with billable services? If not, why does Executive Jet do well while the airlines experience troubles?

WARREN BUFFETT: Well, the big problem with the airlines is not so much what their aggregate payments will be. The real problem is when you're in the airline business and your wage rates are out of line with your competitors.

When you get right down to it, the figure to look at with an airline — among a lot of other things — but you start with the cost per available seat mile. And then you work that through based on the capacity utilization to get to the revenue per — or the cost per — occupied seat mile.

And the — you could have labor costs or any other costs. You certainly have fuel costs up dramatically for the airlines from a couple of years ago.

As long as you're more efficient than your competitor, and your costs are not higher than your competitor, people will continue to fly.

It's when you get your costs out of line with your competitor, which was the situation that — where Charlie and I were directors of USAir a few years back — and our costs per seat mile were far higher than competitors.

And that was fine where we didn't have competitors on some — many of the short routes in the East. But as the Southwest Airlines would move into our territory — and they had costs, we'll say, of — and this is from memory — but they might have had costs below eight cents a seat mile. And our cost might have been 12 cents a seat mile.

You know, that is a — you're going to get killed, eventually. They may not get to this route this year, but they'll get there next year or the year after.

So if you're running a big airline at Delta or United or whatever, if your costs are on parity or less — labor costs — than your other major competitors, that is much more important to you than the absolute level.

And the NetJets service is not really designed to be competitive with United Airlines or an American or something of that sort. It has a different group of competitors.

And I think we have a absolutely terrific pilot force there. And we want them to be happy. But there's a lot of other ways. I mean, you want to pay them fairly. But with our pilots for example, it's extremely important to them, in many cases, to be able to live where they want to and to work the kind of shifts that we can offer. So we attract them in many other ways than bidding against United Airlines or American Airlines.

Big thing in — you just can't take labor costs that are materially higher than your competitor in a business that has commodity-like characteristics such as airline seats. You just can't do it over time.

And you can get away with it for a while. But sooner or later, the nature of a capitalist society is that the guy with the lower cost comes in and kills you.

Charlie?

CHARLIE MUNGER: The airline unions are really tough. And it's interesting to see a group of people that are paid as well as airline pilots with such a brutally tough union structure. That really makes it hard in a commodity-style business.

And no individual airline can take a long shutdown without having considerable effects on habit patterns and future prospects. It's just a very tough business by its nature.

Passenger rail travel, even in a previous era, was a pretty tough way to make a buck. And nothing is all that different with the airline travel.

We hope that our services are preferred by customers more than one airline seat is preferred compared to another.

WARREN BUFFETT: Yes, fractional ownership is not a commodity business. I mean, the people care enormously about service and the assurance of safety. And I don't think that, you know, I don't think if you were buying a parachute you'd want to take the — necessarily take the low bid, and —

CHARLIE MUNGER: Yeah. (Laughter)

WARREN BUFFETT: Now with the big commercial airlines with millions and millions of passengers, people, I think probably correctly assume, that there's quite a similarity in both service and safety.

But if you're in a business that cannot take a long strike, you're basically playing a game of chicken, you know, with your labor unions. Because they're going to lose their jobs, too, if you close down. So you're playing a game of chicken periodically.

And it has a lot — there's a lot of game theory that gets involved.

To some extent, you know, the weaker you are, the better your bargaining position is. Because if you're extremely weak, even a very short strike will put you out of business. And the people who are on the other side of the negotiating table understand that. Whereas, if you have a fair amount of strength, they can push you harder.

But it is of — it is no fun being in a business where you cannot take a strike. We faced that one time back in the early '80s when there were — we were in kind of a death struggle in Buffalo with The Courier-Express.

And when I bought The Buffalo News — actually Charlie did. He was stranded there during a snowstorm, and he got bored. So, he called me and said, "What should I do?" I said, "Well, you might as well buy the paper." (Laughter)

And so we were in this struggle. And — but when we bought the Buffalo News, we had two questions of the management, and one of them I can't tell you.

But the second one was, we wanted to meet with the key union leaders, and we wanted to tell them, "Lookit, if you ever strike us for any length of — significant length of time — we're out of business.

"You know, you can make our investment valueless. So we really want to look you in the eye and see what kind of people you are before we write this check." And we felt quite good about the people, and they were good people.

And we had one situation in 1981, or thereabouts, where a very, very small union, I think, less than 2 percent of our employees, struck over an issue that the other 10 or 11 unions really didn't agree with them that much on.

But they struck, and the other unions observed the picket line, which you would expect them to do in a strongly pro-union town, such as Buffalo.

And I think, as I remember, they struck on a Monday. And I remember leaders of some of the other unions actually with tears in their eyes over this, because they could see it was going to put us out of business.

And frankly, I just took the position then, I said, "Lookit, if you come back in a day, I know we're competitive. If you come back in a year, I know we will not be competitive.

"And if you're smart enough to figure out where exactly the point is that you can push us to and still come back and we have a business and you have jobs, I said, you're smarter than I am. So, you know, go home and figure it out."

And they came back in on Thursday, and we became very competitive again. But they could've — I mean, it was out of my hands. I couldn't make them work, and if they decided they were going to stay out long enough, we were not going to have a newspaper.

And that's the kind of situation, occasionally, you find yourself in. And I would say the airline industry is a good example of people — where people find themselves in that position periodically.

Charlie, anything you want —

CHARLIE MUNGER: Well. The shareholders may be interested to know, vis-à-vis competitive advantages in our NetJets program, that the day that other charter plane crashed in Aspen, NetJets refused to fly into Aspen at all. People remember that kind of thing.

WARREN BUFFETT: Yeah.

12. Berkshire's advantages, and one big disadvantage

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: Good morning, gentlemen. David Winters from Mountain Lakes, New Jersey. Thank you for hosting "Woodstock for Capitalists." (Laughter)

Berkshire seems to have an enormous long-term advantage in spite of its large size and high equity prices.

The structure of the company's activities, non-callable capital, substantial free cash flow, and improving insurance fundamentals, permit Berkshire to capitalize on potential asset price declines and dislocations in financial markets, while most investors would not either have the money or the cool minds to buy.

Am I on the right track here?

WARREN BUFFETT: Well I think, in certain ways, you are. But we do have disadvantages, too.

But we have some significant advantages in buying businesses over time. We would be the preferred purchaser, I think, for a reasonable number of private companies and public companies as well.

And we — our checks clear. So we — (laughter) — we will always have the money. People know that when we make a deal, it will get done, and it will get done as fast as anybody can do it. It won't be subject to any kind of second thoughts or financing difficulties.

And we bought, as you know, we bought Johns Manville because the other group had financing difficulties.

People know they will get to run their businesses as they've run them before, if they care about that, and a lot of people do. Others don't.

We have an ownership structure that is probably more stable than any company our size, or anywhere near our size, in the country. And that's attractive to people, so —

And we are under no pressure to do anything dumb. You know, if we do things dumb, it's because we do things dumb. And it's not — but it's not because anybody's making us do it.

So those are significant advantages. And the disadvantage, the biggest disadvantage we have is size.

I mean, it is harder to double the market value of a hundred billion dollar company than a $1 billion company, using our — what we have in our arsenal.

And that isn't — I hope it isn't going to go away. I mean, I hope we don't become a billion dollar company and enjoy all the benefits of those. (Laughter)

And I hope, in fact, we have the agony of becoming, you know, a much larger company.

So, you are on the right track. Whether we can deliver or not is another question. But we go into combat every day armed with those advantages.

Charlie?

CHARLIE MUNGER: Yeah. This is not a hog heaven period for Berkshire. The investment game is getting more and more competitive. And I see no sign that that is going to change.

WARREN BUFFETT: But people will do stupid things in the future. Even — there's no question. I mean, I will guarantee you sometime in the next 20 years that people will do some exceptionally stupid things in equity markets.

And then the question is, you know, are we in a position to do something about that when that happens?

But we do — we continue to prefer to buy businesses, though. That's what we really enjoy.

When Charlie mentioned hog heaven, I thought we ought to open the peanut brittle here, which I recommend heartily. (Laughter)

13. "There is no such thing as growth stocks or value stocks"

WARREN BUFFETT: Zone 3.

AUDIENCE MEMBER: Good morning. Mo Spence (PH) from Waterloo, Nebraska.

You've often stated that value and growth are opposite sides of the same coin.

Would you care to elaborate on that? And do you prefer a growth company that is selling cheap or a value company with moderate or better growth prospects?

WARREN BUFFETT: Well, actually I think you're — you may be misquoting me. But I really said that growth and value, they're indistinguishable. They're part of the same equation. Or really, growth is part of the value equation.

So, our position is that there is no such thing as growth stocks or value stocks, the way Wall Street generally portrays them as being contrasting asset classes.

Growth, usually, is a chance to — growth, usually, is a positive for value, but only when it means that by adding capital now, you add more cash availability later on, at a rate that's considerably higher than the current rate of interest.

So, there is no — we don't — we calculate into any business we buy what we expect to have happen, in terms of the cash that's going to come out of it, or the cash that's going to go into it.

As I mentioned at FlightSafety, we're going to buy $200 million worth of simulators this year. Our depreciation will probably be in the area of $70 million or thereabouts. So we're putting $130 million above depreciation into that business.

Now that can be good or bad. I mean, it's growth. There's no question about it. We'll have a lot more simulators at the end of the year. But whether that's good or bad depends on what we earn on that incremental $130 million over time.

So if you tell me that you own a business that's going to grow to the sky, and isn't that wonderful, I don't know whether it's wonderful or not until I know what the economics are of that growth. How much you have to put in today, and how much you will reap from putting that in today, later on.

And the classic case, again, is the airline business. The airline business has been a growth business ever since, well, you know, Orville [Wright] took off. But the growth has been the worst thing that happened to it.

It's been great for the American public. But growth has been a curse in the airline business because more and more capital has been put into the business at inadequate returns.

Now, growth is wonderful at See's Candy, because it requires relatively little incremental investment to sell more pounds of candy.

So, its — growth, and I've discussed this in some of the annual reports — growth is part of the equation, but anybody that tells you, "You ought to have your money in growth stocks or value stocks," really does not understand investing. Other than that, they're terrific people. (Laughter)

Charlie?

CHARLIE MUNGER: Well, I think it's fair to say that Berkshire, with a very limited headquarters staff — and that staff pretty old — (laughter) — we are especially partial to laying out large sums of money under circumstances where we won't have to be smart again.

In other words, if we buy good businesses run by good people at reasonable prices, there's a good chance that you people will prosper us for many decades without more intelligence at headquarters. And you can say, in a sense, that's growth stock investing.

WARREN BUFFETT: Yeah, if you had asked Wall Street to classify Berkshire since 1965, year-by-year, is this a growth business or a value business — a growth stock or value stock — you know, who knows what they would have said.

But, you know, the real point is that we're trying to put out capital now to get more capital — or money — we're trying to put out cash now to get more cash back later on. And if you do that, the business grows, obviously. And you can call that value or you can call it growth. But they're not two different categories.

And I just cringe when I hear people talk about, "Now it's time to move from growth stocks to value stocks," or something like that, because it just doesn't make any sense.

14. Advice to young people: Invest in yourself

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Hi. My name is Steven Kampf (PH) from Irvine, California. I'm 10 years old and this is my fourth consecutive year here.

WARREN BUFFETT: Terrific.

AUDIENCE MEMBER: How I got —

WARREN BUFFETT: We're glad to have you here.

AUDIENCE MEMBER: Thanks. This is my fourth consecutive year here, and how I got to owning stock is my dad taught me to start my own business. And I bought Berkshire Hathaway stock with my profits.

In school, they don't teach you how to make and save money, not in high school or college. So my question is, how would you propose to educate kids in this area?

WARREN BUFFETT: Well, that's a good question. Sounds to me like — (Applause)

Sounds to me like you could do a good job yourself, too. And, you know, at 10, you're way ahead of me. Unfortunately, I didn't buy my first stock until I was 11, so I got a very slow start. And — (Laughter)

It's, you know, what it takes really is — and you find it in some classrooms and you don't in others — but it takes teachers who can explain the subject. Charlie would say Ben Franklin was the best teacher of all in that respect.

But, you know, it looks like you either got it from your parents — an education on that — and parents can do more education, really, in that respect, even, than teachers.

But it's, you know, I get a chance to talk to students from time to time. And, you know, one of the things I tell them is, you know, what a valuable asset they have themselves.

I mean, I would pay any bright student probably $50,000 for 10 percent of his future earnings the rest of his life. So he's a $500,000 asset just standing there. And what you do with that $500,000 asset, in terms of developing your mind and your talents, is hugely important.

The best investment you can make, at an early age, is in yourself. And it sounds to me like you're doing very well in that respect. I congratulate you on it.

I don't have any great sweeping program for doing it throughout the schools though. We have — here in Nebraska — we have an annual get-together of students from all the high schools throughout the state. And it’s a day or two of economic education. I think it’s a very good program.

But I think if you just keep doing what you’re doing, you may be an example to other students.

Charlie?

CHARLIE MUNGER: Well, I’d like to interject a word of caution. You sound like somebody who’s likely to succeed at what you’re trying to do. And that’s not always a good idea.

If all you succeed in doing in your life is to get early rich from passive holding of little bits of paper, and you get better and better at only that for all your life, it’s a failed life.

Life is more — (applause) — than being shrewd at passive wealth accumulation. (Applause)

WARREN BUFFETT: I think he’s going to do well in both.

15. Internet “was a chance for people to monetize the hopes of others”

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Good morning. My name is Thomas Kamay (PH). I am 11 years old and from Kentfield, California. This is my fourth annual meeting.

Last year, I asked how the internet might affect some of your holdings. Since a lot of the internet companies have gone out of business, how are — has your view of internet changed?

WARREN BUFFETT: Well, that’s a good question. I think that the internet probably looks to most retailers like less of a competitive threat than it did a couple of years ago.

For example, if you look at the jewelers who have been on the internet and, in many cases — in several cases, at least, had very large valuations a couple of years ago, so the world was betting that they would be very effective competitors against brick and mortar jewelry retailers.

I think that that threat has diminished substantially. I think that’s been true in the furniture business. In both of those industries, very prominent dot-coms that had aggregate valuations in the hundreds of millions have vanished in short order.

So I would say that we think the internet is huge opportunity for certain of our businesses. I mean, GEICO continues to grow in a — at a significant rate in internet business.

See’s Candies’ internet business is up 40 percent this year. Last year it was up a much larger percent from the year before, and it grows and it will continue to grow.

So the internet's an opportunity, but I think the idea that you could take almost any business idea and turn it into wealth on the internet — many were turned into wealth by promoting them to the public. But very few have been turned into wealth by actually producing cash results over time.

So I think there's been a significant change in the degree to which I perceive the internet as a possible threat to our retail businesses. There's been no change in the degree to which I regard it as an opportunity for other of our businesses.

Charlie?

CHARLIE MUNGER: Well, Warren, you and I were once engaged in the credit and delivery grocery business. And it was a terrible business. It barely supported one family for a hundred years with all of them working 90 hours a week.

And somebody actually got the idea that was the wave of the future and turned it into a great internet idea. That can only be described as mania. And it sucked in a lot of intelligent people.

WARREN BUFFETT: Yes, Charlie is talking about the infamous Buffett & Son Grocery Store, which did barely support the family for a hundred years. And, only then did we support the family by hiring guys like Charlie for slave wages. (Laughter)

But I used to go out on those delivery trucks, and it was pretty damned inefficient. You know, people would phone their orders in. And now it's true we took them down with a pencil and an order pad instead of punching them into a computer.

But when we started driving around the trucks and hauling the stuff off and everything, you know, we ran into the same costs that Webvan is running into now.

What the internet offered was a chance for people to monetize the hopes of others, in effect. I mean, you are able to capture the greed and dreams of millions of people and turn that into instant cash, in effect, through venture capital and the markets.

And there was a lot of money transferred in the process, from the gullible to the promoters. But there's been very little money created by pure internet businesses so far. It's been a huge trap for the public.

Charlie?

CHARLIE MUNGER: Nothing more.

16. "We don't have a master plan"

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: Thank you for taking my question. My name is Frank Gurvich (PH). I'm from London, Ontario. It's great to see all the young people asking questions. I even have my own 11-year-old here, Matthew, this year.

I first want to start by passing on a message from my wife to you, Mr. Buffett. And that is, "Thank you, Mr. Buffett for your autograph that Frank brought back last year. However, quite frankly, the ring in the Borsheims box you autographed was far more precious."

WARREN BUFFETT: You can repeat that if you'd like. (Laughter)

AUDIENCE MEMBER: My question relates to the future of Berkshire. Back in 1994, there was a PBS video interview of you at the Flagler Business School. And I believe you said Berkshire was not an insurance company.

It appears that's not quite the case as much anymore, and I suppose insurance acquisitions will provide the financial fuel and the stability the Johns Mansvilles and MidAmerica types of acquisitions will need for their future growth.

But I'm hoping that you and Charlie can describe for us an anticipated future look at, say, 20 years out, of how Berkshire might be different and — from how it is today — and perhaps a couple of the not so obvious problems that Berkshire will need to contend with.

And thank you for all the apparently wonderful acquisitions you've made on our behalf in the last year.

WARREN BUFFETT: Well, thank you. I think you ought to take your wife another ring, too. (Laughter) But thank you.

We actually, as long ago as — I don't remember whether it was in the 1980 annual report, but at least 20 years ago, we did say that we thought insurance would be our most significant business over time.

We had no idea that it would get to be as significant as it is. But we've always felt that that was — we would be in many businesses — but that insurance was likely to be our largest business.

Right now, it's not our largest business in terms of employment. It's our largest business in terms of revenue. And we would hope it gets a lot bigger over time. We don't have anything in the works that would make that happen, although we will have natural growth in what we already own.

But we will just keep acquiring things. And sometimes — some years we'll, you know, we'll make a big acquisition. Some years we'll make a few small acquisitions.

We'll do whatever comes down the pike. I mean, if there's a phone call waiting when this meeting is over and it's an interesting acquisition, it'll get done.

We don't have a master plan. We don't — Charlie and I do not sit around and strategize or talk about the future of various industries or do anything of that sort. It just doesn't happen. We don't have any reports. We don't have any staff. We don't have any of that.

We try to look at what comes in — we try to survey the whole financial field. We try to look at what comes in and look for things we understand, where we think they have a durable, competitive advantage, where we like the management, and where the price is sensible.

And, you know, we had no idea two or three years ago, you know, that we would be the 87 percent owner of the largest carpet company — broadloom carpet company — in the world.

You know, we just don't — we don't plan these things. But I would tell you in a general way that 20 or so years from now, we will own a lot more businesses.

I would still think it likely — I mean, I think it's certain that insurance will be a bigger business for us in 20 years than it is now. Probably much bigger. But I think it's — and I think it's also likely it will be our biggest business still. But that could change.

I mean, we could get a deal offered to us tomorrow that, you know, was a 15- or $20 billion deal, and then we've got a lot of money in that industry at that point.

So it's — we have no more master plan now than we had back in 1965 when we bought the textile mill, really.

I mean, we had a lousy business. I didn't realize it was as lousy as it was when I got into it. And we had to, you know, we just had to start trying to deploy capital in an intelligent way.

But we've been deploying capital, you know, since I was 11. And I mean, that's our business and we enjoy it. And we get opportunities to do it. But the bigger you are, the fewer the opportunities you're likely to get.

Charlie?

CHARLIE MUNGER: Well, I think it's almost a sure thing that 20 years from now there'll be way more strength and value behind each Berkshire share. I also think it is an absolutely sure thing that the annual percentage rate of progress will go way down from what it has been in the past.

WARREN BUFFETT: No question about it.

17. Buffett's cholesterol level

WARREN BUFFETT: On that happy note, we move to zone 7. (Laughter)

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger. My name is Gary Radstrom (PH) from right here in River City [Omaha]. I've been a shareholder since '93, and have loved every minute of it.

Recently, there's been medication available to reduce cholesterol. My doctor even gave it to me since mine is kind of high.

Every time I hear what you like to eat, Warren, it makes me wonder what your cholesterol level is — (Laughter) — or if you even worry about it. I think everyone here wants you to be with us for a long time, so have you considered taking this new medication to reduce your cholesterol level? (Laughter)

WARREN BUFFETT: I do know the number, and I don't remember it. My doctor tells me, "It's a little high," but if he says it's a little high, it means it isn't that high, or he would — because he always tries to push me into making a few changes in my life.

But he — I've got a wonderful doctor. And I was lucky last year, because I hadn't been in to see him for about five years. And — (laughter) — due to — those guys cost a lot of money, I mean. (Laughter)

And due to purely an accident, a reaction to some other medicine I was given when I was out of the city, he got a hold of me, and then he shamed me into having a physical. And it was extremely lucky, because I had a polyp in the colon that would have probably caused trouble, you know, within a couple of years.

I would say that if you ask my doctor, he would want me to make a few changes, but he would also say that my life expectancy is probably a lot better than the average person of 70.

You know, I have no stress whatsoever. Zero. You know, I mean, I get to do what I love to do every day. You know, and I'm surrounded by people that are terrific. So that problem in life just doesn't exist for me. You know, and I don't smoke or drink or, well, we'll end it right there. (Laughter)

And so, you know, if you were an underwriter for a life company, you would rate me considerably better than the average. You'd rate Charlie better than average, too.

And I'm sure that, you know, I could change it slightly, perhaps, on the probabilities, you know, if I change my diet dramatically or something. But it's very unlikely to happen.

Actually, when my mother got to be 80 — you know, the most important thing in life, in terms of how long you live, is how long your parents live. So I got her an exercise bike when she got to be 80. (Laughter)

She put 40,000 miles on it. And I told her to watch her diet and do all these things. And I mean, she lived to be 92, so you know, she did her share, and I helped her do it by giving her the exercise bicycle. So, I think that improved my odds at that point.

Charlie?

CHARLIE MUNGER: Yeah. I have a book recommendation which will be very helpful to all shareholders that worry about Warren's health and longevity.

And that's this book called "Genome" by Matt Ridley, who was, for years, the science editor of The Economist magazine. And if Ridley is right, Warren has a very long life expectancy.

There are very interesting correlations between people who cause stress to others instead of suffering it themselves. (Laughter and applause)

And Warren has been in that position ever since I've known him. (Laughter)

And the figures that Ridley quotes are awesomely interesting. It is a fabulous book.

Of course, I'm recommending a bestseller, but they're selling it in the airport. It's called "Genome," and you'll feel very good about Warren's future if you agree with the science of the book.

18. Unrealistic investment expectations for pension funds

WARREN BUFFETT: Zone 8.

AUDIENCE MEMBER: My name is Charlie Sink (PH). I'm from North Carolina.

Mr. Buffett, your article last year in Fortune Magazine was excellent.

I'm thinking — well, I'm wondering what your thoughts are on American business profit margins and return on equity in the future. I also would like your thoughts about the — some businesses today with their huge inventory write-offs, what your thoughts about those are.

WARREN BUFFETT: Yeah, well, in that article I talked about the unlikelihood of corporate profits in the United States getting much larger than 6 percent of GDP. And historically, the band has been between 4 and 6 percent. And we've been up at 6 percent recently.

So, unless you think that profits, as a part of the whole country's economic output, are going to become a bigger slice of the pie — and bear in mind, they can only become a bigger slice of the pie if other slices get diminished to some extent, and you're talking about personal income and items like that.

So, I think it's perfectly rational and reasonable that in a capitalistic society the corporate profits are something like 6 percent of GDP.

That does not strike me as outlandish in either direction. It attracts massive amounts of capital, because returns on equity will be very good if you earn that sort of money.

And on the other hand, I think it would be very difficult in the society to get where they'd be 10 percent or 12 percent, or something of the sort because it just — it would look like an unfair division of the pie to the populace.

So, I don't see any reason for corporate profits — they're going to be down in the near future as a percentage of GDP from recently, but then they'll go back up at some point. So I think 10 years from now, you'll be looking at a very similar picture.

Now, if that's your assumption and you're already capitalizing those profits at a pretty good multiple, then you have to say that you have to come to the conclusion that the value of American business will grow at a relationship that's not much greater than the growth in GDP.

And most of you would estimate that probably to be, you know, maybe 5 percent a year, if you expect a couple percent a year of inflation.

So, I wouldn't change my thoughts about the profitability of American business over time. And I wouldn't change my thoughts much about the relationship of stock prices over time to those profits. So, I — you know, I would come down very similarly.

Now, interestingly enough, some of those same relationships prevailed decades ago, but you were buying stocks that were yielding you perhaps 5 percent or something like that, so that you were getting 5 percent in your pocket, plus that growth as you went along.

And of course, now if you buy stocks you get 1 1/2 percent, if you're the American public, before the frictional cost. So that the same rate of growth produces a way smaller aggregate return. And some —

You know, I think stocks are a perfectly decent way to make 6 or 7 percent a year over the next 15 or 20 years. But I think anybody that expects to make 15 percent per year, or expects their broker or investment advisor to make that kind of money, is living in a dream world.

And it's particularly interesting to me that back when the prospects for stocks were far better — I even wrote something about this in the late '70s — pension funds were using investment rate assumptions that were often in the 6 percent or thereabout range.

And now when the prospects are way poorer, most pension funds are using — building into their calculations — returns of 9 percent or better on investments. I don't know how they're going to get 9 percent or better on investments.

But I also know that they change the investment assumption down, it will change the charge to earnings substantially. And they don't want to do that.

So, they continue to use investment assumptions which I think are quite unrealistic. And with companies with a big pension component in their financial situation, and therefore in their income statement, that can be quite significant.

It will be interesting to me to see whether in the next couple years where pension funds are experiencing significant shortfalls from their assumptions, how quickly they change the assumptions.

And the consulting firms are not pushing them to do that at all. It's very interesting. The consulting firms are telling them what they want to hear, which is hardly news to any of us. But it's what's taking place.

The second question about inventory write-offs. You know, that gets into the category entirely of big-bath charges, which are the tendencies of management, when some bad news is coming along, to try and put all the bad news that's happened into a single quarter or a single year — and even to put the bad news that they are worried about happening in the future into that year.

And it's — it leads to real deception in accounting. The SEC has tried to get quite tough on that, but my experience has been that managements that want to do it usually can find some ways to do it.

And managements, frequently, are more conscious of what numbers they want to report than they are of what has actually transpired in a given quarter or a given year.

Charlie?

CHARLIE MUNGER: Yeah, pension fund accounting is drifting into scandal by making these unreasonable investment assumptions. It's — evidently, it's part of the human condition that people extrapolate the recent past.

And so, since returns from common stocks have been high for quite a long period, they extrapolate that they will continue to be very high into the future. And that creates a lot of reported earnings, in terms of pension benefits, that aren't available in cash and are likely not to be available at all.

And this is not a good idea, and it's interesting how few corporate managements have just responded like Sam Goldwyn: "Include me out."

You'd think more people would just say, "This is a scummy way to keep the books, and I will not participate." Instead, everybody just drifts along with the tide, assisted by all these wonderful consultants.

WARREN BUFFETT: Yeah, I don't think — I don't know of any case in the United States right now, and I'm sure there are some, but except for the pension funds that we take over, I don't know of any case where people are reducing their assumed investment return.

Now you'd think if interest rates drifted down several percentage points that that might affect what you would think would be earned with money. It certainly is to bond holders or to us with float or something of the sort.

But most major corporations, I believe, are using an investment return assumption of 9 percent or higher. And that's with long-term governments below 6 percent, you know, and maybe high-grade corporates at 7.

They don't know how to get it in the bond market. They don't know how to get it in the mortgage market. I don't think they know how to get it in the stock market. But it would cause their earnings to go down if they change their investment assumption.

And, like I say, I don't know of a major company that's thinking about it. And I don't know of a major actuarial consultant that's suggesting it to the managements. It just — they'd rather not think about it.

CHARLIE MUNGER: The way they're doing things would be like living right on an earthquake fault that was building up stress every year and projecting that the longer it's been without an earthquake the less likely an earthquake is to occur.

That is a dumb way to write earthquake insurance. (Laughter)

And the current practice is a dumb way to do pension fund planning and accounting.

WARREN BUFFETT: If you talk —

CHARLIE MUNGER: Dumb and improper.

WARREN BUFFETT: If you talk to a management or board of directors about that, you get absolutely no place.

CHARLIE MUNGER: No, they — their eyes would glaze over before the hostility came. (Laughter)

19. Executive Jet won't be a "mature" business "for decades"

WARREN BUFFETT: Area 1.

AUDIENCE MEMBER: Good morning, gentlemen. Marc Rabinov from Melbourne, Australia. I had a question on two of our key operating businesses.

Firstly, Executive Jet. Once this becomes a mature business, would it be fair to say that its net margin should be about 5 percent?

And secondly, would it be fair to say that our current insurance businesses are likely to grow aggregate float at about 10 percent over time?

WARREN BUFFETT: Well, it's really anybody's guess. I mean, I don't expect Executive Jet to become a mature business for decades. I mean, it — there's a whole world out there on that one.

And we have something over 2,000 customers in the United States at the current time. We have a little over a hundred, but in Europe.

But there are tens and tens and tens of thousands, and perhaps hundreds of thousands, of people or businesses where it does make sense over time. So it's going to be long time.

I mean, there are only 700, roughly, jets a year being produced. And of course, up until a few years ago that was limited to people who wanted to buy single planes.

But you won't change that output much in the next five years. But — so, you couldn't really take on —

We can take on about 600 customers a year, just in terms of the delivery schedule that we have built into our business. And we couldn't change that — we couldn't double that — because the planes simply aren't available in the next year or two, although we have orders further out.

But I would say it will be a long time until Executive Jet is a mature business, and I would say that — a long, long time.

I mean, we're going to, when we get Europe — as we make progress in Europe, we'll move to Asia. We'll move to Latin America over time. And so we're going to be, I think, growing that business significantly for a very long time.

When it becomes mature, or close to it, you know, if you're talking 5 percent after-tax margins, I'd say that that's probably a reasonable figure. But we're so far away from even thinking about that, that, you know, it's pure speculation.

20. "There's an unlimited market for dumb insurance policies"

WARREN BUFFETT: In our insurance business, we've grown our float and then we've purchased businesses to add to the float.

This year, I would certainly expect, unless one — a big transaction would fall through or something — I would certainly expect our float to grow at least 2 1/2 billion. And that is close to 10 percent of the beginning of the year float.

That's a rational expectation. But whether it can grow 10 percent a year, you know, how far you can do that — I would say the total float of the property-casualty industry in the United States is — I'm pulling this out from making some other calculations in my head as I talk — but it wouldn't be much more than 300 billion.

So, we are close to 10 percent of the entire U.S. float now, and I don't think the U.S. float — the aggregate float — you know, is going to grow at a 10 percent rate.

So when you're as big a part of the pie as we are, it may be difficult to sustain a 10 percent rate. But we're doing everything possible that makes sense to grow float. I mean, that is a major, major objective. But the even bigger objective is to keep it low-cost.

I don't think you can see — unless the world changes in some way — I don't think you can see 10 percent growth over 25 years. But we'll do our darnedest to get it, you know, at the rate you suggest for at least the near future.

Charlie?

CHARLIE MUNGER: Well, I certainly agree that long term, it's not going to happen. Good, but not that good. (Buffett laughs)

WARREN BUFFETT: But we've been surprised at what's happened. I mean, there's no — I mean, when we bought Jack Ringwalt's company in 1967, you know, my memory is Jack had a float of, you know, less than 15 million.

And would we have ever guessed that we might hit something close to 30 billion this year? We never dreamt of it. But we just kept doing things, and we'll keep doing things.

But it can't be at huge rates for a long period of time, because we're too big a part of the pie now. We were nothing initially, and we kept grabbing a little more of the pie as we've gone along. And we like that, but it can't go on forever.

CHARLIE MUNGER: Yeah. That's what I call really low-cost float. If it ever should be advantageous for us to go into what I would call higher-cost float, that might change the figures upward, in terms of growth of float.

WARREN BUFFETT: Yeah. Although, that won't be — I mean, it could happen that we could take on incrementally some higher-cost float under very special circumstances if we saw unusually good ways to use it, but that — we don't even like to think about that.

We certainly don't want the people running our businesses to think about that. Because keeping it low- cost, you know, that is the big end of the game.

Anybody can generate float. I mean, if we gave our managers a goal of generating 5 billion of float next year, they could do it in a minute, you know, and we would be paying the price for decades to come.

You can write dumb insurance policies, you know. There's an unlimited market for dumb insurance policies. And they're very pleasant, because the first day the premium comes in and that's the last time you see any new money. From then on, it's all going out. And that's not our aim in life.

21. GEICO focusing on U.S. instead of global expansion

WARREN BUFFETT: Zone 2?

AUDIENCE MEMBER: My name is Kjell Hagan (PH). I'm a Norwegian working in Tokyo in Japan.

I'm very satisfied to have more than 95 percent of our family's savings in Berkshire. I have two questions.

In my work, I've seen a lot of insurance companies in Europe and Japan. And I think that GEICO's business model is quite superior to most primary insurance companies in Europe and Japan.

And I think that GEICO would be very successful in Europe and Asia. So I'd like to hear what are the views and plans for GEICO doing business in Europe and Asia.

Second, regarding Coca-Cola — living in Japan, I notice that Coke has a relatively low presence in advertising, although they are the largest player with 30 percent market share versus 15 for the number two. I think Coke is being too cheap on advertising, thus hurting the long-term position.

I wonder if advertising strategy internationally is a high enough priority of Coke's management, and if aggressiveness is sufficient. I'd like to hear if you have any comments on this.

Also I'd just like to thank you very much for this experience and for the wonderful company you have created.

WARREN BUFFETT: Well, thank you very much.

Clearly when you've got a business model that works as well as GEICO has in this country and it continues to work well, and has that fundamental advantage of being a low-cost operator, we think about every possible way that we can take that idea and extend it.

It's been remarkably hard to do it. I mean, the management has tried various things, ever since Leo Goodwin started the company in 1936, to take it into other areas, and those efforts have been modestly successful at certain things like life insurance, but then they got out of it, and various other things.

But it's an idea still. We have — you know, we have 4 percent or so of the market in the United States. This market is so huge. And as we look at the drain on human resources involved in extending it into other countries, and we've looked at it a lot, and it may be something we'll do at some time.

But we've never felt that the possible gain, considering the rigidities of these other — both in Europe and in Asia — of breaking in — it's not easy to get into those markets. And the cost, the time, we just felt that it would be better to concentrate those same resources in this country.

It's not a question of capital at all. I mean, we'd put the money in in a second. And we're doing it in something like NetJets in Europe. I mean, we — there's a human cost to it, there's a financial cost to it.

Financial cost bothers us not at all. Human cost is a real question, because it gets back to Charlie's opportunity cost.

We have talented managers, but we have a finite number of them. And I would rather have Tony Nicely and Bill Roberts and their crew focusing on how to gain additional market share in this country at the right rates than I would starting in a project in Europe or Asia now.

But that's — it's a very good question. It's something I can guarantee you we think about all the time and will continue to think about.

We've tried to extend geography. Coke has been the most successful company in the world in extending geography.

We've tried to do it with See's Candy, and it's had limited — very limited — success. I mean, we've tried 50 different ways, because the trials are relatively cheap to do.

And we think it should work, we just haven't been able to make it work. But that — it's a very good question.

22. Coca-Cola advertising in Japan

WARREN BUFFETT: The question about Coke's advertising in Japan. As you know, Coke has a terrific presence in Japan.

Japan's an interesting market, because the percentage of soft drinks sold through vending machines is just far, far higher than any place in the world. And the United States is a very distant second. And then, the rest of the world, there's very little done in the way of vending machines.

I don't know the specifics of the advertising in Japan, but of course, Doug Daft who now is the CEO of Coke, comes with a huge background in Asia. I mean, that was his territory for much of his career.

And Doug — we have a new major — very major — advertising campaign coming up. And you probably read that Coke is going to spend 300 million-plus additional on marketing beyond the normal spend, which is huge.

And I can't tell you the specific markets in which that will be, but I would be surprised if Japan isn't a big part of it, because Japan is an enormous market for Coca-Cola.

Charlie?

CHARLIE MUNGER: I have nothing to add.

23. Berkshire's asbestos exposure

WARREN BUFFETT: Zone 3, please.

AUDIENCE MEMBER: Hi. My name is Steve Rosenberg (PH). I'm from Ann Arbor, Michigan.

First, I just want to thank both of you for being two phenomenal role models. I've really looked up to you both for a long time.

My first question is about reinsurance. I believe that you're willing to write larger policies in reinsurance than anyone else, but that you still insist on the amount of your liability being capped.

I'm wondering, with your investments in companies with — that have exposure to asbestos, have you somehow capped that? Or is that unlimited, especially given joint and several liability?

My second question involves auto insurance. And I was wondering, does State Farm's structure as a mutual insurance company compensate it — or help it compensate — for having a higher cost structure because, over the long term, it need only remain solvent and not provide an adequate return on capital to its investors?

WARREN BUFFETT: The first question, on asbestos. We have not put any significant money, to our knowledge, in any company that has any asbestos exposure now.

You know, we have a small amount of money in USG, where the subsidiary, United States Gypsum, has a major asbestos exposure. But that's a very, very minor investment. The — and that would be the only one that I can think of.

We've walked away from several deals that were quite attractive in every respect except asbestos. But that's like saying to a 120-year-old, you know, "You're in good health except for the fact that you're dead." (Laughter)

So we don't go near asbestos.

Now, in terms of our retroactive insurance policies, we are taking over the liabilities of companies that have lots of asbestos exposure. And in that case, we assume that those exposure — that those contracts — will be paid in full.

I mean, we make no assumption of any reduction in asbestos costs, but we do cap them.

There's a couple things you can't cap in insurance. You can't cap workers' compensation losses. I mean, they —you can as a reinsurer, but I mean, the primary insurer can't do that.

I believe in auto, for example, in the U.K., that it's uncapped. And I think that nobody thought that was very serious until they had a recent accident that caused — I think it involved a car doing something that — an auto doing something to a train that was unbelievable.

So they — there are a few areas where insurance is written on an uncapped basis. And in our case, we write some auto insurance in the U.K. and we write some workers' compensation, primarily in California.

But generally, in the reinsurance business, you are capping the liabilities you take on.

I mean, obviously, when we bought General Re, they had asbestos liabilities from reinsurance contracts they had written. But the reinsurance companies are pretty careful about writing unlimited policies.

We write huge limits. We're the biggest — you know, if somebody wants to write a huge limit, or an unusual limit, they should call us. Because there's no one else in the world that will act as big or as promptly as we will. But we don't write things that are unlimited.

Now, the interesting thing is that the biggest exposures, in our view, are the people that write a lot of primary business and don't have the catastrophe cover they need.

I mean, if you write 10 percent of all the business in homeowners on — or 15 percent — on Long Island or in Florida, I mean, you are writing a catastrophe cover that would blow your mind.

If you're Freddie Mac or Fannie Mae and you're guaranteeing mortgages, you know, for millions of people in areas like that, and they don't have insurance — earthquake in California or property insurance in Florida — they'd be less likely to have earthquakes someplace — you are taking on enormous risks.

I mean, huge risks, far beyond what we would ever take on. They just — but you don't get paid for them, unfortunately.

I mean, just take the New Madrid section of Missouri, down in the corner. That was the area of three of the greatest quakes, that are sort of related in time, in the — certainly in the recorded history, they were the three greatest quakes in the United States.

You know, how much homeowners' business, how much commercial property business, does somebody have in that huge territory, which you know, supposedly caused church bells to ring in Boston when it happened back in whenever it was — 1807, or '9, or something like that?

So, there are all kinds of risks that can aggregate in huge ways that companies are not thinking about at all.

I mean, I don't know whether Freddie Mac or Fannie Mae, for example, is demanding that all of the homes they insure in the, you know, 300-miles radius of New Madrid, have earthquake insurance.

But, you know, it — that sort of thing never comes to mind until the unthinkable happens. But in insurance, the unthinkable always happens.

24. Praise for State Farm

WARREN BUFFETT: State Farm, as a competitor, is a mutual company, and it has a huge amount of net worth.

You referred to them as a higher-cost — a high-cost operator or higher cost — but they're really a relatively low-cost operator. But they're not anywhere near as low-cost as GEICO. But they're a low-cost operator compared to many people in the insurance business.

And it's certainly true that they do not have the demands for profitability, partly because they've done such a great job in the past and built up so much surplus.

I have nothing but basically good things to say about what State Farm has done over the years.

They do not need — they can subsidize, to some extent, current auto policy holders with the profits that were derived from auto policy holders of the past. But that's always true when a stock company competes with a mutual company. And, you know, we know that when we go in the business.

And that's true of — there are a lot of other mutual companies out there that operate without the demands of earning a high return on capital. But if I were State Farm, I'd, you know, I'd probably be doing what they're doing. I don't criticize them at all.

Charlie?

CHARLIE MUNGER: Well, I don't criticize State Farm, either. State Farm is one of the most interesting business stories in the United States.

The idea that it could get as big as it is and has as good a distribution system as it does, it's a thoroughly admirable company. In fact, Berkshire has bought insurance from State Farm. Not auto insurance. (Laughter)

WARREN BUFFETT: GEICO still has a lower cost structure. I mean, it is a great business operation. And we have invested significantly to build that, because it is so attractive.

And, as I pointed out in the annual report, the incremental investment we made last year did not produce the same results as incremental investments in previous years.

So we are finding it hard to grow the business under current circumstances on a basis that we would like to.

But it's a wonderful business, and it has, you know, it has a business model that I wouldn't, you know, I wouldn't trade for anything.

25. "Nobody's going to catch" NetJets

WARREN BUFFETT: Zone 4?

AUDIENCE MEMBER: Hi, Mr. Buffett, Mr. Munger. My name's Dan Sheehan from Oakville, Canada.

Following up on your discussion about GEICO, you've often talked about their advantages as a direct seller and investor of float.

My question is, how do you control claim costs versus your competitors, other than through good underwriting?

Some may have advantages in terms of economies of scale or cutting corners you won't do. And this might allow them to eliminate some of the advantages you've gained on the other side of the combined ratio.

And my second question is, you've said, "It's hard to be smarter than your dumbest competitor." And along that line, what are your thoughts about a recent Wall Street Journal article about a major airline getting into the fractional jet business? Thank you.

WARREN BUFFETT: I don't worry about the dumbest competitor in a business that's service. The customer will figure that out over time.

And we have a huge advantage in the fractional ownership business. I mean, we have 265 planes flying around now, and you can get one on four hours' notice at any one of 5,500 airports. We have planes in Europe for our American customers. We have planes here for our European customers. And nobody's going to catch us, in my view, in fractional ownership.

And we've had some dumb competitors in the past in that business. And, you know, they bleed. And to the extent, you know, we've got more blood than they have.

26. Buffett on the "trick" of good underwriting

WARREN BUFFETT: In the question of GEICO and underwriting, you know, that — it's a fascinating business because there are — in this audience — there are people with hugely different propensities to have an accident. And of course, most people figure they're better than average.

Now, part of the propensity to have an accident will depend on how many miles you drive. Obviously, somebody who never takes the car out of the garage is — no matter what their driving skills might be — is not going to have an accident.

They drive 10 miles a year, you know, you're pretty safe with almost anybody. But — so there's a relationship to miles driven. But there's a relationship to all kinds of other things.

And the trick, in insurance, is being able to figure out the variables and not have them too many, because you still have to get people to fill out a form, and you don't want something that has practically no significance.

But the trick is to find out what questions you need to ask to determine in which category to place people as to their propensity to have an accident.

Now, in the life insurance business, you know, even Charlie and I figured out that the older you get, the more likely you are to die in a given year.

Now that's not the only factor, but everybody understands that. That the older you are, the mortality risks go up. And they've learned a few other things. They've learned that females live longer than males.

Now that doesn't get into a judgment as to why or anything else. You just know it. So, you build that in if you're pricing the product. And then you know a whole bunch of other things.

You may even know that cholesterol's bad — you know, that makes a difference in terms of predicting mortality.

But in the auto insurance business, there are lots of variables that correlate with the frequency with which a person will have an accident per mile driven.

And the more experience you have with a large body of people whom you've asked a lot of questions about and can draw conclusions there from, the better off you are.

State Farm has got a wonderful body of information. I mean, their actuarial judgments should be better than anybody else's, because they've got more experience with more cars and drivers.

But our experience with close to five million policy holders enables us, I think, to underwrite quite intelligently. But every day, you know, we're looking for some variable that will tell us more.

People with a good credit history are better drivers by a significant margin than people with a lousy credit history.

Why? We don't care too much why, because it wouldn't help. What we really need to know is that the two factors correlate. And we're looking for correlations all the time, and we're trying to avoid spurious correlations, which you can have.

And it's, you know, it's a moving target. You keep working on it all the time. But we're better at it than we were five years ago and we'll be better at it five years from now than we are now.

When we go into a new state, we will have a very small body of policy holders. And some of the factors, obviously, prevail over all states, but there's certain things that you learn, actually, only if you're in a given state for a while.

You know, you're more likely to have an accident if you're a — everything else being equal — if you're an urban driver — city driver in a big city — than if you're driving in an area that's very rural where the density of other cars is very low.

If you're the only guy in the county with a car, you know, you're not going to have a lot of two-car accidents.

So, the underwriting question is all important. And fast, fair settlement of claims is very important, because people who really weren't injured start feeling worse and worse as they talk to more and more lawyers.

So, you know, the claims delivery is a vital part of running a good property-casualty operation. And all I can tell you is, at GEICO, that we think very hard about those things, but we'll be thinking about them tomorrow as well as today.

Charlie?

27. Challenges for United's fractional jet venture

CHARLIE MUNGER: Well, vis-à-vis the fractional jet ownership program, which has been announced for United Airlines, I find that very interesting.

A senior United Airlines pilot now makes about $300,000 a year plus fancy fringes, including pension. And what he does is work a very limited hour — number of hours a month. And about half of that he spends sleeping in a comfortable bunk on long ocean flights.

That is not a culture that will work well in fractional jet ownership. Maybe they think they'll get some advantage in recruiting new pilots or something. I don't know why they're doing it. I would not have done it.

WARREN BUFFETT: Well, they haven't done it yet, either, but the — many of the airlines have organized second companies to take care of commuter flights and all of that.

And, you know, that does produce problems when the pilots of the subsidiaries start comparing their benefits to the pilots, you know, of the parent, and all that. I mean, they try to get lower cost structures by doing that.

But I would guess that if you were wanting to set up a fractional ownership company, that — and you were — you would probably not think about trying to align yourself with somebody that has extremely high costs in other areas.

And the advertising campaign will be kind of interesting, too. You know, "Give up first class travel. Start traveling right," you know, or something. It'll be interesting.

But I would tell you that we have competitors in the fractional ownership business, the two largest being companies that are part of plane manufacturers. And you can understand why they went into it, but it is not an easy business. And we've got the best hand, frankly.

28. Calling it a "hedge fund" doesn't make you any smarter

WARREN BUFFETT: Zone 5?

AUDIENCE MEMBER: Michael Wong (PH), San Diego, California. First of all, I would like to thank both of you.

My question is, when you started your business, why you started an investment partnership instead of a mutual fund?

And also, can you recommend a good book, or books, regarding how to start an investment partnership fund and how to service clients, et cetera?

WARREN BUFFETT: Yeah, I don't know of any books on starting partnerships or hedge funds. Do you know, Charlie?

CHARLIE MUNGER: No, but people seem to manage to create them without the books. (Laughter)

The incentives are awesome.

WARREN BUFFETT: Yes. And the one thing, I mean, it's always interesting to both of us how you get certain things that are fashionable. And people think that by naming something a given name, that somehow that makes everybody smarter or able to make money in it.

I mean, there is no magic to private equity funds, international investing, hedge funds — all of the baloney that gets promoted in Wall Street.

What happens is that certain things become very promotable, usually because there's been recent successes by other people, and that the new entrants extrapolate the successes of a few people in the past to promote new money from people currently.

So, they adopt titles that, you know, that they think will attract money and they — but it doesn't make anybody any smarter if they hang out a shingle in front of their house that says, "hedge fund" or they have a shingle that says "asset allocation firm" or something of the sort. The form doesn't create talent.

I backed into the business. I mean, I'd worked for a mutual fund — closed-end investment company. In fact, there's a fellow here today who's a friend of mine that — the two of us worked there, and we were 40 percent of the whole company because there were three other people, all of whom outranked us considerably. And that firm was Graham-Newman Corp, from 1954 to 1956.

And it was a regulated investment company. It was about $6 million in assets, which seemed like a big deal at the time. And Ben Graham was one of the best known investors in the world, and he had $6 million in his fund.

There was a sister partnership called Newman and Graham, which operated in what would, today, be called "hedge fund style," as far as a partnership split of the profits and so on.

And when I left there in ’56 and I came back here, we had seven people, a couple of whom are here in the room, who said, “Do you want to manage money?” And I said, “Well, here’s what I learned at Graham-Newman,” that Newman and Graham is a better way to do it than Graham-Newman.

So I formed a little partnership, and then I met Charlie a few years later. And he figured, if I was making money doing it, he’d make a lot more. So — (laughter) — he formed one. And that was the carefully calculated strategy of how we both became involved in the partnership business.

Charlie? (Laughs)

CHARLIE MUNGER: Yeah, it is amazing how big the hedge fund industry has become. They have conventions on the subject now. And in the late ’20s, you could take a course on how to run a crooked security pool.

And these things come in great waves. I’m not suggesting the hedge funds are crooked, but I am suggesting that you get these waves of fashion that go to great extremes. The amount of money, what is it now, Warren, in hedge funds?

WARREN BUFFETT: It’s very big, although it’s a little less in a few quarters than it used to be. (Laughs)

But I would be willing to put a lot of money up that if you take the aggregate experience of all the hedge funds — as starting right today and going for the next 15 years — I would bet a lot of money it will not hit 10 percent, in terms of return to partners. And I would, if you push me, I would bet at a lower figure than that.

CHARLIE MUNGER: Then you have Bernie Cornfeld’s idea, the Fund of Funds. There are people who want to get paid for selecting hedge funds for other people. And that didn’t work very well for Bernie Cornfeld.

WARREN BUFFETT: Well, it worked pretty well for Bernie for a while, but it didn’t work so well for his investors, actually. (Laughter)

Yeah. That result was probably something Bernie had in mind at the start maybe.

29. Investing small amounts allows bigger opportunities

WARREN BUFFETT: Zone 6.

AUDIENCE MEMBER: I’m Michael Zenga from Danvers, Massachusetts. That’s a town whose band Mr. Buffett so generously sent to the Rose Bowl parade last year, so you’re a very popular guy in my town.

Good morning, Mr. Buffett and Mr. Munger.

Mr. Buffett, I wanted to ask you this question last week when I ran into you after Gillette's annual meeting, but I choked. So now that there's no pressure, here goes. (Laughter)

In the years from — from my reading — in the years from 1956 through '69, you achieved the best results of your career quantitatively. Twenty-nine percent annually against only 7 percent for the Dow.

Your approach then was different than now. You looked for lots of undervalued stocks with less attention to competitive advantage or favorable economics and sold them rather quickly.

As your capital base grew, you switched your approach to buying undervalued excellent companies with favorable long-term economics.

My question is, if you were investing a small sum today, which approach would you use?

WARREN BUFFETT: Well, I would use the approach that I think I'm using now of trying to search out businesses that — where I think they're selling at the lowest price relative to the discounted cash they would produce in the future.

But if I were working with a small amount of money, the universe would be huge compared to the universe of possible ideas I work with now.

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

And so, I would pour through volumes of businesses and I would find one or two that I could put $10,000 into or $15,000 into that just were — they were ridiculously cheap. And obviously, as the money increased, the universe of possible ideas started shrinking dramatically.

The times were also better for doing it in that time.

But I think that, if you're working with a small amount of money, with exactly the same background that Charlie and I have, and same ideas, same whatever ability we have — you know, I think you can make very significant sums.

But you — but as soon as you start getting the money up into the millions — many millions — the curve on expectable results falls off just dramatically. But that's the nature of it.

You've got to — you know, when you get up to things you could put millions of dollars into, you've got a lot of competition looking at that. And they're not looking as I did when I started. When I started, I went through the pages of the manuals page by page.

I mean, I probably went through 20,000 pages in the Moody's industrial, transportation, banks and finance manuals. And I did it twice. And I actually, you know, looked at every business. I didn't look very hard at some.

Well, that's not a practical way to invest tens or hundreds of millions of dollars. So I would say, if you're working with a small sum of money and you're really interested in the business and willing to do the work, you can — you will find something.

There's no question about it in my mind. You will find some things that promise very large returns compared to what we will be able to deliver with large sums of money.

Charlie?

CHARLIE MUNGER: Well, yeah, I think that's right. A brilliant man who can't get any money from other people, and is working with a very small sum, probably should work in very obscure stocks searching out unusual mispriced opportunities.

But, you know, you could — it's such a small world. It may be a way for one person to come up, but it's a long slog.

30. Promotion, not performance, is Wall Street's biggest money maker

WARREN BUFFETT: Yeah, most smart people, unfortunately, in Wall Street figure that they can make a lot more money a lot easier just by, one way or another, you know, getting an override on other people's money or delivering services in some way that people —

And the monetization of hope and greed, you know, is a way to make a huge amount of money. And right now, it's very — just take hedge funds.

I mean, it's — I've had calls from a couple of friends in the last month that don't know anything about investing money. They've been unsuccessful and everything else. And, you know, one of them called me the other day and said, "Well, I'm forming a small hedge fund." A hundred and twenty-five million he was talking about.

Like, the thought that since it was only 125 million, maybe we ought to put in 10 million or something of the sort.

I mean, if you looked at this fellow's Schedule D on his 1040 for the last 20 years, you know, you'd think he ought to be mowing lawns. (Laughter)

But he may get his 125 million. I mean, you know, it's just astounding to me how willing people are, during a bull market, just to toss money around, because, you know, they think it's easy.

And of course, that's what they felt about internet stocks a few years ago. They'll think it about something else next year, too.

But the biggest money made, you know, in Wall Street in recent years, has not been made by great performance, but it's been made by great promotion, basically.

Charlie, do you have anything?

CHARLIE MUNGER: Well, I would state it even more strongly. I think the current scene is obscene. I think there's too much mania. There's too much chasing after easy money. There's too much misleading sales material about investments. There's too much on the television emphasizing speculation in stocks.

31. Powerful forces don't want to expense stock options

WARREN BUFFETT: Zone 7.

AUDIENCE MEMBER: Robert Piton from Chicago. The Honorable Warren Buffett and the Honorable Charlie Munger, I felt it would be appropriate to address you both in a manner that reflects the tremendous amount of value that the two of you have been instrumental in unleashing for your shareholders, your employees, and the good of society. (Applause)

The area that I'd like to inquire about is stock options. As you are aware and have written about in the past reports, companies have been taking advantage of, and contributing to, FASB's inadequate rules regarding stock options.

In particular, the lack of having to expense them on the income statement and the lack of having to report them as a liability on the balance sheet.

My question is, are either one of you doing anything to help FASB's current stance on the issue?

If not, have either one of you ever considered establishing a, quote, "real," end quote, independent body of accountants that would actually try to make companies produce accounting statements that reflect economic reality?

WARREN BUFFETT: Charlie, I'll let you. You have the history on it.

CHARLIE MUNGER: Well, we don't like the accounting, which we've called "corrupt," or at least I have. And I don't think that's too strong a word. I think it's corrupt to have false accounting because you like a certain outcome better than another.

All that said, I don't think either of us spends a lot of time fighting with FASB or trying to create a better one.

It's like splitting your lance against stone or something. You can get a lot of back pressure from the butt of the lance. And we can't be expected to cure all the ills of the world.

WARREN BUFFETT: We've written about it and talked about it. Obviously, you've picked up on it. And when it was an active issue whenever it was, about, I don't know, four years ago or so, Senator [Carl] Levin of Michigan was one of those who felt as we did. And, of course, FASB felt as we did.

But the pressure was incredible that American business brought on, on Congress. They weren't getting — they tried to put pressure on FASB and they weren't getting a result, so they just said, "Well, we're not going to let FASB set the accounting rules, we'll have Congress set the accounting rules."

And I thought that was a bad idea, per se, but I thought in this — and, but they got plenty of supporters. Got a huge number of supporters. I mean, they —

And at the time, I compared it, I think — there was a bill introduced in the Indiana legislature in the 1890s, I believe. And the bill was to change the value of the mathematical term "pi" to three even, instead of 3.1415... (Laughter)

And the legislator who introduced it said that it was too difficult for the school children of Indiana to work with this terribly long, unending term. And it would be so much easier if pi was just three. And he thought they ought to enact that.

Well, I thought that was quite rational compared to, you know, what the Congress of the United States was going to do in telling people that, since it — one of the arguments was that, "It makes it very tough for startup companies if they have to expense this."

Well, it makes tough if they have to pay their electricity bill, too. But, I mean, but those were the kind of arguments you got.

And my memory is, Charlie is better on this than I am probably, but I think the accounting firms 40 years ago or 50 years ago were in accord with our position.

But every client would put pressure on, you know, and they don't want to report expenses. They particularly don't want to report expenses that are paid to them, and that could be huge, and that might prove obnoxious if recorded by conventional accounting. But if it's sort of lost in a table in the proxy statement, people don't pay much attention.

So, the only way it will get changed — we wrote about it and I even talked to a few senators at the time — the only way it will get changed is — and this is the only way corporate governance problems generally will get changed — if 15 or 20 large institutional investors would band together in some way on this.

But some of them have the same problem because they're getting paid extraordinary sums for doing something that, you know, is really not adding that much value.

So, they're not really inclined to call attention, in many cases, to what Charlie would refer to as "obscenities" in other people's compensation.

So, I think it's going to go on. I mean, it's a fascinating subject. But the institutional investors seem to focus very much on matters of form and not substance.

I mean, you get a lot of — they, you know, they cluck a lot about little things that don't have anything to do with their economic return over time, whereas on stock options they're something that's terribly important. They're the ones that are paying the costs, and the costs are there whether they get recorded or not.

But American management will not change its position on that voluntarily. Consultants will never change their position. They're getting paid to encourage people to look at other companies, and it just keeps ratcheting up. So, I don't think you're going to see change unless institutional investors do it.

As I say, I get these questionnaires, you know, about the composition of the board or a nominating committee. None of that makes any difference in terms of how a business performs.

I got one form that said they wanted a list of directors broken down by sex. And I said, "None that I know of." (Laughter)

But it just is not germane.

Charlie?

CHARLIE MUNGER: Well, I can't top that one. (Laughter)

32. No company should predict 15 percent annual growth

WARREN BUFFETT: Zone 8, please.

AUDIENCE MEMBER: Steve Casbell (PH) from Atlanta.

My question concerns Gillette. Do you think their goal of trying to grow earnings at 15-plus percent kind of got them into their current inventory problems at the trade?

And as well, the Duracell acquisition. I know at the time, neither one of you were the biggest fans of the deal. I just want to know how you feel about it now.

WARREN BUFFETT: Well, I would say it's a mistake. And I've said it. I think it's a mistake for any company to predict 15 percent a year growth. But plenty of them do.

For one thing, you know, unless the U.S. economy grows at 15 percent a year, eventually any 15 percent number catches up with you. It just, it doesn't make sense.

Very, very few large companies can compound their earnings at 15 percent. It isn't going to happen.

You can look at the Fortune 500, and if you want to pick 10 names on there that will compound their growth from — other than some extraordinarily depressed year, I mean, if they had a year where they just broke even so the number's practically zero.

But if you pick any company on there that currently has record earnings, and you want to pick out 10 of them that over the next 20 years will average 15 percent or greater, I will, you know, I will bet you that more than half of your list will not make it.

So, I think it's a mistake, and as I've said in the annual report, I think it leads people to stretch on accounting. I think it tends to make them change trade practices.

And you know, I'm not singling out Gillette in the least, but I can tell you that if you look at the companies that have done it, you will find plenty of examples of people who have made those sort of mistakes.

And I think that, in connection with Duracell — I mean, obviously, Duracell has not turned out the way that the management of Gillette, at the time, hoped that it was going to do. And the investment bankers who came in and made the presentations, those presentations would look pretty silly now.

Charlie?

CHARLIE MUNGER: I think that kind of stuff happens all the time. It will continue to happen. It's just built into the system.

I see more predictions of future earnings growth at a high rate, not less. I mean, a few people have sort of taken an abstinence pledge, but it's very few. It's what the analysts want to hear.

WARREN BUFFETT: It's what the investor relations departments want the managements to say. It makes their life easier, you know. But they don't have to be there five years from now or 10 years from now doing the same thing. It's —

If we predicted 15 percent from Berkshire, you know, 15 percent means that — assuming the same multiples — I mean, that means in five years, 200 billion. In 10 years, 400 billion. You know, 15 years, 800 billion. A trillion-six in 20 years. And the values get to be crazy.

And you know, if you have a business with a market value of 4- or 500 billion — and you had a few of those not so long ago — just think of what it takes to deliver, in the way of future cash, at a 15 percent discount rate to justify that.

If you've got a business that's delivering you no cash today and it's selling for $500 billion, you know, to give you 15 percent on your money, it would have to be giving you 75 billion this year.

But if it doesn't give you 75 billion this year, you know, it has to be giving you 86 and a quarter billion next year. And if it doesn't do it next year, it has to be giving you almost a hundred billion in the third year.

It just — those numbers are staggering. I mean, the implications involved in certain market valuations really, you know, belong in "Gulliver's Travels" or something. But people take them very seriously.

I mean, people were valuing businesses at $500 billion a year, a year-and-a-half ago, and there's just no mathematical — almost no mathematical calculation you could make that would — if you demanded something like 15 percent on your money — there's almost no mathematical calculation you could make that would — could possibly lead you to justify those valuations.

Charlie, have any more?

CHARLIE MUNGER: You know, I said on another occasion that, to some extent, stocks sell like Rembrandts. They don't sell based on the value that people are going to get from looking at the picture.

They sell based on the fact that Rembrandts have gone up in value in the past. And when you get that kind of valuation in the stocks, some crazy things can happen.

Bonds are way more rational, because nobody can believe that a bond paying a fixed rate of modest interest can go to the sky, but with stocks they behave partly like Rembrandts.

And I said, suppose you filled every pension fund in America with nothing but Rembrandts? Of course, Rembrandts would keep going up and up as people bought more and more Rembrandts, or pieces of Rembrandts, at higher and higher prices.

I said, "Wouldn't that create a hell of a mess after 20 years of buying Rembrandts?" And to the extent that stock prices generally become sort of irrational, isn't it sort of like filling half the pension funds with Rembrandts? I think those are good questions.

WARREN BUFFETT: Once it gets going, though, people have an enormous interest in pushing Rembrandts. I mean, it creates its own constituency.

33. "It's stupid the way people are extrapolating the past"

WARREN BUFFETT: Zone 1?

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, my name is Joe Schulman (PH). I'm a shareholder from Oxford, Maryland. Thank you for a wonderful meeting.

In order for Berkshire to have an opportunity to hopefully grow its earnings by about 15 percent per year, if we can do that, at least for the next few years, it's obvious that because of the redeployment of earnings and float, the existing businesses do not need to grow at 15 percent.

At what rate would you expect the existing businesses to grow to achieve an aggregate rate close to what I'm describing? And what do you think the probability is of achieving that?

WARREN BUFFETT: Yes. Well, I think the probability of us achieving 15 percent growth in earnings over an extended period of years is so close to zero, it's not worth calculating.

I mean, we'll do our best, and we have a lot of fun doing it. So it is not something where we have to come down and do things that are boring to us or anything of the sort.

I mean, our inclination is to — very much — to do everything we can, legitimately, to add to Berkshire's earnings in things we can understand. But it can't happen, over time. You know, we will have years when we do it, but —

And you're quite correct in pointing out we don't need to do it from the present businesses — we will add things all the time — any more than we needed to do it from the current business back in 1965 with the textile business.

I mean, we have to improvise as we go along. And we will. And the businesses we have are good businesses, in aggregate. They will do well.

They won't do anything like 15 percent growth per annum, but we will take a good rate of progress from those businesses, and we will superimpose upon that acquisitions which will add to that.

But we can't do 15 over a period of time, and — nor, incidentally, do we think any large company in the United States is likely to do.

There will be a couple that do it for a long period of time, but to predict which of the Fortune 500 will end up being the one or two or three, would be very hard to do.

And it won't be more than a couple out of 500, if you take large companies not working from a deflated base year.

I think our method is a pretty good one. I mean, I think the idea of having a group of good businesses to throw off cash in aggregate, in a big way, that themselves grow, that are run by terrific people, and then adding onto those, sometimes at a slow rate, but every now and then at a good clip, more businesses of the same kind, and not increasing the outstanding shares, I think that's about as good a business model as you can have for a company our size. But what it produces, we'll have to see.

Charlie?

CHARLIE MUNGER: I certainly agree that the chances of this 15 percent per annum progress extrapolated way forward is virtually impossible. I think, generally, the shareholding class in America should reduce its expectations a lot.

WARREN BUFFETT: Including the pension funds.

CHARLIE MUNGER: Yeah, including the pension funds, you bet.

It's stupid the way people are extrapolating the past. Not slightly stupid, massively stupid. (Laughter)

WARREN BUFFETT: And this is a message, incidentally, if you think about it. I mean, nobody has any interest in saying this — a financial interest in saying it — whereas people have all kinds of financial interest in saying just the opposite.

I mean, so you do not get an information flow — if you listen to the financial world or read the financial press — you do not get an information flow that is balanced in any way, in terms of looking at the problem, because the money is in believing something different.

And money is what, you know, it's what causes people to become prominent, or it flows from becoming prominent in the investment world in terms of whether you go on television shows, or whether you manage money, or are trying to attract it through funds, or whatever it may be.

I don't think if you were an actuarial consultant and you insisted that the companies that you gave your actuarial report to use a 6 percent investment rate, I don't think you'd have a client.

So, it's almost impossible for the advisors, in effect, in my view, to be intellectually honest on it. Don't you think so, Charlie?

CHARLIE MUNGER: Yeah. There was a very smart — there is a very smart investment advisor in my town, and he said that, "Years ago, some risk arbitrage firm would tell his clients, 'We know how to make 15 percent per annum year in and year out.'"

And he said, “Years ago, everybody said, ‘That’s impossible.’” He says, “Now in this climate, they say, ‘So what?’” You know, who’s interested in a lousy 15 percent?

WARREN BUFFETT: And it was easier in the earlier climate, obviously, because the money hadn’t been attracted into it.

CHARLIE MUNGER: Generally speaking, there’s more felicity to be gained by — from reducing expectations than in any other way. It is simply crazy for this group to have very high expectations. Moderate expectations will do fine for all of us.

34. No comment on USG investment

WARREN BUFFETT: OK. We’ll take one more before we go — we break for lunch. We’ll go to number 2.

AUDIENCE MEMBER: Good morning. My name is Ken Goldberg from Sharon, Massachusetts.

A few questions ago, you mentioned the company’s investment in USG. I was wondering how the company — how you got comfortable with that as an investment, in light of the asbestos exposure?

Do you view the company — the stock — as cheap enough and the asbestos exposure as manageable enough over time, so that the investment is justified?

Or do you view it as, in a worst-case scenario, if the subsidiary with asbestos exposure blows up, the rest of the solid businesses are insulated from that and are alone worth the price of the investment?

CHARLIE MUNGER: Let me answer that. I don’t think we want to comment. (Buffett laughs)

WARREN BUFFETT: Yeah. It’s one-tenth of one percent of Berkshire, roughly. I mean, but as Charlie says, that gets too close to giving stock advice.

But I will tell you their asbestos problems are serious, and they would be the first to tell you that.

Afternoon Session - 2001 Meeting

1. "Insurance float has been a huge asset to Berkshire"

WARREN BUFFETT: OK.

I hope you've all had a cholesterol free lunch. And — (laughter) — we will move on. And when we stopped, we were about to go to zone 3.

AUDIENCE MEMBER: Hi, my name is Jason Tank from Traverse City, Michigan.

I've got one kind of quick question that I'm sure you can answer relatively quickly, if you're not interested.

I know that Walter Scott's on the board of directors and he's also on the board of directors of a company called Level 3 Communications that is in an industry that's — well, there's been a lot of change happening and stock prices have been plummeting. I wonder if you've ever —

You've probably spoken to him at great length about the economics of that business. And have you ever expressed any interest that business, especially at the prices today?

That's the first question. The second question is — if you look at Berkshire Hathaway as a portfolio, you've got wholly owned subsidiaries as operating businesses, marketable securities, common stocks and bonds. If you strip out — and if my premise is wrong, just please tell me.

If you strip out the leverage effect of the cost of the float being, you know, nearly zero or negative throughout the years — if you look at the portfolio minus that leverage piece, how fast do you think your book value would've grown over the last 30-plus years? Are we talking about 5 percent or 6 percent due to just the leverage piece on the insurance float?

WARREN BUFFETT: I don't think it would run as much as 5 or 6 percentage points, but the float has been very useful to us. And actually, I've never made the calculation.

So you could well be correct that if it was 5 or 6 points, that would be a quarter of our book value gain over the years being attributable to insurance float.

And I think that's probably maybe on the high side but — and you can't make it —

We don't look at insurance float 100 percent the same as we would look at equity, but we've looked at it a good bit, you know. It's largely tantamount to equity because we've had so much equity, we could afford to do it that way. So I — you'll have to make that calculation yourself.

We think insurance float has been a huge asset to Berkshire. We think it'll continue to be a huge asset. And we look for every way possible to increase the amount of low-cost float.

On a small scale, we added US Liability last year, an excess surplus lines carrier based in Philadelphia. And so far, that's working out extremely well. Got a terrific guy running it. And, you know, in a small way, we add float there. I just looked at the first quarter on it, and we had a significant underwriting profit and we had float added. And, you know, that's the best of all worlds.

So we'll keep working on it, and it will add — it's a big asset that Berkshire has that a great many companies — I mean, virtually no other company has it to the degree that we have that also invests in other businesses and uses it as a source of money to invest in other businesses.

The question about Level 3, I obviously can't answer. I just — I can tell you that you have two enormously smart and high-grade guys in Walter Scott and Jim Crowe in that business. But it's not a business I know a lot about. And if I did, I wouldn't talk about it.

Charlie?

CHARLIE MUNGER: I cannot talk just as well as you can. (Laughter)

WARREN BUFFETT: Not always. (Laughter)

2. Accounting "shenanigans" and "gamesmanship"

WARREN BUFFETT: OK. Section 4.

AUDIENCE MEMBER: John Golob from Kansas City.

I have a follow-up question to your comments about how financial statements can be distorted by making over-optimistic assumptions about returns for the pension portfolio.

If you believe accounting statements, as published in annual reports, returns on equity for U.S. businesses are amazingly high — higher than in Europe, higher than they've been historically, higher than Japan.

Are these highs, do you think, completely attributable to accounting shenanigans? Or are there any fundamental reasons in addition that might make returns in the U.S. higher than in Europe or higher than they've been historically?

WARREN BUFFETT: Well, I would say that they certainly — to the extent that American returns have been higher than those around the world, at least in developed countries, I would say that they are not solely due at all to accounting shenanigans.

I think that the absence of honest accounting for option costs and — has been a factor. But American business has done very well, excluding — very well — excluding any accounting activities that Charlie and I might differ with.

You know, I'm no expert on exactly what returns have been around the world in developed countries, but my impression definitely is that American business is well above averaged — average — for the developed world, in terms of profitability.

And, you know, I don't have the answers as to why that's occurred. I think that American business, and I think the whole American system, has reflected more of a meritocracy than exists in many countries.

And I think that a meritocracy works best. I think — and I think that mobility between classes, which is the flip side of a meritocracy, you know, does tend to get the Jack Welches into positions of — whether they run a General Electric or an Andy Grove or an Intel or, you know, go with Sam Walton at Walmart.

I think if you'd taken those same individuals and dropped them down in most countries, they would've done very well. But I don't think they would've done quite as well as here. And I think that what they have done well has spilled over, in a big way, to benefit the American economy.

So I would not lay it all on the accounting shenanigans.

And the pension funds accounting, that applies very heavily at some companies. And, of course, most newer companies don't have pensions.

Companies that have started in the last 20 or 30 years are much more inclined to have various kinds of profit sharing or 401(k)s.

The older industries that took on pensions spurred, to a great degree, I think, by World War II, when you got excess profits taxes that ran to 90 percent. And there was a huge incentive to start pension plans and fund them heavily because the government, in effect, was funding 90 percent of your pension obligation.

So there was a great boon — boom period in the inauguration of pension funds. And, of course, that meant steel and auto and all of those big industries of that time.

Charlie?

CHARLIE MUNGER: Yeah. It isn't so much accounting shenanigans as it is deliberate financial practice. Take General Electric.

There's been a deliberate increase in financial leverage, which was made possible by the wonderful and deserved reputation. There's been a deliberate increase in repurchase of stock, which General Electric has done even when they're paying huge multiples of book value.

That sort of thing does wonders for returns on equity as reported, as does the process of writing off everything in sight and various extraordinary charges, removing the burden of past costs from future earnings.

You put all those things together, and American returns on equity are higher partly because the management has deliberately set out to paint the company as unusually efficient in its use of capital, meaning that it earns a high return on shareholders' equity.

Think of how high we could drive our return on equity at Berkshire. I mean, we could make it almost any number you want if we just used enough leverage.

WARREN BUFFETT: Yeah, we could run it with no (inaudible).

CHARLIE MUNGER: We could run Berkshire with no equity. And then people could say, "Gosh, these guys have finally learned how to manage the damn thing." (Laughter)

It's not been an objective around here to reduce the equity to zero. But at other places, in order to make the reported return on equity good, they deliberately pound on the net worth as much as they can.

WARREN BUFFETT: Yeah. The questioner may have seen — if you look at the S&P figures of the last 15 years, they report them both before special charges and after special charges. And there's been a very significant difference between those two figures.

American business likes to frequently write off things and say that doesn't count. And, of course, that takes the equity down. And it actually frequently benefits future earnings because you remove costs that would otherwise hit the income statement in future years.

CHARLIE MUNGER: The truth of the matter is you have — part of this is shrewd and correct management of the companies' financial structure and operations. And part of it can drift into gamesmanship.

3. Save money in your teen years and be very curious

WARREN BUFFETT: Region 5.

AUDIENCE MEMBER: Hi, Mr. Buffett. My name is Mallory Marshall (PH). I am 11 years old and I am from Kearney, Nebraska. I have 2 questions.

First, my dad would like to know if you have any grandsons my age. (Laughter)

WARREN BUFFETT: Any what her age?

CHARLIE MUNGER: She wants to know if you have any grandsons her age.

WARREN BUFFETT: How many shares of stock do you have? And I'll tell you. (Laughter)

AUDIENCE MEMBER: Also, what investment advice do you have for young people of my generation?

WARREN BUFFETT: Yeah. Well, I've got a grandson fairly close to your age and he probably would go for a younger woman anyway, so — (laughter) — I will mention him to you. Mention you to him.

The — well, if you're interested in financial matters, A, you've got to have something to work with. I mean, I was fortunate in that respect because my dad paid for my education. If he hadn't, I probably wouldn't have become educated if I had to pay for it myself, but —

So I was able to save $10,000 by the time I was 21. And, you know, that was a huge, huge head start. If I hadn't have been able to do that and, you know, my first child came along when I was 22.

So it's much easier to save in those teenage years if you're lucky enough to be in a family where you don't have — where your parents are taking care of your financial obligations. Every dollar then is, you know, worth making $10 or $20 later on.

And, so if you are interested in financial matters, getting a stake early is very useful, and getting knowledge early is very useful.

So, you know, I would say you're well on the way if, at 11, you're even interested in coming to a meeting like this.

And I would — if that interest is maintained, you know, I would read financial publications. I would read whatever was of interest to me. I'd be curious about how the businesses around the town of Kearney operated.

I would — to the extent that you can get people to talk to you — and people usually like to talk, you know — learn about who's got good businesses in Kearney and why they're good businesses. And learn about the businesses that went out of business and why they went out of business.

And just keep accumulating knowledge. That's one of the beauties of the business that Charlie and I are in, is that everything is cumulative. The stuff I learned when I was 20 is useful today. Not in necessarily the same way and not necessarily every day. But it's useful.

So you're building a database in your mind that is going to pay off over time. But you have to have a little money to work with. So there's nothing like getting a few dollars ahead. Stay away from credit cards. And you can have a lot of fun, if your mind goes along that track as you get older.

Charlie?

CHARLIE MUNGER: Well, I'm glad to see somebody that has, so early, shown an interest in getting ahead. There's nothing wrong with getting ahead. (Laughter)

WARREN BUFFETT: And actually, she may have the best idea about getting ahead by learning the name of my grandson, too. (Laughter)

CHARLIE MUNGER: Well, there, I can give the young lady some advice. Before your feelings totally take over, you should look carefully at both parents and all four grandparents. (Laughter)

WARREN BUFFETT: Write Charlie and let us know how it works out. (Laughter)

4. GEICO policy retention rates

WARREN BUFFETT: Area 6.

AUDIENCE MEMBER: I'm Jack Hurst (PH), Philadelphia, Pennsylvania. Three notes of thanks. First, for American Express for the terrific job they've done the last three times in scheduling reservations for me.

The second is thanks for the care you take with your annual report. There is nothing more accessible than the statistics in that report, and the text is just absolutely marvelous.

The third one is the care and feeding you give to troubled businesses like World Book, which I'm glad has survived, and Dexter Shoes.

They're closing the plant in Milo, Maine, which is advantageous for the shareholders. But they gave the people enough time that, because of the additional — Jackson Labs expanded, they're hiring, and Fidelity brought 6,000 jobs into the area. So those people will have better chance for jobs than they had to — if they were kicked out right away.

The second point is a question about GEICO. You have a wonderful table in your annual report showing the number of policies issued and the policies in force at the end of each year, for the last seven or eight years.

In general, at the end of one year, the policies in force are equal to 95 percent of the policies in force at the beginning of the year, plus 60 percent of those that have been issued in the year.

And that's been constant, up until this last year, when the amount in force at the end of 2000 is 24 percent of the policies issued in 2000 and 95 percent of those that were in force at the end of 1999.

I'm curious if Mr. Nicely has asked, first, "Why is there such a large difference in lapse between the first year policies and the renewal policies?" and, "Why is there such a discontinuity in the year 2000?"

WARREN BUFFETT: The — I'll answer the last one first, about GEICO. The retention rate is affected overwhelmingly by two factors.

One is the mix between the below-standard business, the standard business, and the better business, in terms of risk. In other words, we have — just making a calculation here — we have 75 percent or so of our business, plus, in the preferred category.

But we have grown faster up till the last year or so — in the last three or four years before that — up till the last year in the standard and the non-standard business. Those latter two categories have far greater lapse — or non-retention ratios — or lapse ratios — than the preferred business.

They're two different businesses almost. So any change in the mix between preferred and the other two categories will change the aggregate retention ratio very substantially.

The second thing is that the first year has a much higher retention — lapse ratio — than the second year of a policy. And, in turn, than the third, and so on.

In other words, if you get to preferred business that's been with you five or more years, you have a very, very high retention ratio.

In the last few years, we've added more new business than we were adding in the years before that. So we have had a higher percentage of new business and we've had a higher percentage of non-preferred business, both of which would make the aggregate lapse ratio look higher, even though the lapse ratio, when categorized by class of business and age of business, really hadn't changed very much.

Now, it's true, however, our retention ratio in the preferred business has fallen by a point or so.

But that's the big difference. And now, unfortunately, you know, our new business is not as strong. So you'll actually see, and — but, our preferred business is running stronger than our standard and non-standard.

So you are seeing the mix go back in the other direction, right now. I mean, currently, that's going on.

Through right to date this year, our preferred business is up in aggregate policy holders. And our standard and non-standard is down.

So what you've deduced from those figures reflects changes in mix and age of business far more than it does retention ratio, although there was a minor change in the retention ratio. And that will be true. And maybe I should explain that better in the annual reports in the future.

I touched on it once a year ago, but we can make that clearer in future reports.

What you said about the American Express people, I echo. I mean, they have just done a fabulous job with people.

We sort of turned the problem over to them of how people get here and where they stay and all of that. And we've had wonderful help from the local American Express office.

And frankly, they've been so good, we don't even think about it. We just refer people on to American Express. And I congratulate them for the job they've done. Thank you. (Applause)

5. "True synergy" between General Re and Berkshire's reinsurance operations

WARREN BUFFETT: Area 7, please.

AUDIENCE MEMBER: I'm Chip Mann (PH) from Minneapolis, Minnesota. Thanks again for this open format and your direct answers to our questions.

You've talked a bit about the super-cat class level of risk that you write. Could you share your thoughts about expanding the competitive advantage and the scale advantages at General Re, referring more to their traditional or historical franchise and the type of contracts they would write?

WARREN BUFFETT: Yeah. General Re was a — is a — and General Re and Cologne are a very different operation than the historical reinsurance business of National Indemnity.

National Indemnity had nothing like their distribution system. And they have a — and a knowledge base for a whole different form of reinsurance than we could ever accumulate at National Indemnity.

General Re did not — nor Cologne — did not take —retain — as much risk as we're quite willing to retain because their financial profile was different before they joined Berkshire.

So it's an opportunity for us, for two reasons, to make more money in that respect than General Re might've made on its own.

One is we can retain much bigger portions of what they would write in the first place, and which they've been writing over the years, but which they've laid off with other companies in what has the fancy name of retrocessionals.

And a second point is that they have a distribution capacity that may well have the ability to deliver to us a lot of big risks that we might not otherwise see. And that, in the past, they might not otherwise have had a good outlet for.

So there is — there's really true — I hate the word — but there's really true synergy in General Re Cologne being married to Berkshire Hathaway. And you've put your finger on, really, one point that has two aspects to it.

And we haven't fully exploited that. We probably won't fully exploit it, you know, 10 years from now.

But it's very much in my mind and the minds of the managers at General Re and Cologne that we have expanded opportunities, simply because Berkshire is willing to take on more risk than just about anybody in the world knowingly takes on.

Although we think some other people take on a lot more risk, unknowingly.

But in terms of writing a specific contract, we are both bigger and faster, I think, than anybody in the world. In effect, we have some of the abilities that used to be associated with going to a Lloyd's of London.

I mean we can — now, I don't know how true all that was over the years, because I wasn't around there then. But we really can give an answer on something in an hour that other companies wouldn't know what to do with in a month. And that should be a plus for us in the world.

Charlie?

CHARLIE MUNGER: Nothing to add.

6. Why Buffett doesn't like to buy a new car

WARREN BUFFETT: OK. Zone 8.

AUDIENCE MEMBER: My name is Ethan Berg. I'm from Cambridge, Massachusetts and I'd like to thank you for the education you've provided, particularly with the annual reports. I've got three brief questions.

Years ago, you wrote to your friend Jerry Orans that you were applying to Columbia's Business School because they had a pretty good finance department and a couple of hot shots in Graham and Dodd.

If you were considering graduate or business school today, with which individuals or professors would you want to study?

The second question is, a friend who wants to know your thoughts on the concrete, cement and aggregates business.

And the third question is from my wife. You mentioned earlier if someone were buying a parachute, they wouldn't buy based on lowest bid. We saw you tooling around in a car this week that, were it to be bought today, could probably be bought at a relatively low bid.

As someone interested in your health, she's wondering whether you've considered a newer automobile, possibly one with lots of airbags. (Laughter)

WARREN BUFFETT: Actually, I picked out the car I have based on the fact that it had airbags on both sides. So that was a factor. It may be the first car of its type ever made with airbags.

But I think my car actually — it's both heavy and has airbags, and those are two primary factors in safety. I don't think any — I don't think a safer car is necessarily being made. It might be safer to drive around in a big, heavy duty truck or something but I'm not ready for that.

Incidentally, on a car, I look at that like anything else. It would take me, probably, a half a day to go through, you know, the exercise of buying a car and reading the owner's manual and all that. And that's just a half a day I don't want to give up in my life for no benefit.

You know, if I could write a check in 30 seconds and be in the same position I'm in now with a newer car, I'd be glad to do it this afternoon. But I don't like to trade away when there's really no benefit to me at all. I'm totally happy with the car.

I just don't want to trade away the amount of time I'd have to spend fooling around to get familiar with and get title to and do all the rest of the things, pick one out, so a new car. But if there's a safer car made, you know, I'll be driving in it.

7. Concrete, cement, and aggregates are understandable

WARREN BUFFETT: The aggregates business, concrete, all of that, those are businesses that — and Charlie probably knows more about them than I do. We've looked at businesses like that.

In fact, we've even owned a few shares at one time or another, because it's an understandable business. And it's a business that — particularly if you get into concrete, cement, I mean, you know, there have been periods of substantial overcapacity, particularly on a regional basis.

But those are fundamental businesses. And at a price, you know, for low-cost capacity and advantageously located raw materials and so on, you know, we would do it. In fact, Charlie and I talked about one probably 10 or 15 years ago —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: — quite a bit. And he's had a fair amount of familiarity with it. And what was the other one? I jotted it down here. Let's see.

8. Business schools are "pathetic" at teaching how to invest

CHARLIE MUNGER: He wanted to know what business school a young man should —

WARREN BUFFETT: Oh, business schools.

CHARLIE MUNGER: — go to.

WARREN BUFFETT: Yeah. Well, I would say this, that I think Bruce Greenwald's class at Columbia is very good. He gets in a lot of people that are practitioners. So there's a lot of practicality to the course.

And I think Bruce is good. He's got a new book coming out probably within the next six months or so that will deal with that.

And then there also has been endowed, at the University of Florida, certain courses relating to value investing. And I think there's been one at the University of Missouri.

So I would suggest you at least check out the curriculum at the University of Missouri and Columbia and Florida. And do a little comparison and maybe check with a few graduates — recent graduates — as to what kind of experience they had.

If you can find them, I think that's the best system for evaluating a place. But those three, at least, have courses that, based on the catalogue, sound like they might be of interest to you.

Charlie?

CHARLIE MUNGER: Yeah. A huge majority of the business school teaching on the field of investment of (inaudible) portfolios of securities is not what we believe and not what Warren was taught years ago by Ben Graham. There're just little pockets of our attitude left. There's one at Stanford. Jack McDonald?

WARREN BUFFETT: Yeah, sure. Yeah, that's graduate school. But yeah.

CHARLIE MUNGER: It's graduate school. And what's interesting about that is I think it's the most popular course in the whole Stanford Business School. They've got some kind of a bidding system. And yet, I asked Jack how he felt and he said he felt lonely.

He's got the most popular course, but in the whole professoriate, dealing with investment matters, the Jack McDonalds are a little clan of their own in a side pocket, so to speak.

Now, they're right. And they can take whatever consolation they get from that. But mostly, if you go to business school you will learn a lot of things we don't believe. (Laughter)

WARREN BUFFETT: Jack — Bob Kirby comes in and works with Jack sometimes, too. And Bob has got a terrific mind, in terms of investment. I mean, there's no question about that.

You know, it's not the easiest school in the world to get into and it is at the graduate level. But there are these occasional little anomalies, as they would say, in the teaching world.

I mean, what you really want a course on investing to be is how to value a business. That's what the game is about. I mean, if you don't know how to value a business, you don't know how to value a stock.

And if you look at what is being taught, I think you'll see very little of how to value a business.

And the rest of it is playing around, maybe, with numbers or, you know, Greek symbols or something of the sort. But it doesn't do you any good. I mean, in the end, you have to decide, you know, whether you're going to value a business at $400 million or $600 million or $800 million.

And then you compare that with the price. And that's what investing is. And I don't know any other kind of investing, you know, basically to do.

And there — that just isn't taught. And the reason it isn't taught is because there aren't teachers around, you know, who know how to teach it.

I mean, they don't know themselves. And since they don't know themselves, they teach something that says, "Nobody knows anything," which is the efficiency market theory. (Laughter)

And if I didn't know how to do it — and if I ever teach physics, I'm going to come up with a theory that nobody knows anything, because it's the only way I can get through the day, you know? But — (Laughter)

It's fascinating to me how, you know, the really great universities operate in this respect.

If you get a sacred writ, I mean, you get in the finance department because you sign on, you know, to whatever the present group thinks. And if they think the world is flat, you'd better think the world is flat too, you know? And your students better answer that the world's flat when they get it on exams.

I would say investment — finance — teaching in this country, in general, is kind of pathetic.

CHARLIE MUNGER: Well, I think the business schools do a pretty good job when it comes to accounting —

WARREN BUFFETT: Oh, accounting, sure, sure.

CHARLIE MUNGER: — or personnel management, or — there're a whole lot of subjects I think they do quite well with. But they miss one enormous opportunity.

If you learn to think intelligently about how to invest successfully in businesses, you'll become a much better business manager than you will if you aren't good at understanding what's required for successful investment.

So they're missing a huge opportunity to improve the management profession by doing such a lousy job in teaching investment.

WARREN BUFFETT: Yeah, see, Charlie and I see CEOs all the time who, in a sense, don't know how to think about the value of businesses they're acquiring. And then, you know, so they go out and hire investment bankers.

And guess what? The investment banker tells them what to do, tells them to do it because they get 20X if they do it and X if they don't do it. And guess how the advice comes out.

So it's a — when a manager of a business feels helpless, which he won't say out loud, but inwardly feels helpless in the question of asset allocation, you know, you've got a real problem.

And there aren't — they have not gone to business schools that have given them any real help, I think, in terms of learning how to think about valuation in businesses. And, you know, that's one of the reasons that we write and talk about it some, because there's a gap there.

9. Credit card advice: "It's crazy to get in debt

WARREN BUFFETT: OK. Number 1.

AUDIENCE MEMBER: My name is Martin Mitchell (PH). I'm from Bakersfield, California.

My question, a two-part question, is concerning debt. We know that individual debt can be devastating.

Do you — are you concerned that the American consumer is so far in debt, as a whole, as to be a problem?

And part two is, do you feel that our trade deficit with other countries is of concern to you?

WARREN BUFFETT: Well, the first question about debt, I think it's very hard to answer about the consumer as a whole. I get letters every day from people who have problems in life. And they revolve — I mean, they're either health or debt. And usually — frequently — the debt is connected with health, you know?

But they — it's been very easy for them to borrow money, and they're in over their heads, and it's all over then.

And there's no question that the American consumer is somewhat more indebted, in aggregate.

But it's a very hard thing, I think, to come into conclusions about whether it poses a serious problem. You know, most people have had assets, directly or indirectly, that have gained in value enormously, particularly in real estate and some in securities.

So there's a greater capacity to carry debt as earning power increases and assets held increases. I don't — I can't give you a useful answer, in terms of the world as a whole.

But I constantly give advice to young people, and those are the only people I talk to, aside from our shareholder group: just don't start out behind the eight ball.

I mean, it's crazy to get in debt because it's so hard to get out of debt. And, I mean, the idea of having credit card debt — and we issue credit cards in all our businesses and, you know, so does every other retailer.

But the idea of trying to borrow money at 18 percent, you know, and thinking you're going to get ahead in life, it isn't going to work.

And I urge people — they can use their credit card, but I urge them to pay it off before it starts revolving because it's just — it's too expensive.

Charlie and I can't make money with 18 percent money. I mean, we're looking around for float because we don't want to pay 5 percent for money.

And, so I'm very sympathetic to people get in debt. But once you get in it, it is hell to get out.

I mean, Charlie will have a few Ben Franklinisms to quote on that subject.

In fact, you want to give a few from Ben now? (Laughter)

CHARLIE MUNGER: Oh, no.

WARREN BUFFETT: He'd love to, but I led him into it the wrong way.

10. Long-term trade deficit is "a significant minus for the country"

WARREN BUFFETT: And the second question about the trade deficit, that's a very interesting thing. Because when you run a trade deficit, what you're doing is you're trading assets of one sort or another for goods, beyond what you're sending abroad.

So in effect, you are selling off a tiny bit of the farm so that the country can consume more than it's producing. If you run a net trade deficit, the country, in aggregate, is consuming less than — or consuming more — than it's producing.

And if you're a very rich country, you can't even see it because if you run a trade deficit of a few hundred billion dollars, you know, compared to an economy that's maybe worth, what, 40 trillion or something like that, you don't see it.

But you're trading off a tiny bit of the farm every year to live a little bit better than if you just lived off the produce of the farm that year.

And you can do it with IOUs if you've got a good record. You can't do it with IOUs if you're a country that's got a terrible record.

So they have to denominate their debt in dollars. And, of course, they don't have the ability to denominate a lot of dollars, and people don't want to accept a weak currency. So a weak country can't get away with doing that, unless it's getting special-type loans from agencies set up to do that.

We can do almost anything we want in this country, because we don't confiscate property and we don't — we haven't destroyed a currency that the people have accepted, in terms of payment for their goods, over the years.

But I basically think a significant trade deficit over a long enough time is a significant minus for the country. You won't see it though, day-by-day, or week-by-week, or month-by-month.

But eventually, if you trade for trinkets or whatever you're getting beyond what you're sending, and you trade away your assets —

Fortunately, some of the assets we traded not that many years ago, like movie studios and some of those things, the other people got the short end of the bargain on.

But by and large, it's not a good policy for the country to run large trade deficits year after year.

Charlie?

CHARLIE MUNGER: Well, it's — that's certainly true if what you're trading for is trinkets, or consumer goods, or something. But, of course, a developing country that ran a trade deficit to put in power plants and what have, that might be a very smart thing to do. In fact, the United States once did that.

WARREN BUFFETT: Yeah, we did it with railroads in a huge way, you know, and —

CHARLIE MUNGER: But under modern conditions, do we look like a twosome that would love a big trade deficit? (Laughter)

WARREN BUFFETT: No. It's one thing to build railroads with the process, but it's another thing, you know, to buy radios and television sets. I mean, it depends what you're getting.

But by and large, we run a trade deficit on consumption goods. And that's not a big plus over time.

11. Satisfied sellers are a "recruiting force"

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: Good afternoon. I'm Jim Hays (PH) from Alexandria, Virginia. I'd like to thank you and Mr. Justin for bringing his masterpiece into the Berkshire family.

But the question arises, will you soon run out of privately-held firms that meet the criteria for acquisitions of sufficient size to continue the returns to Berkshire?

WARREN BUFFETT: Well, that's a good question because people who sell to us have the option of —private business — selling elsewhere or going public.

There seem to be enough people that have built businesses lovingly over 50 or 100 years, and their parents before them and grandparents, that really do care about the eventual disposition of them in some way beyond getting the last dollar that day, that we have a supply from time to time of those businesses. And I think we'll continue to see them.

You do raise an interesting question. How many businesses like that are worth, you know, a billion dollars or more in the whole economy? There seem to be — you know, I wish there were more, but there are enough. So I think we will probably buy, on average, maybe two a year, something of that sort.

The really big ones — I mean, what we'd love to make is a 10- or $15 billion acquisition. And there would be very few private companies that would be in that category.

And then, from the ones that are in that category, you have to find somebody that is not going to conduct an auction.

We don't — we just are not interested in auctions. If somebody wants to auction their business, we're not that excited about getting in with them because we need people to run it after we buy it.

And, if that's the way they look at their business, we may get more unpleasant surprises than we've tended to get in the past with the kind of criteria we've used.

Charlie?

CHARLIE MUNGER: Yeah. There're two aspects of that situation. One is, are there going to be enough businesses? And two, how much competition are we going to get from other buyers?

One thing we do have going for us is that if you are the kind of a business owner that likes the culture that's in this room today, there isn't anybody else like us. Everybody else is off on a different path with a different culture. (Applause)

So — and look at all you. I mean, this culture is popular, at least with a certain group. And surely, there'll be other people who like this culture in the future, as in the past, and will feel right about joining it with their companies.

WARREN BUFFETT: We haven't had any luck internationally so far, but we would hope that that could change.

I was over in Europe about a month ago and I got asked the question a lot of times about whether we would be a prospect for businesses in Europe, for example.

The answer is yes. And then they say, "Well, you know, why haven't you bought anything?" And I said, "The phone's never rung." I don't know whether they thought that was a brilliant answer or not, but they — (Laughter)

But I left my phone number a lot of places, you know? Every time I got a chance, I gave that answer. And maybe the phone will ring.

I've got to believe that, if we were on the radar screen the same way in Europe over the last five years that we have been in the United States, we would've bought a couple of companies.

It's just, they don't think of us. And a lot of people don't think of us in the United States, either, but more do now than did five or 10 years ago.

And we have, actually — a reasonable percentage of our acquisitions come, directly or indirectly, because we've made another acquisition in the past where the seller was happy. It's very hard to find anybody that's been unhappy dealing with us.

And they're friends with other people in their industry, or whatever it may be. So, we hear about things now more often, because we actually have what you might call a recruiting force out there of people that have already done business.

It's very much like NetJets that way. I mean, we spend a lot of money advertising at Executive Jet, the NetJet service. But still, 70 percent or so of our business comes from owners who are with us. They're, by far, the best salespeople we have.

And incidentally, that's the way I was introduced to the business. Frank Rooney, who's in this room today, told me about his good experience with NetJets back in January or so of 1995. And that's when I joined in. And if Frank hadn't told me, I might — six years later, I might not have ever looked into it. I mean, you know, I might've just turned the pages past the ads and —

But when Frank said, "You ought to look into this," I did. Well, that's what we hope we have going for us on the acquisition front. And I think we do, to some degree. But we'd like it to be greater, and we would like it to be more widespread, geographically, than it is.

CHARLIE MUNGER: When I was a lawyer, I used to say, "The best business getter any lawyer has is the work that's already on his desk."

And similarly, probably the best business getter that Berkshire Hathaway has is the business practice that's already on our desk. That's what's driving the new businesses in, right, Warren?

WARREN BUFFETT: Sure. Sure.

CHARLIE MUNGER: So it's a very old-fashioned idea. You just do well with what you already have and more of the same comes in.

12. Why Berkshire sold its Freddie Mac and Fannie Mae stakes

WARREN BUFFETT: Zone 3, please.

AUDIENCE MEMBER: My name is Steve Sondheimer. I live in Chicago and I'm 14 years old. I'm a third generation shareholder and my question is, I noticed that you sold our position in Freddie Mac. What risks do you see in that industry?

WARREN BUFFETT: Are you Joe's granddaughter?

AUDIENCE MEMBER: Yeah.

WARREN BUFFETT: Oh, good. We have an amazing number of second and third and even fourth generation shareholders, which I'm delighted with. I mean, I don't think lots of companies — big companies on the stock exchange — are in that position.

It is true, we sold the Freddie Mac stock last year. And there were certain aspects of the business that we felt less comfortable with as they unfolded — and Fannie Mae, too.

And the consequences of what we saw may not hurt the companies, I mean, at all. But they made us less comfortable than we were earlier, when, actually, those practices or activities didn't exist.

We did not — I would stress — we did not sell because we were worried about more government regulation of Freddie and Fannie. If anything, just the opposite, so —

It was not — it was not — Wall Street occasionally will react negatively to the prospect of more government regulation and the stocks will react sometimes short-term for that reason. But that was not our reason. We were — we felt the risk profile had changed somewhat.

Charlie?

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

WARREN BUFFETT: We're quite sensitive to —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — risk in — whether it's in banks, insurance companies or in what they call GSEs here, in the case of Freddie and Fannie.

We feel there's so much about a financial institution that you don't know by looking at just figures, that if anything bothers us a little bit, we're never sure whether it's an iceberg situation or not.

And that doesn't mean it is an iceberg situation, in the least, at banks or insurance companies that we pass.

But we have seen enough of what happens with financial institutions that push one way or another, that if we get some feeling that that's going on, we just figure we'll never see it until it's too late anyway.

So we bid adieu without — and wish them the best — without any implication that they're doing anything wrong. It's just that we can't be 100 percent sure of the fact they're doing things that we like.

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

Charlie?

CHARLIE MUNGER: Yeah. Financial institutions tend to make us nervous when they're trying to do well. (Laughter)

That sounds paradoxical, but that's the way it is.

WARREN BUFFETT: Financial institutions don't get in trouble by running out of cash in most cases. Other businesses, you can spot that way.

But a financial institution can go beyond the point — and we had banks 10 years ago that did that, en masse — but they can go beyond the point of solvency even while they still have plenty of money around.

13. Debating whether it's good moats are harder to find

WARREN BUFFETT: Area 4, please.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. My name is George Brumley from Durham, North Carolina.

We often consider evaluating companies in the context of Michael Porter's model of position relative to competitors, customers, suppliers, substitute products. You state that much more simply when you say you seek for companies with the protection of wide and deep moats.

To complete the valuation of a company, we all seek to choose the appropriate future cash flow coupons. A qualitative assessment of the protected competitive position is required to precisely forecast those future coupons.

In your opinion, are the dynamic changes in the nature of competition, distribution systems, technology, and even changes in customers, making it more difficult to accurately forecast those future cash flow coupons?

Are good, protected businesses going to be more rare going forward in — than they have been in the past? And if so, does that make the few that do exist more valuable?

WARREN BUFFETT: Well, you've really described the investment process well. I can't see from here, but which George are you? Are you the — are you Fred's brother-in-law or are you one generation down?

AUDIENCE MEMBER: George III. My father is here as well.

WARREN BUFFETT: OK, good. The questions you ask are right on the mark. And we do think, to the extent I understand what — or have read what Porter has written, we think alike, basically, in terms of businesses.

And we do call it a moat. And he makes it all into a book, but that's the difference between the businesses we're in. (Laughter)

I — and Charlie may have a different view on this. I don't think that the quantity or sustainability of moats in American business has changed that dramatically in 30 or 40 years.

Now, you can say that Sears and General Motors and people like that thought there were some very wide moats around their businesses, and it turned out otherwise when, in the case of Sears, Walmart, for example, came along.

But, I think — the businesses we think about, I think the moats that I see now seem as sustainable to me as the moats that I saw 30 years ago.

But I think there are many businesses — industries where it's very hard to evaluate moats. There — those are the businesses of rapid change.

And are there fewer businesses around where change is going to be relatively slow than previously? I don't think so, but maybe Charlie does.

Charlie?

CHARLIE MUNGER: No, I would argue that the old moats, some of them are getting filled in. And the new moats are harder to predict than some of the old moats. No, I would say it's getting harder.

WARREN BUFFETT: Well, there you have it. (Laughter)

Unanimity at Berkshire. OK.

I think it's a very good question. And I really don't — you know, Charlie may be right, I may be right. I think it's a very tough one to figure.

But regardless of whether there are fewer or that — harder to find, that's still what we're trying to do at Berkshire. I mean, that is what it's all about.

Our instructions to our managers — we don't have budgets and we don't have all kinds of reporting systems or anything else. But we do tell them to try and not only protect, but enlarge, the moat. And if you enlarge the moat, everything else follows.

14. How derivatives become "potential dynamite"

WARREN BUFFETT: Area 5?

AUDIENCE MEMBER: Bill Graham (PH) from Los Angeles.

Warren, you've made it possible for outside shareholders to understand Berkshire's financial businesses.

But there is one that seems, to me, anyway, hard to understand, which is the financial products business, which I guess, involves trading of derivatives.

And for the same — given the same kind of concerns that you and Charlie voiced in relation to financial businesses, can you help us out on that and why you're comfortable with it?

WARREN BUFFETT: Well, I think you put your finger on it, Bill.

It is a hard business to understand. And it's a hard business to understand if you own it, let alone read about it in somebody else's annual report.

And I would guess that most people who own complicated or extensive derivatives businesses, I would say that most of the CEOs probably don't understand it. And how many of them stay awake at nights over that, I don't know.

Actually, in financial products, what you see on that one line of income on that, and also what you see in the balance sheet items, is a combination of several things. It's General Re Securities, which used to be GRFP, General Re Financial Products. It's — and it's a couple of other operations.

It actually had our — it has our — structured settlement business in it, which is quite predictable and a very easy business to understand.

And it actually has some trading business that I do that falls in there. It's not our normal investment business, but it may involve, what I think are — it tends to be fixed-income related.

It might involve arbitrage or semi-arbitrage of various types of fixed-income securities. It wouldn't involve any equity arbitrage. That would not be in there.

But I would say that it would be a fair criticism to say that neither Charlie nor I know fully, or even in large part, what goes on in the derivatives business.

Now, we have a fellow who is both smart and trustworthy running that in Mark Byrne. So we feel very good about the individual.

We do not feel the instinctive understanding of everything that's going on that we do, probably, in most of the businesses that we're in. I think we've probably got 17,000 outstanding tickets at General Re Securities. And those interplay in all kinds of ways.

And I don't think that Charlie or I have my mind — our minds — around that book of products. That means we want to be very comfortable with the fellow whose job it is to have his mind around those products. And I will tell you that, you know, there's nobody that I'd feel more comfortable with than Mark Byrne.

But it is — it's not a natural-type business for us.

The other things in that area, and we made a fair amount of money in some things that aren't related to the derivative business last year. And those are under my direct control. So I feel OK about that.

The structured settlement business is a minor profit area. But it's made us some money. And right now, it's not attractive. But it could be again in the future.

And there could be other financial-type things we would stick in there. But if we stuck in anything, it would be something that I would be running.

Charlie?

CHARLIE MUNGER: Yeah, that mix includes what I would call oddball pastimes of Warren Buffett — (laughter) — outside —

WARREN BUFFETT: The ones that are publishable. (Laughter)

CHARLIE MUNGER: — outside the common stock field. That I'm quite comfortable with, although I'm sure the results will be irregular.

The rest of it — and I think we also have what might be called oddball personal ideas of Mark Byrne, and I'm quite comfortable with those.

As you get away from that, into what might be called more standardized derivative trading businesses, I think it's fair to say I like them less than most of the people do who are in them.

WARREN BUFFETT: Quite a bit less. (Laughter)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah, we regard that area as potentially being dynamite because if you get a group — a large group — of people that, in many cases in that business — although we've tried to go away from it ourselves — but in many cases in that business are getting paid based on front-ending potential profits, you can get — I mean, that's a dangerous situation to place a hundred people in. You're going to find people who will crack under that, in terms of what they will do.

You know, they had — we had a case of it, actually, in the electric utility industry a year or two ago, when Edison in California, through a subsidiary, compensated people based on projecting the profitability of the business they were putting on the books that day.

That's Wall Street practice and it was brought to the utility industry. And it produced I'd say predictable results.

So it's dangerous to pay people to make deals where you won't know the outcome for 15 or 20 years and give them a lot of money upfront for doing it.

And that's fairly standard practice in the business. I mean, it was standard practice at Salomon when I was there. And as I say, people occasionally crack under that.

It isn't exactly analogous, but it's worth reading Roger Lowenstein's book entitled "When Genius Failed," because it touches on some of the problems we've described that Charlie and I are apprehensive about.

CHARLIE MUNGER: Yeah, the derivatives business has the very significant problem that the accounting profession sold out. The accounting is improper. It front-ends way too much income.

It's irrationally optimistic because that's the way the denizens of the field want it because it creates bigger compensation. This is intrinsically an irresponsible system. And it's another case where the accounting profession has failed the wider civilization.

WARREN BUFFETT: We found — Charlie was on the audit committee at Salomon — and we found positons — single positions — mismarked by close to $20 million, for example, didn't we, Charlie?

CHARLIE MUNGER: Oh, yeah. But deliberate mismarkings was not the main problem. The main problem is the whole system of accounting is wrong. The whole system of accounting is too optimistic. It would be like going into the taxi cab business with a 30-year depreciation rate.

WARREN BUFFETT: Yeah. Or it'd be like writing long, very long-tail insurance, and paying a big commission upfront based on the expected profit of that insurance over a 10-year period or something, with that prepared by the guy who wrote the policy.

There are certain activities that are really just dangerous in the financial world. And when you get close to that kind of situation, you just have to be very careful.

Now you — actually, Mark has been implementing a system that compensates — that accounts for this — significantly differently than occurs at many institutions. So, you know, you can try to attack it. But it's also hard to get too far away from industry norms and still do business. I mean —

CHARLIE MUNGER: Yeah. Our accounting is way more conservative than the standard derivative accounting of the country, thank God.

15. GEICO's Lou Simpson manages "autonomously"

WARREN BUFFETT: OK. Area 6.

AUDIENCE MEMBER: My name is Scott Tilson (PH). I'm from Owings Mills, Maryland.

Gentlemen, you have stated many times that Lou Simpson manages the GEICO investment portfolio on an independent and autonomous basis.

What unique or superior qualities does Mr. Simpson possess as an investor that has earned him this tremendous vote of confidence?

Secondly, Berkshire invests in privately-held businesses as well as publicly-traded securities. While the skillset required to value public and private businesses may be the same, does Mr. Simpson also have the additional experience and skills necessary to negotiate a private transaction, if called upon to do so?

WARREN BUFFETT: Yeah, I think he could. But I hope he doesn't get called on to very soon. (Laughter)

Lou is smart, and careful, and high-grade, and experienced.

So he does manage a couple billion dollars autonomously. He will buy things. I won't know about them until I either look at a monthly sheet or sometimes read it in the paper. And that's fine, you know? He doesn't know what I'm doing. I don't know what he's doing.

Every now and then, we're in the same security, so we try and coordinate if we're buying or selling under those circumstances.

And incidentally, you will occasionally read a headline, not a very big headline, but in the financial press that says, "Buffett buying X, Y, Z." Well, sometimes it should say, "Simpson buying X, Y, Z."

They — the reports we file would not necessarily tell the reader which one of us made the decision, because even if the reports show that something was bought in GEICO, that could be bought in — by me and placed in GEICO for various reasons.

Or conceivably, Lou can buy something and place it in National Indemnity or some other Berkshire company also for perfectly good reasons. But some of what gets reported as done by Berkshire is done by Lou entirely independent of me.

And most of it, in terms of dollars, is done by me. But Lou's record is just as good as mine, so.

And Lou would know how to evaluate businesses, whether private negotiations or public securities, and — but I'm in no hurry to turn it over. (Laughs)

16. Berkshire's investment in Finova

WARREN BUFFETT: Seven.

AUDIENCE MEMBER: Good afternoon. My name is Scott Croy (PH). I'm from Chicago, Illinois.

Mr. Buffett, could you please describe the situation — the extent, if any, of Berkshire Hathaway's investment in Finova Group earlier this year? Finova's back appears to be against the wall.

WARREN BUFFETT: Yeah. It's worse than against the wall. They're in Chapter 11. (Laughter)

But that was all contemplated, obviously.

Finova is the old Greyhound leasing company, and grew to about 13 or $14 billion in assets. And then just about a year ago, now, ran into funding difficulties.

And when you run a highly leveraged finance business and you run into funding difficulties, they compound on you very quickly.

You know, confidence is a real coward. I mean, it runs when it sees trouble.

And in a finance business, you're constantly faced with refinancing old obligations, and you have commercial paper out and all of that. So there's no honeymoon period when you get in trouble in the finance business.

And we've even seen big ones in the past, like Chrysler Financial and all of that. I mean, it can strike anywhere when confidence disappears.

And so that hit Finova about a year ago. And it became clear not that many months later that Finova would have to either be sold or reorganized.

And I think there were attempts made to sell the company to other finance companies, and even a couple of little portions of the portfolio were sold. But they didn't make a sale.

And when the bonds started selling down to prices that I thought were very attractive, in the fall or whenever it was of last year — and by attractive, I mean, I thought that if they went into bankruptcy that the assets were considerably greater in relationship to the liabilities than indicated by the market — we started buying bonds.

And we bought — we publicly announced it. We bought $1,428,000,000 face amount of bonds or bank debt. So we, out of 11 billion of aggregate debt at Finova, we own $1,428,000,000 face value. And we bought those at prices that looked attractive then and look attractive now.

And it became clear — it was somewhat — it was clear all along that they were either going to sell or go into bankruptcy. And it became clearer that they weren't finding a buyer as time went by. And so it became very likely that they would declare bankruptcy sometime earlier this year.

One of the reasons being is they didn't want to use the available cash to pay out the creditors whose money was coming due tomorrow, and thereby shortchange creditors whose claims were due at later dates.

We thought, perhaps, somebody would come in with a plan of reorganization. And it got very close to where they —in our view — they were going to default. And so we jointly, with Leucadia, in a joint venture called Berkadia, put forth our own plan and made a — and arranged a transaction.

But they are now in Chapter 11, and there will be plans presented to the — a plan or plans — presented to the court in short order. And then the court will determine —

I'm not — Charlie may know more about exactly how bankruptcy works than I do, although I don't think he's had any personal experience — that a plan gets submitted to creditors for approval.

And we will have a plan, which will be — which has been outlined in the press, and will be submitted to the court, almost certainly within a week, and when you can read about it at that time.

And then we will see whether anything else happens. I mean, it may be that somebody else comes in with a plan. It may be that our plan is approved.

And if our plan is approved, it involves a significant additional investment so that an initial payment can be made to the present debt holders. And then we'll see what happens.

We feel very good about Berkadia. I — we think Berkadia — well, we think the Leucadia part of Berkadia brings a lot to the party, in terms of efficiently managing the assets that are there. It makes it — when an entity gets in bankruptcy, it makes a lot of difference how it's handled.

I mean it, you can — there can be a lot of wastage of assets in bankruptcy. Or there could be a reasonably efficient way of handling it.

We think that the Berkadia arrangement will maximize the value of the assets. And we think that's important. But we'll see what happens. I think our position is going to work out fine.

Charlie?

CHARLIE MUNGER: Yeah. I think it's —

WARREN BUFFETT: Microphone.

CHARLIE MUNGER: — a very interesting transaction. And you would hope there would be more of it.

WARREN BUFFETT: There will be. (Laughter)

CHARLIE MUNGER: No, I mean, not more bankruptcy, but more cures of bankruptcy following this model. I think it's a very intelligent model and a very clean, simple, prompt way of cleaning up a corporate mess.

And I hope the rest of the world feels about it the way I do, and that the judge and other people concerned will say, "Thank God," and we want this one to go through and we want more like it to happen.

WARREN BUFFETT: That's what we tried to do in Salomon, incidentally. I mean, we tried to behave in a somewhat different way, in terms of a corporate crisis, than typical.

And we hoped that if that got a good result, that that might become a model that people might gravitate toward in future problems, because there will be future problems.

We are the largest creditor of Finova now. So we have more money on the line than anybody else, and we don't have an interest —

You know, our interest is not primarily in getting fees or extending the bankruptcy or, you know, any of that sort of thing. We want to get the greatest realization of assets as possible. And the swing in that between doing it right and doing it wrong, you know, could be measured in the billions.

17. GEICO's Lou Simpson bought Berkshire's Gap shares

WARREN BUFFETT: Area 8.

AUDIENCE MEMBER: Good afternoon. I'm Claudia Fenner (PH) from Long Island, New York and I have two questions.

The first is, as a big fan of the Gap, I'd like to know why at this time you feel that the Gap is undervalued.

And the second question, if you could direct your answer to my husband, as a shareholder, would you agree that buying a large present at Borsheims this afternoon is like taking money out of one pocket and putting it back in another? (Laughter and applause)

WARREN BUFFETT: I'll let Charlie handle the second one. (Laughter)

He's our expert on consumption at Berkshire.

The Gap is a good illustration of what I talked about earlier, because I think the world assumes that I made a decision to buy Gap at Berkshire. And actually, that's totally, 100 percent a Lou Simpson portfolio investment.

I don't think I've read the annual report of the — I know — I haven't read the annual report of the Gap ever. And I don't know anything about it. I mean, you probably know a lot more about it than I do, and I hope Lou knows a lot more about it than I do. (Laughter)

It's not a company I've ever looked at.

And Lou operates — and he has people that help him — Lou operates in somewhat — he can look at smaller securities, in terms of aggregate market caps, than I can, because I'm investing $2 billion. He can work with $200 million positions or even $100 million positions sometimes.

And I will do that occasionally, just because I happen to bump into them, in effect. But I'm really looking for things that we can put a billion or 2 billion or more in. And Lou's universe of possible candidates for purchase is a bigger universe than mine.

And that may be a good thing, I mean, having two of us in there. Because he just is going to see things that I'm not going to see. So you'll have to ask Lou about the Gap.

18. Buffett's never regretted buying jewelry

WARREN BUFFETT: But, well, Charlie, give her a little advice on Borsheim's. (Laughter)

CHARLIE MUNGER: Well, I think when you're buying jewelry for the lady you love, it probably shouldn't get too much financial calculation into it. (Laughter and applause)

WARREN BUFFETT: I will say this. And this is true. And you're talking to a guy who does not normally go down this path, but I would say this:

I've never bought a piece of jewelry that I've regretted, in terms of what has happened subsequently, so it — (Laughter)

Well, if that isn't a sales pitch, I don't know what is. (Laughter)

19. Why GEICO can't give everyone a better deal

WARREN BUFFETT: Zone 1.

AUDIENCE MEMBER: You're a tough act to follow.

I'm Matt Richards. I'm from Parkton, Maryland.

Last year at this meeting, a gentleman stood up and implored you, Mr. Buffett, to invest in some technology stocks to juice our returns. I would like to this year thank you for having not done that. (Applause)

My question is regarding GEICO. I've been a USAA preferred risk customer for something like 15 years now.

WARREN BUFFETT: Yeah. You'll do very well with USAA. They're a perfect —

AUDIENCE MEMBER: Yes, well —

WARREN BUFFETT: — company.

AUDIENCE MEMBER: — I'd prefer to be a customer of the company that I own part of. Unfortunately, due to an accident and two speeding tickets in the last five years, they will not accept me as a preferred risk.

And I wonder if this isn't an untapped group of people who are preferred risks with their own company.

Couldn't GEICO possibly take their current preferred risk status into account when determining whether to accept them as a customer?

WARREN BUFFETT: Yeah, I would — USAA, incidentally, is a terrific company.

And Leo Goodwin, who started GEICO, which was then called Government Employees Insurance Company in 1936 — Leo actually was a key employee of USAA, as was his wife, Lillian. They both came from USAA.

And, they felt that — I mean, USAA as you know, limits its clientele — at that time, they limited their clientele to the officers in the armed services. And Leo wanted to extend — and that was a preferred class, and history has shown it to be a preferred class.

Leo wanted to extend that to other classes that he felt also had similar characteristics that USAA was not interested in. And that's the reason he formed Government Employees Insurance.

He felt that the preferred characteristic that could be determined by employment in that area as to their propensity for accidents would extend beyond the officer ranks of the armed services. And he was right. It's a fascinating story.

And there's a good book about USAA that came out about two or three years ago, tells the whole story.

It's hard for us to take away the preferred customers of USAA. It's hard for them to take away our preferred customers, too.

But USAA has some of the same qualities that we have talked about in terms of State Farm. It has, as I remember, maybe a $6 billion, maybe larger now, surplus.

It's slightly different than State Farm. It's not a true mutual. It's a reciprocal, as I remember. But, it's tantamount to a mutual.

So the 6 billion that has been accumulated over the years is working for present policy holders, which is a terrific asset for them.

And the fact that they keep you as a preferred risk probably means you are a preferred risk. I mean, their underwriting judgment is very good.

You know, we have various categories that relate to speeding tickets or accidents and all of that sort of thing. And in aggregate, they are a good predictor of future accident potential. But it's only in aggregate.

I mean, it's like saying, you know, "Because I'm 70, that I have X percent chance of dying," but it doesn't say what's going to happen to me specifically. But it does mean if you're insuring 100,000 70-year-olds, you'd better get this sort of price.

We have these predictors, too. And past driving history is an important predictor. But you've got this long history with USAA. And they, probably for very good reason on that total history, keep you in the preferred class.

And we, based on criteria that are developed from looking at 5 million policy holders, we can't make the determination — we can't come out and actually observe you driving, or anything of the sort.

We have to look at the information that comes to us, which if it says speeding tickets or accident, it does result in various scores being applied. So I really can't offer you a better deal. I'd like to. I have a feeling you'd be a good client. If USAA ever gets mad at you, come over and see us.

20. "We regard volatility as a measure of risk to be nuts"

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: I'm Bob Kline (PH) from Los Angeles.

Wall Street often evaluates the riskiness of a particular security by the volatility of its quarterly or annual results. And likewise, evaluates money managers by their volatility — measures their risk by volatility, I should say.

And I know you guys don't agree with that approach. I wonder if you could give us some detail about how you come at the concept of risk, how you measure it, and just in general how you approach risk.

WARREN BUFFETT: Yeah, we regard volatility as a measure of risk to be nuts.

And the reason it's used is because the people that are teaching want to talk about risk. And the truth is, they don't know how to measure it in business.

I mean, that would be part of our course on how to value a business. It would also be, how risky is the business? And we think about that in terms of every business we buy. And risk with us relates to —

Well, it relates to several possibilities. One is the risk of permanent capital loss. And then the other risk is just an inadequate return on the kind of capital we put in. It does not relate to volatility at all.

Our See's Candy business will lose money — and it depends on when Easter falls — but it'll lose money in two quarters of the four quarters of the year. So it has a huge volatility of earnings within the year.

It's one of the least risky businesses I know.

You can find all kinds of, you know, wonderful businesses that have great volatility and results. But it does not make them bad businesses. And you can find some very — you can find some terrible businesses that are very smooth.

I mean, you could have a business that did nothing, you know? And its results would not vary from quarter to quarter, right? So it just doesn't make any sense to translate — (laughter) — volatility into risk.

And Charlie, you want to add anything on that?

CHARLIE MUNGER: Well, it raises an interesting question, which is how can a professoriate that is so smart come up with such silly ideas and spread them all over the country? (Laughter)

It is a — it's a very interesting question. If all of us felt that — (Laughter)

WARREN BUFFETT: Charlie, your Dilly Bar's arrived.

CHARLIE MUNGER: Oh, good.

WARREN BUFFETT: Yeah. You've heard of getting a second wind.

CHARLIE MUNGER: Oh, fine.

WARREN BUFFETT: Thank you. (Laughter and applause)

You tip him. (Laughter)

I didn't think our cracks were that funny. (Laughter)

CHARLIE MUNGER: Right, right. But I've been waiting for this craziness to pass for several decades now. I do think it's getting dented some. But it's not passing.

WARREN BUFFETT: If somebody starts talking to you about beta, you know, zip up your pocketbook. (Laughter)

21. Zen Buddhism and the value of low expectations

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: Brian Zen (PH) from China.

As a Coke addict myself, I'm excited to report to you — (laughter) — our worldwide promoter-in-chief, that the Cokes in Beijing taste just as wonderful as in Omaha.

As a ex-Zen monk, today I feel like visiting the Buddha of the financial world. (Laughter)

We have an investment club, but with a name that ends in .com, believe it or not, which tells you that the frenzy — .com frenzy — even seduced Zen monks when we tried to follow you.

We find that Mrs. Susan Buffett used to send Zen Buddhism books to her sorority sisters. That's probably why she always has a peaceful smile due to her low expectation of life which, according to Buddha, is full of sufferings.

But Mr. Munger would tell me that Susan's smile is because you, as the husband, exceeded her low expectations.

CHARLIE MUNGER: That's right. (Laughter)

WARREN BUFFETT: Yeah. And her father's even lower expectations. (Laughter)

CHARLIE MUNGER: Right, right.

AUDIENCE MEMBER: Anyway, my question is, did Susan also send those Zen books to your office or your bedroom?

And if you have read those books, what are the key ideas that contributed to your investment tao, which even made sense to secluded, narrow-minded Zen monks like me? Thanks for the financial enlightenments you've given us today.

WARREN BUFFETT: Thank you. I sent those books on to Charlie so I'll let him answer. (Applause)

CHARLIE MUNGER: Actually, I tend to be a follower of Confucius. (Laughter)

And I think this room is full of Confucian values, you know? If the first law of Confucianism is filial piety, particularly toward elderly males, you can see why I like that system. (Laughter)

22. Capital and opportunity costs

WARREN BUFFETT: Area 4. (Laughter)

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Kevin Truitt (PH) from Chicago. I have three questions for you.

Mr. Munger, at last year's shareholder meeting, you stated that you didn't feel that the concept of the cost of capital made true economic sense. Would you explain why you felt this way and what you would do to replace it with anything?

My second question is to Mr. Buffett. You've stated the importance of an occasional big idea. How were you able to, in fact, tell when you had a big idea?

And my third question, Mr. Buffett, you have talked about the importance of the franchise and sustainable competitive advantage.

Companies like Kellogg and Campbell's Soup are companies that most people would have said had those qualities. However, over time, those qualities were lost as a result of a change in consumer taste.

What gives you confidence that the same things won't happen to Coke or Gillette?

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Well —

WARREN BUFFETT: Cost of capital.

CHARLIE MUNGER: Cost of capital, first.

Obviously, considerations of cost are important in business. And obviously, opportunity costs, which is a doctrine of economics, really a doctrine of lifesmanship, are also very important. And we've always had that kind of basic thinking.

Of course, capital isn't free. And, of course, you could figure cost of capital when you're borrowing money. Or at least you can figure cost of loans. But the theorists had to develop some theory for what equity cost. And there, they just went bonkers.

They said if you earned a hundred percent on capital because you had some marvelous business, your cost of capital was a hundred percent. And therefore, you shouldn't look at any opportunity that delivered a lousy 80 percent.

That is the kind of thinking, which came out of the capital assets pricing models and so forth, that I've always considered inanity.

What is Berkshire's cost of capital? We have this damn capital. It just keeps multiplying and multiplying. What is its cost? You have perfectly good, old-fashioned doctrines like opportunity cost, you know?

At any given time when we consider an investment, we have to compare it to the best alternative investment we have at that time. We have perfectly good, old-fashioned ideas that are very basic to use, but they weren't good enough for these modern theorists.

So they invented all this ridiculous mathematics, which concluded that the companies that made the most money had the highest costs of capital.

Well, all I can say is, it's not for us.

Now, the other half of that question I leave for Mr. Buffett.

WARREN BUFFETT: Yeah, what you find, of course, is that the cost of capital is about a quarter percent below the return promised by any deal that the CEO wants to do. It's — (laughter) — very simple.

You know, we have three questions on capital — with capital, throughout — leaving aside whether we want to borrow money, which we generally don't want to do.

And one is, does it make more sense to pay it out to the shareholders than to keep it within the company? A sub-question on that is if we pay it out, is it better off to do it via repurchases or via dividend?

The test for whether we pay it out in dividends is, can we create more than a dollar of value within the company with that dollar than paying it out? And you never know the answer to that. But so far, the answer as judged by results is yes, we can.

And we think that prospectively, we can. But, that's a — you know, that's a hope on our part. And it's justified to some extent by past history, but it's not a certainty.

Once we've crossed that threshold, then do we repurchase stock? Well, obviously, if you can buy your stock at a significant discount from conservatively calculated intrinsic value, and you could buy it in reasonable quantity, that's a use for capital.

Beyond that, then the question becomes, if you have the capital, you think you can create more than a dollar, how do you create the most with the least risk? And that gets to business risk. It doesn't get to any calculation of the volatility.

I don't know the risk in See's Candy as measured by its stock volatility because the stock hasn't been outstanding since 1972. Does that mean I can't determine how risky a business See's is, because we don't have a daily quote on it?

No. I can determine it by looking at the business, and the competitive environment in which it operates, and so on.

So once we cross the threshold of deciding that we can deploy capital so as to create more than a dollar of present value for every dollar retained, then it's just a question of doing the most intelligent thing that you can find. And, you know, that is —

The cost of every deal we do is measured by the second best deal that's around at a given time, including more — doing more of some of the things we're already in.

And I have listened to cost of capital discussions at all kinds of corporate board meetings and everything else. And, you know, I've never found anything that made very much sense in it except for the fact that it's what they learned in business school and that's what the consultants talked about.

And most of the board members would nod their head without knowing what the hell was going on. And that's been my history with the cost of capital.

23. How Buffett knows when he's had a "big idea"

WARREN BUFFETT: Now, moving onto the big ideas, you know when you've got a big idea. And I can't tell you, you know, exactly what happens within your nervous system or brain at that time.

But we've had relatively few big ideas, good ideas, over the years. I don't know how many you think we've had in aggregate, probably, career, maybe 25 each or something?

CHARLIE MUNGER: If you took the top 15 out of Berkshire Hathaway, most of you people wouldn't be here. (Laughter)

So, roughly one every two years.

WARREN BUFFETT: Yeah, one every year or two. And sometimes there'll be a bunch of them, like in 1973 and -4. But the problem is, for us is that big, now, really means big. I mean, it has to be billions of dollars to move the needle very much at Berkshire.

But I would say that when I would turn those pages, 50 years ago in the Moody's Manuals, I would know when I hit a big idea. I've got half a dozen of them that I keep the Xeroxes from those reports around from 50 years ago just because it was so obvious that they just — they were incredible. And that happens every now and then.

When I met Lorimer Davidson, you know, in end of January, 1951, and he spent four hours or five hours with me explaining GEICO, I knew it was a big idea.

Eight months later, no, probably 10 months later, I wrote an article for The Commercial and Financial Chronicle on "The Security I Like Best." It was a big idea.

When I found Western Insurance Securities, I knew it was a big idea.

I couldn't put billion — millions — of dollars into it, but I didn't have millions so it didn't make any difference.

And I — we've seen things subsequently. And we'll see, you know. If we have a normal lifespan, we'll see a few more before we get done, but I can't tell you that —exactly how —

I can't tell you exactly what transpires in my mind that says, you know, flashes a neon sign up that says, "This is a big idea."

What happens with you, Charlie?

(Laughter)

Actually, one of my — I've have a real system. (Laughter)

My idea of a truly big idea is, one I get it and I call Charlie and he only says no, rather than, "That's the worst idea I've ever heard of." But if he just says no, it's a hell of an idea.

CHARLIE MUNGER: You know, the game in our kind of life is being able to recognize a good idea when you rarely get it, and — or when it rarely is presented to you. And I think that's something you have to prepare for over a long period.

What is the old saying? That opportunity comes to the prepared mind? And I don't think you can teach people in two minutes how to have a prepared mind. But that's the game.

WARREN BUFFETT: Things we learned 40 years ago, though, will help and recognize the next big idea.

CHARLIE MUNGER: And on opportunity costs, going back to that, the current freshman economics text, which is sweeping the country, has right in practically the first page. And it says, "All intelligent people should think primarily in terms of opportunity cost." And that's obviously correct.

But it's very hard to teach business based on opportunity cost. It's much easier to teach the capital assets pricing model where you could just punch in numbers and out come numbers. And therefore, people teach what is easy to teach, instead of what is correct to teach.

It reminds me of Einstein's famous saying. He says, "Everything should be made as simple as possible, but no more simple."

WARREN BUFFETT: Write that down. (Laughter)

24. Big retailers are attacking big brand-name moats

You asked an interesting question about franchises, too, and mentioned Campbell's Soup and Kellogg.

And, you know, I'm no expert on that but I would say that, just based on my general observation over the years, is that the problems there came from two different things.

I think that the problems with cereal — ready-to-eat cereal — were not so much changes in taste or consumption patterns. But I think they maybe just pushed their pricing too far to the point that they lost market share without getting — without having — the moat that they thought they had, as opposed to the General Mills cereals, and the General Food cereals, and all of that sort of thing.

I mean, if you're pricing really gets out of whack and people regard Wheaties or Grape-Nuts in the same category as they regard Kellogg's Corn Flakes, you know, you're going to lose share. And once you start losing share, it's hard to get back.

The problems with soup I think relate more to lifestyle. I think it's become — it's a little less — it fits in a little less well with current lifestyles, maybe, than 40 years ago.

Soft drinks, — the consumption of soft drinks — I don't have the figures here, but I would wager that in 110 years, the per capita of soft drinks has gone up virtually every year throughout that history.

I mean, it's now 30 — close to 30 percent — of U.S. consumption of liquids. So, if the average American has about 64 ounces of liquids a day, you're talking about, say, 18 ounces of that being soft drinks and 43 percent of that 18, or almost 8 ounces a day, of being Coca-Cola products.

In other words, 1/8th of all the liquid man, woman and child in the United States take in comes from Coca-Cola products. But that has gone up, virtually — well, throughout the world it's gone up on a per capita basis, you know, almost since soft drinks were discovered.

I would say that that trend is almost impossible to reverse on a worldwide basis. I mean, there's so much potential in countries where per capita consumption is like — well, I think it's, you know, maybe 8 per capita, which is — 8-ounce servings they talk in terms — 64 ounces a year.

So you have 1/50th of the consumption, per capita, on Coke products in many — in some important countries — that you have here. I don't — I just don't see it as being —

Now, you can push pricing too far. I mean, there comes a point — it depends on the country in which you're doing it, but that depends even on areas within the country in which you do it.

But if you establish too wide a differential between Coke and a private label product, you will change consumption patterns somewhat. Not huge, but enough so that you don't want to do it. But I don't think you'll see —

It's interesting. Coffee's gone down every year. People talk about Starbucks and all that, but if you look at coffee consumption in this country, if you look at milk consumption in this country, you know, per capita, it just goes down, down, down, down, year, after year, after year, after year.

And I think it's pretty clear what people like to drink once they get used to it, and with the price right.

Interesting thing about Coca-Cola is, when I was born in 1930, a 6 1/2-ounce Coke cost a nickel and you put a two cent deposit on the bottle. But forget about that, just take the nickel.

Now you buy a 12-ounce can or a larger product, and you're paying, if you buy it on the weekends in the supermarket special or something, you're paying maybe a little more than twice per ounce what you were paying in 1930, 70 years ago.

And compare that to the price behavior of almost any product, you know, that you can find except raw commodities. But compare it to cars, housing, anything. And there's been very, very little price inflation in it.

And I think that's a contributor, of course, to the growth in per capitas over time.

Charlie, how about cereals and soup?

CHARLIE MUNGER: Well, I think those are examples where the moats got less hostile for the competitors.

Part of the trouble was the buying power got more concentrated and tougher.

I mean, the big grocery chains now have a lot of clout. And then you add the Walmarts and the Costcos and the Sam's and the — it's a different world faced by the Kelloggs than the one they had 30 or 40 years ago.

WARREN BUFFETT: Yeah, there will be a battle, always, between brands and retailers, because the retailer would like his name to be the brand.

And, to the extent that people trust Costco or Walmart more than they — or as much as — they trust the brand, then the value of having the brand moves over to the retailer from the product itself.

And that's gone on for a long, long time. You know, the first — I would — cases I know about in any real quantity were back with A&P in the '30s. And A&P, I believe, was the largest food retailer in this country. And they were also a big promoter of private labels. Ann Page I think was a big private label with them, for example.

And they felt they could convince the consumer in the '30s that their brand meant more than having Del Monte on it or Campbell's or whatever it might be in the different categories. And people thought they were going to win that war for a while.

And who knows? I mean, I don't know all the variables that went into A&P's decline, but it was dramatic. I mean, it was one of — it was a great American success story for a while, and then it was a great American failure.

Charlie, you —?

CHARLIE MUNGER: The muscle power of the Sam's Clubs and the Costcos has gotten very extreme. A little earlier this morning, when I was autographing books, a very good looking woman came up to me and said she wanted to thank me.

And I said, "For what?" And she said, "You told me to buy this pantyhose I'm wearing from Costco."

And I'd evidently made some previous comment about how amazing it was that Costco could get Hanes, of all people, to allow a co-branded pantyhose, Hanes-dash-Kirkland, in the Costco stores. That wouldn't have happened 20 years ago.

WARREN BUFFETT: She must've been pretty desperate if she was consulting with you on where to buy pantyhose, Charlie. (Laughter)

25. Selling short is "tempting" but "very painful"

WARREN BUFFETT: OK, let's move to area 5.

CHARLIE MUNGER: Yeah, right.

AUDIENCE MEMBER: Hi, I'm Dave Staples from Hanover, New Hampshire and I've got two questions for you.

First, I'd like to hear your thoughts on selling securities short and what your experience has been recently and over the course of your career.

The second question I'd like to ask is how you go about building a position in a security you've identified.

Using USG as a recent example, I believe you bought most of your shares at between 14 and $15 a share. But certainly, you must've thought it was a reasonable investment at 18 or 19.

Why was 14 and 15 the magic number? And now that it's dropped to around 12, do you continue to build your position? How do you decide what your ultimate position is going to be?

WARREN BUFFETT: Well, we can't talk about any specific security, so — our buying techniques depend very much on the kind of security we're dealing in. Sometimes, it's a security that might take many, many months to acquire. And other times, you can do it very quickly. And sometimes, it may pay to pay up. And other times, it doesn't.

And the truth is, you never know exactly what the right technique is to use as you're doing it, but you just use your best judgment based on past purchases. But we can't discuss any specific one.

Short selling, it's an interesting item to study because it's, I mean, it's ruined a lot of people. It is the sort of thing that you can go broke doing.

Bob Wilson, there're famous stories about him and Resorts International. He didn't go broke doing it. In fact, he's done very well subsequently.

But being short something where your loss is unlimited is quite different than being long something that you've already paid for.

And it's tempting. You see way more stocks that are dramatically overvalued in your career than you will see stocks that are dramatically undervalued.

I mean there — it's the nature of securities markets to occasionally promote various things to the sky, so that securities will frequently sell for five or 10 times what they're worth, and they will very, very seldom sell for 20 percent or 10 percent of what they're worth.

So, therefore, you see these much greater discrepancies between price and value on the overvaluation side. So you might think it's easier to make money on short selling. And all I can say is, it hasn't been for me. I don't think it's been for Charlie.

It is a very, very tough business because of the fact that you face unlimited losses, and because of the fact that people that have overvalued stocks — very overvalued stocks — are frequently on some scale between promoter and crook. And that's why they get there. And once there —

And they also know how to use that very valuation to bootstrap value into the business, because if you have a stock that's selling at 100 that's worth 10, obviously it's to your interest to go out and issue a whole lot of shares. And if you do that, when you get all through, the value can be 50.

In fact, there's a lot of chain letter-type stock promotions that are sort of based on the implicit assumption that the management will keep doing that.

And if they do it once and build it to 50 by issuing a lot of shares at 100 when it's worth 10, now the value is 50 and people say, "Well, these guys are so good at that. Let's pay 200 for it or 300," and then they could do it again and so on.

It’s not usually that — quite that clear in their minds. But that’s the basic principle underlying a lot of stock promotions. And if you get caught up in one of those that is successful, you know, you can run out of money before the promoter runs out of ideas.

In the end, they almost always work. I mean, I would say that, of the things that we have felt like shorting over the years, the batting average is very high in terms of eventual — that they would work out very well eventually if you held them through.

But it is very painful and it’s — in my experience, it was a whole lot easier to make money on the long side.

I had one situation, actually, an arbitrage situation when I was in — well, it was when I moved to New York in 1954, so it would’ve been about June or July of 1954 — that involved a surefire-type transaction, an arbitrage transaction that had to work.

But there was a technical wrinkle in it and I was short something. And I felt like a — for a short period of time — I felt like Finova was feeling last fall. I mean, it was very unpleasant.

It — you can’t make — in my view, you can’t make really big money doing it because you can’t expose yourself to the loss that would be there if you did do it on a big scale.

And Charlie, how about you?

CHARLIE MUNGER: Well, Ben Franklin said, “If you want to be miserable, you know, during Easter or something like that,” he says, “borrow a lot of money to be repaid at Lent,” or something to that effect.

And similarly, being short something, which keeps going up because somebody is promoting it in a half-crooked way, and you keep losing, and they call on you for more margin — it just isn’t worth it to have that much irritation in your life.

It isn’t that hard to make money somewhere else with less irritation.

WARREN BUFFETT: It would never work on a Berkshire scale anyway. I mean, you could never do it for the kind of money that would be necessary to do it with in order to have a real effect on Berkshire’s overall value. So it’s not something we think about.

It’s interesting though. I mean, I’ve got a copy of The New York Times from the day of the Northern Pacific Corner. And that was a case where two opposing business titans each owned over 50 percent of the Northern Pacific Company —the Northern Pacific Railroad.

And when two people each own over 50 percent of something, you know, it’s going to be interesting. And — (laughter) — Northern Pacific, on that day, went from 170 to a thousand.

And it was selling for cash, because you had to actually have the certificates that day, rather than the normal settlement date.

And on the front page of The New York Times — which, incidentally, sold for a penny in those days. It's had a little more inflation than Coca-Cola — front page of The New York Times, right next to the story about it, it told about a brewer in Newark, New Jersey who had gotten a margin call that day because of this.

And he jumped into a vat of hot beer and died. And that's really never appealed to me as, you know, the ending — (laughter) — of a financial career.

And who knows? You know, when they had a corner in Piggly Wiggly, they had a corner in Auburn Motors in the 1920s. I mean, there were corners. That was part of the game back when it was played in kind of a footloose manner. And it did not pay to be short.

Actually, during that period — you might find it interesting — in the current issue of The New Yorker, maybe one issue ago, the one that has the interesting story about Ted Turner, there's also a story about Hetty Green.

And Hetty Green was one of the original incorporators of Hathaway Manufacturing, half of our Berkshire Hathaway operation, back in the 1880s. And Hetty Green was just piling up money. She was the richest woman in the — maybe in the world. Certainly in the United States. Maybe some queen was richer abroad.

But Hetty Green just made it by the slow, old-fashioned way. I doubt if Hetty was ever short anything.

So as a spiritual descendent of Hetty Green, we're going to stay away from shorts at Berkshire.

OK, area 6.

Hetty, incidentally — this story, it's a very interesting story. As I read the story, it's almost conclusively clear to me that she forged a will to try and collect some significant money from, I believe, her aunt.

And it was a very, very famous trial back in whenever it was, 1860 or '70. And they found against Hetty when it got all through, but she still managed to become the richest woman in the country.

26. The value of Berkshire's "loyalty effect"

WARREN BUFFETT: Area 6.

AUDIENCE MEMBER: Yeah, hi. I'm James Halperin from Dallas, Texas. And I've been a shareholder since 1995. And I feel great about it, so thank you.

This question has to do with Berkshire's so-called permanent holdings and whether, when making investment decisions, you somehow mathematically calculate a value to Berkshire's reputation for loyalty to its public investees.

Let's say you are confident enough that Pepsi or Procter and Gamble would grow cash flow faster than Coke or Gillette would. And that the replacement value of the stock was less expensive enough to more than make up for the taxes.

Would you then sell Coke, for example, to buy Pepsi? And if not, why not? And how do you value this reputation for loyalty aspect in those decisions?

WARREN BUFFETT: Well, I think that's a very good question.

I don't think we would ever — I think it's very unlikely we would come to the conclusion that we were that certain that — you mentioned P&G and Pepsi versus the ones — but that some major consumer products company would do better than the ones we're in.

We might very well decide that some other one is going to do quite well and buy that additionally.

As a practical matter, if I'm on the board of a company, or Charlie were to be, representing Berkshire, it's very difficult — I would say it's almost impossible for us to trade in their securities.

It just — it creates too many problems. People would think we knew something we didn't. Or, you know, particularly if we were selling it, you know, we would have people questioning very much whether we had detected something within the company that was not available to the rest of the world.

So we really give up an enormous amount of investment mobility when we go on a board.

And so I don't even think about doing what you're suggesting, although I might very well if I were just a money manager running the business.

We certainly, and we've laid it out in the ground rules in the back of the — in our Owner's Manual back in the annual report — we've certainly said, in terms of businesses we buy control of, that they just aren't for sale. And a fancy price will not tempt us.

And that we lay out that exception relating to businesses where we think there's a permanent loss of cash for as far as the eye can see, or businesses where we have labor troubles, which we — I described earlier in the day, we might've had at The Buffalo News at that one period.

But otherwise, simply because we can use the money better someplace else, we're not interested in it.

You know, I can't really dig into my psyche and tell you how much of that is because I think that will help us buy businesses in the future if we behave that way, or how much is just my natural inclination that when I make a deal with somebody and I'm happy with how they behave with me, that I want to stick with them. It's probably both, you know?

And I wouldn't want to try and weight the two. I'm happy, you know, with the results of the first and I'm happy with the way I feel, essentially, about the second.

I just think it's crazy — I know if I owned all of Berkshire myself, I wouldn't dream of trading around businesses with people that have trusted in me and that I like and have been more than fair with me.

I wouldn't dream of trading around businesses so that my estate was 105 percent of some very large number instead of 100 percent of some large number. I just would regard that as a crazy way to live.

And I don't want the fact I run a public company to cause me to behave in a way that I would be uncomfortable behaving if we were a private company.

But I also feel that you, as shareholders, are entitled to know that that's an idiosyncrasy of mine. And therefore, I lay it out, and have laid it out for 20 years, as something that you should understand, as an investor or before you become an investor.

I'm sure it helps us in acquisitions over time. But whether that in any way compensations the opportunity costs that Charlie talks about of making an occasional advantageous disposal, I don't know and it's something I'll never calculate.

Charlie?

CHARLIE MUNGER: Well, I do tend to calculate it, at least roughly. And so far, I think that the loyalty effect is a plus in our life.

WARREN BUFFETT: Would you regard that as true though in both public — I mean, both marketable securities and owned businesses?

CHARLIE MUNGER: Oh, no. I don't think the loyalty effect in lots of public companies is nearly as important as it is with the private companies.

WARREN BUFFETT: You can say it's a mistake for us to be directors of companies, because we give up huge amount of flexibility in investment because we are directors. I — and there's no question that we do.

It's — if you're thinking solely of making money, you do not want to be a director of any company. So there's just no question about that.

27. Confidence that Berkshire's culture will endure

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: Tom Harrison (PH) from Claremore, Oklahoma. Good afternoon, gentlemen. And thanks for a wonderful weekend.

This question's for Mr. Buffett. Being somewhat pessimistic by nature, I have a recurrent nightmare of a Wall Street Journal headline proclaiming, "Buffett kicks bucket."

WARREN BUFFETT: They may phrase it a little more elegantly than that — (laughter) — but someday, the headline will be there. (Laughter)

AUDIENCE MEMBER: And, of course, Charlie's no spring chicken either. (Laughter)

In light of these concerns, could you please go into a little more detail than that presented in your annual report regarding the succession issue? And my apologies for the morbid nature of the question.

WARREN BUFFETT: Oh, there's no reason to apologize. I mean, it's a question I ask our managers, incidentally, every couple of years.

I — about every two years, I send them a letter and I say, you know, "If you die tonight, what will you — what will I wish you had told me tomorrow morning?" You know, because I have to make that same decision and I'm not conversing with them every night.

So I want them to put in writing to me, once every couple of years, what they think about the subject, who they think should succeed them, or whether there are several candidates, or what the strengths and weaknesses are. And I have that information available.

And, you know, you're entitled to the same sort of answer about succession. It's a part of buying into this business.

And it — I can tell you that no one has more of an interest in it than I do. And Charlie has a similar interest, because, we have a very high percentage of our net worth in the business.

Plus, we've got a lifetime of effort in the business. And we want it to succeed for both, in our cases probably, at least my case, the ultimate reward, the foundation I have.

But also because we just want — we like what's happened so far and we want to prove that it can — it's not dependent upon a couple of guys like us, but that it can be institutionalized, in effect.

And we have, and Charlie and I, we know who will succeed me in what are likely to be two jobs, one marketable securities and one business operations.

We want to be very sure that the culture is maintained. And I think it's so strong that I think it'd be very hard to change it.

But in addition, the stock ownership situation with me is such that it can — if there were any inclination to change it, it can be prevented from happening. I don't think it would, anyway.

Now, in terms of who succeeds me, that depends when I die. I — and there's no sense telling you who it would be today. There'd be no plus to that, and it might not be the same 20 years from now.

I mean, 20 years ago, it would've been Charlie, obviously. But it won't be Charlie now because of his age. And it'll be somebody else.

But 20 years from now or 15 years from now it might be some third party. But we've got —we feel very good about the succession situation.

We feel very good about the stability of the organization, in terms of the stock ownership situation, because that is insured for a very, very long time to come. We couldn't feel better about the managers we have in place and the culture we have in place. And, you know, the individual will be named.

I think I've mentioned, though, that when they open that envelope — all of the contents of that envelope are already known to the key people — but when they open that envelope, the first instruction is, you know, take my pulse again. (Laughter)

But if I flunk that test, there will be somebody very good in place.

Charlie?

CHARLIE MUNGER: The main defense, of course, is to have assets that will do well, more or less, automatically. And we have a lot of those.

And to the extent you improve that further by having very good managers in place and very good individualized systems for bringing new managers into the places, there's a lot of momentum here that would go on very nicely with the present management gone.

And now, I don't think our successors are going to be as good as Warren at actually — (applause) — allocating the money. (Louder applause and laughter)

WARREN BUFFETT: No, we ran a little test case 10 years ago because for nine months and four days, I took another job at Salomon. And things went fine at Berkshire.

We've got — the managers don't need me. We have to allocate capital. We have to make sure they're treated fairly. And —

But we are not making decisions around the place, except in the allocation of capital. And that will be important. But some of that is semiautomatic. And others, you know, it does require, you know, some imagination sometime or something of the sort.

But for nine months and four days in 1991, you know, Salomon was primarily on my mind and Berkshire wasn't. And everything went on just as before. And we are far, far, far stronger now than we were 10 years ago.

So I'm very comfortable with 99 percent of my estate being in Berkshire shares. And I think it's an intelligent holding, eventually, for the foundation. And knowing that, you know, I won't be around at some point before the foundation gets it.

28. "We don't want to talk about silver"

WARREN BUFFETT: OK, area 8.

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger. My name's Matt Ahner (PH). I'm from Tucson, Arizona. It's a tremendous pleasure to be here today.

This question probably falls into Charlie Munger's realm of oddball investment activities.

But considering Berkshire's previous experience in silver, what are your thoughts on the silver market today? How do you analyze this market? Have you determined an equilibrium price for silver? And if so, would you share that price, or explain to us how you determined it?

CHARLIE MUNGER: The short answer is we don't want to talk about silver. (Laughter)

WARREN BUFFETT: Yeah. We're not going to comment, you know, on oil or the prices of anything in terms of making any forecasts about it.

The equilibrium price though I can tell you is whatever it's selling for today. But there will be a different equilibrium price a year from now or five years from now. But we can't tell you what it'll be.

29. Electricity deregulation led to damaging shortages

WARREN BUFFETT: Area 1.

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger. My name's Bob Odem (PH) from Seattle, Washington.

Considering the political climate, and what seems to be a more regulated environment than not in the electric utilities market, and politicians that seem to be pacifying their constituents rather than the common sense of price and quantity —

Is it not a risky venture to participate in these markets more than what has already been done with MidAmerican, considering that, even with a possible repeal of the PUHCA laws, that they may be reinstated some years later, with the addition or subtraction of any other legislation that a politician may dream up, and then put the investment at risk?

WARREN BUFFETT: Charlie, you're a resident of California. (Laughs)

CHARLIE MUNGER: Well, the production of electricity, of course, is an enormous business. And it's not going away.

And the thought that there might be something additional that we might do in that field is not at all inconceivable. It's a very fundamental business.

Now, you're certainly right in that we have an unholy mess, in California, in terms of electricity.

And again, it reflects, I would say, a fundamental flaw in the education system of the country, that is many smart people of all kinds, utility executives, governors, legislators, journalistic leaders, they have difficulty recognizing that the most important thing with a power system is to have a surplus of capacity.

Is that a very difficult concept? (Laughter)

You know, everybody understands that if you're building a bridge, you don't want a bridge that will handle exactly 20,000 pounds and no more.

You want a bridge that'll handle a lot more than the maximum likely load. And that margin of safety is enormously important in bridge building.

Well, a power system is a similar thing. Now, why do all these intelligent people, you know, ignore the single most obvious and important factor and just screw it up to a fare-thee-well?

So I'm giving you a response which is, of course, another question. As the — my old professor used to say, "Let me know what your problem is and I'll try and make it more difficult for you." (Laughter)

WARREN BUFFETT: Well, to me, the interesting thing is that you had a system — I mean, Charlie's obviously right in that you've got about three goals in terms of — from a societal standpoint — you've got perhaps three goals in what you would like your electric utility business to be.

One is you would like it to be reasonably efficiently operated.

Secondly, since it does tend to have, in many situations, monopoly characteristics, you would want something that produced a fair return, but not a great return for capital. But enough to attract capital.

And then third, you'd want this margin of safety, this ample supply.

Now, when you've got a long lead time to creation of supply, which is the nature of putting on generation capacity, you have to have a system that rewards people for fulfilling that obligation to have extra capacity around.

A regulated system does that. If you give people a return on the capital employed, if they keep a little too much capital employed so that they have this margin of safety on generation, and they get paid for it, they stay ahead of the curve. They always have 15 or 20 percent more generating capacity than needed.

And one of the disadvantages of that regulation and the monopoly nature is that it doesn't have the spur to efficiency. They try to build it in various ways, but it's difficult to have a spur to great efficiency if somebody can get a return on any capital they spend.

So utility regulators have always been worried about somebody just building any damn thing and getting whatever the state-allowed return is.

But I would say that the problems that would arise from, say, a little bit of sloppy management are nothing compared to the problems that arise from inadequate generation.

So here you have in California — my view as an outsider — you had a situation under regulation where the utilities had the incentive to have a little extra generating capacity because they got allowed to earn a decent return on it, a return that would attract capital.

Then you had, I think, the forced sell-off of half of their generating capacity or something like that. And they sold it at multiples of book value to a bunch of people who were now just generators who were deregulated.

They've got — they don't have an interest in having too much supply. They've got an interest in having too little supply.

So you've totally changed the equation because the fellow that now has the deregulated asset, for which he paid three times book, now has to earn a return on a three times book what the fellow was formally earning under the regulated environment at one times book.

And so, he is not going to build extra generating capacity. That — all that does is it brings down the price of electricity. You know, he hopes things are tight.

So you've created, in my view, a situation where the interests of the companies in the business have diverged in a significant way from the interests of society. And I — it just doesn't make any sense to me. And I really think that the old system made more societal sense.

Let people earn a good return, not a great return, but a return that attracts capital, on an investment that has built into it the incentives to keep ahead of the game on capacity because you can't fine tune it that carefully. And you do have this long lead time, so.

Now, what you do with the scrambled eggs now, you know, is something. And with all the political forces back and forth, I think that you'd better have a system that encourages building extra capacity.

Because you don't know how much rainfall there will be in the Pacific Northwest and, therefore, how much hydro will be available. And you don't know what natural gas prices will do. And therefore, you know, whether it's advantageous for a gas-fired turbine to be operating.

And it — the old system really strikes me as somewhat better than this semi-deregulated environment that we've more or less stumbled into.

But Charlie, what do you think on that?

CHARLIE MUNGER: Of course, even the old system got in some troubles in that since everybody had the NIMBY syndrome — "Not In My Back Yard" — everybody wanted any new power plant to be anyplace not near me.

And if everybody feels that way, and if the political system means that the obstructionists are always going to rule, which is true in some places in terms of zoning and other matters, you get in deep trouble.

If you let the unreasonable, self-centered people make all the decisions of that kind, you may well get so you just run out of power. That was a mistake.

And we may make that mistake with oil refineries. It is — you know, we haven't had many new, big oil refineries in the last, well, period. So you may get to do this all over again.

WARREN BUFFETT: All of that being said, there will be need for more generation capacity. I mean, the electric utility industry will be — will grow. It will need lots of capital.

And there should be ways to participate in that where we get reasonable returns on capital. We would not expect to get great returns on capital. But we would, you know, we would be happy to do that. We generate a lot of capital and we would be comfortable in that business.

We would not feel the risks were undue, as long as we didn't go around paying incredible prices for somebody else's capacity and then have people get very upset at what that meant in terms of their electric rates. You can't go out and —

If you've got a utility plant in this country that was put in place at X and then you go out and encourage entrepreneurs to buy in at 3X, you cannot expect utility prices — electricity prices — to fall. And that was, in my view, a very basic mistake. I may not understand it fully.

30. Can a good business make up for bad management?

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: Good afternoon. My name is Pavel Begun. I am from Minsk, Belarus. And I have two questions.

And before I'll have questions for you, I'd like to say thank you for recommending to read "Intelligent Investor." It's a terrific book and it reshaped me tremendously, literally, overnight. So I'd like to thank you for that.

And now the question. Say I'm an owner of the business. And the business has a durable competitive advantage and superior business model and is run by able people.

And then, you know, I start noticing that, basically, management starts doing things which are far from intelligent.

So what should I do as an owner, as an investor? Should I try to tell them how they should run the business? Or should I just sit back and do nothing because superior business model should overcome poor management? That's the first question.

And the second question is, how important is nominal experience in the business of investing? And by saying nominal, I mean the number of — the actual time you've been in the business, as opposed to real experience that also includes experience you acquire from, say, Ben Graham, or you, or Peter Lynch, when you read books? So those are the questions.

WARREN BUFFETT: On your first question, did you assume that you had control of the business, or you just owned a marketable security?

AUDIENCE MEMBER: Yes, if I own, say, 20 percent of marketable securities.

WARREN BUFFETT: All right. Well, the situation you described is not hypothetical, in the first case. (Laughter)

And I would say that the history that Charlie and I have had of persuading decent, intelligent people, who we thought were doing unintelligent things, to change their course of action has been poor.

Would you agree with that, Charlie, or no?

CHARLIE MUNGER: Worse than poor.

WARREN BUFFETT: Yeah. (Laughter)

So I would say that if you really think you're in with people that have got a good business, but they're going to keep doing dumb things with your money, you'll probably do better to get out and get in with people who've got a good business and you think they're going to do sensible things with it. I mean, you've got that option.

Now, you also have the option of trying to persuade them to change their mind. But it's just very, very difficult. I mean it is, you know, that's been something we've faced for 50 years.

And initially, we faced it from a position where nobody even knew who the hell we were, or anything of the sort.

So we've acquired a certain stature over time, perhaps in talking on the subject. And we've written on the subject. And we still don't get very far. I mean, when people want to do something, they want to do something.

And they didn't rise to become the CEO of a company to have some shareholder tell them that their most recent idea is dumb. I mean, that is just not the type that gets to the top.

So I would say that, as a matter of investment technique, and maybe as a matter of, you know, avoiding stress in your life and all of that sort of thing, that it's — and dealing with smaller quantities of stock so it's easier to sell and buy and all that sort of thing — I would say that it's better to be in with a management you're simpatico with, than simply to be in a great business with a management that's bent on doing things that don't make much sense to you.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that.

31. Having "your head screwed on right in the first place"

WARREN BUFFETT: Second question — (laughs) — I gather is, sort of, how much does our actual business experience versus book experience help us?

AUDIENCE MEMBER: Well, it's, you know, if you look at a person who has just made two years of being in the business of investing, versus a person who has been for 10 years in the business of investing.

And say the person who has been for two years, you know, has read a lot about, you know, Ben Graham's techniques, and your techniques, and, say, Peter Lynch's techniques. So would you say that the person who has only two years of experience may do much better than the second person?

WARREN BUFFETT: Well, if everything else is equal, I mean, everything else is equal, except the amount of experience you have, I think the experience is probably useful. But it isn't going to be equal. And I don't think that — I don't think that the —

I think it's way more important what you've thought about for two years than what you've practiced for 10 years. If you're — if the direction — if there's a divergence in techniques applied, I would rather be with the one that I'm philosophically in sync with.

If I'm philosophically in sync with both and one's had 10 years of experience, the chances are they will know a little bit more about more businesses if they've been around for 10 years, looking at them, than if they've been around for two years.

But the biggest thing is that, you know, basically they've got their head screwed on right in the first place, in terms of how they value businesses and how they look at stocks.

Whether they look at them as pieces of businesses or whether they look at them as little things that move around, and that you can tell a lot by looking at charts or listening to strategists on or something of the sort.

We have — Charlie and I have learned a lot about a lot of businesses over 40 or 50 years. But I would say that, in terms of the new things that would come to us, at the end of the second year, we were probably about as good judges of them as we would be today.

But I think there's a little plus to having seen — more in terms of human behavior and that sort of thing — than knowing about the specifics of a given business model.

Charlie?

CHARLIE MUNGER: Yeah, I think that — I've watched Warren for a long time now, and I would say he's actually getting better as he gets older. Not at golf or — (Buffett laughs) — many other activities, but —

WARREN BUFFETT: Stay with generalities.

CHARLIE MUNGER: — as an investor, he's better — (laughter) — which I think's remarkable. It shows that scale of experience matters.

WARREN BUFFETT: Yeah, it helps somewhat to have seen a lot of business situation — I mean, Charlie talks about models and you construct your models as you go along based on observation.

And your models will — if you're paying attention, your models will be somewhat better the more years you've spent really observing and not just trying to make everything fit into what you saw the first few years.

32. Berkshire stock recommendations would be "big mistake"

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: Hi, my name is Richard Marvel (PH) from Washington, D.C. And my question has to do with the intrinsic value of Berkshire Hathaway.

You've stated several times that you would prefer the stock to be neither overvalued nor undervalued so that the time people spend owning the security represents a gain from what the security — the results during that period of time.

However, it's a very difficult security to value because of the disparate pieces.

And, as we saw last year, when you provide a little bit of guidance — in last year's annual report you said that when the stock price hit $45,000 a share, you considered buying, but thought it was unfair until the annual report came out so everyone had the same information.

And while I also realize that you don't feel there is a particular quote-unquote "correct" number, would you ever consider giving any guidance in this direction?

WARREN BUFFETT: Yeah. The answer is we really wouldn't. I mean, to the extent that we were going to repurchase shares, you could certainly interpret that as indicating that we thought it was attractive from the standpoint of remaining shareholders to do so.

And we certainly wouldn't be paying over intrinsic value, at least in our judgment, and benefiting the exiting shareholders to the disadvantage of the continuing shareholders. So you might draw that conclusion at that point.

But other than that, we've — you know, we would prefer Berkshire's shares to fluctuate far less than they do. Because we would like the — ideally — we would like the experience of every investor during the time they held the shares to be exactly proportionate to the progress, or lack thereof, of the business.

And I think we've come, over the years, reasonably close to that, compared to most companies. But the nature of markets is such that reasonably close is as, you know, probably as good as it's going to get.

We don't know the exact intrinsic value of Berkshire, obviously. And if you looked at the figures, we — if we had written down secret figures over the — ever since 1965 — they would — some of them would look silly now, in terms of what has actually transpired.

But we try to give you — I think Berkshire is easier to value than most businesses, actually, because we give you all the information that, at least, is important to us in valuing it.

And then the biggest judgment you have to make is how well capital will be deployed in the future.

Because it's easy — it's relatively easy — to figure out the present value of most of our businesses, but the question becomes, "What do we do with the money, as it comes in?"

And that will have a huge impact on the value 10 years from now. And that will depend a lot on the environment in which we operate over the next 10 years. There'll be a lot of luck in it.

I think — you know, I think there's a reasonable chance of good luck. But who knows?

It would be a mistake for us to do anything — I mean, a big mistake — to ever recommend buying or selling the stock. I mean, how would you tell everybody to do it at once? You know, you would negate your own advice.

You're certainly not going to tell one person, you know, to the advantage or the disadvantage of somebody else.

So there's really no way for us to ever talk about whether we think the stock — whether we think it's a buy or a sale, except to the extent, like I say, on repurchases where there's obviously an implicit judgment being given the shareholders.

Charlie?

CHARLIE MUNGER: Yeah. I rather like the way it's worked out.

If you average out the period that we've been through, we've come within hailing distance of the objective of having our stock track its intrinsic value. It gets a little ahead sometimes and a little behind other times, but averaged out, it's worked pretty well.

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

WARREN BUFFETT: Area 4.

AUDIENCE MEMBER: Good afternoon. My name is Martin O'Leary (PH) and I'm from Houston, Texas. My question to you is this.

In your annual report this year, in the letter to the shareholders, you indicated that it was 50 years ago that you met Benjamin Graham, and that he had a major impact in your life, especially in your investment success.

Moreover, you've stated in the past that "The Intelligent Investor" is, by far, the greatest book ever written on investing.

One of the central tenants in the book was that if you bought a group of stocks, say, 10 or 20, that traded at two-thirds or less than net current assets, that you would be assured of a margin of safety, coupled with a satisfactory rate of return.

Today, if you were to find 10 or 20 stocks that trade at two-thirds of net current assets, would you be inclined to purchase those stocks for your own personal portfolio, not for Berkshire Hathaway?

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

WARREN BUFFETT: Yeah, in respect to your first question, you could probably — if you found a group like that — and you won't, I don't think — you'd probably do all right buying the group.

But not because the businesses themselves worked out that well over time, but because there would probably be a reasonable amount of corporate activity in a group like that, either in terms of the managements taking them private, or takeovers, or that sort of thing.

But those sub-working capital stocks are just almost impossible to find now. And if you got into a market where a lot of them existed, you'd probably find wonderful businesses selling a lot cheaper, too. And our inclination would be to go with a cheap, wonderful business.

I don't think you'll get — in a high market or something close to it — I don't think you'll get a lot of sub- working capital stocks anymore. There's just too much money around to promote deals before they really get to that point.

But that was a technique. It was 50 years ago.

And is Walter Schloss here still? Walter, are you here? Stand up if you're here.

I met Walter 50 years ago when I met Ben Graham. I know Walter's — came out this year, but he already knows everything I've been talking about, so he may have left.

But Walter, actually, has practiced in securities, much closer to the original — he's run a partnership now for 46 years, I guess it is. And he's done it much more with the type of stocks that Ben was talking about in those days.

And he has a record that is absolutely sensational, that is far better than people who get promoted and go on television shows and do all of that sort of thing.

And he's done it in, you know, what I tend to call cigar butt companies. You know, you get one free puff and that's about it, but they don't cost anything.

And that's — that was the sub-working capital type situations. Walter's had to extend that somewhat, but it's been a great, great record over a considerable — I mean, 46 years — a very considerable period of time.

So I think, if you found that kind of a group and did it as a group operation, and Ben always emphasized a group operation because when you're dealing with lousy companies but you expect a certain number to be taken over and all that, you'd better have a group of them.

Whereas if you deal with wonderful companies, you only need a couple. But I think, if you see that period again, we'll be very active. But it won't be in those kind of securities.

Charlie?

CHARLIE MUNGER: Yeah. And there's another change. In the old days, if the business stopped working, you could take the working capital and stick it in the shareholders' pockets.

And nowadays, as you can tell from all the restructuring charges, when things really go to hell in a bucket, somebody else owns a lot of the working capital. The whole culture has changed.

If you have a little business in France and you get tired of it, as Marks & Spencer has, the French say, "What the hell do you mean trying to take your capital back from France? There're French workers in this business."

And they don't care. They don't say, "It's your working capital. Take it back," when the business no longer works for you. They say, "It's our working capital." The whole culture has changed on that one.

Not completely, but a lot from Ben Graham's day. There're a lot of reasons why the investment idiosyncrasies of one era don't translate that perfectly into another.

WARREN BUFFETT: That list that was published, I forget whether it was published in the 1951 edition of "Security Analysis" or the '49 edition of "Intelligent Investor," but there were a list of companies.

There was Saco-Lowell, there was Marshall-Wells, there was Cleveland Worsted Mills, there was Foster Wheeler, and all those companies were sub-working capital companies selling at three or four times earnings.

And there was a — if you bought a group of stocks like that, you were going to do well. But, you know, I — you certainly don't see that in companies of any size today.

And I've seen a few lists of tech companies selling below cash. But they're determined to use that cash. And it may not be there in a year or two.

It was a different breed of animal, to some extent, in Ben's list at that time.

34. Book recommendations

WARREN BUFFETT: Did you ask a second question?

CHARLIE MUNGER: Books you've read.

WARREN BUFFETT: Oh, books I've read.

Well, tell him what books you've read, Charlie. (Laughter)

CHARLIE MUNGER: Well, I mentioned that one book "Genome." I have a hell of a time putting the accent on the first syllable. But that is a marvelous book.

And some shareholder sent me a book that not many of you will like, by Herb Simon I think, "Models of My Life." And it's a very interesting book for a certain academic type.

But that "Genome," you know, which is the history of a species in 23 chapters, and it's a perfectly amazing book, and very interesting.

WARREN BUFFETT: I may have recommended it before, but if you haven't read "Personal History" by Katharine Graham, I think you'd find that it's a fascinating story. And more amazing yet, it's an honest story.

You know, if I ever write my autobiography, I'm going to look like Arnold Schwarzenegger, but — (Laughter)

But she is compulsively honest about what's happened. And it's really quite a saga.

CHARLIE MUNGER: It is a good book.

That Janet Lowe book about me I find has had a very interesting sub-chapter, so to speak, in its distribution.

I notice a considerable number of people buying that book and sending one copy to each descendant.

They believe that if they just do that, the descendants will behave more like the parents. It'll be interesting to see if that works. If it does, it's going to outsell the Bible. (Laughter)

WARREN BUFFETT: Hold your breath — (Laughter)

35. Congress should loosen capital restrictions for utilities

WARREN BUFFETT: Area 5.

AUDIENCE MEMBER: Good afternoon. I'm Laura Rittenhouse (PH) from New York City. And I want to say it's a great pleasure to be here. You talked earlier about companies that monetize greed. And it's great to be with people and with leaders who monetize values.

You — a couple years ago, you spoke very passionately about campaign finance reform, and I wondered if you could comment on your views of this, given recent developments related to another question in Washington.

What's your expectation for the passage of the repeal of PUHCA? I know there was some recent activity in a Senate sub-committee.

And lastly, a question for Charlie. How would you, or do you, apply the principles of intrinsic investing to real estate?

WARREN BUFFETT: OK. In respect to PUHCA, it's hard for me to — you know, I have no great record of handicapping legislative action.

But I would say that the awareness of the public problems in the electric utility industry under current circumstances, you know, has mushroomed. I mean, it's ballooned.

And so I think that — I think it's likely that Congress is more receptive to the idea that they need to do something that ensures that the power supply is adequate.

And I think that there's probably a number of them that would think that PUHCA is a barrier to capital entering the industry from a lot of sources where capital is available. And that it's going to take capital to solve this problem.

Now, they don't have to solve it by letting Berkshire do more things. But it's not a crazy approach to say that if Berkshire has billions of dollars to invest, that it might be a net plus for the availability of electricity down the road.

So I think that certainly the chances of repeal or major change are far higher now than they were a couple of years ago. And, I mean, politicians do not like to face major brownouts.

I mean, they can try and blame it on someone else and they may well be accurate in blaming it on someone else.

But the public is going to at least partially blame political leaders if this country runs out of electricity, because it hasn't run out of the ability to build generators.

You know, we could create all the generators we needed to have plenty of electricity. And we could create the transmission lines and all of that.

But you do need a flow of capital to the industry. And PUHCA restricts that flow to quite a degree, I would say.

36. More regulation needed for campaign contributions

WARREN BUFFETT: Campaign finance reform, you've read about it as much as I have. You know, I happen to admire enormously what McCain and Feingold have done.

I don't think it's a panacea. I mean, money is going to find its way into trying to buy political influence one way or another.

But the present situation, in my view, has gotten totally out of control and, incidentally, totally out of sync with what the American Congress, even, as well as the public, intended, because in 1907, Congress said, and it's never been changed, that corporations shall not contribute money to federal elections.

And in 1947, they said the same thing about labor unions. And then they enacted campaign legislation in the early '70s which, when later interpreted by the Federal Election Commission, enabled corporations and unions to do on an unlimited scale, what Congress had said they shouldn't do at all.

And politicians did not really understand the potential in that, initially. I remember the first guy that called me, Senate candidate, called me for a soft money contribution probably in 1985, or so.

And he was kind of embarrassed about it and sort of danced around the subject about how this money was going to find its way into his campaign and everything. And he was asking me for an amount of money that was illegal under the law, except if I did it via soft money.

And that has developed to the point where I have literally had people, where I have firsthand knowledge, of requesting million dollar contributions or larger, which would never be reported. We'd never be required to report it. And I regard that as a perversion of the system.

But I think we're going to get some significant improvement. I think it was only possible because of the credibility that McCain built up with the public and the fact that he just wouldn't let go of this issue.

So I'm — but I'm not hopeful about it changing the whole course of American democracy or anything of the sort.

But I am hopeful that the system of government where access is sold to the highest bidder, and where the bidding starts at a higher level, by a material amount, in every election cycle, will at least be checked for a while.

Charlie, she had a question for you.

CHARLIE MUNGER: Well, my trouble with campaign finance reform is that I fear career politicians just staying on and on just about as much as I fear special interests protecting themselves with money. And I never know exactly how the reform is going to work.

When I came to California, we had sort of a semi-corrupt, part-time legislature dominated by race tracks and saloons and liquor distributors, and so on.

And people went up and entertained the legislators with prostitutes and what have you. And I really sort of prefer that government, in retrospect — (laughter) — to the full-time legislators I have now.

So I just am more skeptical about my ability to predict which reform I'm going to like the results of and which I would like to trade back in for my former evils.

37. Munger has moved on from real estate investing

WARREN BUFFETT: Laura, you had one more, did you on —? Was it for Charlie?

AUDIENCE MEMBER: It was a question about the principles of intrinsic value investing applied to real estate.

CHARLIE MUNGER: Oh, that period of my life involved the remote past. And I much prefer business investment to real estate investment.

38. Q&A concludes

WARREN BUFFETT: OK. It’s 3:30. We’re going to have a directors meeting here, we do that once a year, following this meeting. And so I’ll ask the directors to stick around.

Morning Session - 2002 Meeting

1. Formal business meeting begins

(Video recording begins after meeting has started)

WARREN BUFFETT: … second or anybody would like to speak to that motion, might now work their way over to the microphone in zone 1. Could we have a spotlight on where that is? In that way, when we get to that point of the program —

If anybody that would like to speak to the motion that was in the proxy statement, if you'll work your way over to the microphone there then we'll be ready at the time — you can be ready at the time when it will be appropriate to talk about it.

And so we'll get there in just a minute and if you'll all wander over there that are interested.

Also with us today are partners in the firm of Deloitte & Touche, our auditors. They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter, the secretary of Berkshire. He will make a written record of the proceedings.

Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for the meeting are Walter Scott Jr. and Marc D. Hamburg.

We will conduct the business of the meeting and then adjourn the formal meeting. After that, we will entertain questions that you might have.

2. Berkshire's shares outstanding

WARREN BUFFETT: Does the secretary have a report of the number of Berkshire shares outstanding entitled to vote and represented at the meeting?

FORREST KRUTTER: Yes, I do.

As indicated in the proxy statement that accompanied the notice of this meeting that was sent by first class mail to all shareholders of record on March 6, 2002, being the record date for this meeting, there were 1,323,707 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting and 6,290,415 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,103,455 Class A shares and 5,260,231 Class B shares are represented at this meeting by proxies returned through Thursday evening, May 2nd.

WARREN BUFFETT: Thank you. That number represents a quorum and we will therefore directly proceed with the meeting.

3. Previous meeting's minutes approved

WARREN BUFFETT: First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second? The motion has been moved and seconded.

Are there any comments or questions? Three second pause. We will vote on this motion by voice vote.

All those in favor say aye. Opposed? The motion's carried.

4. Susie Buffett "leads the ticket"

WARREN BUFFETT: The first item of business of this meeting is to elect directors. The shareholders present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors here, he or she may do so.

Also, if any shareholder that is present and has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you.

Would those persons desiring ballots please identify themselves so that we may distribute these?

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren E. Buffett, Charles T. Munger, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Ronald L. Olson and Walter Scott Jr. be elected as directors.

WARREN BUFFETT: Is there a second?

It has been moved and seconded that Warren E. Buffett, Charles T. Munger, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Ronald L. Olson and Walter Scott Jr be elected as directors. Sounds like a hell of a slate to me.

Are there any other nominations? Is there any discussion?

Nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

The proxy holders please all submit to the inspector of elections a ballot on the election of directors, voting the proxies in accordance with the instructions they have received.

I will have to say at this point, deviating from my script, that — in the spirt of disclosure which now permeates the corporate world — I have a tally here from yesterday as to the number of votes each director has received.

And the — I won't give the affirmative votes, but the total — basically negative vote is a withhold vote — Charlie and I and Howie came in last, by a significant margin.

Susie did the best. She only had 1,000 votes against her, but Charlie and I had 16,000-some votes against us.

So, I really suspect that Susie voted against us so that she could lead the ticket, but who knows? (Laughter)

Miss Amick, when you're ready you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxy holders in response to proxies that were received through last Thursday evening has not less than 1,139,672 votes for each nomine.

That number far exceeds a majority of the number of the total vote related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the vote, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr. have been elected as directors.

Next — (Applause)

5. Shareholder proposal on charitable contributions, abortion, and overpopulation

The next item of business is the proposal put forth by a Berkshire shareholder, Gloria Jay Patrick, the owner of two Class B shares.

Miss Patrick's motion is set forth in the proxy statement and provides that the shareholders request the company to refrain from making charitable contributions.

The directors have recommended that the shareholders vote against this proposal.

We will now open the floor to recognize Miss Patrick or her designee to present her proposal.

And I believe we have Mr. Mosher at the microphone in area one to speak to — to make the proposal and speak to it. Would you go ahead please, sir?

STEVEN MOSHER: Thank you, Chairman Buffett. I apologize if this is a little loud. I was told I would have to really project but I think you can hear me up there on the stage and I hope you can hear me up in the rafters.

My name is Steven Mosher. I'm the chairman of the Population Research Institute, a nonprofit organization dedicated to making the case for people as the ultimate resource, the one resource that we, as investors, cannot do without, and to debunking the hype about overpopulation, what the New York Times has called, and I quote, "One of the myths of the 20th century." Of course, we're now living in the 21st century.

I've written about the coming depopulation — that's right, I said depopulation — in the Wall Street Journal and other publications.

I say all this to explain why Gloria Patrick, a Berkshire Hathaway shareholder, has asked me to present her action at this meeting, the following proposal.

And I do have one other qualification: I have nine children.

Now when people gasp at this, I remind them that my children will be paying their Social Security one day. Of course, if you invest in Berkshire Hathaway stock, you won't need Social Security.

I will present the proposal and then, with the chairman's indulgence, spend a couple of minutes explaining why it's necessary.

Here is the resolution:

Whereas, charitable contributions should serve to enhance shareholder value.

Whereas, the company has given money to groups involved in controversial activities like population control and abortion.

Whereas, our company is dependent on people to buy the products and services of the various companies we own.

Whereas, our company is being boycotted by Life Decisions International and investment-related groups like Pro Vita Advisors because of these contributions.

Resolved: The shareholders request the company to refrain from making charitable contributions.

Let me take these very quickly, point by point.

You all know shareholder money is entrusted to the board of directors to be invested in a prudent manner for the shareholders.

I think you will all agree, as the resolution states, that charitable contributions should serve to enhance shareholder value.

Indeed, this is already Berkshire Hathaway policy with regard to its operating subsidiaries.

As Chairman Buffett explained in his Chairman's Letter of last year, quote, "We trust our managers to make gifts in a manner that delivers commensurate tangible or intangible benefits to the operations they manage. We did not invest money in this company so it could be given to someone else's favorite charity."

I think you will also likewise agree that activities like population control and abortion are controversial.

In fact, some of the charitable money has been given to Planned Parenthood, a group that is responsible for almost 200,000 abortions a year in the United States — (applause) — and in countless more through its population control programs worldwide.

Now, we believe abortion is the taking of a human life, but even if you disagree on this fundamental point, you must concur that these ongoing boycotts of Berkshire Hathaway company products are not a good thing.

Next, it should be self-evident that Berkshire Hathaway, like the economy as a whole, is dependent upon people. It is people who produce the products and services of the various companies we own, and it is people who buy them.

Now, you may think that there is the superabundance of people in the world and that we will never run short, but this is not true.

Half of the countries of the world, including countries in Latin America, Africa, and Asia, now have birthrates below replacement.

Europe and Japan are literally dying, filling more coffins than cradles each year.

Dying populations may shrink the economic pie. We already see this happening in Japan and some European countries.

How much of Japan's continuing economic malaise can be directly traced to a lack of young people to power the economy?

Dying populations may also make economic development nearly impossible. Russia is having trouble finding its feet economically. Why? Because of its ongoing demographic collapse, losing a million people a year.

These problems will spread to many more countries in the near future.

Charitable contributions to simple-minded population control programs, in which governments impose restrictions on childbearing, are not in Berkshire Hathaway's interest.

Such programs are not investing in humanity's future, they are compromising humanity's future and putting a roadblock in the way of future economic growth.

There is no global share buyback in store for those who fund population control programs, because such programs will rob the world of future consumers and producers and threaten to shrink the economic pie.

Let me give you a concrete example of what I mean. Berkshire Hathaway owns Dairy Queen.

Now, there are 103 Dairy Queens in Thailand. But Thailand, due to a massive population control campaign, now has a birthrate that is below replacement and falling.

This means that its cohorts of young children are shrinking. There will be fewer and fewer families in the years to come and its population will eventually fall.

Now, you may think Thailand has too many children. But is it possible for there to be too many children for Dairy Queen?

According to Dairy Queen, the Dairy Queen concept especially appeals to, quote, "young families." But there will be fewer young families in Thailand's future and Dairy Queen's future because of population control.

So I urge you to vote yes on this resolution: let it be resolved that this company refrain from making charitable contributions.

One final point. Should you, on the other hand, both continue the current practice of making charitable contributions based on shareholder designations, I would urge you all to designate 501(c)(3)s, like the Population Research Institute, which are attempting to help the poor become the agents of their own development and not simply try to reduce their number through population control.

Thank you, Mr. Chairman for this opportunity to speak. (Applause)

WARREN BUFFETT: Thank you.

Do we have a — do we have a second to the motion?

Ok, we have.

And is there are any further discussion? Is there anyone there at the microphone that would like to talk?

OK. If there's no further discussion, we'll have Miss Amick report on the votes cast on that.

If anybody wishes to cast a vote in person, they can raise their hand and submit that, but we'll have a preliminary report from Miss Amick.

BECKI AMICK: My report is ready.

The ballot of the proxy holders in response to the proxies that were received through last Thursday evening cast 28,452 votes for the motion, and 1,014,353 votes against the motion. (Applause)

As the number of votes against the motion exceeds a majority of the number of votes related to all Class A and Class B shares outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the vote will be given to the secretary and placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick. The proposal failed.

6. Formal meeting adjourned

WARREN BUFFETT: After adjournment of the business meeting, I will respond to questions that you may have that relate to the businesses of Berkshire but do not call for any action at this meeting.

Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Walter Scott to place a motion before the meeting.

WALTER SCOTT: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second?

Motion to adjourn has been made and seconded. We will vote by voice.

Is there any discussion? If not, all in favor say aye. All say no? The meeting's adjourned. Thank you. (Applause)

7. Mickey Newman introduced

WARREN BUFFETT: Now, before we get on to the questions, and when we get to the questions we will move through various zones sequentially, there are just a few special guests that I would like to recognize, and because of the crowd, I've not had an opportunity to make sure all of these special guests are here, but we will find out here shortly.

The first guest, and I hope very much he's here. He was planning to be here. It was — let's see — 40 — 48 years ago this July or so — well about June — I got a letter from Ben Graham who I had been pestering for a job for about three years and getting no place, and then said the next time you're in New York, come in and talk to me.

So, I was there about ten hours later. I didn't have a NetJets plane, so it took a little longer.

And I went in to see Ben and he offered me a job and I took it on the spot. I didn't ask what the salary was, or anything else, and a month or two later the family joined me.

I had — my daughter was already born and Susie was pregnant with Howie. And we moved back there and I went to work for Graham-Newman Corp.

And, one of my three bosses — I had three bosses that — Ben Graham, Jerry Newman, and Mickey Newman. And Mickey was exactly ten years older than I was at that time and he's exactly ten years older now.

And Mickey was a major factor in a hugely successful — he ran the place — company that was not quite that successful yet in 1954 when I went back there: the Philadelphia and Reading Coal and Iron Company, as it was called then.

And after I'd been there maybe a year — Mickey was in charge of Philadelphia and Reading — and a fellow named Jack Goldfarb came into the office, and I really didn't know what was going on.

I had a good bit of my net worth in Philadelphia and Reading, so I was interested, but Jack Goldfarb and Mickey were behind closed doors, largely.

But when they emerged, the Philadelphia and Reading Company, which was controlled by Graham-Newman, had bought Union Underwear, which was the manufacturer of Fruit of the Loom product under a license at that time.

And, as I told in the annual report, was a very, very attractive buy, and Mickey made a number of good buys.

And when — Mickey and I have talked and seen each other over the years, some, not a lot, but we would see each other.

And when Fruit of the Loom entered bankruptcy a few years ago, Mickey called me and sort of said, what are you going to do about it? You should do something.

And he was very helpful, particularly helpful, in introducing me to John Holland, who runs Fruit of the Loom, and who is a tremendous asset to the company. And, Mickey gave me lots of insights on that.

And when I got discouraged with the bankruptcy procedure — and it is discouraging to try and buy a company out of bankruptcy — Mickey would gently prod me along.

And so I believe, today, we have with us Mickey Newman and his son, who I last saw when he was a little red-headed kid, Bill.

Mickey and Bill, if you're here, if you'd stand up, it'd be great. Now, let's see if they made it.

There they are. Let's have a spotlight on them. (Applause)

I can't see very well from here whether Bill is still redheaded.

But Mickey is 81, believe it or not. You won't believe it if you meet him.

And he's been a tremendous help and a great friend over the years.

And he accomplished much for us in the past year. We — I don't think we would have Fruit of the Loom if it hadn't been for Mickey, particularly nudging me along as we went through the process.

8. Scott and Fetzer's Ralph Schey introduced

WARREN BUFFETT: I also hope we have today with us, and again, I didn't get a chance to see them before the meeting, but are Ralph and Luci Schey here? Ralph and Luci? Did they — were they able to make it or not?

Yeah, there they are. (Applause)

Ralph is in the Berkshire Hathaway Hall of Fame. I mean, this is like being at Cooperstown, you know, and introducing Bob Gibson or Sandy Koufax.

Ralph, for a great many years, added tremendous value to Berkshire at Scott and Fetzer.

We wouldn't be able to buy some of the things, like Fruit of the Loom, if it hadn't been for the profits developed under Ralph's management at Scott Fetzer.

So I'm delighted that he and Luci can join us. (Applause)

9. Larry and Dolores Brandon introduced

WARREN BUFFETT: I believe, and I hope we have Larry and Dolores Brandon. Are they here?

Show your — there they are. Let's have a spotlight on them. (Applause)

Delores is also known as "Dutchy" but we call her "Saint Dutchy" at Berkshire headquarters because she gave birth some years ago to Joe Brandon, and Joe has been doing a fabulous job for us at General Re. He took over early in September.

It's really going to be our number one asset. There're been a lot happened since those days in September when Joe took over. I think you're going to see some terrific results throughout our insurance business, but particularly at General Re.

I wrote Dutchy a letter and I said, you know, it's terrific what you've done for us, but — you know, I was a little like the farmer that went into the henhouse, and I, you know, pulled out an ostrich egg, and said to the hens, you know, I don't like to complain, but this is just a sample of what the competition's doing. (Laughter)

Well, I berated her a little bit for not having twins, because if she just had a twin for Joe, we'd own the world.

But she tells me that — and she wrote me back and said — she really had done her best. I mean, she'd had seven children, five of whom are in the insurance business, and she has 19 grandchildren.

So, we have people out on the road trying to sign up these grandchildren now and — (Laughter)

If you get a chance, you know, tell her her productive years are not over. (Laughter)

10. Andy Heyward introduced

WARREN BUFFETT: And finally, we have with us today the fellow who put together that terrific cartoon.

Anybody that can — even takes on the job of making me look like James Bond is a very brave person.

And, Andy Heyward has a company called DiC Entertainment, which is a leading producer of children's programming. When you turn on the television on Saturday morning, you will be seeing his output.

And Andy puts this product together. He sends people to Omaha. He does it all.

It's his script, it's his production. He does it on his own time, on his own nickel, he just — it's his contribution to the Berkshire meeting. And it, I mean, it's absolutely fabulous.

And I have to tell you that this fall, Andy is going to have a series of 40 episodes that are called — I think it's called "Liberty's Kids."

It will be on public broadcasting at 4:30, five days a week. And it's really the story of America.

It's told — Charlie will like this — Charlie doesn't know about this — it will be told through the eyes of three young apprentices in Ben Franklin's print shop.

And it will view the evolving of the American democracy and the Constitution, and all with Andy's creative characters, but it will use the voices of various other people.

And I'm flattered. I get to be James Madison in this. And we have Sylvester Stallone, we have Billy Crystal, we have Whoopi Goldberg.

And Charlie will be crushed to find — I think its Walter Cronkite is going to be Ben Franklin.

I mean, I think Charlie held out for too much money or something. (Laughter)

But, it's going to be a fabulous series. I mean, I am looking forward to this. It will run all this year, starting in the fall, and then it will run again in the following year. And it will be a great, great, piece for American children and American adults.

I plan on watching it myself. And it will just be the story of how this country came about, through the eyes of these three young apprentices of Ben Franklin.

So, Andy is here with his son Michael, and if Andy and Michael would stand up, I'd like to give them a hand myself. Andy, where are you? (Applause)

They're here someplace. (Applause continues)

11. Berkshire managers praised

WARREN BUFFETT: We've got a lot of other special guests, but they're up here in our managers' section. You saw them up on the screen. They're the people who make this place work.

We have a larger and better cast this year than we've had even in the past, and it will grow in the future.

This is a company of managers. And, you know, we confess to how little we do around headquarters, as you saw in the movie.

And we now have, I think — I'm not sure of the exact number, whether we have 130,000 now, or something like that — people working all over the world in all kinds of occupations.

And, I think they get a sense when they come here that they're working for real people on this side, too.

I mean, they get to see people who are actual owners. We have some institution holders, but we have 350,000 individual owners now, and I think — I believe — it's correct to say that our stock turns over — less turnover — in the shares of Berkshire than in any other company of major size in the country.

Which means, in effect, we have more what I would call real owners, people who want to be in partnership with the kind of managers we have. And Charlie and I are very proud of them.

12. Q1 insurance update

WARREN BUFFETT: Now we're going to get to the questions in just one second.

I thought I would give you a little update on, particularly, the insurance aspects of the first quarter, because insurance cost us a lot of money last year.

It's our main business. It's always going to be our main business. It's a very, very big business, and it's going to get bigger.

And, there were some special events of last year, and there were some mistakes of our own that made it a bad year for insurance last year.

Our float last year cost us almost 13 percent, and that's a lot to pay for money.

It's not our record. We had a period in the '80s when we ran into even more difficulties.

But I think there's been — well, I know there's been — there's been a change in the market. There's been a change, to a degree, in the culture at a very important unit.

And, I think that, barring some really mega-catastrophe, and we'll talk about those later — possibility — that we are — I think we're doing pretty well.

And if we could have the first chart that I — yeah — the first chart, which I can't see myself here, but I think it will be the insurance underwriting results for the first quarter.

And you will see that two good things happened in the first quarter.

One is our float increased by $1.8 billion. That's a lot of money to take in, net. I don't think there's any company, probably in the world, that had a gain in float that was even close to that.

And we actually achieved that with a small underwriting profit. So the float not only cost of nothing in the first quarter, but we had a gain of a billion-eight in it. And all units contributed to that. (Applause)

Our goal is to obtain more and more float at minimal or no cost. And there have been a number of years in the past when we've run an underwriting profit, which means that the use of that money is essentially free, or even better than free.

And we've had one very bad year, and a couple of so-so years before that.

But I think our cost of float over the next few years, unless we get into an extraordinary catastrophe, I think it should be pretty satisfactory.

Now, you'll notice there's a note down at the bottom that's slightly technical, but it's an important enough item in Berkshire, and in understanding our cost of float, that I thought I'd just devote a minute to it.

If you find this uninteresting, you can live a happy life without understanding what I'm about to explain next. You may even lead a happier life if you don't understand it. (Laughter)

As I look at the people that understand it and don't understand it, I'm not sure which group is happier. (Laughter)

When we write — we write a good bit — and have written a good bit, I should say — of retroactive insurance.

Now, in retroactive insurance, a company may come to us that's merging with another company, and they want to put a cap on their liabilities, or define them better, from past incidents.

So they may come to us and say, we want you to pick up all the losses that are going to be paid from things that happened prior to, say, 1990.

And we think that we owe $1 billion — have yet to be paid in losses from that period — but we want to protect ourselves up to, say, $2 billion, or some number like that.

So they write us a check and we take over — this is called retroactive insurance — we take over their losses from the past for a specific period and for a specific amount.

And, when we do that, the accounting — it's not accounting you run into every day — we've explained it in the past — but it creates a charge which will occur over time in the future.

And, as you can see, in the first quarter, the 20 million of underwriting profit we made was after a total of 112 million for the amortization of this charge that is set up.

So, if a company comes in and says, for example, we want you to protect us up to a billion-and-a-half for losses that occurred in the past, and we'll give you a billion dollars for it, we will debit cash for a billion dollars and we'll debit this deferred charge for half a billion and we'll set up a liability for a billion-and-a-half.

And that 500 million we set up as a deferred charge, we amortize over a period of time as we expect to pay the claims.

Now, there would be a lot of room for judgement — there is a lot of room for judgement — in terms of how fast we amortize that.

We try to be conservative. We make an estimate of when we will pay those claims and how much we will pay, and we try to amortize it over a reasonable period.

I've got another slide that shows how those amortization charges will work over time.

And we're going to put these slides on the internet, because we feel that our shareholders should understand the impact of these charges that will come against underwriting profits.

In the year 2002, we will have a 400 million-plus charge for this. It's built into the figures now.

And if we do 20 billion of premium volume, that's about a 2 percent charge.

So, to have our float be cost free, we have to make 400-plus million on underwriting elsewhere, in order to offset that.

And as you can see, we did that the first quarter and we'll find out whether we do it for the full year.

It's a — not many companies do this kind of business and it's a big item with us, so I really want all the shareholders to understand it, and for that reason, we'll put it on the internet.

I should emphasize that in all of these contracts, we cap our liability. So a lot of these contracts apply to liabilities that primarily — or not primarily — but in a significant way, and often primarily, arise from asbestos.

But when you read about asbestos claims accelerating and all of that, the numbers are capped in our case, in all of these contracts. So really don't care whether we pay it on an asbestos claim or whether we pay it on an old auto liability claim, or whatever.

The question is whether we've been correct in estimating the speed at which we will pay. And in some cases, we may pay even less than our maximum amount.

So, anyway, that's available for those of you who have previously were unhappy not understanding this and now are thrilled to know how it all works. (Laughter)

13. GEICO growth resumes

WARREN BUFFETT: Now the final item, which is a little easier to understand, is — we talked in the annual report about how we expected growth to resume at GEICO.

And I put up — again I can't see what's up there — but I assume that we have the GEICO policies in force figure and the increase by — Charlie hasn't seen these, as a factor of fact, so I'll give him the slide.

And as you can see, growth, not at the rates of a couple of years ago, but quite a turnaround from last year. Growth has resumed at GEICO in a reasonable way.

We figure each policyholder of a preferred nature is worth $1000 to us, at least, and so if we had 40,000 policyholders in a month, we've created, in our view, $40 million of value.

And, of course, we have the earnings in the float, and so on, that goes with it.

You'll notice on the first slide, GEICO operated at a significant underwriting profit in the first quarter, so all of its float was free and its float has continued to grow.

We are — you saw one of our little squirrel ads there which I like — we are getting — we are not getting a whole lot more inquiries than a year ago, but we're closing a significantly higher percentage of those that call. So our growth has been — has been picking up because our closure rate has increased quite substantially, and our retention rate of old policyholders, also, is increasing month by month.

So we've got two trends that are quite favorable, in terms of adding business.

And the third one of adding more inquiries is something that we are working on, and we're delighted to spend a lot of money on it, if we can figure out the way to spend it intelligently.

But, the increase in the retention ratio, the increase in the closure ratio, is resulting in very decent growth at GEICO.

And it's growth in all of our categories, in the preferred class, and the standard class, and the nonstandard class of business, whereas last year, the latter two fell.

Well, that's enough about the formal presentation.

14. How Buffett decides when to sell stocks

WARREN BUFFETT: Now, we're going to go in the various zones.

I promised a young shareholder in zone one that he would get to ask the first question and we're ready for zone 1.

AUDIENCE MEMBER: Hello Mr. Buffett and Mr. Munger. My name is David Klein-Rodick from Lincolnshire, Illinois. Thank you for letting me ask the first question.

I wanted to say I am sorry for the loss of your friend Mrs. Graham last year.

My question is: you have said that your favorite time to own a stock is forever.

Yet, you sold McDonald's and Disney after not owning them for long.

How do you do decide when to hold forever and when to sell?

And also, are you and Mr. Munger wearing Fruit of the Loom? (Laughter and applause)

WARREN BUFFETT: Charlie? (Laughter)

I think I better answer the question. I can answer unequivocally. I am wearing Fruit of the Loom.

I'm not sure whether Charlie wears underwear. Do you? (Laughter)

CHARLIE MUNGER: I haven't bought any new underwear in a long time and therefore I'm inappropriately attired. (Laughter)

WARREN BUFFETT: He's waiting for a discount, don't let him kid you. (Laughter)

Well, the answer — it's a very good question about selling. I mean, we — it's not our natural inclination to sell.

And on the other hand — and we have held the Washington Post stock since 1973. I've never sold a share of Berkshire, having bought the first shares in 1962.

And we've held Coke stock since 1988. We've held Gillette stock since 1989. Held American Express stock since 1991.

We had actually previously been in American Express in the '60s and Disney.

So, there are companies we are familiar with.

We generally sell by — we would sell if we needed money for something else — but that has not been the problem the last 10 or 15 years.

Forty years ago my sales were all because I found something that I liked even better. I hated to sell what I sold, but I also didn't want to borrow money, so I would reluctantly sell something that I thought was terribly cheap to buy something that was even cheaper.

Those were the times when I had more ideas than money. Now I've got more money than ideas, and that's a different equation.

So now we sell — really when we think that we've — when we're reevaluating the economic characteristics of the business.

In other words, if you take the — don't want to name names — but take a stock we've sold, of some sort.

We probably had one view of the long-term competitive advantage of the company at the time we bought it, and we may have modified that.

That doesn't mean we think that the company is going into some disastrous period or anything remotely like that. We think McDonald's has a fine future. We think Disney has a fine future. And there are others.

But we probably don't think that their competitive advantage is as strong as we might have thought — as we thought it was — when we initially made the decision.

That may mean that we were wrong when we made the decision originally. It may mean that we're wrong now, and that their strengths are every bit as what they were before.

But, for one reason or another, we think that the strengths may have been eroded to some degree.

A classic case on that would be the newspaper industry, generally, for example.

I mean, in 1970, Charlie and I were looking at the newspaper business. We felt it was about as impregnable a franchise as could be found.

We still think it's quite a business, but we do not think the franchise in 2002 is the same as it was in 1970.

We do not think the franchise of a network television station in 2002 is the same as it was in 1965.

And those beliefs change quite gradually. And who knows whether they're precise — you know, whether they're right, even.

But that is the reason, in general, that we sell now.

If we got into some terribly cheap market, we might sell some things that we thought were cheap to buy something even cheaper, after we'd bought lots and lots of equities. But that's not the occasion right now.

Charlie?

CHARLIE MUNGER: Nothing to add.

WARREN BUFFETT: He's been practicing for weeks. (Laughter)

15. Cost of float is more important than its size

WARREN BUFFETT: OK, let's go to zone 2.

AUDIENCE MEMBER: I'm John Bailey from Boston, Massachusetts and I hope I'm not asking you to repeat your insurance presentation, but I have a question about the growth of our float.

There's an increasingly popular piece of analysis out there where people project the growth of float for a large number of years into the future in order to determine the value of our business here.

But I wanted to ask more fundamentally, the existing float that we have runs off annually at a pretty considerable rate.

In order to maintain that, we have to replace it through our operations.

And then going the next step, to achieve the growth, we have more than replace it.

And so I wanted to ask you to address the characteristics of the — maybe the non-GEICO insurance businesses — that should give us the confidence to expect large amounts of replacement and growth float, at reasonable costs, going forward?

WARREN BUFFETT: Yeah, in a sense, float is somewhat similar to being in the oil business. I mean, you know, every day, some goes out as you pay claims, and the question is, did you find more oil than you produced that day? And it's very relevant.

It's a good question to, you know, what is the permanence of the float? What is the cost of the float? What's the likelihood of it growing? Could it actually run off?

As you saw up on the slide, we have $37 billion-plus of float. I think we have more float in our property-casualty business. A little bit of that float is in General Re's life and health business, but very small.

So, basically you're looking at property-casualty float when you look at that 37 billion.

I believe that's more than any company has in the United States and it's possible — I haven't checked Swiss Re and Munich — but it's even possible it's larger than anybody in the world.

Now, if you go to 30th and Harney Street, here in Omaha, you'll see National Indemnity building. It's the same building that was there when we bought the company in 1967 from Jack Ringwalt, when it had, maybe, 12 million of float.

And I had no idea that that 12 million, or whatever the number was, would turn into 37 billion. I mean, sometimes I can't really quite figure out how it happened.

But in any event, it did, and it's — we don't want people focusing on growth in our insurance business. I mean, we want them focusing on intelligent growth when we can do it at a GEICO or whatever it may be.

But I think it's suicide, from a business standpoint, to tell a bunch of insurance managers to go out and grow a lot.

So, you can say, well, with that lack of push from the home office, you know, how is that 37 1/2 billion going to grow? And I would say, just as I would have said to you for the last, you know, 30-odd years, I don't know.

But I think that — well, I can tell you this, that our float would have less natural runoff than the float from just about any company in the world.

I mean, we have a longer duration to our float because it arises from these retroactive contracts and from reinsurance, long-tail reinsurance, and that sort of thing.

So, our float has less natural erosion than any — just about any — that I know of in the world, but it erodes. It is a long-lived oil field, but it — we're pumping it every day.

You know, if I had to bet my life on whether the float would be higher or lower three years from now, or five years from now, I would certainly bet it would be higher.

And it's turned out, over the decades, that it's grown at a very significant rate. But I don't want to push anybody to do it. It grew at $1,800,000,000 the first quarter.

Now, there are a few special transactions in that, but we seem to attract special transactions.

There's nothing more important to Berkshire than to — to have that float, at least, be maintained, but I would say grow. And it will grow, I think. And to have it be obtained at low cost.

That float did us no good last year at all. That float was — lost us a lot of money in the year 2001, because it cost us, I think, 12.8 percent. And we didn't have a way to make money with 12.8 percent money.

We will make a lot of money if we can obtain a float at no cost, as we did in the first quarter.

The answer to your question is that without knowing any specifics that — without being able to promise you any specifics — you know, I think the float is more likely to grow than to erode.

I said last year at this meeting that there — you know, that the float of the American property-casualty business was 300-and-some billion, and I thought we were sneaking up on 10 percent of it.

I was corrected later on. Ferguson pointed out to me that — he sent me the figures. The float of the American property-casualty business is well over 400 billion.

But even at that, you know, we are 8 or 9 percent, or some figure like that, of the float of the whole country.

And, obviously, we can't grow at the same percentage rate starting from that kind of a base as we could when we started back in 1967.

But I still think we can grow it.

Charlie?

CHARLIE MUNGER: Yeah, I think the questioner realizes that growing float at a good clip, with very low costs, is extremely difficult.

It is. It's almost impossible. But we intend to do it anyway. (Laughter)

WARREN BUFFETT: See, of the two variables, though, that the most important thing to do is to focus at getting it at a very low cost. If we get $37 billion at no cost, or very low cost, you know, then if we don't do — if we don't make money with that, shame on us.

I mean, the troops have delivered and then it's up to Charlie and me to figure out ways to use that money.

So the important thing is the cost of the float and not the size of the float, although, obviously, we would like it to grow and we will do what we can to make sure that happens.

16. Asbestos liability risks and opportunities

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: Good morning, gentlemen. My name is Hugh Stephenson. I'm a shareholder from Atlanta.

My question is on asbestos liability tort cases. It seems like this is growing to be a bigger and bigger problem, including more and more companies, including a number of companies in the Dow Jones 30 industrials.

What do you see for Berkshire as the risks and opportunities in the operating and insurance businesses?

And, if you two were in charge of writing or structuring a settlement for the whole problem, how would you do it?

WARREN BUFFETT: OK, I'm going to let Charlie tackle most of that, because he's — we've both done a lot of thinking on it. I think Charlie's thinking is — I know — it's better, and it may even be more extensive.

Asbestos, as I mentioned in some of these retroactive contracts, is a big part of the liability, but it really doesn't make any difference, unless — it's much more dependent on the speed of payments than the amount of payment.

We are capped on all those types of contracts.

So, there's a figure in the annual report about aggregate asbestos and environmental liability. And that number may look quite big compared to some other insurance companies — but most of that, there's a limit on.

And, it's a good thing, because asbestos continues to explode. It's just — we talked about it last year at this meeting, and I said no matter how bad you thought it was, it was going to be worse. And it has been worse. And it will be worse.

And you make a very good point when you bring up the fact that many companies that are thought to be, or have been thought to have been, insulated from the asbestos litigation have now been dragged in one way or another. And that won't stop, either.

Ironically, it's not impossible that that asbestos litigation actually produces some opportunities for Berkshire, in terms of buying companies out of bankruptcy, free of their asbestos liabilities.

We did that — although it occurred much earlier in the — but we bought Johns Manville, which was the, in my memory, was the first major company, really big company, to go into bankruptcy and be forced there by asbestos liability. That happened back in the early '80s.

And that subsequently, they were cleansed of their liability by, in effect, giving a very high percentage of the company and its debt to the plaintiffs. And their lawyers, I might add.

And when we came along a year ago, I mean, that was all past history. But we probably wouldn't own the Johns Manville company if it hadn't been for some asbestos litigation that started 20 years ago or more.

We may see, actually, more companies that end up in Berkshire that have been forced into bankruptcy through asbestos.

But it is a — it's really a cancer on the American corporate world. And it's one that growing. And I think I'll let Charlie talk about it.

CHARLIE MUNGER: Well, the asbestos liability situation in the country is morphed into a very disadvantageous situation where there's an enormous amount of fraud.

And the wrong people are getting money, and there are vast profits for people who are arranging the fraud. And so it isn't a good situation.

There's also real liability to people who have serious injuries, and some of those people are being deprived because the meritless claims are taking so much of the money that there isn't adequate money for the people who had the worst injuries.

The Supreme Court has practically invited Congress to please step in and create a solution, but, deterred by the plaintiffs contingency fee bar, Congress has refused to do anything.

This is not a good situation, and if you can do anything about it, why, I would encourage you to do so.

WARREN BUFFETT: What do you think it will look like in five years, Charlie?

CHARLIE MUNGER: I would be surprised if there were a constructive solution. I think we'll have more of the mess we have now.

WARREN BUFFETT: It's huge, too. I mean, you — there are companies that some of you may own stock in that had huge potential liabilities.

They didn't think they had those liabilities, even, maybe, a few years ago. But, they're finding ways to drag in almost anyone.

And, you know, it's a concern when we buy businesses, because we are a deep pocket. And a tiny — a smaller — company may not have been worth people investing lots of hours on a speculative idea that they could create some kind of a connection with, you know, the ABC Company and hundreds of thousands of people that are claimed to be sick.

But, it gets more interesting if Berkshire — it could get more interesting — if Berkshire's involved.

So, it's a real problem for corporate America and they have not been able, in effect, to come up with a solution.

There was a solution, as I remember, and the Supreme Court didn't allow it. Isn't that right, Charlie?

CHARLIE MUNGER: That's right.

WARREN BUFFETT: Yep.

We will be very careful, both in our insurance operations, but just as importantly, in our acquisitions and all of that, in terms of avoiding unnecessary exposure to asbestos liability.

I'm not terrified at all about our insurance operation, in terms of what's there from the past.

I'm not saying that I know with any precision what the amounts will be, but I — that is not at the top of my list.

But, essentially you will have a plaintiffs bar that, going beyond asbestos, will try to turn any kind of human adversity into a claim against somebody that's got a lot of money.

And that's going on with mold. I mean, you may have seen Ed McMahon is suing his insurer for $20 million for the mold in his house. I just wish I could get some of that mold. I mean — (laughs) —

CHARLIE MUNGER: You probably have it.

WARREN BUFFETT: Yeah. (Laughter)

I hope you're referring to the house. (Laughter)

17. How to pick a stock index fund

WARREN BUFFETT: OK. Area 4.

AUDIENCE MEMBER: Good morning. My name is Tedd Friedman. I'm from Cincinnati, Ohio.

You said in the 1996 annual report that most investors will find that the best way to own common stocks is in an index fund that charges minimal fees.

Two questions. First: there are a lot of different index funds that hold different baskets of stocks. What criteria would you use, or recommend, to select an appropriate index fund?

Second: The price-to-earnings ratio of the S&P 500 is significantly higher than its historical average. What benchmark should an investor use in purchasing this index?

WARREN BUFFETT: Yeah, I would say that in terms of the index fund, I would just take a very broad index. I would take the S&P 500, as long as I wasn't putting all my money in at one time.

If I were going to put money into an index fund in relatively equal amounts over a 20 or 30-year period, I would pick a fund — and I know Vanguard has very low costs. I'm sure there are a whole bunch of others that do. I just haven't looked at the field.

But I would be very careful about the costs involved, because all they're doing for you is buying that index. I think that the people who buy those index funds, on average, will get better results than the people that buy funds that have higher costs attached to them, because it's just a matter of math.

If you have a very high percentage of funds being institutionally managed, and a great many institutions charge a lot of money for doing it and others charge a little, they're going to get very similar growth results but different net results.

And I recommend to all of you reading — John Bogle's written a couple of books in the last five years, and I can't give you the titles but they're very good books, and anybody investing in funds should read those books before investing, or if you've already invested, you still should read the books. And it's all you need to know, really, about fund investing.

So I would pick a broad index, but I wouldn't toss a chunk in at any one time. I would do it over a period of time, because the very nature of index funds is that you are saying, I think America's business is going to do well over a — reasonably well — over a long period of time, but I don't know enough to pick the winners and I don't know enough to pick the winning times.

There's nothing wrong with that. I don't know enough to pick the winning times. Occasionally, I think I know enough to pick a winner, but not very often.

And I certainly can't pick winners by going down through the whole list and saying, this is a winner and this isn't and so on.

So, the important thing to do, if you have an overall feeling that business is a reasonable place to have your money over a long period of time, is to invest over a long period of time, and not make any bet, implicitly, by putting a big chunk in at a given time.

As to the criteria as to when you should or shouldn't, I don't think there are great criteria on that.

I don't think price-earnings ratios, you know, determine things. I don't think price-book ratios, price-sales ratios — I don't think any — there's no single metric I can give you, or that anybody else can give you, in my view, that will tell you this is a great time to buy stocks or not to buy stocks or anything of the sort.

It just isn't that easy. That's why you go to an index fund, and that's why you buy over a period of time. It isn't that easy.

You can't get it by reading a magazine. You can't get it by, you know, watching television. You can't — you'd love to have something that said, you know, if P/Es are 12 or below or some number, you buy, and if they're 25 or above, you sell.

It doesn't work that way. It's a more complex business than that. It couldn't be that easy when you think about it.

So, if you are buying an index fund, you are protecting yourself against the fact that you don't know the answers to those questions but that you think you can do well over time without knowing the answers to those questions, as long as you consciously recognize that fact.

And, you know, I would — if you're a young person and you intend to save a portion of your income over time, I'd just say, just pick out a very broad index — I would probably use the S&P 500.

But I think if you start getting beyond that — starting to think you should be in small caps this time and large caps that time, or this foreign stock — and as soon as you do that, you know, you're in a game you don't know — you know, you're not equipped to play, in all candor.

That would be my recommendation.

Charlie?

CHARLIE MUNGER: I think his second worry is that common stocks could become so high-priced that if you bought index funds, you wouldn't expect to do very well.

I didn't think I'd live long enough to think that was likely to happen, but now I think that may happen.

WARREN BUFFETT: But, probably what you're saying there is they could get to a level and be at — they'd have to be at a sustained level like that for a long time.

CHARLIE MUNGER: They could be there and stay there for a long time.

WARREN BUFFETT: In which case, you might make 3 or 4 percent.

But would there be any way better than that around, under those circumstances, anyway? And pass the peanut brittle, please. (Laughs)

CHARLIE MUNGER: Well, in Japan, where something like this happened, the returns from owning a nice index over the last 13 years or so is negative.

Can something as horrible as that happen here? I mean, is it conceivable? I think the answer is yes.

WARREN BUFFETT: But the option in Japan, of course, is to have deposits in a bank, or own Japanese bonds, at somewhere between 0 and 1 or 1 1/2 percent.

So, if rates on everything get very low, which means stocks sell very high, you know, then it just means that you live in a different world than existed 20 or 30 years ago when, generally, capital got paid better.

CHARLIE MUNGER: I must say that we have very good packaging.

WARREN BUFFETT: Yeah. (Laughs)

Normally he does this in a less formal manner, but he's on his good behavior today.

CHARLIE MUNGER: We're protecting the integrity of the peanut brittle.

WARREN BUFFETT: That is true. The package — the nature of anything with butter in it, you know, is that it starts going downhill from the moment you make it. And therefore, the packing has to be extraordinary in order to meet the quality standards that Charlie and I insist on. (Laughter)

18. Effect of 9/11 on insurance underwriting

WARREN BUFFETT: OK, we'll go to zone 5.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my name is Thomas May (PH). I am 12 years old. I live in Kentfield, California. This is my fifth annual meeting.

I know you lost a lot of money as a result of 9/11. But I would like to know how 9/11 changed your life and your investment strategy?

WARREN BUFFETT: Well, I think it, in a sense, is changing — good question.

And, it made everybody, I think, in the country aware, I mean, we've gone through world wars and all of that, and essentially felt quite protected within these borders.

And I have been quite worried about — Charlie can attest to — you know, the possibility, particularly of some kind of nuclear device in this country, by — probably more likely by terrorists than by some, at least, declared act of war by another state.

And 9/11 made everybody realize that as humans have not progressed, particularly, in terms of how they behave with each other over the years, they have progressed enormously in their ability to inflict damage on those they hate for one reason or another.

And that has increased, you know, for a long time. In the world, if you didn't like somebody, the most you could do was throw a rock at them.

And that went on for millennia, and then it moved into what you might characterize, ironically, as more advanced states. And in the last 50 years, it's increased exponentially.

And so now people who are megalomaniacs, or psychotics, or religious fanatics, or whatever, and who hate others in some unreasonable way, now have means at their disposal to inflict a whole lot more damage, incredibly more damage, than they had not too many decades ago.

And 9/11 brought that home to everybody, something they probably understood subconsciously and didn't think about very often, to something they thought about much more intensely and it's become much more real to them.

It hasn't really changed my view about — I mean, in the sense that I — you know, there are millions and millions and millions of people in the world that hate us. And most of them can't do anything about it.

But, a few have always tried to do something about it, and now the instruments they can use, in the most extreme, in a sense, being the human bombs that have appeared in the Middle East, but there's more ability to — incredibly more ability — for the deranged who want to inflict harm to do harm. And that's the reality.

In terms of the business aspects of it, in your question, obviously the area at Berkshire that it effects most significantly, by miles, is insurance.

And prior to 9/11, even though we recognized that there could be huge monetary damages that flowed from the activities of what I would call deranged people, we hadn't really written the contracts in such a way as to either get paid for taking that risk or to exclude the risk. In other words, we were throwing it in for nothing.

We had excluded risk for war. I mean, we knew that we'd seen what had happened in England in the 40s, and so we had taken account of something that some of us had seen with our own eyes, but we didn't take account of something that we knew is possible, but we just hadn't seen. And that's, you know, that's the human condition, to some degree.

Since September 11th, everybody in the insurance business recognizes that they had exposures that they weren't charging for, and they either had to exclude those exposure or they had to charge for them.

We have written — first thing we had to do, of course, is we had lots of policies on the books that left us exposed to this, and most of those policies ran for a year, starting at different points. Those have run off to a great degree, but they're not entirely run off.

The other thing we did was on new policies. We have sold a fair amount, quite a large amount, of terrorism insurance that excludes what we call NCB, nuclear, chemical, and biological, as well as fire following nuclear.

And, we can take a fair amount of exposure to that sort of terrorism, because it doesn't — it won't aggregate. It aggregated at the Twin Towers in a way that — World Trade Center — in a way that just about was as extreme as you could get for non-NCB-type activities.

I mean, that was a huge amount of damage done without nuclear, chemical, or biological.

But we can have tens of billions of dollars with NCB excluded throughout a greater New York area, or something, but we can't have hundreds of billions of exposure that would be exposed, say, to, nuclear activities, because there an act or two, or three, coordinated, could cause damage that would destroy the insurance industry.

And if we had coverage on that, it would destroy us as well. So, we write very little — we do write a little, because we can take —we can lose a billion or two billion dollars, and if we got paid appropriately for taking the risk, you know, that's a business we're in.

But we can't lose 50 or 100 billion dollars. And, so we take a little bit — we take a few risks that involve nuclear, chemical, or biological, but, generally speaking, the terrorism insurance that we're writing, and we've written a fair amount of it, excludes those particular risks.

You can say, you know, take biological. How could that be something significant from an insurance standpoint?

Well, many people don't realize it, but the World Trade Center loss was, by a huge margin, the largest workers' compensation loss in history.

We think of it as property damage, but, in the end, close to 3000 people had died who were working at the time they died, and therefore, covered by workers' compensation.

If the same thing had happened at Yankee Stadium while they were all watching a baseball game, or some other place, they wouldn't have been covered by workers' compensation. So it was happenstance, to some degree.

But that was — became the largest workers' compensation loss in history by a huge margin.

Now, if you were trying to cause huge damage in this country, and you could figure out something in the way of a biological agent — and there are people working on this — that could be injected into the ventilation systems, or whatever, of large plants, large office buildings, you could create workers' compensation losses that, you know, would just totally boggle your mind.

And anybody that was working on such a thing, you have to expect they would — if they thought they had perfected it — would try to do something close to simultaneously in areas where there would be thousands and thousands of people working. And it could make the World Trade Center loss look like nothing.

So, we have to be, basically, vigilant, in how much risk we let aggregate in something of that sort.

People have always been vigilant about how many houses they'll insure along a shoreline, or, in terms of physical risk, you know, they don't want too many homes or factories on the San Andreas Fault, or something of the sort, because they recognize that as having aggregation possibilities.

But now you have to think about things that man may plan in the way of catastrophes that will have aggregation possibilities, and that is something that's pretty much been introduced into the insurance world's thinking since September 11.

And I can tell you, you know, we think a lot about it. But — I mean, the social consequences are far worse than insurance, but we have to think about how we'd pay our claims, because if we ever do anything really foolish and endanger — take an aggregation — that would cause us to lose the net worth of Berkshire, we would not only not be able to pay the claims of the people in that disaster, but there are other people that suffered injuries 15 years ago, paraplegics and all that, that we're making payments to for the rest of their lifetime. And we wouldn't be able to make those payments. And we're not going to run our business that way.

Charlie?

CHARLIE MUNGER: Yeah. To the extent that September 11th has caused us to be less weak, foolish, and sloppy, as we plainly were in facing some plain reality, it's a plus.

We regret, of course, what happened, but we should not regret at all that we now face reality with more intelligence.

This inconvenience that we all have, this tightening of immigration procedures, etc., should have been done years ago.

WARREN BUFFETT: The most important thing in investments is not having a high IQ, thank God.

I mean, the important thing is realism and discipline. And you don't need to be extraordinarily bright to do well in investments, if you are realistic and disciplined.

And the same thing applies in insurance underwriting. It is not some arcane science that, you know, the ability to which to do successfully is given only to a few, or which requires the ability to do — mathematics have very little to do with it.

There's an understanding of probabilities and all that, a kind of gut understanding, that's important. But it does not require the ability to manipulate figures — does not — you know, you can do it without calculus, you can do it — you can really do it with a good understanding of arithmetic and an inherent sense of probabilities.

As Charlie says, to the extent that — I think we've always, from the investment standpoint, you know, if we've had any distinguishing characteristics, it would be that, in terms of realism and discipline.

And generally that means finding what you don't know.

In insurance underwriting, it's the same thing. You have to have — you have to be realistic about what you can understand and what you can't understand, and therefore, what you can insure and what you can't insure.

And you have to be disciplined about turning down all kinds of offerings where you're not getting paid appropriately.

And September 11th drove home those lessons and probably redefined getting paid appropriately in certain cases.

19. All banks aren't the same

WARREN BUFFETT: Area 6?

AUDIENCE MEMBER: Hello. My name is Everett Puri (PH). I'm from Atlanta.

I wanted to ask you to comment on the relative P/E multiples of bank stocks versus the S&P.

They seem to be at 30, 35 to 50-year year relative lows to the S&P, and I was wondering if that's the result of the market — a change in the market's perception of the forward growth rates of banks or if the market has perceived that there's a change in risk there.

WARREN BUFFETT: You're asking about the performance of what group compared to the S&P?

AUDIENCE MEMBER: Banks.

WARREN BUFFETT: Banks? Well, and what was your assertion about the performance, historically?

AUDIENCE MEMBER: Well —the relative multiple of bank stocks versus the S&P.

Back in the '40s — '40s, '50s, '60s, they commonly traded at, say, one times the S&P multiple and now they're maybe half that level.

WARREN BUFFETT: Yeah. Harry Keith (PH) used to have a lot of figures on this.

I don't really think about them. I mean, the appropriate multiple for a business, relative to the S&P, will depend on what you expect that business to achieve in terms of returns on equity, and incremental returns on incremental equity, versus that S&P.

I mean, if you've got two types of businesses, and we'll say the S&P earns X on equity, and can deploy an additional amount of capital at Y, and then you compare that with any other business, and that's how you determine which one is cheaper.

I would not characterize all banks as the same. I mean, we have in this room John Forlines, who runs the Bank of Granite — Granite, North Carolina — and they've earned 2 percent on assets without taking any real risks for decades. It's a tremendous record.

And then you have other banks that have been run by people that took them right into the ground.

I mean, whether it was First Pennsylvania, going back 30 years ago, I think it was John Bunting, and they — they're not a homogeneous group.

We own a couple of — stock — in a couple of banks. We own stock in M&T, that has an exhibit downstairs today. We own stock in Wells Fargo. And we think those institutions are somewhat different than other businesses.

So, I don't think there's — it goes back to that earlier question.

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

What you're trying to do is look at all the cash a business will produce between now and judgment day, and discount it back at a rate that's appropriate, and then buy it a lot cheaper than that.

And, whether the money comes from a bank, whether it comes from an internet company, or whether it comes from a brick company, the money all spends the same.

Now the question is, what are the economic characteristics of the internet company or the bank or the brick company that tell you how much cash they're going to generate over long periods in the future.

And I would come to a very different answers, you know, on M&T Bank versus some other bank.

So, I wouldn't want to have a single yardstick, or a, you know, relative P/E that I went by.

I think that banks have sold — a good many banks have sold — at very reasonable prices.

We bought all of a bank in 1969. We bought a bank in Rockford, Illinois.

Charlie and I went and looked — we must have looked at a half a dozen banks at that — you know, in a two or three-year period.

CHARLIE MUNGER: Absolutely.

WARREN BUFFETT: Yeah. We trudged around and we found some very oddball banks that we liked.

And they were characterized by very little risk on the asset side and very cheap money on the deposit side. And even Charlie and I can understand that. And low prices, incidentally, too.

And then they passed the Bank Holding Company Act in 1969, and they killed off our chances to do anything further in buying all of banks.

So, we look at banks. We will own bank stocks from time to time in the future. We'll probably buy stocks in other banks.

We've also seen all kinds of banks ruined. I think it was, what was the fellow? M.A. Schapiro, who came up with the statement, he said, "There are more banks than bankers."

And if you think about that a bit, you'll see what I mean. (Laughter)

There have been — you know, there have been a lot of people that have run banks in a very injudicious manner, but that's made for opportunities for other people.

A lot of banks have disappeared over time. I mean, up in Buffalo, where Bob Wilmers runs M&T, there were some other very prestigious institutions that went right down the tubes. And a lot of that happened in the early '90s or late '80s.

I wouldn't look for a single metric like relative P/Es to determine what — how — to invest money.

You really want to look for things you understand, and where you think you can see out for a good many years, in a general way, as to the cash that can be generated from the business.

And then, if you can buy it at a cheap enough price compared to that cash, it doesn't make any difference what the name attached to the cash is.

Charlie?

CHARLIE MUNGER: Yeah, I think the questioner is, maybe, even asking the wrong people that question.

I would argue that Warren and I have failed to properly diagnose banking. I think we underestimated the general good results that would happen because we were so afraid of what non-bankers might do when they were in charge of banks.

WARREN BUFFETT: There are a number of banks, that over the last five or six years, on tangible net worth, the number net of goodwill, but on tangible net worth have earned over 20 percent on equity.

You would think that would be difficult for an industry to do dealing in a commodity like money, and, of course, the banks will argue it's not a commodity — but it's got a lot of commodity-like characteristics —and you would think those kind of returns in a world of 6 percent long-term interest rates and much lower, you would think that would be very hard — well, you would have though it wouldn't have occurred, you'd think it would be hard to sustain.

We been wrong in the sense that banks have earned a lot more money on tangible equity than Charlie and I would have thought possible.

Now, I think, to some extent, they've done because they stretched out equity much further than was the case 20 or 30 years ago.

I mean, they operate with more dollars working per dollar of equity than people thought was prudent 30 or 40 years ago.

But, however they've done it, they've earned — a number of banks have earned — very high returns on equity in recent years.

And, if you earn high enough returns on equity and you can keep employing more of that equity at the same rate — that's also difficult to do — you know, the world compounds very fast.

You know, banking as a whole has earned at rates that are well beyond, on tangible equity, you know, well beyond, I think, what much more glamorous businesses have earned in recent years.

Charlie, you have any further thoughts on that?

CHARLIE MUNGER: No, I say again, we didn't diagnose it as it actually turned out and, even worse than that, we haven't changed. (Laughter)

WARREN BUFFETT: And even worse than that, we won't. (Laughter)

20. Detecting fraud and the evils of EBITDA

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Andrew Sole, and I'm a shareholder from New York City.

I have two questions. The first one, I'd like to direct to Mr. Munger.

Pertaining to cash flow analysis, given the practices of numerous corporations of deliberately fabricating cash flow numbers, which occurred in some of the telcos, where they characterized like-kind exchanges as product sales.

How do you ferret out this type of fraud? What do you recommend a shareholder, an individual investor, to do, short of obtaining a degree in forensic accounting to uncover this type of fraud?

And the second question is, on a lighter note, what books would either of you gentlemen recommend to shareholders that you read this year that you liked?

CHARLIE MUNGER: Yeah. I think you're asking for a lot if you want some simple way of not being taken in by the frauds of the world.

If you stop to think about it, enormously talented people deliberately go into fraud, drift gradually into it because the culture carries them there, and the frauds get very sophisticated and they're very slickly done.

I think it's part of the business of getting wisdom in life that you avoid getting taken by the frauds.

And so I think you're asking a very good question, but I don't think there is any short answer.

I think there are whole fields that you can just quit playing because it looks like there's too much fraud in it.

And I think we do a lot of that, don't we, Warren?

WARREN BUFFETT: Yeah. How many times have we been defrauded in the last 20 years?

CHARLIE MUNGER: Well, damn little that we can — it's amazing how little.

WARREN BUFFETT: Yep.

CHARLIE MUNGER: And I've always said that the guy who takes us is going to have a modest little office and a modest demeanor and —

WARREN BUFFETT: He'll carry around Ben Franklin's autobiography, I can —

CHARLIE MUNGER: The kind of people who defraud us are not going to be the kind of people who are defrauding everybody else.

WARREN BUFFETT: Yeah. I mean, it's a very good question. It's tough to answer.

But I will tell you that we haven't, and we won't get defrauded often. Now, that may mean we pass up a whole lot of other opportunities, too.

But, for example, you raised the question about cash flow. I would say the number of times we're going to buy into a company, whether it's through stocks or through the entire company, where people are talking about EBITDA, is going to be about zero.

I mean, we start out with — if somebody's talking about EBITDA, you know — if we take all the people in the world that talk about EBITDA and all the people in the world who haven't talked about EBITDA, there are more frauds in the first group, percentage-wise, by a substantial margin. Very substantial. I mean, it is, you know, it's just a start.

Now, that isn't — you know, that — it's very interesting to me. If you look at some enormously successful companies, Walmart, General Electric, Microsoft, I don't think that term has ever appeared in their annual reports.

I mean, they just — so when people start talking about that sort of thing, either they're trying to con you in some way, or they've conned themselves, to a great degree. I mean —

CHARLIE MUNGER: Or both.

WARREN BUFFETT: Yeah. Well, that often happens. I mean, if you set out to con somebody, after a while you con yourself, which is why some of the people in the internet stocks, you know, stayed with them.

It's — if somebody is — if they think you're focusing on EBITDA, they may arrange things so that that number looks bigger than it really is.

It's bigger than it really is, anyway. I mean, the implication of that number is it has great meaning.

You take telecoms, they're spending every dime that comes in, I mean, in many cases.

There isn't — it isn't cash flow. I mean, the cash is flowing out. But it — you know, you can look at the statement and there's billions of dollars, supposedly, in depreciation and so on. But there — you know, interest is an expense.

Actually, taxes are going to be an expense. Anybody that tells us that making a lot of money before taxes, in terms of EBITDA, is meaningful — you know, you get depreciation by laying out money ahead of time. It's the worst kind of expense.

We look for float, where we get the money and then pay out later on. But depreciation occurs because you buy an asset first and then you get the deduction later on. It's the worst kind of expense there is.

And you start paying taxes when you actually make money, and when the depreciation runs out at some point.

So these — it just amazes me how widespread the usage of EBITDA has become, and I would say there have been people who have tried to dress up financial statements in a way to appeal to people who are impressed by such a number.

Charlie and I have found, actually, that — at least to us — many of the crooks look like crooks.

Now, we have spotted — we haven't shorted them — but we have spotted a lot of frauds over the years in public companies. And years before, you know, that the roof fell in.

And they usually are people that tell you things that are too good to be true, for one thing.

I mean, they, you know, they tell you very mediocre businesses are wonderful businesses for one reason or another. Or they — they just have a smell about them, you know, in effect.

Wouldn't you say that's true, Charlie?

CHARLIE MUNGER: Well, sometimes it's amazingly obvious. Maxwell, of England, his nickname was the "bouncing Czech."

And three weeks before he went under, Salomon —

WARREN BUFFETT: (Inaudible)

CHARLIE MUNGER: — Salomon was aggressively seeking more business from him, with both Warren and I on the board. It shows how much influence outside directors often have.

WARREN BUFFETT: Yeah. Wall Street is —

CHARLIE MUNGER: Imagine extending credit to a guy whose nickname is the "bouncing Czech." You'd think it — if you wrote it as satire, people would say it was too extreme to be funny. (Laughter)

WARREN BUFFETT: We have read — I mean, Charlie and I have — it's a hobby keeping track of the Maxwells of the world, and the —

They get — there's a syndrome. I mean, they give off a lot of the same messages.

I mean, Maxwell was a classic case, but there — time after time — Wall Street has no filter against them. Wall Street loves them, as long as, you know, as long as they're pushing out securities and the commissions are there.

Charlie and I could not have stopped Salomon from making a deal with Maxwell, you know, right to the last 30 seconds before he sunk, you know, under the ocean.

CHARLIE MUNGER: We didn't stop First Normandy with Lou Simpson and Warren Buffett and Charlie Munger on the board.

WARREN BUFFETT: Yeah. First Normandy was a case of some guy that manufactured a record out in California that he claimed was from owning a bunch of securities, including Berkshire Hathaway.

And, he was going to go public and Salomon was courting him. And this — the record was, you know, it was total baloney.

And I think they actually went public for a day or so and then the SEC pulled it back.

CHARLIE MUNGER: Absolutely. They had the offering and then they canceled it before the money changed hands.

But it was a very embarrassing episode. And we remonstrated against this obvious insanity, they told us the underwriting committee had approved it.

WARREN BUFFETT: I don't think they changed underwriting committees, either. (Laughs)

21. Quick decision to buy Larson-Juhl

WARREN BUFFETT: OK. Zone 8.

WARREN BUFFETT: We're a cheery group up here, aren't we, on the human condition?

AUDIENCE MEMBER: Good evening from Germany. My name is Norman Reinzhoff (PH). I'm a shareholder for about 10 years. And I want to thank you gentlemen for your long-term performance.

I brought you two of my favorite German chocolates. One for you, Mr. Buffett. One for you, Mr. Munger. And I will give them to you tomorrow at the steak house.

WARREN BUFFETT: How much do they sell for a pound? I'm just curious. (Laughter)

AUDIENCE MEMBER: Well, by the way, this is not the chocolate company you wrote to two years ago.

WARREN BUFFETT: Oh.

AUDIENCE MEMBER: They were sold about a week ago for a very low price.

WARREN BUFFETT: Is that —

AUDIENCE MEMBER: This can still be fixed. (Laughter)

My question is concerning that what you were just describing as smelling.

And, I mean, you told us in former shareholder meetings that if management loves money, do not invest.

If they love what they do, preferably if they come tap dancing to the office every day, and all other things are right, then invest.

That resonated to me very good with the biblical truth that not money itself, but love for money, is the root of all evil.

As a principal that once made once made Prussia the largest of all kingdoms, namely the ethos of doing a job for its own sake.

You tell us in this year's report that you buy a company after talking to the owners for no more than 90 minutes.

I'm wondering what kind of — is it the wisdom of experience, just like you described it, or do you do more background work before talking to the owners for 90 minutes?

What's the process like? Do you do background checks or do you talk to competitors?

Do the other people in headquarters do that work for you? How does this whole thing work?

WARREN BUFFETT: Well, it's a very good question. And all of the things you suggest might well make sense. I mean, talking to competitors, talking to ex-employees, talking to current employees, talking to customers, talking to suppliers, all of those things Phil Fisher laid out in a book over 40 years ago, and we have done a fair amount of that over the years.

But, Charlie would have behaved exactly the same way I did on the company you're referring to.

I got a call from Craig Ponzio in December, on a Monday. It was about a company that made custom picture frames.

I'd never heard of the company before. I'd never heard of Craig before.

I didn't talk to him on the phone much more than 15 minutes. He's a very — he'd be here today but his wife became seriously ill, at least we hope it's not serious, but at least there was a problem last night — but Craig talked to me, maybe 20 minutes. And, you can tell when — I mean, it's just all the difference in the world.

And he laid out what the custom frame — how the — custom frame picture business works, and it's not complicated.

I hadn't thought about it for 10 seconds in my whole life up till then, you know. I'd had some pictures framed — you know, I get around (laughs)

But it's not hard — I mean, if you think about it for 30 seconds, you — the economics of the industry will sort of make themselves manifest to you.

There are 18,000 or so framers in the country. It's a small business. So you're dealing with thousands of people.

Now, what's important to those thousands of people that you're dealing to? They're doing 250 thousand, or 300, or 400 thousand dollars of business a year, and they have customers who come in periodically — like I come in once every three months, or every six months, and say, here, I'd like a frame, and they may ask me about what kind of frame I want or I may leave it up to them.

It's a service operation to a very great degree. And Craig built something starting with, in 1980 or so, with 3 million of sales, he built an organization that became enormously responsive to these 18,000 or so framers.

They call on those people five or six times a year. They get 85 percent of the frames to those people the next day when they order them. That's what counts in that kind of a business.

You know, you're not supplying the Big Three with auto parts. You're not — there's all kinds of things that give it a distinctive economic character.

So Craig told me about that, like I say, in not more than 20 minutes. And he told me the price and he told me the capital that was employed and he gave me some — a few figures.

I knew in talking to him that he had a deal that made sense, you know, and I said, when can you come in? That was on a Monday. He said, I'll be there Wednesday morning. And he came with Steve McKenzie, who is here today, and who I encourage you to meet, and I think they got there at nine and they left at 10:30, and we'd shaken hands.

I was hoping to see Craig at the — today — or tomorrow — but I won't because of this illness.

But, I haven't seen Craig since, you know. I mean, we made — he got this money, he knew he was making a deal, he had a reason why he wanted — he wanted to sell it to somebody that would be sure to close, that would be a good owner, where the people who worked there wouldn't be worried because he was leaving.

He was leaving with a lot of money, and, you know, people — he wanted to be sure — a lot of people leave with a lot of money and they leave the employees behind and they don't care what happens. But this guy cared. And I could tell that, and that's a big plus with me.

So, you know, I have not been to their headquarters yet. I plan to be at their headquarters. Steve, I apologize.

But I understand what the business is about. And you can — most good businesses, you can understand what they're about in a very few minutes, unless they're a kind of business that you can never understand what they're about.

I mean, there are other businesses, if you spent years on them you still wouldn't understand what the hell is going on.

I don't know which one of — which American auto company is going to the best 10 years from now. And if I spent all year talking to dealers for Ford and Chrysler and General Motors, and I talked to suppliers, and I talked to people who are driving their cars, I still wouldn't know anything about what it's going to look like five or 10 years from now.

But I know that you can't crack our custom picture frame business. I mean, you cannot figure out a way to call on those 18,000 people that are in that business and figure out a way to divert their business to you when you can't offer a frame as good as ours and you can't offer service remotely like ours. So it's a good business.

And Craig was 100 percent up — I mean, he told me exactly what he wanted to receive for the business. He wanted cash. You know, that fits us.

And there's nothing complicated about it. I mean, you can drag it out for a long time. But what would be the sense of it? I mean, if you're going to make a deal, you're going to make a deal.

Charlie?

CHARLIE MUNGER: Yeah. If you stop to think about it, the ordinary result when a big publicly-held corporation buys another corporation is that, maybe two-thirds of the time, it's a terrible deal for the buying corporation and yet the people have taken an enormous time doing it.

And we've bought all these businesses taking practically no time in doing it, and on average they've worked out wonderfully.

Why is that? That's a good question. The answer is we wait for the no-brainers. We're not trying to do the difficult things.

WARREN BUFFETT: We're for those.

CHARLIE MUNGER: Yeah. And we have the patience to wait. And then we're so peculiar that there actually are a good number of businesses in America where they prefer selling to us than to other people. That's very helpful.

WARREN BUFFETT: I just saw a review of a major company. Made 10 acquisitions in a recent five-year period.

Every one of those 10 acquisitions was preceded by due diligence and all the baloney they go through, and they probably had an investment banker's book and everything.

Not one of the 10 in 2001 lived up — or was even close — to the expectations of the presentation that was made at the time of purchase.

In aggregate, the 10 earned one-quarter of what they were projected to earn in 2001. In other words, the projections were for four times the actual earnings.

And these were companies with strategic — this is a company with a strategic, you know, acquisition department with loads of people to go over the due diligence with investment bankers, quote, "helping them," end quote, all along the way.

And, you know, and 10 out of 10 failed miserably. And, you know, you have to ask yourself, how can you produce that? Because the world didn't go to hell during that period, either. I mean, that was not a time when we went into a great depression or anything of the sort.

It's — they were getting — they were buying what was getting sold to them, and it was fulfilling some things that the management — myths — that the management had about itself. And managements have many myths about themselves.

And it isn't that complicated if you just wait for the fat pitch. And the fat pitch doesn't have to be somebody else doing something dumb or anything like that, because people don't do that.

People come to us, come for a good reason. I mean, they usually want a transaction that a) they want one they're sure to close. They want —if a deal is made — and they want one that will leave the people happy, that are at the business.

When it was announced at Johns Manville, I believe, that Berkshire was the buyer, I understand there was a standing ovation. And I've seen it at, you know, whether it's Jordan's or Star Furniture.

People are concerned. If you've been working at a company for 20 years and you know that the owning family is getting older and has some problems to take care of, believe me, they talk in the hallways about that.

What's going to happen when, you know, the family sells the place? And people worry about that.

And to have an answer for them, so that they all sleep the night that it's announced that the business has changed hands, means some —a lot — to some owners. And it doesn't mean anything to other owners.

I don't think we've ever bought a business from a financial operator. Can you think of any, Charlie?

CHARLIE MUNGER: I can't think of one.

The — you know, somebody once defined hell, in a legal system, as a place with endless due process and no justice. And we're getting close.

And similarly, in the corporate world, if you have endless due diligence and no horse sense, you've just described a corporate hell, at least for the people who own the business.

22. Buffett shows little interest in cryonic suspension

WARREN BUFFETT: Go back to zone 1.

Oh, I'm sorry. Excuse me one second. We have — we have — Mark, do we have a number of people in the music hall that —

Pardon me?

VOICE: Yes.

WARREN BUFFETT: Do we have somebody at zone nine?

VOICE: Yes.

WARREN BUFFETT: OK.

AUDIENCE MEMBER: Mr. Buffett, my name is Luke Nosek from Palo Alto in California.

The first thing I'd like is just to thank you for saving my shirt from the internet stocks for the last few years.

And, actually, it's not quite true. I lost my shirt but you did save my underpants. I bought the stock in late 2000.

And, it’s actually not just been about the stock. It’s about — been about — learning from you and your investment philosophy and your character.

It’s been very inspiring at the beginning of my professional life to have a mentor like that.

And I would love to — (Applause)

I think it’s been very inspiring for all of us for, I guess, it’s been almost 50 years of your investment professional life that’s been continuing to go over the top.

I’d love that — for that — to continue for a long time. I’d love to see the next 50 years.

And, I don’t know if that’s possible, given current medical technology, but I have some friends in biotech who have been involved in companies that do something called cryonic suspension.

And I’m curious if you’ve heard of it. It’s the process of — or looked into it — the process of freezing people as they’re dying, and —

WARREN BUFFETT: Just don’t do it too early with me. (Laughter)

AUDIENCE MEMBER: It’s, actually, legally, after pass away.

But even if the risks are — even if the chances of it working are very small and the discount rate is huge over a long period of time, I wonder if you’d looked into it?

What — if you would consider or think about that possibility?

And again, thank you for your service and all the lessons for the last 50 years (inaudible)?

WARREN BUFFETT: Well, I appreciate the suggestion and there probably isn’t much downside to it. (Laughter)

CHARLIE MUNGER: It takes a lot of electricity to keep you frozen for all eternity. (Laughter)

WARREN BUFFETT: That’s all right. We get our electricity wholesale at MidAmerican. (Laughter)

We’re for anything that extends our productive years.

I must say, at 71, I can’t recall ever having any more fun than I’m having now. And I think Charlie seems to be in pretty good spirits too, so it —

We are lucky to be in the business we’re in. I mean, just imagine, you know, if we’d been in — been halfway athletic, or anything like that, where you’re, you know, you — essentially you’re limited by age.

But, there's really no — there are no problems in this business. I mean, as long as I can kind of lift the phone up (laughs) and hear Craig on the other end, or if I can't hear him, I get him to tell to Charlie and he can relay it on to me.

It's a very easy business to conduct throughout your life. And we're fortunate that way.

23. Fruit of the Loom: good management for good company

WARREN BUFFETT: Zone 10, do we have anybody?

AUDIENCE MEMBER: Good morning. My name is Pamela Harrington and I live here in Omaha, Nebraska.

And my question concerns your investment in Fruit of the Loom.

Could you tell us about how that investment fits in with your philosophy about turnaround situations and your preference for businesses that have barriers to entrance? Thank you.

WARREN BUFFETT: Yeah. Well, Fruit of the Loom got in trouble for two reasons.

One is they borrowed too much money. They borrowed about a billion, 200-million, and actually it went something beyond that because they were engaged in some other transactions that were off balance sheet and so on.

So, it was a company that, in a financial sense, was out of control. Simultaneously with that, they had a lot of operating problems, too.

But we were not going to inherit the capital structure and we were not going to inherit the management that had caused the operating problems.

But, much to our pleasure, we were going to inherit a management that had done an incredible job in running the business for a long time prior to the sins of the recent period.

And, we made a condition — I don't think there'd probably ever been a condition made to a bankruptcy court proposal — where we said our offer is not contingent on financing, it's not contingent on, you know, if war breaks out, our offer is still good and everything else.

But John — but we did make it contingent on John Holland being available to run the business, because John had done a sensational job of running the business before the difficulties of the excess leverage and operating insanities. And he was willing to come back, which was very important to us.

And Fruit of the Loom has, I don't know, between 40 and 45 percent of the men's and boy's market. It's a product that has a deserved quality image.

It’s accepted in a big way by very important retailers who were disturbed by things that took place prior to, and early in, the bankruptcy, but who loved the idea of having a product like Fruit of the Loom in their stores.

And it’s a very low-cost producer of a very basic product.

So, it fits us very well. And now the management can simply worry about building the brand and running plants as efficiently as possible.

And there’s been some rearrangement of plants, as has happened throughout to many things connected with textiles.

But it’s an absolutely first-class business. And, you know, we’d like to get a little more share in the women’s market. We’d like to get a little more share in the men’s and boy’s market, too.

But it’s made to order for us. But it’s only made to order with the present management.

If we had to take on the management that was there for a few years, you know, we wouldn’t have bought it for a dollar. It would have been a disaster. And it was a disaster for a while.

But fortunately, it’s a little like GEICO in the mid ’70s. I mean, GEICO was a marvelous company that got mismanaged in a big way for a while.

But its fundamental advantages were there throughout the period, and what you had to do was get rid of the mismanagement and get back to the basics.

Charlie?

24. Three book recommendations

CHARLIE MUNGER: Yeah, I don’t have anything on that subject, but I neglected to answer the question about what books would we recommend.

The two books that I recommend this year were both sent to me by Berkshire shareholders who thought I might like them, and boy were they right.

The first is called “Ice Age,” which is a description of the past history of glaciation in the last few hundred-thousand years and how they figured out what had happened and why it had happened.

And I think it’s the best book of scientific explanation I have ever read. It’s been published in England and it’s going to be published in the United States this fall. And the airport has like 20 copies — PD Waterhouse — which they did by scrounging all of Canada.

And so, I recommend that book to you, but a lot of you are going to have to wait for the fall, I think.

The other book was "How the Scots Have Helped Create the Modern World." That's a subject that's always interested me, how a tiny, poor, little population of Celtic people had such a huge favorable impact on the world, starting from poverty.

And, of course, it's related to the Irish, who were a similar ethnic strain with a different religion.

And, it was marvelous book. And I forget the author's name, but I recommend both of those books to all of you.

WARREN BUFFETT: Yeah. I'll recommend a book which may sound a little self-serving, but it nevertheless — I think — I think this group, many of you would enjoy reading about the Berkshire managers.

And Bob Miles has brought out a book and it tells about the people who are handling your capital. And, I don't think you could have a — well, I know you couldn't have a better group.

And so therefore, if you feel like reading about them, I would — Bob has done a good job of interviewing — and I would encourage you to read about them.

And I think you'll like your investment better after you read about the managers than if you just read what Charlie and I write.

25. How to make the "right" friends

WARREN BUFFETT: Let's go back to zone 1.

We're going to break at noon, incidentally, and we'll probably break for 30 minutes or thereabouts and then we'll come back. Go ahead.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name is Jesse Spong (PH) and I am 12 years old, from California.

This is my second consecutive year in attendance. My parents brought me here to learn from you.

My question is not about money. It's about friendship.

How do you remain friends and business partners for so long? And what advice do you have for young people like me in selecting true friends and future business partners? Thank you. (Applause)

WARREN BUFFETT: Well, when Charlie and I met in 1959 we were introduced by the Davis family, and they predicted that within 30 minutes we would either not be able to stand each other or we would get along terrifically.

And that was a fairly insightful analysis, actually, by the Davises, because you had two personalities that both had some tendencies toward dominance in certain situations.

But we hit it off. We have disagreed, but we have never had an argument that I can remember at all in 43 years.

And yet we both have strong opinions and they aren't the same strong opinions at times.

But the truth is we've had an enormous amount of fun together, we continue to have an enormous amount of fun, and nothing will change that, basically.

It may have worked better because he's in California and I'm in Omaha, I don't know. (Laughs)

I'll let Charlie comment on it.

CHARLIE MUNGER: Well, that's a wonderful question you've asked, because Warren and I both know some very successful businessmen who have not one true friend on earth. And rightly so. (Laughter)

WARREN BUFFETT: That's true.

CHARLIE MUNGER: And that is no way to live a life. And if by asking that question, you're asking how do I get the right friends, you are really onto the right question.

And when you get with the right friends, if you've worked hard at becoming the right sort of fellow, I think you'll recognize what you have and then all you have to do is hang on.

WARREN BUFFETT: The real question — what is — the question is what do you like in other people? I mean, what do you want from a friend?

And if you'll think about it, there are certain qualities that you admire in other people, that you find likeable, and that cause you to want to be around certain people.

And then look at those qualities and say to yourself, "Which of these is it physically or mentally impossible for me to have?" And the answer will be none, you know.

I mean, you — it's only reasonable that if certain things that attract you to other people that, if you possess those, they will attract other people to you.

And secondarily, if you find certain things repulsive in other people, whether they brag or they're dishonest or whatever it may be, if that turns you off, it's going to turn other people off if you possess those qualities. And those are choices.

You know, very few of those things, you know, are in your DNA. They are choices.

And they are also habits. I mean, if you have habits that attract people early on, you'll have them later on.

And if you have habits that repel people, you're not going to cure it when you're 60 or 70.

So it's not a complicated equation. And, as I remember, Ben Franklin did something like that one time. Didn't he list the qualities he admired, and then just set out to acquire them?

CHARLIE MUNGER: Absolutely. He went at it the way you've gone after acquiring money. (Laughter)

WARREN BUFFETT: They're not mutually exclusive.

CHARLIE MUNGER: No.

26. One thing you don't need for investing

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name is Kevin Hewitt (PH) and I'm a shareholder from Chicago, Illinois. This question is for you, Mr. Buffett, and Mr. Munger.

Mr. Buffett, I've followed your career since I first read about you in the first edition of the Forbes 400 that came out in '82.

Reading your profile also led me to Ben Graham's book, The Intelligent Investor.

Since that time, I've followed the careers of — I've also followed the careers of other successful investors, such as Walter Schloss, Bill Ruane, Richard Rainwater, Robert Bass, and Edward Lampert.

In following your career, and the careers of these other highly successful investors, it's my observation and my firm belief that despite their obvious high level of intelligence and some of them having gone to some of the best schools in the country, none of these people, including yourself, were born great investors.

Every one of these, including yourself, learned to be a great investor. Graham learned from his experience. You, Bill Ruane, Walter Schloss, learned from Graham.

Richard Rainwater learned from you, Bill Fisher, and Charlie Allen, and from reading Graham.

Robert Bass and Ed Lampert learned from Richard Rainwater and, most likely, from reading Graham and Fisher as well.

These observations lead me to the conclusion that despite intellectual brilliance, although that probably helps, I've come to the conclusion that great investors are made, not born.

Do you and Mr. Munger agree with this conclusion? If so, why? If not, why not?

And if you do agree, what things would you recommend that someone do if they wanted to become a great investor?

Also, what mental attributes do you think a person should have if they want to try to become a great investor? Thank you very much.

WARREN BUFFETT: Yeah, I'd largely agree with what you said.

I would say that there — I don't know to what extent — an ability to detach yourself from the crowd, for example — I don't know to what extent that's innate or to what extent that's learned — but that's a quality you need.

I would agree totally with you that a great IQ is not needed. I mean, you do not have to be terrifically smart to do well as an investor, at all.

I would say you're 100 percent right that I learned from Graham first in a very, very big way, and I learned something additionally from Bill Fisher, and I learned a lot from Charlie.

And the proof is in my record, actually. From 11 to 19, I was reading Garfield Drew, and Edwards and Magee, and all kinds of — I mean, I read every book — Gerald M. Loeb — I mean, I read every book there was on investments, and I didn't do well at all.

And I had no real investment philosophy. I had a lot of things I tried. I was having a lot of fun. I wasn't making any money.

And I read Ben's book in 1949 when I was at University of Nebraska, and that actually just changed my whole view of investing. And it really did, basically, told me to think about a stock as a part of a business.

Now, that seems so obvious. You can say, you know, that why should you regard that as the Rosetta Stone? But it is a Rosetta Stone, in a sense.

Once you crank into your mental apparatus that you're not looking at things that wiggle up and down on charts, or that people send you little missives on, you know, saying buy this because it’s going up next week, or it’s going to split, or the dividend’s going to get increased, or whatever, but instead you’re buying a business.

You’ve now set a foundation for going on and thinking rationally about investing. And there’s no reason why you need a high IQ to do that. There’s no reason why you have to be born in some way.

I do think there’s certain matters of temperament that may be innate, they may be learned, they may be intensified by experience as you go on, partially innate, but then reinforced in various ways by your experience as you go through life, but that’s enormously important.

I mean, you have to be realistic. You have to just define your circle of competence accurately. You have to know what you don’t know and not get enticed by it.

You can’t be — you’ve got to have an interest in money, I think, or you won’t be good in investing. But I think if you’re very greedy, it’ll be a disaster, because that will overcome rationality.

But I think the same books I read had really molded what I — how I — thought about businesses and investing. I think that they’re just as valid now.

I mean, I haven’t seen anything in the last 25 years, and I read — I glance through — most of the books. I’ve seen nothing to improve on Graham and Fisher in terms of the basic approach of going about investing, which is to think about stocks as businesses, and then think about what makes a good business.

And really, that’s all there is to investing, and having a margin of safety, which Ben talks about, and so on.

It’s not a complicated process, but it definitely requires a discipline.

It requires insulating yourself from popular opinion. You just simply cannot — you can’t pay any attention to it. It doesn’t mean anything.

So you can’t — the idea of listening to lots of people tell you things, it’s just a waste of time, you know. You’d be better off just sitting and thinking a little bit.

I mean, there were no analyst reports on custom frame makers, you know. It just doesn’t — and they wouldn’t have been any good anyway.

You just have to think, but you have to think about them in terms of their business characteristics and what they can earn on capital employed, and that sort of thing.

I would just read the, you know, I would read the Graham and the Phil Fisher books. And then read lots of annual reports, think about businesses, and try and think about which businesses you understand and which you don't understand.

And you don't have to understand them all. Just forget about the ones that you don't understand.

Charlie?

CHARLIE MUNGER: Yeah, I have a deeper level of generality.

If you have a passionate interest in knowing why things are happening, you always are trying to figure out the world in terms of why is this happening or why is this not happening, that cast of mind, kept over long periods, gradually improves your ability to cope with reality.

And if you don't have that cast of mind, I think you're destined, probably, for failure, even if you've got a pretty high IQ.

WARREN BUFFETT: I would say we've seen relatively little correlation between investment results and IQ.

I mean, not that there are a whole bunch of people out there with 80 IQs that are knocking, you know, the cover off the ball, but there are all kinds of people with high IQs that get no place.

And, yet, it's probably, in a sense, it's more interesting to look at why people with high IQs don't succeed, and then sort of cast out those factors, see if you can cast them out in yourself, and leave a residual that will work.

Because it's like Charlie always says, "All I want to know is where I'm going to die, so I'll never go there." (Laughter)

If you study the people who die financially, you know, with high IQs and say why do they die, you know, you'll see certain overwhelming characteristics that are present in most of the cases.

And you've just got to make sure that either you don't possess them, or if you do possess them, that you can get rid of them or control them in some manner.

27. Coca-Cola's domestic marketing

WARREN BUFFETT: Area 3?

AUDIENCE MEMBER: Yes. Steve Pattice (PH), shareholder from Los Angeles. Good morning, Warren and Charlie.

I'd like to address the domestic Coke business.

It seems to me that Coke has been pulling back from what former great CEO Roberto Goizueta often said, and I paraphrase, we can't control what soft drinks people buy at retail. But in public venues, including food service, we can control that.

We've all heard about the marquee lawsuits that Coca-Cola has had, such as the NFL, United Airlines, and emerging restaurant brands like Baja Fresh Mexican Grill.

But they're also losing contracts with major — or minor — league baseball, college, and high school vendors.

Furthermore, it's my understanding that our competitor PepsiCo has been the fastest-growing domestic beverage company for three consecutive years.

My question is has Coke's vision changed, and is my perception that the domestic fountain division has lost their way correct?

WARREN BUFFETT: No, I would not say that's correct, but I understand the reason for the question. Because there is the question, always, of the marquee-type accounts.

I mean, the truth is, either of the two major colas that are going to be sold and associated with, say, the Olympics or Disney World, or whatever it is, is going to lose a lot of money, if only directly thought of in terms of those contracts.

But there is that association over years. I mean, Coke wants to be where people are happy, and they want that in people's minds.

And that tends to be, you know, sporting events, it's the Disneylands, Disney Worlds, of the world.

But, in the end, can you have a determination to be at every one of them at any price? And the answer, obviously, is no.

It was sort of interesting, about five years ago, or thereabouts, Coke took Venezuela, essentially, away from Pepsi.

Pepsi — Venezuela was one of the few countries in the world in which Pepsi was the leader, and that was because the Cisneros family had developed the business down there very early.

So, Pepsi had 70 percent or 80 percent of the business. And in sort of a midnight raid, Coke bought the Cisneros operation, converted it all to Coke overnight, flew 747s in because they didn't want to have — they wanted it to be a surprise, and they just reversed the whole situation in Venezuela.

And, it actually — whether that is going to turn out to be smart or not is another question, because they paid a lot of money to do it.

But in any event, Pepsi was very upset.

And so, the University of Nebraska pouring rights came up, very shortly thereafter. And the universities, as you know, bid out these things to give sort of an exclusive to a given university.

And Pepsi came in and bid about twice as much for the Nebraska pouring — the University of Nebraska — pouring rights, as was the sort of the standard, in terms of per-student at universities throughout the country, at Penn State or something.

And I like to think that they were trying to stick it in the eye of Coke by doing that in Nebraska. And I feel that the University of Nebraska really should give me credit for about 5 million a year of contribution to the university, because I don't think Pepsi would have done it if it hadn't been Nebraska.

Now, the question is, people at Coke called me, and they said, you know, "Do you want us to go up against this?" And I said, you know, no.

I mean, it's nice to have everybody at University of Nebraska drinking Coke, but if we've got everybody at Penn State drinking Coke, I mean, it's probably worth as much, as potential Coke customers.

So, there is this bit where one organization or the other, particularly if they've lost one in the immediate past, may overbid a little for the next one.

And you know, for United Airlines, the question is how far do you let United, or whomever it is, drive you, in terms of making that specific deal.

I would say that in something like the Olympics, you know, I think Eastman Kodak made a huge mistake when they let Fuji take away the Los Angeles Olympics 20 years ago or so, because it allowed Fuji to get put on a mental parity, to a degree, with Kodak, whereas Kodak had always owned that.

And now Fuji was there with Coca-Cola and IBM and a few premier companies. And it was a mistake.

So, in the end you end up overpaying, in any kind of an objective quantitative sense, for most of these marquee properties. But you can't — it'd be foolish to think that you had to have them all.

Coca-Cola, actually Pepsi-Cola — colas have generally declined, somewhat, as a percentage of per capita consumption in the United States. And Pepsi-Cola has lost considerably more than Coke.

What has kept Pepsi doing well, basically, is Mountain Dew. Mountain Dew has been a very successful product for Pepsi, and that has gained share in carbonated soft drinks.

Carbonated soft drinks — the average person in this room drinks 64 ounces of liquid a year. Carbonated soft drinks are just under 30 percent of that. And beer and milk are each about 11 or 12 percent. They're both down from 10 years ago. Carbonated soft drinks are up substantially.

Bottled water is up somewhat, but the only two categories that are really up are carbonated soft drinks, from ten years ago, and bottled water.

Coffee is down significantly. You think Starbucks has done a lot, but coffee just keeps going down and down and down.

If you look at Coke, of the almost 30 percent of the liquids consumed in the United States, they have about 43 percent of the 30, in their arenas.

So you're talking 13 percent of all liquids, you know, tap water, everything else that the American water — the American people — drink, is a Coca-Cola product.

And it's off a couple tenths of 1 percent from the high, but it's higher than five years ago, it's higher than 10 years ago. And, actually, in the first quarter, it did quite well, too.

So, I think there's been no — I mean, I'm sure there's been no loss of marketing vigor.

Doug Daft is a marketer at heart. He's a, you know, he comes from the same — he's put together the same way as — along the same lines — as Don Keough. There'll never be another Don Keough.

But Doug is the same type of guy. He's in tune with the product.

And I would — if I had to bet, I would bet the market share of Coke, in terms of both carbonated soft drinks and in terms — actually in terms of water.

I mean, the Dasani — the gains in Dasani last year were like 95 percent, in the first quarter they were about 60 percent. Those were huge gains. And Pepsi got an earlier start with Aquafina. But Coke has almost closed that gap.

Coke is a very, very powerful marketing organization. So 18, I think, point-seven billion cases, there's nothing like it in the world.

And I do not think they've lost their focus or drive in any way whatsoever.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: You might try Vanilla Coke, too. It'll be out next month.

28. How long does it take to dig a moat?

WARREN BUFFETT: Area 4.

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger. My name is Jerry McLaughlin. I'm from San Mateo, California.

First, I just want to thank you for all the effort you put into the annual reports, the letters, and these conversations.

I've learned a lot, and they're terrific, which is why I'm here from half a country away. (Applause)

You know, you've said that great companies are those that have an economic moat, and I understand that phrase to mean a sustainable competitive advantage.

Do businesses begin their lives with sustainable competitive advantages, or must that be developed over a very long time?

And then, what are the fundamental bases upon which you've seen companies successfully develop sustainable competitive advantages?

Of those, which do you think is the most enduring and which is the least?

WARREN BUFFETT: Well, sometimes they can develop it very quickly.

I mean, I would say that Microsoft, in terms of the operating system, you know, that was a relatively quick development. But that was an industry that was exploding, and things were changing very fast.

On the other hand, if you go back to See's Candy, which started in 1921, you know, there was no way you could build a sustainable competitive advantage, at least that would be recognizable, in times measured shorter than decades.

I mean, you opened up one shop at a time, and nobody'd heard of you originally, and then a few people did.

And boxed chocolates were something that, you know, people may have bought once or twice a year for a holiday occasion or whatever.

So, you weren't going to embed yourself in the minds of Californians in one or two or five years just because you were turning out, you know, outstanding box of chocolates.

So it depends on the way the industry itself is developing.

Walmart has done a fabulous job in a — an incredible job — in quite a short period of time. But even they, you know, they took it in the small towns, and they progressed along, and refined their techniques as they went.

But I would say that there could be things in new industries.

I would say with NetJets, we have a sustainable competitive advantage. And that's an industry that was only originated in 1986 when Rich Santulli got the idea, and it was in its infancy — I mean total infancy — for a good many years after that.

But what he has built, and is building and fortifying, is that sustainable competitive advantage.

But it depends very much on the industry you're in.

And I mean, Coca-Cola, 1886, Jacobs Pharmacy, Atlanta, Georgia, you know, John Pemberton came up with a product. And did he have a sustainable competitive advantage that day? If he did, he blew it because he sold the place for 2,000 bucks to Asa Candler.

He did — and it took decades, thousands of competitors over that time, and — you know, but they were painting one barn at a time and designing one Saturday Evening Post ad at a time, and all of that.

And — and pebbles — you know, around the world in World War II, General Eisenhower went to Mr. Woodruff and he said, "I want a Coke within the arm's length of every American serviceman." He said, "I want something to remind them of home."

And so he built a lot of bottling plants for Coke around the world. And that was a huge impetus.

But that was, what, 60 years or so after the product was invented. So it takes — it takes a long time in certain kinds of products, but I could see certain areas of the world where a huge competitive advantage is built in a very short period of time.

I would say that probably, in terms of animated feature-length films, for example, Walt Disney did that.

And after "Snow White" and a few more, it took him a while until he could cash in on it, but he — it became Disney and nobody else in that field for quite a while, and fairly quickly.

Charlie?

CHARLIE MUNGER: Yeah, there are a lot of different models that create a sustainable competitive advantage. And there are also some models of where you can lose it very fast.

Just ask Arthur Andersen. That was a very good name in America not very long ago.

And I think it would be harder to lose the good name of Wrigley's gum than the good name of Arthur Andersen.

I think there's some perfectly remarkable competitive advantages that people have gotten over time.

And the great trouble with the investment process is that they're so damned obvious that the stocks sell at very high prices.

WARREN BUFFETT: Snickers has been the number one candy bar for probably 30 or 40 years now.

CHARLIE MUNGER: Yeah, and —

WARREN BUFFETT: Well —

CHARLIE MUNGER: — in Russia, it turns out that everybody likes Snickers.

WARREN BUFFETT: What — how do you really knock it off?

You know, I mean, we make candy, we would love to displace Snickers, but it's hard to think of ways to knock them from the number one spot.

I mean, my guess is that they'll be number one in, you know, 10 years from now in candy bars, and the list doesn't change much in that field because — if you think about the nature of how you make that choice as to what candy bar —

If you were chewing Spearmint chewing gum five years ago, and you buy a pack of some chewing gum today, it's likely to be Spearmint.

I mean, there's just things that you experiment a lot with, and there're things that you don't fool around with once you're happy.

And, you know, you can understand that if you observe your own habits and people's habits around you.

But there's other — usually if something can gain competitive advantage very quickly, you have to worry about them losing it quickly, too.

I mean, when an industry is in flux, there are a lot of people that think they're the survivors, or the ones that are going to prosper, where it turns out otherwise.

29. Bullish on Coca-Cola & Gillette

WARREN BUFFETT: Area 5.

AUDIENCE MEMBER: Mr. Buffett, my name is Pete Danner (PH) from Boulder, Colorado. And I would also like to thank you two for what you bring to the game.

I heard your response to the Coke — to the question regarding Coca-Cola.

In the annual report a few years back, you described Coca-Cola and Gillette as the two "invincibles."

With Pepsi as a strong competitor today, do you still continue to view Coca-Cola as the "invincible?"

Additionally, with respect to American Express Company, with last year's financial results at American Express, how do you now view American Express?

WARREN BUFFETT: Yeah, I think the term I used was "inevitables," actually, but it's very close to the same thing.

And I would — and I think when I made that statement, I said Coca-Cola in soft drinks or Gillette in blades and razors. I mean, I did not extend them to the entire corporate portfolio, particularly in the case of Gillette, but to the blade and razor business.

Gillette now has 71 percent, by value, of the blade and razor business in the world. Just think of that. I mean, 71 percent.

Here's a product that everybody knows what it does, they know how to — you know, they know where it's sold, they know that it's a high-margin business. I mean, it isn't like the world — the capitalist world — is unaware of the money that could be made if they could knock off Gillette.

But they can't knock off Gillette, and it's 71 percent. And that's a little higher percentage than when I wrote about it.

Actually, Coca-Cola's worldwide market share is a little higher now than it was when I wrote that five years ago.

And I would say that five or 10 years from now I would be amazed if Gillette or Coca-Cola has lost market share in their respective fields.

Coca-Cola sells half, roughly, of the soft drinks in the world, and soft drink consumption per capita goes up, basically, every year, and the per capitas go up — I mean the capitas — go up every year, also.

So you get these gains, maybe they're 3 percent or 5 percent in units, or 4 percent, 5 percent in the first quarter, but it was poorer than that. I think it was 3 percent last year.

But when you have half the world, and the world's population is growing at a little under 2 percent and you're getting 3 percent or 4 percent from something as pervasive as soft drinks, you know, you are doing all right.

And it was crazy, in my view, for people to think that earnings can grow 15 or 18 percent a year in a business where units — we had half the world's business, and units are going to grow fine — but they're not going to grow anything like 15 or 12 percent or 10 percent.

The Coca-Cola business has done fine. People went crazy, in terms of valuing some of these businesses a few years back, and I think we had some cautionary language in there, generally, about the valuations at which the businesses sold.

But the businesses — at 71 percent in blades and razors, that is a — there's some countries where it's 90. In the U.S., it's also about 70 percent.

Those are huge market shares of something people use every day. In this country, you know, it's a little over eight ounces per day, more like — well ,actually more like 9 1/2 ounces per day — for every man, woman, and child in the United States, out of the 64 ounces they drink.

Well, you're not going to have galloping percentage increases from that arena. But the company's made, basically, good progress.

People got carried away from the stock — with the stock — and I would argue that they may have gotten encouraged a little bit too much by, not only Wall Street, but even by company pronouncements, in terms of attainable — possibly attainable — gains.

There aren't large companies —you know, there may be one someplace, somehow, very large now that will grow at 15 or 18 percent a year — but it just isn't in the cards in the world.

And we don't want anybody to think Berkshire can do that either, because we can't do it from a very large base. The world doesn't allow that.

But it does allow making reasonable progress, and certainly Coke and Gillette, in those areas where I said they were inevitable, have done very well.

They haven't — Gillette has not done as well with acquisitions, which is clear.

I mean, the Duracell — the Gillette acquisition of Duracell — resulted in giving 20-odd percent of the business for another business, and that business has not done nearly as well as either the management or the investment bankers thought it was going to do at the time the deal was made.

Charlie?

CHARLIE MUNGER: Well, I would say, regarding that last instance, that that's the normal result.

When you try and — you've got a wonderful business and you issue shares in it to buy another business, I'd say at least two times out of three, it's a terrible idea.

WARREN BUFFETT: Well, GEICO is a great example. GEICO is a wonderful business. Absolutely wonderful, gets more wonderful by the day, has the world's best manager, Tony Nicely, running it.

GEICO, in the last 20 years, went into three — at least three — other insurance businesses I can think of.

They went into Resolute Insurance, which was a reinsurance operation started in the mid-80s. It was a disaster.

They went into two others, Southern something or other, and another one that started with an M.

I don't know why in the hell they would go into them. I mean, they had a great, great insurance business, and there aren't that many great insurance businesses. And neither one of those amounted to anything. I think, you know, they sold them off at some point.

But why would you have an absolutely wonderful business and start one and buy two others that are obviously mediocre, where you bring nothing to the party?

But managements — it's very human to want to do that. It's no great sin that the GEICO management did it, because we see it happen time after time after time.

I can tell you this: Charlie and I have no urges like that. I mean, we want to buy easy things. We do not have to prove our manhood by doing something terribly difficult.

And I think a lot of managements feel that necessity. They've got a wonderful business —

The cigarette companies did that. Cigarette companies had these great businesses, and, you know — it irritated them that they — they liked to think they're business geniuses, so they would go out and buy other things and those other businesses, generally, did not do that well.

I'm not saying they should've been in the cigarette business in the first place, but they were not business geniuses because they made a lot of money selling an addictive, you know, product.

That did not make them business geniuses, and so they wanted to prove it other ways, and they bought businesses and fell on their face, in many cases.

Charlie, do you have any more to add on cigarette companies?

CHARLIE MUNGER: No, but I think a lot of people rise to the top in publicly-held corporations, who come up in sales or, you know, engineering, or drug development, or what have you.

It's natural to assume once you're sitting in the top chair that now you know pretty much everything.

Or at least, how to get wisdom out of this wonderful staff and all these outside advisors that are now available to you.

And so I think it's very natural that perfectly terrible acquisition decisions get made, I'd say, more often than not.

30. Staying rational and avoiding confirmation bias

WARREN BUFFETT: Area 6.

We have a break in about five minutes. In fact, we'll do this question and then we'll break.

AUDIENCE MEMBER: OK. My name's Paul Tomasik from Illinois.

I'd like to talk about your thinking, if you don't mind.

In the "Fortune" magazine article that you sent to all the shareholders, you referenced a practice by Darwin that when he found something that was contrary to his established conclusions, he quickly wrote it down because the mind would've pushed it out.

And if you read "The Origin of Species," Darwin's very careful to avoid fooling himself. He very carefully asks and answers the hard questions.

It's a feedback mechanism, and you've picked up on one of his feedback mechanisms to avoid fooling yourself.

So the two questions are this:

If you look — model — how you think, Charlie thinks, how physicists think, how mathematicians think, you see the same pattern.

You want to use logic. You're dedicated to logic. But logic's not enough. You have to avoid fooling yourself, so you build feedback mechanisms.

So the first question is, do you see it that way? That you're thinking just like mathematicians, physicists, and some of the other exceptional businessmen, by being logical and being careful to have feedback mechanisms?

And the second question is about other feedback mechanisms.

Your partnership — sitting next to you is a great feedback mechanism. Hard to fool yourself when you partner with Charlie Munger.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: This meeting's a feedback —

WARREN BUFFETT: Hard to fool him, too. (Laughter)

AUDIENCE MEMBER: But that's not an accident.

The meeting is one level of feedback mechanism, the way you attack the annual report letter is a feedback mechanism.

So you could comment, both of you, on other feedback mechanisms you developed? Thank you.

WARREN BUFFETT: Well, you've come up with two very good ones. I mean, there's no question that Charlie will not accept anything I say because I say it, whereas a lot of other people will.

You know, I mean, it's just the way the world works.

And it's terrific to have a partner who will say, you know, you're not thinking straight.

CHARLIE MUNGER: It doesn't happen very often.

WARREN BUFFETT: There's no question, the human mind — what the human being is best at doing is interpreting all new information so that their prior conclusions remain intact. I mean, that is a talent everyone seems to have mastered.

And how do we guard ourselves against it? Well, we don't achieve it perfectly.

I mean, Charlie and I have made big mistakes because, in effect, we have been unwilling to look afresh at something.

You know, that happens.

But we do have — I think the annual report is a good feedback mechanism. I think that reporting on yourself, and giving the report honestly, whether you do it through an annual report or do it through some other mechanism, is very useful.

But there — I would say a partner, who is not subservient, and who himself is extremely logical, you know, is probably the best mechanism you can have.

I would say that on the contrary, to get back to looking things you have to be sure you don't fall into, I would say the typical corporate organization is designed so that the CEO opinions and biases and previous beliefs are reinforced in every possible way.

I mean, having staff surround you that know what you want to do, you are not going to get a lot of — you're not going to get a lot of contrary thinking.

I mean, most staffs, if they know you want to buy a company, you're going to get a recommendation.

Whatever your hurdle rate, if it's 15 percent internal rate of return, which very few deals ever work out at, you know, or 12 or — they're going to come back, and they're going to come back with whatever they feel that you want.

And if you arrange your organization so that you basically have a bunch of, you know, sycophants who are cloaked in other, you know, titles, you're not going to get — you are going to leave your prior conclusions intact, and you're going to get whatever you go in with your biases wanting.

And the board is not going to be much of a check on that. I've seen very, very few boards that can stand up to the CEO on something that's important to the CEO and just say, you know, "You're not going to get it."

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

And that can be very expensive in the investment and business world.

And, like I say, I think we've got a pretty good system. And I think that most of the systems aren't very good, that exist in corporate America, to avoid falling into the trap you're talking about.

Charlie?

CHARLIE MUNGER: Yeah, I think it also helps to be willing to reverse course even when it's quite painful.

As we sit here, I think Berkshire is the only big corporation in America that is running off a derivative book.

And we originally made the decision to allow the General Re derivative book to continue, and it's a very unpleasant thing to do to reverse that decision, yet we're perfectly willing to do it.

Nobody else is doing it, and yet it's perfectly obvious, at least to me, that to say that derivative accounting in America is a sewer is an insult to sewage. (Laughter)

WARREN BUFFETT: I would second that. I might not have chosen those exact words, and we may not even use those words in describing why we got out of it, but —

Yeah. And in the first quarter of this year, we'll show quite a bit of income — and anything we say here, we ought to put on the internet, Marc — but I think we'll show, what, 100 and, I don't know, 60 million or something like that of financial — maybe it's 140, I'll take a look here.

Well, you'll have 160-odd million of income in that funny little line we have from financials income.

But that will be after an $88 million loss, in terms of getting — the first steps — of getting out of the General Re — what used to be called General Re Financial Products — derivative book.

You know, those losses were there. I mean, some of that is a shutdown loss, 30-odd, 30 million or thereabouts is severance pay and that sort of thing.

But the truth is that derivative accounting is absolutely terrible in this country, and there are a lot of companies that will not want to face up to what would be involved if they actually got out.

Now you're seeing derivative accounting unwound at Enron, in a very major way. And believe me, it's not being unwound at a profit, except to the extent that the bankruptcy court lets them disaffirm certain contracts.

I mean, it is — there was no place where there was as much potential for phonying numbers at a place like Enron than the derivative kind of data.

They were marking-to-model, they were doing all these things.

You give a whole bunch of traders the ability to create income by putting little numbers down on a piece of paper that nobody can really check, and it, you know, it can get out of control. It will get out of control.

And so we decided, finally, to bite the bullet on it, and we'd get out of it.

And it would — incidentally, we would not have reported $88 million of loss if we'd stayed in it. Might have reported a tiny profit or something, but, in the end, you know, the loss was there.

And there will be — it could well be — some more to come in that, because once you get into derivatives — I think our longest contract may run 40 years or something like that.

The guy who put the 40-year contract on the book probably got paid, you know, that week for putting it on, virtually. And, you know, we've got a bunch of assumptions as to how it's all going to work out over 40 years. You couldn't devise a worse system.

And, in the end, you know, we didn't want to be in the business when we got in it, and we are now in the process of getting out.

But you don't get out of fast — out fast — in something like this.

I mean, it's, you know, it's a little like hell. It's easy to get into, and it's hard — very hard — to get out of. (Laughs)

Afternoon Session - 2002 Meeting

1. Blue Chip Stamps plunges under Buffett and Munger

WARREN BUFFETT: You've heard us talk here about the importance of our managers. However, occasionally, Charlie and I get involved in management ourselves. And we would normally be too modest to claim any great accomplishments.

But we have had one rather incredible performance which, since Charlie participated in it as well I do — I think if we put up the slide on the company that Charlie and I have managed personally, you'll see that this entity — you can't — Charlie, here it is, right here.

It's one where we took over 30-odd years ago. And as you can see, the 46,000 became — what?

VOICE: That's the wrong slide.

WARREN BUFFETT: Oh. Excuse me. Are you sure? Oh.

VOICE: Oh, yeah.

WARREN BUFFETT: OK. Well, I guess we better put up the next slide.

We — (laughter) — they got that first one — they got it reversed. We were doing 120 million when we took over, and we're now doing $46,000 a year. But we may get a bounce one of these years. (Laughter)

That was a company that also had a lot of float — (laughs) that we were attracted to. And the interesting thing is, you know, this was Blue Chip Stamps.

Although Blue Chip was a copy, of a sort, of Sperry & Hutchinson, which really was the main inventor of trading stamps on any large scale in the country, and they go back to the 19th century.

But if you think about it, S&H Stamps — Green Stamps — or Blue Chip Stamps, had many similarities to frequent flyer miles. You know, the only difference being that, you know, you got them a lot at, like, grocery stores and all of that and then you had to lick them and put them in a book. Whereas now, it's all done electronically.

But the basic underlying business was very similar to frequent flyer miles, which have this incredible hold on the American public. But somehow, we were not able to make the transfer.

We haven't yet made the transformation, let's put it that way, from the lick-it stamp to something that the public will accept.

But we've still got $47,000 of revenue annually from the entire state of California, so we're building a base. (Laughter)

Charlie and I continue to spend most of our time working on this one.

2. Shareholders share the wealth through philanthropy

WARREN BUFFETT: Let's go to area 7. I think we stopped in area 6 last time, and we'll go from there.

AUDIENCE MEMBER: Yes, my name is Mort November. I'm from Cleveland, Ohio. I'm here with my wife, Iris, who in 1986 founded the Statue of Liberty Collectors' Club.

I wanted to tell you personally what Berkshire Hathaway has meant for me. By owning it, we have become philanthropists in Cleveland. And the way it happened is we sold all our other stock. It was never any fun owning it, and I could never understand that my stock went down and the CEO's bonuses went up.

So, I got rid of that, and we took all of that money and we're doing things for children in Cleveland. On May 16th, we're sending a group — (applause) — thank you.

On May 16th, for the tenth year in a row, we're sending a group of children from Cleveland Municipal Schools, who win the trip by doing good work in their class and good work in the community, to Dearborn, Michigan, Henry Ford Museum, Greenfield Village. It's a lot of fun for them and it's really a lot of fun for us.

We invested in a building in the Cuyahoga National Park for campers, and hopefully we'll be able to help put up an addition to a library in East Cleveland, Ohio, which really needs all the help it can get.

So, my wish for you gentlemen is that you have many, many more years of good health and that we have the opportunity to see you on this stage, or any stage, for as many years as you want. I salute you both.

WARREN BUFFETT: Thank you. (Applause)

It's terrific what a number — a large number — of Berkshire shareholders, particularly the ones, perhaps — well maybe not particularly — but in the Omaha area, because they go way back to the partnership, and a number of them are in their mid-seventies or thereabouts.

But there have been a lot of things that have come out of the stock. In fact, there's been a suggestion that somebody may do a book on some of the things that have flowed from various Berkshire shareholders.

And I'm sure many of you know about the case of Don and Mid Othmer. Don went to Central High, here in Omaha. Mid Othmer's mother, Mattie Topp, was a wonderful woman, who was a customer when I started selling securities when I was 20 or 21, and she ran a dress shop.

And they, you know, they left about $750 million to a group of mainly 4 or 5 charities, one of which was the University of Nebraska.

But there have been all kinds of things. And there may actually be something done on that at some point, but I'm glad to hear what you're doing in Cleveland.

3. Hard to pick pharmaceutical winners

WARREN BUFFETT: Let's hear from area 8, please.

AUDIENCE MEMBER: Hi, my name is Jennifer Pearlman from Toronto, Canada.

Mr. Buffett, in 1998, you were asked to comment on the pharmaceutical industry, and at that time your answer was that you considered it a mistake not to have taken a basket approach to the industry.

I was wondering if you could revisit the issue, now that valuations have contracted so dramatically.

And also, considering that health care spending is outpacing inflation, and that there are significant moats in the industry, I was wondering if you could share with us your thoughts on the health care industry at large.

WARREN BUFFETT: Charlie may be better equipped on that than I am, but it certainly — it's been, as an industry, a very, very good business over time. And if you take the aggregate capital in it and what it's earned over time, it's been a very good business.

And we did make a mistake, your memory's 100 percent accurate, in we'd — in what we said in earlier meetings, because we should have taken a package approach. We actually did buy a tiny, tiny bit, but that's worse than buying none almost. I mean, it's just aggravating — back there in '93.

It's certainly the — they're certainly the kind of businesses that, as an industry, we can understand. We would not have great insights on specific companies. So, if we did something, we would be more inclined to do it on an industry-wide basis.

It's hard to evaluate the individual companies. As you know, Bristol-Myers has recently had a big stumble, and even Merck has fallen back. And so, it's hard to pick the winners.

But that's no reason not to have a basket approach to the industry. And at some valuation level, it would be something we would think very hard about. And it's something where we could put quite a bit of money if it happened, which is another plus to us.

Charlie?

CHARLIE MUNGER: Well, I mean, failed to get it right the last time. We'll probably fail to get it right the next time. (Laughter)

WARREN BUFFETT: I don't know what he had for lunch. (Laughter)

4. Accounting at Coca-Cola and its bottlers

WARREN BUFFETT: OK, we'll go to number 1. Well, wait a second, is there anybody at number 9? Probably not, now.

AUDIENCE MEMBER: Yes, there is.

WARREN BUFFETT: OK, good enough. Nine.

AUDIENCE MEMBER: Phil McCaw (PH), from Greenwich, Connecticut.

Could you discuss if and how you take into account the individual balance sheets of the Coca-Cola bottlers to the Coca-Cola Company, and if you view various regulatory control issues as a potential problem for Coca-Cola?

WARREN BUFFETT: Yeah, well, certain Coca-Cola bottlers became quite leveraged, the ones that were, in general, acquiring companies. Coca-Cola Enterprises certainly became very leveraged over — it started out fairly leveraged, and it became more leveraged in recent times.

And they have a business that's a solid, steady business, but it's not one with abnormal profitability. So, it can take leverage, in the sense that it won't be subject to huge dips, but it also is a business where it's very tough to increase margins significantly.

So, if most of the money goes to debt service, you know, that is something that you have to take into account when you value the equity.

It's a fairly capital-intensive business, the bottling business. On average, you'll probably spend between 5 and 6 percent of revenues on capital expenditures just to stay in the same place.

And in a business that, before depreciation, makes — and interest and taxes — makes maybe 15 cents on the dollar, having 5 or 6 cents on the dollar go to capital expenditures is a pretty healthy percentage of that. That's true at the Pepsi-Cola bottling company, too.

It's just the nature of the bottling business. It's a reason why I like, basically, the syrup business better than the bottling business. It's less capital-intensive.

And I think that the bottling business is a perfectly decent business. It isn't a wonderful business because the — it's very competitive out there.

I mean, on any given weekend, the big supermarket in town, or the Walmart, or whatever, is going to be featuring one or the other of the colas, and they're going to — it's going to be based on price. And you're going to read ads saying, you know, 12 for something or other, or 6 for something or other.

And it has become something where a lot of people will switch from one to another, based on price, on that weekend. And that makes it a tough business for bottlers. But it's a decent business.

But it doesn't, in terms of the Coca-Cola Company, itself, its bottlers are going to do perfectly OK over time. And they've got to earn enough money to be able to sustain that kind of capital expenditure and earn a cost of capital.

And if they get in trouble, it's because, if they pay too much for another bottler, it gets tough to make the math work.

Was there a second question about Coca-Cola then, too?

AUDIENCE MEMBER: Well, I was curious if you concern yourself, when you see FASB-type issues come out about control —

WARREN BUFFETT: No. Yeah, no, I understand. I'm talking —

AUDIENCE MEMBER: Combining all the balance sheets, type of thing.

WARREN BUFFETT: Yeah, that really doesn't make any difference to us. I mean, in the end, the Coca-Cola Company, there's no question about it in my mind, the Coca-Cola Company needs a successful bottling group in order to prosper as a syrup manufacturer.

But the profitability of bottling will allow that. And the capital requirements at the — at Big Coke, as it's called — are relatively minor, so most of the money they make can either be used as dividends or share repurchases.

But nobody's going to run out of money at Coca-Cola, nor are their bottlers, basically, going to run out of money. So, it is not a big balance sheet issue at all. And whether the figures are consolidated or otherwise, the economics are basically the same.

I mean, you have a, you know, there's not going to be a capital crunch of any kind. It would show different ratios if you consolidated and if you didn't, but it really wouldn't change the basic economics any.

Charlie?

AUDIENCE MEMBER: Thank you.

CHARLIE MUNGER: Yeah, I don't think it changes anything on a basic level. But ideally, in the world, you wouldn't have capitalization structures that are designed partly for appearance's sake.

AUDIENCE MEMBER: Thank you.

WARREN BUFFETT: We — thank you.

5. Accounting is a starting point, but it doesn't always reflect reality

WARREN BUFFETT: We pay a lot of attention to what we regard as the reality of the balance sheets and economic conditions and cash situation, all of that of a business. And sometimes we think accounting reflects reality, and sometimes we don't.

It's a good starting point for us always, but I mean, there are companies in the United — there's at least one company, at least last year, that was using a 12 percent investment return assumption on its pension plan, and there are other companies that use, I think, even below six, certainly six.

And in the end, should we look at the figures the same of one company, particularly if the pension fund's a big element, that uses 12 and six? No, we look at what it says they're using.

But, in our minds, we don't think the company that's using a 12 percent assumption is likely to do any better with their pension fund than one of the one's that's using six. In fact, we might even think the one that's using six is likely to do better because we might think they're more realistic about the world.

So, we start with the figures of the companies we look at, but we've got our own model in mind as to what they will look like. It's true of the businesses we own a hundred percent of. Some of them have some debt in them, some of them don't, partly that situation's inherited.

In the end, we've got the same metrics that apply to them, whether they happen to have some debt on their own particular balance sheet or not, because in the end, we're not going to be willing to have very much debt at all at Berkshire.

And where it's placed doesn't really make any difference because we're going to pay everything we owe, no matter where it is. And it's almost an accident whether company A or company B has a little debt attached to it.

6. New goodwill accounting is "making sense"

WARREN BUFFETT: Area 10, is there anybody there?

AUDIENCE MEMBER: Yes, sir. My name Adam Chud. I'm from Columbus, Ohio. I attend the Ohio State University.

My question is, your comments on the new standards for the accounting of goodwill?

WARREN BUFFETT: Yeah, the question about the new standards for goodwill.

Actually, if you read, I think, the annual report — maybe the 2000 annual report, and maybe even earlier.

But we prescribed — we said what we thought would be the preferable system for how goodwill was handled, namely, that it would not be amortized, and that combinations of companies be accounted for as purchases. And it pretty well is what ended up coming out of the accounting profession.

So, the goodwill rules now are in accord with what we believe they should be. And for a long time, they weren't.

You might argue that it was against our interests to have what we think proper accounting has put in, because some people were averse to buying businesses because of a goodwill charge they would incur, whereas it didn't make — it made no difference to us whatsoever. We just looked at the underlying economics.

So we may have a little more competition, even, on buying businesses simply because now, competitive buyers are not faced with a goodwill charge which may have bothered them but didn't bother us. I regard the present goodwill rules as making sense.

Charlie?

CHARLIE MUNGER: Well, I agree.

WARREN BUFFETT: OK.

AUDIENCE MEMBER: Thank you.

7. I used a hearse to pick up your aunt for a date

WARREN BUFFETT: Area 1.

AUDIENCE MEMBER: My name is Martin Wiegand, from Bethesda, Maryland.

Thank you for hosting this wonderful and formative shareholder meeting. Thank you also for running Berkshire in a manner that is an example to corporate America and the world. You make us proud to be shareholders.

My question, you touched on just before the lunch break. Did the compensation plans at Berkshire and its competitors have anything to do with the mispriced insurance policies they issued?

And if so, has Berkshire or its competitors changed their compensation plans to correctly price those policies?

WARREN BUFFETT: Incidentally, I asked you this last year, I think, but are you my Martin's son or grandson?

AUDIENCE MEMBER: Son.

WARREN BUFFETT: Son, OK. Good enough. It — Martin's father and I went to high school together. Matter of fact, your Aunt Barbara and I went to high school together also.

And she went out on one date with me, and that was the end. (Laughter)

It was not because I didn't ask her out again. (Laughter)

I picked her up in a hearse. I think that kind of put the — (Laughter)

8. General Re's "cultural drift"

I think compensation plans lead to a lot of silly things, but I would say that, at Berkshire's insurance companies, I don't think our problems resulted from compensation plans at all.

I think we had an — and we're talking about General Re here basically, because that's where we had the problem.

I think General Re had an enormously successful operation, which went on for a long time. And I think that there was some drift away, perhaps because competitors were drifting away in a big way, too, from certain disciplines, and we paid a price for that.

But I don't think the comp plans entered in at — in any significant way, if at all, into the fact that we did drift away for a while.

I think it — I think you want to have rational comp plans. I think we've got a rational comp plan at General Re, but — and it's quite similar to what we had before. And I just don't think that was the problem.

It's very difficult, it's difficult in the investment world, when other people are doing things that look like they're working very well, you know, and they get sillier and sillier. It's — it could be difficult for many people to not succumb and do the same things.

And that happens in investments, but it also happens in insurance. And it was, you know, it's a competitive world, and your people are out there every day, and they're competing against Swiss Re, and Munich Re, and Employers Re, and all of these people.

And you've worked hard to get clients, and the client says, "I want to stay with you, but the competitor says if I go with him, I don't have to do this or that, or I can get it a little cheaper," or whatever. You know, it's tough to walk away. And it may even be a mistake to walk away in certain cases.

So, I just think that there was a — what you might call a cultural drift. I don't think it was a shift, but it was a drift. And I think it was produced, in part, by the environment in which the company was operating. And it took a jolt to get it back. And I think that it is back.

I think it's probably stronger than ever in terms of what we have now, but I would not attribute it much to the compensation system.

But I have seen a great many compensation systems that are abominations and lead to all kinds of behavior that I would regard not as in the interest of shareholders. But I don't think we've had much of that at Berkshire.

Charlie?

9. "Demented" and "immoral" stock options

CHARLIE MUNGER: Yeah, I think if you talk generally about stock option plans in America, you see a lot of terrible behavior caused. And, no doubt, they do a lot of good at other places. But whether they do more good than harm overall, I wouldn't know.

I think, in particular, if you have a corporation where a man has risen to be CEO, and he now has hundreds of millions of dollars in the stock of the company.

He's been loyal to the company and the company's been loyal to him for decades, and he has his directors vote him a great stock option annually to preserve his loyalty to the company, and his enthusiasm to the business when he's already old, I think it's demented.

WARREN BUFFETT: How about when they grant options as he leaves the company?

CHARLIE MUNGER: I — and I also think it's immoral. I think that there comes a time when — (Applause)

I don't think you would improve the behavior of the surgeons at the Mayo Clinic, or the partners of Cravath, Swaine & Moore, if you gave the top people stock options in their sixties.

I mean, by that time, you ought to have settled loyalties, and you ought to be thinking more about the right example for the company than whether you take another hundred million for yourself.

WARREN BUFFETT: Yeah, well, we had a case — (Applause)

We've inherited some option plans because the companies we merged with had them. And in some cases they got settled for cash at the time, in some cases they continued on, depending on the situation.

But more money has been made from options at Berkshire by accident, and that, you know, this is not — it just happened that way, but more money was made by people that had options on General Re stock during a period when General Re contributed to a decrease in value of Berkshire.

So we had all of the other managers essentially, in a great many cases, turning in fine results, and we had a bad result at General Re, and yet more money, by a significant margin, was made under options at General Re than had been made probably by all other entities combined.

But it was an accident, but that's the point, it leads — it can lead to extremely capricious compensation results that have no bearing on the performance of the people that, in some cases get great benefits, and in other cases people did great jobs and were — their efforts were negated by results elsewhere.

So, it's — it would be very capricious at Berkshire — you can argue that at Berkshire, for those that succeed me and Charlie, that anybody that is in the very top position at Berkshire has got the job of allocating resources for the whole place.

There could be a logically constructed option plan for that person, and it would make some sense because they are responsible for what takes place overall.

But a logically constructed plan would have a cost of capital built into it for every year. We don't pay out any dividends, so why should we get money from you free?

We could put it in a savings account and it would grow in value without us doing anything. And a fixed-price option over 10 years would accrue dramatic value to whoever was running the place, if they had a large option, for putting the money in a savings account or in government bonds.

So, there has to be a cost of capital factor in to make options equitable, in my view, that there can be cases where they make sense. They should not be granted at below the intrinsic value of the company.

I mean, the market — a CEO who says, you know, my stock is ridiculously low when a merger — when somebody comes around and wants to buy the company, but then grants himself an option at a price that he's just gotten through saying is ridiculously low, that bothers me.

So if somebody says, you know, I wouldn't — we don't want to sell this company for less than $30 this year because it's going to be worth a lot more later on, you know, my notion is that the option should be at $30 even if the stock is 15.

You know, otherwise you have a — actually a premium built in of — for having a low stock price in relation to value. And I've never gotten too excited about that.

Charlie, you have any further thoughts on options?

CHARLIE MUNGER: Well, we've been — we're so different from the rest of corporate America on this subject that, you know, we can sound like a couple of Johnny One Notes, but I don't think we ever quite tire of the subject. (Laughter)

A lot is horribly wrong in corporate compensation in America. And the system of using stock options on the theory they really don't cost anything has contributed to a lot of gross excess. And that excess is not good for the country.

You know, Aristotle said that systems work better when people look at the different outcomes and basically appraise them as fair. And when large percentages of people look at corporate compensation practices and think of them as unfair, it's not good for the country. (Applause)

WARREN BUFFETT: It will be hard to change though, because basically, the corporate CEOs have their hands on the switch. I mean, they control the process.

You can have comp committees and all of that, but as a practical matter — I've been on 19 public boards, Charlie's been on a lot of them.

And in the end, the CEOs tend to get pretty much what they want. And what they want tends to go up every year because they see other people getting more every year. And there's a ratcheting effect, and the consultants fan the flames. And it's very difficult to get changed.

And right now, you've got corporate CEOs descending upon Washington, doing everything from trying to persuade to threaten your elected representatives to not have options expensed. And it's — I think it's kind of shameful, actually.

Because it, you know, this group, who is getting fed very well under the system does not want to have those — what clearly is a compensation expense recorded because they know they won't get as much. I mean, it's that simple. And it's not based on anything much more complicated. (Applause)

10. Float size isn't limiting investments

WARREN BUFFETT: Area 2?

AUDIENCE MEMBER: Good afternoon. David Winters, Mountain Lakes, New Jersey.

Mr. Buffett and Mr. Munger, thank you for hosting "Woodstock for Capitalists." I know it's a lot of fun for everybody, and I think a lot of fun for you, too.

Assuming growth of low-cost float and the sins of the past do not impede progress, does the sheer size of the float create constraints that change the allocation of future investments to more high-quality fixed-income obligations rather than equity coupons or workouts that can grow over time?

It seems otherwise Berkshire is incredibly well positioned if valuations ever decline.

WARREN BUFFETT: Well, I think the answer is we probably are pretty well positioned if valuations decline.

And it's a good question. If you have 37 billion of float, are you going to be more constrained to conventional investments than if you were working with a half a billion or a billion, as we were not so long ago?

As long as you have a huge capital position, which we have and will continue to have, and as long as you have a lot of outside earning power, which we have and will continue to have, I don't think we're constrained very much.

I mean, that — we'll always want to have a significant level of liquidity, relative to any kind of payment pattern that we see for a good length of time.

But we will probably be operating with so much capital and with so much earning power, independent of the insurance business, and with so much liquidity, that we really will be able to make decisions as to where — as to how — the assets should be deployed, in terms of, simply, where we see the best returns and virtually no risk.

And sometimes we see virtually no risk in equities when they're extremely cheap. We don't see that situation now, but we could see it again. And I don't think we'll be much — I don't think we'll be very constrained when the time comes.

Charlie?

CHARLIE MUNGER: Yeah, our constraint doesn't come from structure, it comes from a lack of enthusiasm for stocks generally. The bonds are held as a default option.

11. Price of gold not a factor in valuing a business

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: Dear Mr. Buffett and Mr. Munger, my name is Adrian Chur (PH), and I'm a shareholder from Hong Kong.

Thank you for your leadership and inspiration, as always. It's wonderful, always, listening to you. If I may, I would like to ask of you both gentlemen, a question in two parts.

Perhaps I can ask the second part after you've answered the first part. The first part of the question relates to the Fortune article dated 10th of December you included in our shareholder materials.

In this article, you mentioned that one couldn't explain the remarkable divergence in markets by differences in the growth of GNP. However, one could explain the divergence by interest rates.

The first question I have is this: I wonder, sir, if you were to look at the price of gold during the two periods of times you mentioned, that is to say 1948-'64 and '64-'81, if the explanation could be even more clear?

Thus, the logical reason would be why the Dow in '48 was 177 was because — and half the level of 1929, of 381 index points — is because of the 71 percent devaluation of the American dollar from 20.5 cents an ounce to 35 cents an ounce, which would put the fair value of the Dow at 166, after factoring in the record 50 percent per capita gain of the 1940s that you had mentioned.

WARREN BUFFETT: Yeah, I grew up in a household — and my sisters are here — where gold was talked about frequently. So I've been exposed to a lot of thinking on that over the years.

I don't really think gold has really — the price of gold, I should say — has anything, really, to do with the valuation of businesses.

It may reflect certain things that are going on in prices attached to those businesses at given times.

But I would not regard — I mean, the price of gold does not enter into my thinking in any way, shape, or form, in terms of how I value a business today, a year ago, 10 years ago, or tomorrow.

When we look at Larson-Juhl, the custom picture frame operation, you know, I'm not thinking against — I'm not thinking of that and relating it in any way to what gold has done.

So, I — it's just not a factor with us, any more than other commodities would be. I mean, you know, whether it's wheat, whether it's cocoa beans or whatever.

It has — you know, it has a certain hold on some people and they — but we don't look at it as an interesting investment and we don't look at it as a yardstick for valuing other investments.

Charlie?

CHARLIE MUNGER: Yeah, Warren is right when he says that interest rates are very important in determining the value of stocks, generally. And I think he's also right when he says gold is very unimportant.

12. Warning: Speculating is not investing

WARREN BUFFETT: And the second part of the question?

AUDIENCE MEMBER: Thank you, sir. The second part of my question is this: given your assumptions on gold, if you were to factor a significant decline in the value of the dollar against gold, let's say 40 percent or more, and given the correlation of 1929-'48 and '64-'81 eras positively to the decline of the dollar, and the negative correlation in the other two areas that you had studied, would you care to adjust the 7 percent total annual return you were quoted as expecting for common equity in the coming decade?

And in conjunction with that, would you care to comment on your expected rate or return on all other major asset classes, perhaps like bonds, real estates? And which would you believe offers the best value for investors? Thank you very much.

WARREN BUFFETT: Yeah. Well, except under unusual circumstances, my expected rate — my expectancy on something like bonds is what bonds are producing at a given time. I don't think I'm smarter than the bond market.

Now, you can say, when they — when those rates swing all over, does that mean I swing all over? The answer is pretty close to yes. I mean, that — I don't know what the right rate for bonds is. I think that if there's —

I'm very leery of economic correlations. I mean, I spent years fooling around with that sort of thing, and I mean, I correlated stock prices with everything in the world. And the — and you know, the problem was when I found a correlation.

I mean, it's — (laughs) — you know, you've seen these things on whether the AFC or the NFL wins the Super Bowl and all of that sort of thing. You can find something that correlates with something else.

But in the end, a business or any economic asset is going to be worth what it produces in the way of cash over its lifetime.

And if you own a — if you own an oil field, if you own a farm, if you own an apartment house, you know, with the oil field, it's the life of the oil field and what you can get out of it. And maybe you get secondary recovery, maybe you get tertiary recovery.

But whatever it may be, it's worth the discounted value of the oil that's going to come out. And then you have to make an estimate as to volume and as to price.

With a farm, you might make an estimate as to crop yield, and cost, and crop prices.

And the apartment house, you make an estimate as to rentals, and operating expenses, and how long it'll last, and when people will build other new apartment houses that potential renters in the future will find preferable, and so on.

But all investment is, is laying out some money now to get more money back in the future. Now, there's two ways of looking at the getting the money back. One is from what the asset itself will produce. That's investment.

One is from what somebody else will pay you for it later on, irrespective of what the asset produces, and I call that speculation.

So, if you are looking to the asset itself, you don't care about the quote because the asset is going to produce the money for you. And that's how — that's what society, as a whole, is going to get from investing in that asset.

Then there's the other way of looking at it, is what somebody will pay you tomorrow for it, even if it's valueless. And that's speculation. And of course, society gets nothing out of that eventually, but one group profits at the expense of another.

And of course, you had that operate in a huge way in the bubble of a few years ago. You had all kinds of things that were going to produce nothing, but where you had great amounts of wealth transfer in the short term.

As investments, you know, they were a disaster. As means of wealth transfer, they were terrific for certain people. And they were, for the other people that were on the other side of the wealth transfer, they were disasters.

We look solely — we don't care whether something's quoted because we're not — we don't buy it with the idea of selling it to somebody. We look at what the business itself will produce.

We bought See's Candy in 1972. The success of that has been because of the cash it's produced subsequently.

It's not based on the fact that I call up somebody at a brokerage house every day and say, "What's my See's Candy stock worth?" And that is our approach to anything.

On interest rates, I'm no good. I bought some REITs a couple of years ago because I thought they were undervalued. Why did I think they were undervalued?

Because I thought they could produce 11 or 12 percent, in terms of the assets that those companies had. And I thought an 11 or 12 percent return was attractive.

Now the REITs are selling at higher prices and, you know, they're not as attractive as they were then.

But you just look at — every asset class, every business, every farm, every REIT, whatever it may be, and say, "What is this thing likely to produce over time?" and that's what it's worth.

It may sell at vastly different prices from time to time, but that just means one person is profiting against another, and that's not our game.

Charlie?

13. Hard to predict when a bubble will burst

CHARLIE MUNGER: Yeah, what makes common stock prices so hard to predict is that a general liquid market for common stocks creates, from time to time, either in sectors of the market or in the whole market, a Ponzi scheme.

In other words, you have an automatic process where people get sucked in and other people come in because it worked last month or last year. And it can build to perfectly ridiculous levels, and the levels can last for considerable periods.

Trying to predict that kind of thing, sort of a Ponzi scheme which is, if you will, accidentally thrown into the valuation of common stocks by just the forces of life, by definition that's going to be very, very hard to predict. But that's what makes it so dangerous to short stocks, even when they're grossly overvalued.

It's hard to know just how overvalued they can become in addition to the overvaluation that exists. And I don't think you're going to predict the Ponzi scheme effect in markets by looking at the price of gold or any other correlation.

WARREN BUFFETT: Charlie and I probably — I mean, I'm pulling a figure out of the air — we have probably agreed on at least a hundred companies, maybe more, that we felt were frauds, you know, bubble-type things.

And if we had acted on shorting those over the years, we might be broke now, but we were right on probably just about a hundred out of a hundred. It's very hard to predict how far what Charlie calls the Ponzi scheme will go.

It's not exactly a scheme in the sense that it isn't concocted, for most cases, by one person. It's sort of a natural phenomenon that seems to — nursed along by promoters and investment bankers and venture capitalists and so on. But they don't all sit in a room and work it out.

It just — it plays on human nature in certain ways and it creates its own momentum, and eventually it pops, you know. And nobody knows when it's going to pop, and that's why you can't short, at least we don't find it makes good sense to short those things.

But they are — it is recognizable. You know when you're dealing with those kind of crazy things, but you don't know when the — how high they'll go or when it'll end or anything else.

And people who think they do, you know, sometimes play in it. And other people know how to take advantage of it, I mean there's no question about that.

You do not have to have a 200 IQ to see a period like that and figure out how to have a big wealth transfer from somebody else to you, you know. And that was done on a huge scale, you know, in recent years. It's not the, you know — it's not the most admirable aspect of capitalism.

14. Stock options as compensation isn't sinful, but …

WARREN BUFFETT: Area 4.

AUDIENCE MEMBER: Yes, good afternoon, Mr. Buffett and Mr. Munger. My name is Ho Nam (PH), and I'm from San Francisco, California.

I have a question related to an issue you touched on a few moments ago on the debate over whether or not stock options should be expensed and reflected on the income statement of companies.

With the current system, shareholders are incurring the burden of stock options since exercised options dilute earnings per share.

As a shareholder of companies that issue stock options, I think I'm OK with that, especially in entrepreneurial companies that may not have enough cash to attract talent from larger competitors, or in cases where you have younger employees or lower-level employees who do not have the cash to purchase stock without the use of options.

I have a two-part question. If companies are required to expense stock options and it hits — impacts the P&L, does it — would that lead to double-counting the impact of stock options?

And the second part is, if the use of stock options are largely eliminated, might that impact the competitiveness of entrepreneurial companies which help drive innovation and growth and create more of a dividing line between shareholders and employees?

WARREN BUFFETT: Yeah, the first question is that there really isn't the double-counting necessarily.

For example, let's just take a company with a million shares of stock outstanding, selling at a hundred dollars a share.

And let's say that options are granted for 9 million shares — we'll make it extreme — at a hundred dollars a share. At that moment, you've given 90 percent of the upside to the management. We're taking a very extreme example. That's been a huge cost to the shareholders.

Now, interestingly enough, if the stock was selling at $100 a share, the fully diluted earnings are exactly the same as the basic earnings in that year, because the dilution is not counted at all unless the stock is selling above, and then only by the difference in the market value and what it costs to repurchase the optioned shares. So, there is not double-counting.

And you can — you could issue — the very fact that you issued that million, the options on 9 million more shares at 100, would undoubtedly cause the price to actually fall well below 100 and there would be no dilution shown in terms of the way GAAP reports diluted earnings.

The second question, as to whether, if you expense the options, it would discourage the option use.

Well, the argument, you know, that is made when there — people issue options is that it's doing more for the company than giving people cash compensation. It may be more convenient than cash compensation, too, for young and upcoming companies.

But the fact that you are doing something in terms of paying people in a way that you say is even more effective than paying them in cash, to say that therefore you shouldn't have to record the payment, I've never really followed.

I don't have any objection to options under some conditions. I've never taken a blanket position that options are sinful or anything of the sort. I just say they are an expense.

And to be truthful with people about what you're earning, you should record the expense. And if a company can't afford to be truthful, you know, I have trouble with that.

And we will take, as we've said, you can pay your insurance premium to me in options. There'd be lots of companies I'd be happy to take options in and give them credit.

I'd take options above the market. Give me a 10-year option 50 percent above the market in many companies, and we will take that — appropriate number of shares — and take that in lieu of cash.

But that means we simply like, you know, the value of what we're getting better than the equivalent amount of cash and we think the company that gives it to us has incurred an expense.

We've received something of value, they've given something of value up, and that's income to us and expense to them.

And I think all of the opposition, at bottom, to the — to expensing of options comes from people who know they're not going to get as many options if they're expensed. And you know, they would like cash not to be expensed, but they can't get away with that, you know. I mean —

CHARLIE MUNGER: Yeah. (Laughter)

WARREN BUFFETT: If you had an accounting rule that said the CEO's salary should not be counted in cash, believe me, the CEOs would be in there fighting to have that rule maintained.

I mean, because no one would — they would feel that they were going to get more cash if it wasn't expensed, and options are the same way.

It's another argument I get a kick out of, I was just reading it the other day, where they say, "Well, options are too tough to value."

Well, I've answered that in various forms, but I notice that — what is it, Dell Computer, you know, has a great number of put options out, and it's going to cost them a lot of money on the put options they have out.

And for a company to say, "We can't figure out the value of options, and therefore we can't expense them," and then at the same time be dealing in billions of dollars' worth of options, they are saying, "We are out buying or selling options in the billions of dollars, but we don't know how to value these things." That strikes me as a little bit specious — a little disconnected, cognitive dissonance, as they say.

Charlie?

CHARLIE MUNGER: Yeah, I'm not at all against stock options in venture capital, for instance. But the argument that prominent venture capitalists have made, that not expensing stock options is appropriate because if you expense them it would be counting the stock options double, that's an insane argument.

The stock option is both an expense and a dilution, and both factors should be taken into account in proper accounting.

John Doerr, the venture capitalist, as he argues to the contrary, is taking a public position that, "Were it offered to me as part of my employment, I would rather make my living playing a piano in a whorehouse." (Laughter)

WARREN BUFFETT: We always get to the good stuff in the afternoon. (Laughter)

I hope the children are in bed.

15. Hard to predict what happens after a bubble bursts

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Good afternoon. My name is Bob Baden (PH), from Rochester, New York.

Mr. Munger, this morning, while discussing index funds, you used the example of Japan as a real example of poor performance of a major index over a long period.

Indeed, the S&P 500 index declined over 60 percent, in real terms, from the early '60s through the mid-'70s.

Could you discuss the mental models you use to consider the impact of inflation or deflation on your investment decisions and the likelihood of either occurring over the next decade?

CHARLIE MUNGER: Well, that's partly easy and partly tough.

If interest rates are going to go way up, you can obviously have a lot of deflation of stock prices. And a lot of that happened in the American period you're talking about.

What's interesting about Japan is that I don't think anybody thought that a major modern Keynesian democracy, pervaded by a good culture in terms of engineering, product quality, product innovation, and so forth, could have a period where you would have negative returns over 13 years without major depression either.

WARREN BUFFETT: (Inaudible)

CHARLIE MUNGER: I think — and that it would occur while interest rates were going down, not up. I think that was so novel that the models of the past totally failed to predict it.

But I think these anomalies are always very interesting, and I think it's crazy for Americans to assume that what's happening in Argentina, what has happened in Japan, are totally inconceivable forever in America. They are not totally inconceivable.

WARREN BUFFETT: You had a huge bubble in equity prices in Japan, and now you've had interest rates go to virtually nothing.

You've had the passage of time, the country hasn't disappeared. People are going to work every day, and you've had this — the Nikkei, you know, now at a third of what it sold for not that many years ago. It's an interesting phenomenon.

CHARLIE MUNGER: And huge fiscal stimulus in the whole period from the government.

WARREN BUFFETT: Post-bubble periods, I think, depending on how big the bubble is and how many were participating in it, but post-bubble periods, I think, can produce fallout that not everyone will be terribly good at predicting.

16. Ben Graham and the long/short model

WARREN BUFFETT: Six?

AUDIENCE MEMBER: Hi, I'm Steve Rosenberg (PH). I'm 22, from Ann Arbor, Michigan. It's a privilege to be here.

First, I'd just like to thank you both for serving as a hero and positive role model for me and many others. Much more than your success, itself, I respect your unparalleled integrity.

I have three quick questions for you. The first is how a youngster like myself would develop and define their circle of competence.

The second involves the role of creative accounting in the stories of tremendous growth and success over many years. GE, Tyco, and IBM immediately come to mind for me, but I was hoping you could also discuss that issue in relation to Coke.

Some people have said that their decision to lay off much of the capital in the system onto the bottlers, who earn low returns on capital, is a form of creative accounting.

On the flip side, others counter that Coke's valuation, at first glance on, say, a price-to-book metric, is actually less richly valued than it seems because they earn basically all the economic rents in the entire system.

My final question is, if you could comment on the A.W. Jones model, the long/short equity model. I understand that it doesn't make sense for capital the size of Berkshire's to take that type of a strategy.

But it just seems to me that playing the short side in combination also seems incredibly compelling, even giving the inherent structural and mathematical disadvantages of shorting. And I was wondering if you could talk a little bit more about why you would have lost money on your basket of a hundred frauds.

WARREN BUFFETT: Yeah, it's an interesting question. And we'll start — we'll go in reverse order.

Many people think of A.W. Jones, who was a Fortune writer at one time, and who developed the best-known hedge fund, whenever it was, in the early '60s or thereabouts, maybe the late '50s even.

And for some of the audience, the idea originally with A.W. Jones is that they would go long and short more or less equal amounts and have a market-neutral fund so that it didn't make any difference which way the market went.

They didn't really stick with that over time. And I'm not even sure whether A.W. Jones said that they would. But they, you know, sometimes they'd be 140 percent long and 80 percent short, so they'd have a 60 percent net long, or whatever it might be.

They were not market-neutral throughout the period, but they did operate on the theory of being long stocks that seemed underpriced and short stocks that were overpriced.

Even the Federal Reserve, in a report they made on the Long-Term Capital Management situation a few years ago, credited A.W. Jones with being sort of the father of this theory of hedge funds.

As Mickey Newman, if he's still here, knows, I think it was in 1924 that Ben Graham set up the Benjamin Graham Fund, which was designed exactly along those lines, and which even used paired securities.

In other words, he would look at General Motors and Chrysler and decide which he thought was undervalued relative to the other, and go long one and short the other.

So, the idea — and he was paid a percentage of the profits. And it had all of the attributes of today's hedge funds, except it was started in 1924.

And I don't know that Ben was the first on that, but I know that he was 30 years ahead of the one that the Federal Reserve credited with being the first, and that many people still talk about as being the first, A.W. Jones.

Ben did not find that particularly successful. And he even wrote about it some in his — in terms of the problems he encountered with that approach.

And my memory is that a quite high percentage of the paired investments worked out well. He was right. The undervalued one went up and the overvalued — or the spread between the two narrowed.

But the one time out of four, or whatever it was, that he was wrong lost a lot more money than the average of the three that he was right on.

And you know, all I can say is that I've shorted stocks in my life, and had one particularly harrowing experience in 1954. And I have — I can't — I can hardly think of a situation where I was wrong, if viewed from 10 years later.

But I can think of some ones where I was certainly wrong from the view of 10 weeks later, which happened to be the relevant period, and during which my net worth was evaporating and my liquid assets were getting less liquid, and so on. So, it's — all I can tell you is it's very difficult.

And the interesting thing about it, of course, is A.W. Jones was a darling of the late 1960's. And Carol Loomis is here, and she wrote an article called "The Jones Nobody Keeps Up With." And it's a very interesting article, but nobody's writing articles — nobody was writing articles about A.W. Jones in 1979.

I mean, something went wrong, and there were spin-offs from his operation. Carl Jones spun off from his operation, Dick Radcliffe spun off from his operation. There were — you can go down the list.

And out of many, many, many that left, they — a very high percentage of them bit the dust, including suicides, cab drivers, subsequent employment — the whole thing. And these people were —

There was a book written in the late '60s, it had a lot of pictures in it. I don't remember the name of it, but it showed all these portraits of all these people that were highly successful in the hedge fund business, but they didn't bring out a second edition. So, it's just tough.

Logically, it should work well, but the math of only — you can't short a lot of something. You can buy till the cows come home if you've got the money. You can buy the whole company if need be, but you can't short the whole company.

A fellow named Robert Wilson, there's some interesting stories about him. He's a very, very smart guy, and he took a trip to Asia one time, being short, I think it was Resorts International or maybe it's Mary Carter Paint, it was still called in those days.

And he lost a lot of money before he got back to this country. He's a very smart guy, and he made a lot of money shorting stocks, but it just takes one to kill you.

And you need more and more money as the stock goes up. You don't need more and more money when a stock goes down, if you paid for it originally and didn't buy it on margin. You just sit and find out whether you were right or not.

But you can't necessarily sit and find out whether you're right on being short a stock.

I think I'll let Charlie comment on that before I go to your other two questions.

17. "Creative accounting is an absolute curse"

CHARLIE MUNGER: Well, he asked about creative accounting and he named certain companies. I wouldn't agree that all those companies were plainly sinful, although I'm sure there are significant sins in the group as a whole.

Creative accounting is an absolute curse to a civilization. You can argue that one of the great inventions of man was double-entry bookkeeping, where we could keep our economic affairs under better control.

And it was a north Italian development, spread by a monk. And anything that sort of undoes the monk's work by turning this great system into kind of a tool for fraud and folly, I think, does enormous damage to the country.

Now, I think a democracy is ordinarily set up so it takes a big scandal to cause much reform. And there may be some favorable fallout from Enron because that was certainly the most disgusting example of a business culture gone wrong that any of us has seen in a long, long time.

And what was particularly interesting was it took in, eventually, a lot of nice people that you wouldn't have expected to sink into the whirlpool.

And I think we'll always get Enron-type behavior, but it may be moderated some in the next few years.

WARREN BUFFETT: A question of accounting and the economic profits to be gathered in the bottling system versus the production of the syrup, Coke. I've just gotten through reading the annual reports of Coca-Cola FEMSA and Panamco, which are two big Latin American bottlers.

And I mean, they make pretty decent money, quite significant money. And there is more money in owning the trademark. It isn't the plants that make the syrup or anything to sell. The trademark is where a huge amount of value is.

The trademark is where a huge amount of value is in See's Candy. You know, those are big, big assets.

And I would say that you can make good money as a bottler. A lot of bottlers have become rich over the years. If I had a choice between owning the trademark and owning a bottling business, I'd rather own the trademark, but that doesn't mean the bottling business is a bad business at all.

And it's riding on the back of a trademark. I mean, that is why a bottling system is valuable, is because it has the right to sell a trademarked product, which hundreds of millions of people every day are going to go in and ask for by name. And the right to distribute that product is worth good money.

And it really — I don't see any accounting questions in that sort of thing. In other words, if the Coca-Cola Company did not own a share in any of its bottlers, and for many years it either owned a hundred percent of a bottler, or a large part, or — and very few of those — or none of it.

But if they owned no interest in their bottlers, I think the economics would be very, very similar to what they are now.

I mean, the bottlers would still be able to borrow a lot of money because they would have contracts with the Coca-Cola Company, and that were important, and that would allow them to make decent money distributing the product.

But they don't make the kind of money that you make if you own the trademark. That's just the way it works.

18. How to stay in your "circle of competence"

WARREN BUFFETT: What was the first question again that —

AUDIENCE MEMBER: It was how a youngster like myself would define and develop a circle of competence.

WARREN BUFFETT: Oh, yeah, that's a good question. And I'm — you know. I'd — I would say this, if you have doubts about something being into your circle of competence, it isn't.

You know, I mean, in other words, I would look down the list of businesses and I would bet you that you can — I mean, you can understand a Coke bottler. You can understand the Coca-Cola Company. You can understand McDonald's.

You can understand, you know, you can understand, in a general way, General Motors. You may not be able to value it.

But there are all kinds of businesses. You can certainly understand Walmart. That doesn't mean whether you decide whether the price — what the price should be — but you understand Walmart. You can understand Costco.

And if you get to something that your friend is buying, or that everybody says a lot of money's going to be made, and you don't — you're not sure whether you understand it or not, you don't.

You know, I mean, and it's better to be well within the circle than to be trying to tiptoe along the line.

And you'll find plenty of things within the circle. I mean, it's not terrible to have a small circle of competence. I'd say my circle of competence is pretty small, but it's big enough. You know, I can find a few things.

And when somebody calls me with a Larson-Juhl, that is within my circle of competence. I hadn't even thought about it before, but I know it's within it. I mean, I can evaluate a business like that.

And if I get called — I got called the other day on a very large finance company. I understand what they do, but I don't understand everything that's going on within it, and I don't understand that — whether I can continually fund it, you know, on a basis, independent from using Berkshire's credit, and so on.

So, even though I could understand every individual transaction they did, I don't regard the whole enterprise, or the operation of it, necessarily as being within my circle of competence.

Charlie?

CHARLIE MUNGER: Yeah, I think that if you have competence, you almost automatically have a feeling of where the edge of the competence is. Because after all, it wouldn't be much of a competence if you didn't know its boundary. And so, I think you've asked a question that almost answers itself.

And my guess is you do know what you're perfectly competent to do, you know, all kinds of areas. And you do have all kinds of other areas where you know you'd be over your depth.

I mean, you're not trying to play chess against Bobby Fischer or do stunts on the high trapeze if you've had no training for it.

And my guess is you know pretty well where the boundaries of your competence lies. And I think you also probably know pretty well where you want to stretch the boundary. And you've got to stretch the boundary by working at it, including practice.

WARREN BUFFETT: And one of the drawbacks to Berkshire, of course, is that Charlie and I, our circles largely overlap, so you don't get two big complete circles at all, but that's just the way it is. And it's probably why we get along so well, too.

19. Population growth and "carrying capacity"

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good afternoon, gentlemen. Wayne Peters is my name, and I'm from Sydney, Australia.

WARREN BUFFETT: I'd have never guessed.

AUDIENCE MEMBER: No. (Laughter)

I'll speak a little slower so my accent doesn't throw you.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: My question goes further to the resolution on population control raised this morning. Firstly, can I just say I voted against it, and I guess that's just the beauty of the democratic society?

Of concern, however, was the gentleman's implication that the world's population has decreased, or is decreasing.

Having read the book Charlie recommended last year, by Garrett Hardin, called "Living Within Limits," I've got a reasonable feel and understand the population grew by about 1.7 percent last year, which is approximately 67 million people.

In my terms, I'd relate that to approximately 4 times the population of Australia, clearly an alarming rate over the long term if you're talking, you know, 500 or a thousand years.

Reading between the lines, my guess is that the issue of population growth is likely to be a key focus of the Buffett Foundation.

My question to you this afternoon is, how do you currently see this critical issue being tackled?

WARREN BUFFETT: Yeah, well, population projections are just that, they're projections. And they've been notoriously inaccurate over the years. And the gentleman that made the motion referred to a recent New York Times story.

And there are some — there are projections that, based on fertility rates and what happens to them in different countries, under different economic conditions and all that, I mean, you can come up with all kinds of projections.

I don't know the answer on it. Nobody does at any given time. And the carrying capacity of the Earth has turned out to be a lot greater than people have thought in the past, but there is some amount that does relate to the carrying capacity. It may have been expandable, but it's not infinitely expandable.

And I would suggest that the errors of being on the low side, in terms of population relative to estimated carrying capacity, the danger from those errors is far, far less than the dangers from overshooting, in terms of population compared to carrying capacity.

And since we don't know what carrying capacity is or will be a hundred years from now, I think that, generally, that mankind has an interest in making sure it doesn't overshoot, in terms of population. And if it — there's no great penalties attached to undershooting at all that I see.

And it's very, you know, it's the old analogy. If you were going to go on a spaceship for a hundred years and you knew in the back of the spaceship there were provisions — there were a lot of provisions, but you didn't know exactly how much — in terms of filling the front of the spaceship with a given number of people, you would probably err on the low side.

I mean, you would — and if you thought maybe it could handle 300, in terms of the provisions, I don't think you'd put 300 people in there. I think you'd put about 150 or 200.

And you'd figure that you just didn't know, you know, for sure, the spaceship would get back in a hundred years. You wouldn't know how much was in the back. And you would be careful, in terms of not overshooting the carrying capacity of whatever the vehicle you were in.

And we are in a vehicle called Earth. We don't know its carrying capacity. We have learned that it's a lot larger than might have been thought by Malthus or somebody a few hundred years ago, but that doesn't mean it's infinite at all.

And I don't — the one thing I will assure you is that the projections that were run in the New York Times, you know, a few weeks ago, are not going to be the ones that are going to be run 50 years from now, or 30 years from now.

And it's not the sort of thing that is cured after the fact. I mean, you're not going to go around trying to intentionally reduce the population. It's much better to prevent population growth than to try and correct afterwards. And Garrett Hardin has got some interesting stuff on that.

Charlie?

CHARLIE MUNGER: Yeah, I will say that the whole controversy has been interesting in the way both sides don't understand the other side's model.

But by and large, on the population alarm side, the ecology side, they've always underestimated the capacity of modern civilization to increase carrying capacity.

And the more they underestimate, why the least — the less they seem to learn. That is not to the credit.

And the other side has equal folly. I think it's — I think you're just talking about the human condition.

It's a complicated, controversial subject and people feel strongly about it, and they learn slowly. And I just think that's the way it's going to be as far ahead as you can see.

WARREN BUFFETT: I think the chances of a world inhabited by 15 billion people having behavior, on average, better than if the world were inhabited by 5 billion people is low, but you know, that is — we'll never find a way to test that. But that's my instinct on it.

20. Expect "satisfactory" results

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: My name is Bert Flossbach. I'm from Cologne, in Germany. And first of all, I would like you gentlemen, for all the monitoring you have done and the pristine investment philosophy, which is more and more followed in Germany as well.

My question refers to the importance of realism. If the dim prospects of the — on the stock market Mr. Munger made earlier become true, and given that the size of Berkshire Hathaway diminishes the impact of small investments, what do you think would be the realistic return on the float over the next 10 years or 20 years?

WARREN BUFFETT: Well, I wish I knew. The only thing I can tell you is it'll be less than it's been in the last 20 years.

But I think it'll be satisfactory, compared to most alternatives. But I don't know whether the alternatives are going to produce 4 percent a year or 8 percent a year. I don't think they're going to produce 15 percent a year.

And I would think that if we obtain very low-cost float, which I think we should and I think we will, and we keep getting chances to buy businesses on reasonable terms, not sensational terms, and we get occasional market — which we've even had a few occasions of things we've done in the bond market the last few years. We haven't made huge amounts of money, but we've made a pretty good amount of money. And we'll see some things to do on equities.

I think overall, we can have a return that we won't be ashamed of, but we won't come close to a return that you might think, looking back, we could achieve, but —

We don't think the returns on equities are going to be terrible over the next 20 years. We just think that people whose expectations were built by 1982 to 1999 are going to be very disappointed.

But there's nothing wrong with earning 6 or 7 percent on your money. I mean, there — it's — in a world of relatively low inflation, you know, how much more is capital entitled to than that? I mean, it has to come out of somebody.

And to keep doing it on increasing amounts of money, if you earned much higher returns than that, you would have a whole shift in the national income stream over time.

So, I think we'll get chances to do things that will leave us satisfied, but the question is whether they leave you satisfied.

Charlie?

CHARLIE MUNGER: Well, I certainly can't improve on that, but it won't stop me from trying to say something. (Laughter) The —

I think one of the smartest things that a person can do under present conditions is just dampen the expectations way down from the investment achievements of the past, including, of course, with reference to Berkshire stock. I think that's maturity and good sense.

All that said, I like our model and I like what we have in place, and I like what's been coming in recently.

And I think we've had a lot of fun in the past, and some achievement, and my guess is we'll continue to do that.

And I'm just up here, most of the time, to indicate to the rest of you that maybe you've got 10 more tolerable years coming out of Warren — (laughter) — and I'm doing the best I can at that. (Applause)

21. Discipline is more important than location

WARREN BUFFETT: Number 9, please.

AUDIENCE MEMBER: Good afternoon. I'd like to get back to the basics and talk about the insurance side, which is the core of Berkshire.

In ’98, when we bought Gen Re, they had a Lloyd’s syndicate, DP Mann, now known as Faraday. In addition, in 2000, we bought the Marlborough Agency.

I’d like to get your perspective on what you see is happening at Lloyd’s and their future, as well as our commitment to the Lloyd’s market.

WARREN BUFFETT: Yeah, well, we do have what is now known as the Faraday syndicate. And actually, our takedown of their capacity, which I think was maybe, I don’t know, in the area of 30 percent a few years back, is now well into the mid-90s percent.

So, we, in effect, have a much larger commitment, through Faraday, to the London market. And I would think we would do pretty well with that commitment.

But in the end it really doesn’t make any difference whether you’re in London or whether you’re in Washington, as GEICO is, or whether you’re in — I mean, actually, for a while, Ajit lived here in Omaha, or whether, you know, you — it really depends —because you’re — it’s a worldwide market.

You’re going to see things — assuming that you have a reputation for paying claims and for having the capital to do things, and being willing to act — you’re going to see things every place in the world.

It’s really like investing. I mean, you can invest, whether you’re in London or Omaha or New York. It doesn’t make any difference where you’re located.

What counts is the ability to, and the discipline, to look at thousands of different things and select from them a group to do, because you can do anything in the world in insurance.

I mean, we could write tens of billions of premiums in, you know, in a month if we just opened the floodgates, but it’s out there.

There’s lots of business out there. There’s lots of investment opportunities — or investment choices — out there. And the question is, is what you say yes to and what you say no to.

And that should be determined by what you are able to evaluate and, in the case of insurance, even if they’re attractive, preventing an aggregation risk that could cause you major embarrassment at some time.

But we don’t have any — we don’t specifically think the London market is better than the U.S. — being domiciled in the U.S. — or vice versa. And as you know, we have an operation domiciled in Germany. And that isn’t the key to it.

You know, the key is having people making decisions daily where they accept risks they understand and that are properly priced, and avoiding undue aggregation, and the occasional problem, in terms of dealing with people that are less than honest.

But the first two items are the important ones day in and day out. And that can be done at Lloyd's, it can be done at Omaha.

I mean, National Indemnity did not have any great geographical advantage in sitting at 30th and Harney, but it's done very well, just in its primary business, ever since Jack Ringwalt founded it in 1941, or whatever year it was.

I mean, it — and Jack Ringwalt — some of you here may have known him — Jack Ringwalt — a very good friend of mine — but Jack Ringwalt was not an insurance genius.

And he never, you know, my guess is he never looked at an actuarial book in his life or even thought about it. But he just was an intelligent fellow who had enough sense to do — to stick with what he understood in virtually all cases, and to make sure that he got paid appropriately for the risk he was taking.

And he beat the pants off, you know, people that had been around for a hundred years in Hartford, who you know, had vast agency organizations and huge amounts of capital and actuaries and all kinds, you know, all kinds of data and everything.

But they didn't have the discipline that he had. And that's what it's all about.

So, I don't really relate it to geography. I would like to be exposed to as much business in the world as possible and have that exposure be manifested through people that have the disciplines I talked about.

And if we can see everything that takes place in the world, and people want to come to us for one reason or another, often because of our capital position or our willingness to take on volatility —

If those people come to us, wherever they come to us, and the people that they — who represent us use the guidelines we've talked about, we'll do very well.

And you know, the more places they have to intersect with us, as far as I'm concerned, as long as that intersection takes place with people who have that discipline.

Charlie?

CHARLIE MUNGER: Yeah, the insurance business is a lot like the investment business at Berkshire.

If you combine a vast exposure with a vast decline rate, you have an opportunity to make quite a few good decisions.

WARREN BUFFETT: And I think we're making them now. You can check on me next year on that.

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

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: I'm Lowell Chrisman (PH), from Phoenix, Arizona. I am retired and teaching in — seniors in high school. I wish they could be here to hear you today.

I'm teaching these people an investment course part-time. And the first class I went to, they asked me to teach them how to prepare for retirement.

I would like to know what the two or three things are that you would suggest that I include in this course.

WARREN BUFFETT: Well —

CHARLIE MUNGER: What the hell does Warren know about retirement? (Laughter)

WARREN BUFFETT: Yeah. We haven't even thought about it.

Now, let me give you one suggestion for that group. I use this sometimes when I talk to high school — a bunch of high school seniors down in Nebraska Wesleyan, a few weeks ago.

Tell the youngsters in the class, they're probably around 16 or 17, and if they're like I was when I was 16, you know, I was only thinking of two things.

And Martin's Aunt Barbara wasn't going out with me, so I was down to cars. (Laughter)

I tried hearses, but that didn't work. The —

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

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

And you still name whatever the car of your dreams is, and the next morning you receive that car.

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

You know, you change the oil twice as often as they tell you to do. You keep the tires inflated properly. If you get a little nick, you fix it that day so it doesn't rust on you.

In other words, you make sure that this car of your dreams at age 16 is going to still be the car of your dreams at age 50 or 60, because you treat it as the only one you'll ever get in your lifetime.

And then I would suggest to your students in Phoenix that they are going to get exactly one mind and one body, and that's the mind and body they're going to have at age 40 and 50 and 60.

And it isn't so much a question of preparing for retirement, precisely, at those ages, it's a question of preparing for life at those ages.

And that they should treat the importance of taking care and maximizing that mind, and taking care of that body in a way, that when they get to be 50 or 60 or 70, they've got a real asset instead of something that's rusted and been ignored over the years.

And it will be too late to think about that when they're 60 or 70. You can't repair the car back into the shape it was. You can maintain it. And in the case of a mind, you can enhance it in a very big way over time.

But the most important asset your students have is themselves.

You know, I will take a person graduating from college, and assuming they're in normal shape and everything, I will be glad to pay them, you know, probably $50,000 for 10 percent of all their earnings for the rest of their lives.

Well, I'm willing to pay them 10 percent for — $50,000 for 10 percent — that means they're worth $500,000 if they haven't got a dime in their pocket, as long as they've got a good mind and a good body.

Now that asset is far, far more important than any other asset they've got, unless they've been very lucky in terms of inheritance or something, but overwhelmingly their main asset is themselves. And they ought to treat their main asset as they would any other asset that was divorced from themselves.

And if they do that, and they start thinking about it now, and they develop the habits that maintain and enhance the asset, you know, they will have a very good car, mind, and body when they get to be 60. And if they don't, they'll have a wreck.

Charlie? (Applause)

23. Why Berkshire won't be providing guards to airports

WARREN BUFFETT: Number 1?

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I'm George Brumley, from Durham, North Carolina.

It's been reasonably argued that the most critical factor in evaluating a business is establishing the sustainability of a competitive advantage.

Let's assume that we have knowledge in hand about a few truly unique companies that possess sufficient strengths to out-duel the competition, and that we can therefore estimate future cash flows with relative certainty.

I admit that getting this far is far from easy, moreover it seems that the wild card of an unchecked tort system has grave potential to turn even such sound analysis on its head.

Predicted cash flows and reasonably estimated terminal values can be effectively driven to zero for business owners via a transfer to both litigants and litigators.

My question is, how should intelligent investors attempt to factor such uncertainty into their valuations of potential investment opportunities?

WARREN BUFFETT: Charlie's the lawyer, so I'll tell him how — I'll have him tell you how to protect yourself from his brethren.

AUDIENCE MEMBER: And I have quick follow-up.

CHARLIE MUNGER: I think it is entirely fair, as an investor, to just quitclaim certain areas of business as having too many problems.

I almost feel that way about workman's compensation insurance in California.

In other words, the system morphs into something that is so unfair and so crazy that I'm willing to pretty much, at least, leave it behind. And I think there are all kinds of areas like that.

Another fellow and I once controlled a company that invented a better policeman's helmet. And we told them not to make it. We told them to sell it to somebody else who was judgment-proof or — we wanted the policemen to have the helmet, but we didn't want to make it.

I think there are whole areas of activity where, for the already rich, the tort system makes participation foolish. And I think you can sort of figure out where those are and avoid them. I don't think the tort system is going to be fixed quickly.

WARREN BUFFETT: Yeah, George — actually, George Gillespie is, I think, here today. And he and I were directors of Pinkerton 20 years ago. And in fact, we owned a very significant percentage of Pinkertons, although it was controlled by the family foundation.

But one of the interesting problems then was a question of whether we would want to supply guards, for example, at airports.

And if you think about it, Berkshire, itself — well, forget about Pinkerton — would be absolutely crazy to go into the business of supplying guards to airports.

We might be more responsible, in terms of selecting the guards. But if we were to have a guard, say, at that Portland airport from which a plane took off — or where from what the original boarding was of the people that took off from Logan — or we are the guards at Logan or wherever — we might have been held liable for billions and billions of dollars.

You know that people would have gone after us because we would have had deep pockets and we would have had an employee of ours, and people would have said that if it hadn't for your employee, these people wouldn't have all died, and everything else wouldn't have happened.

And for us to be in a business, like Charlie and the helmet business, I mean, for us to be in a business like that would be madness when some other guy operating out of his basement can have guards and if, you know, if they blow up the whole airport it doesn't make any difference because he's judgment-proof.

So, it actually is a system that may discourage, perhaps, more responsible people from ever even dreaming of being in that kind of business.

And unfortunately, I would say that the range of businesses, since 1980, when we were thinking about that sort of thing at Pinkertons, the range of businesses to whom such reasoning might apply has probably enlarged to a significant degree.

There's just a lot of things that a rich corporation shouldn't do because they will pay a price if they are wrong, or if even somebody maybe suspects they were wrong, that would be incredibly disproportionate to what somebody in different economic circumstances would bear.

It's absolutely a selection by the tort system of people that are going to provide certain services and products. And I don't know any answer for that except to avoid it.

24. Finova deal won't be as profitable as expected

WARREN BUFFETT: Now, you had another question, George?

AUDIENCE MEMBER: Yes, just briefly, if you could give us an update on the economics of the Finova deal?

WARREN BUFFETT: Well, the Finova deal is about like — well, it is like when we wrote the annual report.

And actually, Finova's annual report deals with this, too. I think most of you know the terms of it.

We guaranteed what was originally going to be a $6 billion loan that enabled creditors to be paid a large percentage of their claim in the Finova bankruptcy. And we only took down 5.6 billion of the 6 billion because there had been payments made faster at Finova.

Finova was a failed finance company, a very big one, and we were in partnership with Leucadia in this operation. And they have management responsibility, and they're doing a fine job.

That loan of 5.6 billion, on which, in effect, we make roughly a 2 percent override on 90 percent of the loan. So, if it had been 6 billion, we would have had a carry of 108 million a year, although it was going to come down.

Now the loan is down to 3.2 billion, I believe. There was a bulk sale of some franchise receivables for about 500 million to GE Credit here not so long ago.

So the exposure's down to 3.2 billion, but of course the 2 percent override is down to 2 percent on 3.2 billion.

We feel — well, after September 11th, many of the assets at Finova were aircraft. And they were not the latest of aircraft, and they were not to the greatest of lessees in many cases.

So there was a big hit to the aircraft portfolio, and there was — there were other receivables relating to resort properties and that sort of thing, which were also hit by anything that impacted travel and that sort of thing.

So the portfolio was worth less — appreciably less — on September 12th than it was on September 10th. And that will not, in my view — our 3.2 billion, as far as I'm concerned, we've guaranteed it, but I think that is very close to 100 percent OK.

And then there's a group of bonds underneath it which are the residual bonds, you might say, of the ones that existed in the bankruptcy, because 70 percent got paid off and 30 percent didn't. And we own that means of that residual — we own 13 percent or so.

Those bonds are going to be worth a lot less than we thought they were going to be worth the summer of last year.

We bought our position at 67 cents on the dollar, and we've already — we got 70 cents on the dollar, plus these bonds, plus we get the override on the Berkadia loan.

So we got all our money back, and then some, on the bonds that we bought, and we get the override on the Berkadia, so we will, in all likelihood, almost certainly, I would say — although, who knows? I mean, I didn't know about September 11th — but we will almost — we're very, very likely — to make a significant amount of money on the whole transaction, but not as much money as we thought we were going to make last summer.

And we feel very pleased with the way Leucadia's handling things, but there is not as much value in that portfolio today because of the events of September 11th.

Charlie?

CHARLIE MUNGER: Yeah, it's an interesting example of Ben Graham's margin of safety principle. A whole lot has gone wrong that we didn't predict, and yet we're coming out fine.

WARREN BUFFETT: Yeah, we should make some hundreds of millions in aggregate over time on it, but a lot went wrong. But we, as Charlie said, we had a margin of safety when we bought into it, and we felt we had a margin of safety, and it turns out we needed it.

AUDIENCE MEMBER: Thank you.

25. "Hard to find real estate that's really mispriced"

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: I'm Bob Kline (PH), from Los Angeles.

I wonder if you could give us a glimpse into your investment process, the way you approach looking at a particular industry. And I wonder if you could use real estate as an example.

I know real estate hasn't been a big, huge part of Berkshire's portfolio over the years. And I wonder if that's because you view real estate as a commodity business or if, maybe, the cash flows from real estate tend to be more predictable than, perhaps, from some other industries, and thus, it tends to be less likely to be mispriced, and therefore less likely to find terrific bargains in real estate. So —

WARREN BUFFETT: Yeah, you're — go ahead.

AUDIENCE MEMBER: So, just wondering if we could — if we were watching a discussion between you and Charlie hashing out the merits of real estate,[tell us] how it would go.

WARREN BUFFETT: Well, it would go like all our other conversations. He would say no for about 15 minutes — (laughter) — and I would gauge by the degree to which he — the emotion he put into his 'no's as to whether he really liked the deal or not. (Laughter) But the —

We've both had a fair amount of experience in real estate, and Charlie made his early money in real estate. The second point is the more important point.

Real estate is not a commodity, but I think it tends to be more accurately priced — particularly developed real estate — more accurately priced most of the time.

Now, during the RTC period, when you had huge amounts of transactions and you had an owner that didn't want to be an owner in a very big way, and they didn't know what the hell they owned, and all of that sort of thing, I mean, you had a lot of mispricing then. And I know a few people in this room that made a lot of money off of that.

But under most conditions, it's hard to find real estate that's really mispriced.

I mean, when I look at the transactions that REITs engage in currently — and you get a lot of information on that sort of thing — you know, they're very similar. But it's a competitive world and, you know, they all know about what a class A office building in, you know, in Chicago or wherever it may be, is going to produce.

So at least they have — they may all be wrong, as it turns out, because of some unusual events, but it's hard to argue with the current conventional wisdom, most of the time, in the real estate world.

But occasionally there have been some, you know, there could be big opportunities in the field. But if they exist, it will certainly be because there's a — there'll probably be a lot of chaos in real estate financing for one reason or another.

We've done some real estate financing and you have to have the money shut off to quite a degree, probably, to get any big mispricing across the board.

Charlie?

CHARLIE MUNGER: Yeah, we don't have any competitive advantage over experienced real estate investors in the field, and we wouldn't have if were operating with our own money as a partnership.

And if you operate as a corporation such as ours, which is taxable under Chapter C of the Internal Revenue Code, you've got a whole layer of corporate taxes between the real estate income and the use of the income by the people who own the real estate.

So, by its nature, real estate tends to be a very lousy investment for people who are taxed under Subchapter C of the code relating to corporations.

So, the combination of having it generally allows the activity for people with our tax structure, and having no special competence in the field means that we spend almost no time thinking about anything in real estate.

And then such real estate as we've actually done, like holding surplus real estate and trying to sell it off, I'd say we have a poor record at.

WARREN BUFFETT: Yeah, C corps really, it doesn't make any sense. I mean, I know there are C corps around that are in real estate, but there are other structures that are more attractive.

There really aren't other structures — I mean, Lloyd's is an attempt at it, to some degree — but there aren't other structures that work well for big insurance companies, or —

I mean, you can't have a Walmart very well that does not exist in a C corp. So, they are not subject to S corp, or partnership competition, that determines the returns on capital in the discount store field.

But if you're competing with S — the equivalent of S corps — REITs or partnerships or individuals, you've just got an economic disadvantage as a C corp, which is, for those of you who don't love reading the Internal Revenue Code, is just the standard vanilla corporation that you think of — all of the Dow Jones companies, all of the S&P companies, and so on.

And as Charlie says, it's unlikely that the disadvantage of our structure, combined with the competitive nature of people with better structures buying those kinds of assets, will ever lead to anything really interesting.

Although, I would say that we missed the boat, to some extent, during the RTC days. I mean, it was a sufficiently inefficient market at that time, and there was a lack of financing that— we could have made a lot of money if we were — had been geared up for it at that time.

We actually had a few transactions that were pretty interesting, but not — but nothing that was significant in relation to our total capital.

CHARLIE MUNGER: We thought significantly about buying the Irvine Corporation —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — when it became available. So, but that's the only big one I can remember that we seriously thought about.

WARREN BUFFETT: Yeah, and that was in 1977 or so, as I remember?

CHARLIE MUNGER: Way back.

WARREN BUFFETT: Yeah, Mobil Oil was interested, and you know, Don Bren ended up putting together a group for it.

And that kind of thing could conceivably happen, but it's unlikely.

26. The problem with how Black-Scholes values options

WARREN BUFFETT: Number 3?

AUDIENCE MEMBER: Hello, my name is Joseph Lepre (PH). I'm a shareholder from Minneapolis, Minnesota, and I'd like to thank you for this opportunity to ask a question.

Mr. Buffett, you mentioned earlier today that you'd be willing to sell insurance in exchange for stock options. If possible, could you please describe a methodology for the valuation of stock options, particularly in cases where there is no market pricing data available for the option being valued?

WARREN BUFFETT: Yeah, I would — I could figure out what I would pay for an option on a private business. I could figure out what I could pay for an option on a public business. It might be a little easier. I could figure out what I'd pay for an option on an apartment house or a farm.

I had a friend, I mean, when I was 20 years old, we developed a big plan and we were going to go out and option out — option farms, you know, outside of what were then the city limits of Omaha.

And we figured that if we offered a farmer a modest amount, which would be annual income to him, to option his farm at double the price it was bringing then, that it would, you know, he would be happy to sell for double the price that year, and maybe we could do something. And it might have worked out OK.

Every option has value. You know, I've got a house worth X. If you offer me a few dollars to give you an option at 2X for 10 years, I'm not going to take it, because there are all kinds of possibilities in terms of inflation.

All options have value. And people that get options usually understand that better than people that give options. I'm not talking about stock options now, but in other arenas.

So we would be happy, you know. I mean, what I could get — let's say — we'll just pull one out of the air. Let's take an untraded company like Mars, Inc.

Would I be happy to have an option, a 10-year option on a piece of Mars, Inc. at some given price?

Sure, I would. And there's an amount I would take for that — I would take in lieu of getting cash if I was writing a big insurance policy with Mars, Inc. They're not going to do this with me, but that —

And I would be happy, you know, instead of if you buy homeowner's insurance from me, if you want to give me an option on your house for 10 years, I'll take that in lieu of the premium.

I'll make my own calculation as to value. It won't be Black-Scholes, although that might be the best arrangement under many circumstances, but I would probably crank into — in my own case.

We've bought and sold options some. And as a matter of fact, on June 3rd, Berkshire Hathaway will receive $60 million if the S&P 500 closes at 1150-something or below.

And two years ago, when the S&P was 14-something, we agreed for — on that June 3rd option, or whatever it was — $400 million nominal value, where, in effect the counter party would get the profit above 2,000 and something, 42 percent up from the current cash price. And we got the profit between 5 and 20 percent on the downside on a put.

People who were calculating the values of options at that time, under traditional methods, felt that that was a cashless transaction — that the value of the call that we gave was equal to the value of the put that we received. You know, I decided differently.

So, we don't accept, blindly, option values as determined by the calculations of people who win Nobel Prizes. Instead, you know, we actually put an aspect of judgment into some.

There would be businesses that would come out with identical Black-Scholes values on options for 10 years, and we would pay a different amount for one than the other, maybe a significantly different amount.

But we would pay something for just about any option. And you know, it is the nature of prices in this world to change, and economic conditions to change. And an option is a chance to participate in a change without giving up anything other than that original premium you pay.

Many people just don't seem to grasp that, but believe me, the people who are getting options on stock do grasp that.

And the people who are giving them, which are the shareholders, you know, represented by a group like this, who don't have any real voice in giving it, but they sometimes don't fully realize what's being given away.

Imagine, you know, going up a few miles away from here and having two farms for sale. And you say to the guy, "How much do you want for them?" and they both say a thousand dollars an acre, but the one guy says, "But every year, I want you to option, you know, I want you to give me 2 percent of the place back at a thousand. So, you know, at the end of 10 years, 20 percent of the upside belongs to me, but you've got all the downside." I mean, which farm are you going to buy? The one without the options or the one with the options? It's not very complicated.

And we will — we are dead serious when we say we will take options in lieu of cash. Incidentally, the company that gives us those options in lieu of cash for an insurance premium has to record the expense in terms of the fair value of the option they've given us.

The only item for which they don't have to record that as expense is compensation. But if they give it to us for their light bill, or if they give it to us for their insurance premium, or they give it to us for their rent, they have to call it a cost.

But only when it comes to the CEO's compensation, and other people like it, do they not have to record it as a cost, and that's because they've been able to get Congress to bow to their will and to their campaign contributions.

Charlie?

CHARLIE MUNGER: Yeah, the Black-Scholes crowd really did get a Nobel Prize for inventing this formula to value options, not executive stock options, but just options generally.

And if you don't know anything about the company, except the past price history of stock transactions —

WARREN BUFFETT: And dividends.

CHARLIE MUNGER: — and if it's — and the dividend being paid — and if the option is over a very short term, it's a very good way of approximating the value of the option.

But if it's a long-term option and you think you know something, it's an insane way to value the option.

And Wall Street is full of people with IQs of 150 that are using Black-Scholes to value options that shouldn't be tortured into the model.

And all of corporate — of America is using Black-Scholes to price stock options in the footnotes of the accounting statements, and they do that because it comes up with the lowest cost number.

WARREN BUFFETT: Well, they not only do that, but they assume the term is less than the actual term of the option. And I mean, they'll do everything they can, and I've been in on these discussions. They'll do everything they can to make the number look as low as possible. It's that simple.

CHARLIE MUNGER: And they're using a phony process to determine the number in the first place. So, it's a Mad Hatter's tea party, and the only thing that's consisting — consistent — in it is that the whole thing is disgusting. (Laughter and applause)

27. Investment bankers are "in the lucky part of society"

WARREN BUFFETT: Number 4, please.

AUDIENCE MEMBER: I'm John Golob, from Kansas City. I'm mostly retired, but also teach a course on financial markets at the University of Missouri in Kansas City.

I always tell my students that I learned much more about investing at Berkshire Hathaway meetings than I ever did from my professors at the Wharton School. (Applause)

I have a general question about investment banks. Now, given your connection with Salomon, I'm always surprised at sort of the attitude you represent to this industry. Somehow I get the idea that you view them as just their main social value is charging very high fees for unnecessary churning.

I'm wondering if you have any perspective on the general influence of investment banks in U.S. finance that is — rising or falling.

I hate to be a Pollyanna, but I might hope that Enron-like debacles would reduce, maybe, the influence of investment banks, that people wouldn't necessarily trust, you know, some of the advice they're giving.

WARREN BUFFETT: I think Enron is bound to have some favorable fallout in various areas. I mean, it — to the extent that it causes people to look more carefully at how various entities behave and that sort of thing. No, I think Enron was a plus for the American economy.

And the truth is our capital system, you know, despite all kinds of excesses and errors and everything else, you know, one way or another, we've come up in this country with 50-odd-percent of the world's market value for 4 1/2 percent of the world's population.

So, you know, I'm not negative on how the American capital system has developed. I do get negative about how certain people behave within that system, but you know, they would behave badly in any system. So, you know, it's the human condition.

But that is, you know, Charlie and I still think we should criticize things that we think are improper, but we don't criticize the whole system in any way, shape, or form. It's — you know, it's been a tremendous economic machine in this country.

But I would say that a market system, and I don't have anything better than — in fact, I think a market system is responsible in a material way for the prosperity of this country. So, I have no substitute in mind for the market system.

I do think it produces extraordinarily inequitable results, in terms of some overall view of humanity, and that that should be largely corrected by a tax system.

I don't think it should be any comparable worth system or anything like that. I just — the idea of the government trying to — (laughs) — assign all that just strikes me as wild.

But the market system lets a fellow like me, you know, make so much money because I know how to allocate capital, you know, compared to a great teacher, or nurses, cancer — whatever. I mean, it just showers rewards on somebody that has this particular skill at this particular time.

And that's great for me, but it should — there — in a really prosperous society, that should — there should be some corrective aspects to that.

Because it really strikes me as inappropriate that the spread of prosperity in a hugely prosperous economy should be decided totally by the quirks of skills that come into play and get rewarded so hugely from the market system.

So, I — but I, you know, I believe that — that's why I believe in a progressive tax system, and so on.

I would say, in terms of investment banking particularly — I mean — (laughs) — I was standing one time with an investment banker, and he was looking out the window, and he said, "Just look." He says, "As far as you can see, nobody's producing anything." And I said, "Yeah, that seems to be a mandate they take pretty seriously, too." (Laughter)

But it — you know, there is a huge amount of money in a system, you know, with 14 trillion, or whatever it may be, of market values, and where people are spending other people's money, and corporations, and where the more you spend for something, sometimes you get — gets equated with value as in fairness opinions, and all of that sort of thing.

It's quite disproportionate to what I really think the ultimate contribution to the country is of various people, but I don't have a better system — (laughter) — to substitute for it. I don't want anybody to think — come away thinking that I think we ought to tinker with that very much.

I think that the — I think your tax system should be the way that you distribute the prosperity in a somewhat better way.

When we ask people to go to war, you know, or that sort of thing, we don't take the person who's made the most money and say, "Well, they benefited the most from society, so we'll send them and put them in the front lines," or anything like that.

I mean, we — there's various aspects of being a citizen in this country that I think should make sure the people that don't get the great tickets for — that make them prosper in a market setting, they still should do pretty darn well, as far as I'm concerned.

And really, people like me shouldn't, you know —

It doesn't make any sense to compensate me the way this world has. And it wouldn't have happened if I'd been born in Bangladesh, or it wouldn't have happened if I had been born 200 years ago.

You know, somebody — another one of those genie stories. Imagine, you know, when I was — 24 hours before I was born and there had been some guy with exactly my DNA right next to me, who was also going to be born in 24 hours. And the genie had come to the two of us and said, "We're now going to have a bidding contest.

"And the one that bids the most of their future income gets to be born in the United States, and the one that loses in this is born in Bangladesh. And what percent of your future income will you give to be born in the United States?"

I'd have gone pretty high in the bidding. (Laughs)

You know, I mean, that would have been an interesting test of how important I thought my own abilities were compared to the soil in which I was going to be planted.

So, I, you know, I feel I'm lucky, and I am lucky, I mean, obviously. But I think we ought to figure out ways to take care of the people that are less lucky.

And I think that investment bankers should consider themselves in the lucky part of society.

And you know, there's nothing wrong with what they do. Raising capital for American business is a fine thing and all that. I just think that they are paid, in relation to the talent and that sort of thing they bring to the game, I think they are paid obscenely high, but I think that's true of me, too.

Charlie?

CHARLIE MUNGER: Yeah, the — but I would argue that the general culture of investment banking has deteriorated over the last 30 or 40 years. And it — remember, we issued a little bond issue, Warren, way back?

WARREN BUFFETT: Yeah, 6 million.

CHARLIE MUNGER: Diversified Retailing. And we had this very high-grade investment bankers from Omaha and Lincoln. And they cared terribly whether their customers, whom they knew, were going to get their money back.

WARREN BUFFETT: Yep.

CHARLIE MUNGER: And they fussed over every clause in the indenture, and they talked about whether we were really OK. And so, that was a very admirable process that we were put through.

WARREN BUFFETT: Yeah, we were screened in that.

CHARLIE MUNGER: We were screened, and intelligently screened. And it may not have been too intelligent to let us through, but it was an intelligent process.

And I'd say the culture on Wall Street lately has drifted more and more to anything that can be sold at a profit will be sold at a profit.

WARREN BUFFETT: Yeah. Can you sell it? That's the question.

CHARLIE MUNGER: Can you sell it is the moral test. That is not an adequate test for investment banking. And —

WARREN BUFFETT: And there used to be two classes of investment bankers, too, really. I mean, there were the ones that did the screening and all of that.

And then there was a really low-class element that essentially merchandised securities no matter what they were. And there were clean lines, but the lines have disappeared.

CHARLIE MUNGER: Yeah, so it hasn't been good to have this deterioration of standards in high finance.

And will it ever swing back? You would certainly hope so.

WARREN BUFFETT: You can see why were so popular at Salomon. (Laughter)

CHARLIE MUNGER: But in fairness, we had a very effective investment banking service from Salomon.

WARREN BUFFETT: That is true. That is true. And we — when we sold the B stock, for example, now we set the rules. And they wouldn't have done it that way necessarily, but they did a very good job of doing it the way we asked them to do it.

And so, we said we don't want people hyped into the stock. We want a very low commission and we're going to issue as much as the market takes so that nobody gets excited about the after-market behavior and buys because they think it's a hot issue.

I mean, we set a bunch of rules we thought were rational, and Salomon did a terrific job of following through on that and doing exactly what we asked them to. And it was successful by our standards.

So, no, I would say they did a terrific job in that case.

CHARLIE MUNGER: And they thoroughly enjoyed doing it, the people working on the job.

WARREN BUFFETT: That's true.

CHARLIE MUNGER: They'd never done one like it before.

WARREN BUFFETT: That's true. Yeah.

We've changed our whole opinion here in a matter of seconds. (Laughter)

CHARLIE MUNGER: Well, but there's a lesson in that.

Certain kinds of clients get higher quality service than other kinds of clients. In fact, there are many clients who should never be accepted at all at investment banking houses, yet they are.

WARREN BUFFETT: Are you thinking of the fellow at Normandy? (Laughter)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: I mean, can I you imagine that guy even getting in the door? I mean, it just — it blows your mind. I mean, he went to jail subsequently. He should have.

CHARLIE MUNGER: He was married to his high school teacher, who was at least two decades older than he was.

WARREN BUFFETT: Charlie has more opinions on this kind of thing than I do, but go ahead. (Laughter)

CHARLIE MUNGER: There were enough peculiarities in the situation. (Laughter)

I wouldn't have thought it so peculiar, except that he was a man and she was a woman.

28. Dexter Shoe acquisition was a mistake

WARREN BUFFETT: OK, number 5. (Laughter)

AUDIENCE MEMBER: Good afternoon. Mike Envine (PH) from Chelmsford, Massachusetts.

I noticed in the annual report that you took a charge-off for Dexter and put it under the management of H.H. Brown.

And I was thinking back, I believe in 1985 you wrote about the process you went through in closing the textile business. And I was wondering if you could elaborate how this situation is different.

I believe you indicated, in the textile business, that despite excellent management, it wasn't possible to earn an economic return on the assets.

WARREN BUFFETT: Yeah. Did you say that we took a charge-off on H.H. Brown?

AUDIENCE MEMBER: No, I meant to say we took a charge-off on Dexter.

WARREN BUFFETT: Oh, Dexter, yeah, absolutely. We lost a very significant amount of money on Dexter, thanks to a dumb decision that I made, and maybe several dumb decisions.

And I mean, that is a business that went offshore in a huge way. They're close to 1,200,000,000 pairs of shoes made in — or used in this country. I never can figure out how they get to that number. I mean, I use a pair — (laughs) — about every five years. But four for every man, woman, and child. I don't know, but that's the number.

And you know, I don't know whether it's 5 percent now, but it's something in that area, are made in this country, and hundreds of thousands of jobs have gone offshore with that.

The textile business, as you know, has gotten almost destroyed in this country. And when you have somebody like Burlington go into bankruptcy, you know, a wonderful company, spent lots of money on keeping their plants up to date and all of that sort of thing.

But in the end, you know, if you're paying 10 times as much per hour for labor as somebody else, it's awfully hard to be that good.

And that's going on in furniture manufacturing now, too. We have a number of furniture retailers and, you know, Bill Child, or Irv Blumkin will go over to the Orient fairly frequently now. We'll buy — we buy a lot — a lot of furniture comes from there. And that trend is moving in that direction in a very significant way.

And your question is — was your question why Fruit of the Loom would be different?

AUDIENCE MEMBER: No, I was just wondering if there's any hope for Dexter, or if it's going down the same path as with textiles?

WARREN BUFFETT: Oh, no, well, Dexter is now part of H.H. Brown, and it's selling product which, overwhelmingly, is produced abroad. And H.H. Brown sells a very significant amount of product that's produced outside the United States, although they still produce a lot of product in the United States.

But — no, the Dexter — we will have a significant shoe business. The shoe business — we had some contracts on the books from Dexter that were unprofitable, and they will run for another quarter. But we made a fair amount of money in the shoe business in the first quarter. Justin made money.

I think our shoe business will be OK. It won't be a bonanza over time, but I think our shoe business — we've got very good management in there. We've got good management at H.H. Brown, and we've got good management at Justin.

And I would expect that we would have a substantial and a reasonably profitable shoe business in the future, but we will not be able to do it with a hundred percent or 90 percent or 80 percent domestic-produced shoes.

And in that respect, I was very wrong in paying what I did, and paying it in the manner I did, which was stock in the case of Dexter, for a domestic shoe manufacturer.

Charlie?

CHARLIE MUNGER: Yeah, that shows, which is important to show, that no matter how hard you work at having systems for avoiding error and practices of trying to stay within your circle of competency, et cetera, et cetera, you still make mistakes. And I think I can confidently promise that it won't be our last mistake.

WARREN BUFFETT: OK, here's our Blue Chip Stamps. (Laughter)

But you know, you might think about this a bit, too. We had a lot of workers up in Dexter, Maine, and we've had a lot of workers at some of the H.H. Brown plants.

And you know, we take a little hit financially and we make it up by some trading strategy in government bonds or something like that, that requires, you know, no effort and not really too much brain power.

And when you think of the consequences to the people that have spent a lifetime learning one trade, you know, and who live in those areas, and through no fault of their own — none, I mean they've done a good job — they've done a great job — working.

They're productive, but in the end, you know, their cost was 10 times or more, and they weren't getting paid that well, but 10 times what it could get done for elsewhere in the world.

So, we haven't really paid the price for that change in economic conditions. I mean, it's the people who work there, the people who work at Burlington, or wherever, where the jobs disappear.

And that's no argument for huge tariffs or anything of the sort. But retraining doesn't do much good if you've worked in our textile mill, as many people did years ago, and you're 60 years old and you only speak Portuguese.

Or if you work in Dexter, Maine, and you're 58. I mean, retraining, it gets kind of meaningless. So, we're the lucky ones, you know, basically in these situations.

And it is tough when you know one trade, particularly if you live in a small town, not lots of other employment opportunities or anything. So, you know, we have a charge-off and they have a huge change in their lives, basically.

29. Contrarian shareholder thinks annual report is too short

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Jack Hurst (PH), Philadelphia. I have 3 questions, or 3 points.

The first is, I want to thank you for the pleasure it is to shop at Borsheims or Nebraska Furniture Mart, or even Benjamin Moore.

You have terrific people working there, and I've never been as satisfied with products as with what I've bought at those firms.

WARREN BUFFETT: Oh, well, thank you for that. And I thank you on behalf of the managements. They are terrific people that work at those companies.

AUDIENCE MEMBER: I agree with that.

You've dropped quite a bit from the annual report. There must be some God-given decree that it be limited to 72 pages.

But I wondered if you could put that in an internet message, such as that wonderful table about GEICO, its renewal policies and new policies, and the four pages at the end of the report about the business categories, where you separate the insurance from the finance from the manufacturing, and also that discussion that you had of look-through earnings. I think that it's invaluable for looking at the company.

WARREN BUFFETT: OK, well, I appreciate the suggestions. And I —

AUDIENCE MEMBER: I have a third point. Oh, go ahead.

WARREN BUFFETT: But we do go through a — I mean, I don't know whether 72 pages is the magic number, or when I get to about 11,000 words, but occasionally, you know, we do make an editorial decision.

The look-through earnings, for example, didn't seem that important, and they're fairly easy to roughly calculate, for anybody that's interested. But you know, they are something that if I wrote for 15,000 words, I would have included.

So, I appreciate the suggestion on it, and I don't think anybody's accused me of writing too short a report — (laughter) — yet. But I'll take —

It's certainly on the — it's possible on the internet to put up anything, and we'll put up any material we've given you here before the opening on Monday morning so that nobody has a jump on any information.

We try to make it — I mean, I really want to cover the things that would be important to me if I were hearing about them on the other end. And we try to keep it to some number of pages, but I'm glad you want more. (Laughs)

30. Simplicity helps keep audit fees low

AUDIENCE MEMBER: OK, the third point is — the first of March, the Wall Street Journal analyzed — or compared — the auditing fees by the fees related to audit services and other audit services for the 30 stocks in the Dow Jones Industrial Average.

And there seems to be an inverse relation between the amount of non-audit fees with respect to market capitalization, an inverse correlation with that factor to the five-year compound growth of earnings, or the five-year total return for the companies.

And for the top — for the companies with the lowest ratio of non-audit fees to market capitalization, the increase in earnings was 10 percent annually. The total return was 18 percent annually.

For the other — for the total — it was 5.2 percent return annually on increase in earnings, and 11 percent increase in total return.

Is it because these non-audit fees are non-productive that it has this result? Or is it a chance — just a spurious fluctuation? Or is there something to the relation?

WARREN BUFFETT: I don't know the answer to that. And I hadn't seen what you are referring to. But it doesn't totally surprise me, because we like places that care about expenses.

And you know, I've never — I think Jack Welch had something in his book about no, you know, no company ever getting — going broke from cutting expenses too rapidly.

And when you see managements that are pretty lavish in what they toss around, you know, I think on balance that group doesn't do as well for shareholders as the other, but I have no statistical way of proving that.

And I don't know a way that — I don't know how you would set up a sample that would really be valid in terms of one kind versus the other kind.

But what you say doesn't shock me. We try to watch all expenses around Berkshire.

And I think that, at our subsidiaries, we — generally speaking — we have managers that are very, very good about that.

And I think that our audit costs, relative to the size of the enterprise and all of that, I think, are fairly low, although they're not as low as they were a few years back. But it's something that we care about, I can assure you of that.

I don't know how to — I wouldn't want to buy stocks, though, or sell stocks, based on any kind of statistical measure like that, even though that it looks good on what they call a backtest.

Charlie?

CHARLIE MUNGER: Well, one of the reasons our audit costs are so low is we have this passion for keeping everything simple. We don't want to be difficult to audit. And we prefer activities that are simple.

If you take the See's Candy company, the whole company goes to cash at the end of December every year, as if it were a farm where the crop came in and was sold in December.

I mean, an idiot could audit the See's Candy company without getting into trouble. (Laughter)

And there's a lot in Berkshire that's like the See's Candy company. It would be really hard to screw up.

31. Arthur Andersen as Enron's collateral damage

WARREN BUFFETT: We don't like complicated accounting. I mean, it — we really do like things that produce cash.

And Enron is a good example. Enron's grotesque in what happened. But there's no question in my mind that auditors have been unduly compliant to client wishes over the last few decades, and more so as they went along, even to the point where they started suggesting what I would consider quite dubious accounting to people in mergers and so on, so as to make their figures look better later on. And I've seen it firsthand.

So, I just — I think that although the auditors are supposed to work for the shareholders, that they got too much so they were working for management.

But I think that Enron may push them back significantly, even in the other direction. So, I think Enron will have a distinct beneficial effect on auditing, and it was needed.

CHARLIE MUNGER: Well, it's going to have a distinct beneficial effect on one fewer auditors. (Laughter)

WARREN BUFFETT: Yeah, although — (applause) — you know, it's an interesting question, and Charlie and I may differ on this. I mean — I don't think that — I don't know how many people Andersen employed, but it was a huge number.

And I certainly — it's clear that the weaknesses and culpability at Andersen goes far beyond anything remotely we saw at Salomon.

But it would have been a shame for Salomon, with 8,000 people, to have, actually, the bad acts of one guy, and the lapse in terms of reporting and all of that — which was a big mistake, but by a few other people — cause 8,000 people to get dislocated in their lives and lose their jobs.

I don't know, how do you feel, Charlie, about, you know, the bottom 40,000 people at Andersen who really didn't have a damn thing to do with shredding or the Houston office or anything of the sort? I mean, their lives are really getting changed in many cases.

CHARLIE MUNGER: I regard it as very unfair and totally undeserved in all those cases. Yet even so, I think that capitalism without failure, as somebody once said, it's like religion without sin or —

WARREN BUFFETT: Religion without hell.

CHARLIE MUNGER: — religion without hell.

I think when it gets this bad, and the lack of adequate control mechanisms throughout the system, I mean, Andersen plainly didn't have a good total system of control.

And I think that it may be that capitalism should just accept this kind of unfairness in all these individual cases and let the firms go down.

WARREN BUFFETT: Well, let's say you and I did something really terrible, Charlie, at Berkshire. How do you feel about the 130,000 people then? I mean, should they —

CHARLIE MUNGER: You'd feel terrible about them, and there's no question about it.

And — but I'll tell you something, they wouldn't go down. The way we're organized, they wouldn't go down.

Warren, there's nothing you can do that is going to destroy the value of the subsidiaries — (applause) — and the careers within the subsidiaries.

You can blow your own reputation, you can blow the reputation at the holding company level, but you can't destroy their livelihood. I — that is a good —

WARREN BUFFETT: Well, we can mess up —

CHARLIE MUNGER: — way to be organized.

WARREN BUFFETT: We can mess up their lives though, I mean, if they lost their funding. Or yeah, I mean, I agree with you about their —

CHARLIE MUNGER: Not very much.

WARREN BUFFETT: — viability, but you know —

CHARLIE MUNGER: Not very — Andersen was particularly vulnerable, being a professional partnership.

But maybe you should be extraordinarily careful if you're a professional partnership, with what clients you take on and how far you go for them.

The law firms that I admire most have fairly strict cultures of risk control. I think it's crazy, in the kind of world we inhabit, to operate in any other way.

32. No formula to pick out great investors

WARREN BUFFETT: OK, number 7. (Applause)

AUDIENCE MEMBER: My name is Rheon Martins (PH), from Cape Town, South Africa, and I became a big fan and avid reader of your ideas about 10 years ago.

In 1999, I did an MBA and was nicknamed Warren Buffett, because I quoted you in all the classroom discussions.

All I wanted to learn was how to value a stock and think about the stock prices, but sadly I was rather disappointed to find out that our MBA did not really teach that.

Mr. Buffett and Mr. Munger, my question is this: if you had to predict who would be the superior investors from a group of young, bright people, who share your investment philosophy and possess the realism and discipline you referred to earlier, which characteristics or work habits would you like to know about the individuals in the group?

And what weighting would you place on each factor to ensure the greatest probability of your prediction being correct?

WARREN BUFFETT: Well, that's too easy a question for me, so I'll let Charlie answer that. (Laughter)

CHARLIE MUNGER: I think the fair answer to that one is that I'm not capable of answering it.

WARREN BUFFETT: No, but I do — I think this: I think that's exactly right. I mean, if you ask me what should — how should you pick a wife, you know, 18 percent to humor, 12 percent to looks, you know, 17 percent, you know, to parents.

I can't give you the formula, but I think you'll make the right decision, you know — (laughter) — when you get —

And I think if Charlie and I were around a dozen very bright MBAs with good records and all of that, and we spent some time with them, I think we'd have a reasonable chance of picking somebody from that group that might not necessarily be number one, but they would be in the upper quartile, in terms of how they actually turned out.

And I — but I can't tell you how to, you know, I can't write out a software program or anything that will enable you to do that.

It — you know, I had that problem exactly at Salomon that went — on that Saturday morning, whatever it was, August 17th, and I had to pick a guy to run the place.

And there were a dozen or so people that all thought that they were the ones, or a number of them thought they were the ones to run it.

And they all had high IQs, and they all had lots of experience in investment banking and everything, and I — you know, in the end, I had to pick one.

And I did pick the right one, I will say that. And you know, was I — could I be a hundred percent sure at that time it was the right one? Well, probably not, but I felt pretty sure I had the right one.

And I can't tell you — I've had people say to me, "Well, what did you ask them? And how did you evaluate it?" and all, because I only had about three hours to do it.

And, I don't know. I mean, I can't write you out a set of questions that you should ask somebody.

And, you know, some of it may be body language and different things of that sort. There are a lot of variables in it.

But I think, in the end, you would have picked the same person I picked if you'd been in that spot.

You'd had to pick somebody in the three hours. And it — but quantifying it for you, I just — I can't do it.

Charlie, have you got —

CHARLIE MUNGER: Yeah, well, when multiple factors are causing success, you get these anomalies. You have two people who are going to be equally successful, and one is terribly good at A and terrible at Z, and the other is terribly good at Z — is very good at Z — and terrible at A.

They're equal. Which factor is most important? The answer, it doesn't matter in that case. When you've got multiple factors, great strength in one will compensate some for weakness in another.

And the factors can be quite different. I think the investment world is full of people who are succeeding based on quite different sorts of talent.

WARREN BUFFETT: We'll try to do better next year.

33. Why See's won't be sold at Costco

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Good afternoon. My name is Catherine Dorr (PH), from Minneapolis, Minnesota. This is my first time here. Thank you for hosting this meeting today.

With the political and financial and corporate developments since September 11th, I am thankful every day that persons of your integrity and the managers that you have are still managing my inheritance money.

And I believe that the character and integrity is the most important criteria. I can sleep well at night.

I have two questions. The first one is for Mr. Munger.

When will there be a permanent store location, not a cart, of See's Candies at the Mall of America in Bloomington, Minnesota? (Laughter)

This is the largest indoor shopping mall, I believe, in the country, and hosts thousands of domestic and foreign visitors each year. A hint, you can sell See's Candies to other nationalities when they visit us.

Also, is it possible for Costco stores to sell See's Candies, since Mr. Munger has a shareholder interest in Costco? I would be interested in his answer. We could sell related products in our system. And I'll wait for his answer to ask the second question to Mr. Buffett.

CHARLIE MUNGER: The — the short answer to your questions is that, under our decentralized system, decisions of that kind go, rightly, to the person in charge of See's, who's here, Chuck Huggins.

And he may not be here through this afternoon session. He may have some limited interest, but Chuck can answer those questions. He knows a lot about candy.

WARREN BUFFETT: We had a Helzberg — we do have a Helzberg's at the Mall of America though, incidentally.

CHARLIE MUNGER: We have a what?

WARREN BUFFETT: We have a Helzberg's operation at Mall of America which does fine.

And I would add, we have not done as well moving away from the West as Charlie and I might have — well, certainly as well as we hoped for when we originally bought See's.

I mean, we've done way, way better in terms of the overall result, but it has been interesting to us.

Now, bear in mind, no one really makes any money with boxed chocolates through retail — through their own retail outlets in the United States, except for See's.

I mean, it — there's only one pound per capita of boxed chocolates, roughly, sold in the United States. I'm told I gave the wrong figure on — I said 64 ounces per year on people drinking. You really don't look like you only drink 64 ounces of liquid a year, it was a day.

But on this one, it is one pound per capita per year on boxed chocolates. So, it is not a big business. It's not a business — well, the truth is hundreds and hundreds of firms, including some that were a lot larger than See's, have failed. And there really is no one making any money elsewhere.

Russell Stover makes very good money selling through a distribution channel that is different, but nobody's found a way to do it in stores. We've found a way to do it in the West. We have not found a way to do it elsewhere.

And it's very irritating to me, and to Chuck, as far as that's concerned, that we can't figure out a way, because it's so successful when it works, as it does in the West.

But the answer is you can look at Archibald Candy, you know, the bonds are selling for 50. They own Fanny Farmer and Fannie May and Laura Secord up in Canada.

It is a very tough business in this country, because Americans just don't buy much boxed chocolate.

They're always happy to get it as a gift. Everybody in this room would love to get a gift of it, and they may buy it when they're here, but you don't normally walk down the street and — or walk in a mall and buy it for yourself. It's usually a gift or it's usually at holiday time.

So we don't do as well as you might think we would when we get to very successful malls that are located in other parts of the country.

We have opened holiday shops, kiosks really, at 50 stores at Christmastime, around the country, away from our natural territory. And we make some money out of that, but we wouldn't make money if we were there year-round.

And we've been thinking about it, I'll guarantee you, for 30 years because it's a terrific business where it works.

And it's a very good question you ask, because you would think, I mean and the Mall of America is an obvious example.

Simon would be tough to deal with, the landlord, but we could figure out a way to do that.

And the — but you would think we could make money at a Mall of America.

And we do fine with Helzberg's there, but I'm not positive a candy store would work. But we may try one, just because you asked the question. We'll — I'll talk to Chuck about it. (Laughter)

AUDIENCE MEMBER: OK —

WARREN BUFFETT: How about Costco?

AUDIENCE MEMBER: My second question —

CHARLIE MUNGER: Oh, Costco —

AUDIENCE MEBER: Oh, I'm sorry.

CHARLIE MUNGER: Costco makes its own decisions, and so does See's. And I wouldn't think of getting into that one.

AUDIENCE MEMBER: Oh.

WARREN BUFFETT: Well, I'll get into it. (Laughter)

We don't want people discounting our candy, it's very simple, any more than Rolex wants somebody discounting their watches.

And we will not — we're not going to go through any distribution channel at See's. We're already getting a bargain at our retail prices — (laughs) — and we're not going to go through any other distribution channel — any distribution channel at See's that's going to discount.

And Costco has no interest, and I don't blame them. I mean, they are based on giving people special prices. And that's fine, and God bless them, and, you know, we'll buy things from Costco, but we're not going to sell a product where the price is part of the integrity of the product — we're not going to sell it through a distribution system that — where discounting is basic to their whole approach.

Costco is a wonderful operation, and See's is a wonderful operation, and never the twain shall meet. (Laughter)

AUDIENCE MEMBER: Very logical.

34. Why Berkshire issued its B shares

AUDIENCE MEMBER: My second question is to Mr. Buffett.

Since I am a new shareholder, and because this is my first attendance here, I am not sure if this question has been asked before or not. And if it is addressed in your publications, I may have overlooked it, so please bear with me.

This is on the relationship between the A and the B shares. On page one of the booklet it states, quote, “Each share of Class A stock is entitled to one vote per share, and each class of — each share of Class B stock is entitled to 1/200th of one vote per share,” close quote.

Calculating the voting weight per share would therefore be 200 Class B shares equaling one vote equally weighted of one Class A share. However, the Class B share price is 1/30th, traditionally, of a Class A share.

Given that the B share owners are purchasing into the same corporation and assets as the A share owners, and the cash is just as green no matter which share you buy, therefore it would be logical that the voting weight and price relationship of the shares be proportional all around, either 1/30th or 1/200th of pricing and voting weight, respectively.

The question, therefore, is why are the B shares not given voting weight of 1/30th instead of 1/200th? Or conversely why the B shares are not priced at 1/200th of an A share?

This may or may not be popular depending on with share you own. And I would appreciate your insight on that.

WARREN BUFFETT: Yeah, thank you. It’s a good question. I — you may not be aware of the history of the issuance, but we issued the B shares — there were no — I mean, they’re just a common share, so we renamed the old shares A shares. But we issued the B shares, whatever it was, what, seven or eight years ago, Charlie? Something like that.

And we did that in response to some people, particularly a fellow in Philadelphia, who we felt was going to induce people who really didn’t understand Berkshire at all into a terribly expensive way of owning tiny pieces of Berkshire, probably sold on the basis of an historical record that we did not think was representative of what could be incurred in the future.

In other words, we were disturbed by somebody who saw a chance to make a lot of money off of people who were really uninformed, using our stock as the vehicle.

And we were going to reap the unhappiness of those people subsequently. They’re going to run into tax problems and various administrative cost problems, and so on.

So, to ward that off, and only to ward that off, I mean, we issued the B stock, which effectively put that fellow out of business, because it was a better vehicle for doing what he was going to try and get people to do, at great profit for himself.

And when we issued it, it had not existed before, and we made — we put two differences in it from the A stock.

A, we wanted to create a lower value per share, so we did it on a 1/30th basis. At the time, it was around $1,100 or thereabouts because the A was selling for in the low 30,000.

But we put on the prospectus, which is a very unusual prospectus in other respects, we put on there we were going to differentiate the stock in only two ways, but we were going to differentiate it in those two ways.

And one was the voting power, because we didn't want to issue the stock and we didn't want to change the voting situation much.

And the second way was in terms of the designated charitable contributions, which we — the A was going to continue to enjoy and the B would not participate in.

And the reason the B wasn't going to participate in it is because the amounts would have gotten to the point where it would have been an administrative nightmare. I mean, this year, we designated $18 on the A shares. We've got a lot of one-share B holders, which would be 60 cents. And it just — it does not make any sense.

And we saw that, so we just said if you buy the B shares, you're buying into an instrument which economically is equal to 1/30th of an A. In voting, it is not equal to 1/30th of an A because we don't want to change the voting that much.

And it does not — it has a slight economic difference in terms of the fact it doesn't get to participate in the charitable contributions program, which is a very small item relative to the whole capitalization, but it's still — it's something.

But we do not — you'll notice our A and B, compared to other companies that have different voting arrangements — I was just looking at one the other day where the premium for the voting stock is 10 or 12 percent, or something like that, relative to the economic interests.

That's because people assume that if, you know, if the company's ever sold, or anything like that, the guy that owns the A will get treated better than the B. And Charlie and I have been in a situation where we got somewhat taken because of a situation — because of a relationship like that.

We will treat the B exactly as the A, except for those two things, which, at the time of issuance, we set out as being differences. We set — and those two items, everybody saw coming into the picture, and they're going to stay — they will stay as part of the picture.

Actually, you know, in terms of when the meeting will be held two years from now, you know, we aren't even going to vote by votes in a sense.

I mean, I'm going to get a sense of what people want to do, but I regard, in that respect, I think that it ought to be the most convenient for the most people, not for the most number of shares.

A will not vote any different than B or anything because, you know, you're all individual people and I want whatever works best for the most.

But in terms of those two other items, they were set out that way and they'll stay that way.

If — you know, if we'd set out a different — we would not change the relationship once the — of the two stocks once they were issued. We would not benefit one relative to the other, but those are the terms of the two.

Charlie?

CHARLIE MUNGER: Yeah, we had to issue the B stock to frustrate the ambitions of this jerk promoter. And — (laughter) — yet, we didn't want to split the A stock down into — all of it — down to tiny little fractions, which would have frustrated him, but forced us to have a stock split we didn't want.

So, we created a vehicle which was — had these two slight disadvantages, and that kept most of our capitalization in its traditional A-stock and also frustrated the promoter. It's an historical quirk. It's an accident of life.

WARREN BUFFETT: And the B is sold at a remarkably consistent relationship to the A. If the discount got as low as — or as high, I should say, as — I think it was over 4 percent for a small period of time — but it's, generally speaking, the B is sold at parity to slightly, very slightly, below parity.

And indeed, A shares get converted to B, and that would not happen unless the B were at parity. So, it — I think it's worked out pretty well. I mean, we didn't — we backed into it, but I don't think anybody's been disadvantaged by it.

35. Leasing of silver doesn't affect its price

WARREN BUFFETT: Number 9?

AUDIENCE MEMBER: I'm reading the question of Mark Rescigno (PH), from New York. "I've idolized you since I first heard of you 10 years ago. My only regret so far is that both of my children are girls, so I couldn't name them Warren."

WARREN BUFFETT: How about Warrenella? (Laughter)

AUDIENCE MEMBER: That might work.

Is there any merit to the argument that leasing of silver is suppressing the price of the metal, and thereby not allowing it to reflect the fundamentals?

WARREN BUFFETT: Oh, you hear that all the time. I don't think so. And in the end, the question of where it'll sell will be affected by how much there is around and how much there isn't.

And people get upset with shorts and they get upset with forward sales by producers, and they get upset with leasing, and all of that sort of thing. But in the end, if silver gets tight, it will go up in price. And if it isn't tight, it really doesn't make much difference whether it's leased or not.

It's like companies that get upset about the short position of their stock. I've even had a few people write me because there'd be some —

I don't care whether there's a thousand shares short of Berkshire or 300,000 shares short, it really doesn't make any difference, because someday, the people that are short have to buy and, you know, it's part of markets.

So the leasing of silver takes place because somebody's got some silver around, would rather get a small amount of income by leasing it to somebody that needs to use it for one reason or another.

But it's because the silver was sitting around in the first place that it's available for lease. And it really doesn't make much difference, I don't think, in terms of pricing over time.

Charlie?

CHARLIE MUNGER: I have nothing to say.

WARREN BUFFETT: Oh. (Laughter)

36. Buffett criticizes ABC News report on Kirby vacuums

WARREN BUFFETT: OK. It's — we've got time for one more question from number 10, and that will complete the cycle, also. So, shoot.

AUDIENCE MEMBER: My name is Jerry Miller (PH), Highland Park, Illinois, shareholder. I don't want to end this meeting on a down note, although I'm going to do it. (Laughter)

Before I say that, I would like to make a positive statement, one of many, but I'll hold it to one.

I have —since I've been retired, I've gone to quite a few shareholders meetings. And I only wish there was some way I could force most of the CEOs to attend.

They may not understand what's going on, but I would just like them to see how a shareholders meeting should be handled.

And now for the down — (applause) — a little bit.

I'm downstairs. I can hear some good results.

The — if you're going to sit behind the desk that says the $37 billion buck stops here, you're going to have to handle all questions. The one that I was really surprised I didn't hear, and I — today from anybody, including you — the two of you — would —

Although they've taken the 'E' word away from us, and the 'AA' word away from us, I don't want them to take the Berkshire Hathaway 'K' word away from us.

Do you understand that? If you do, just wave a finger. And if not, I'll explain it.

WARREN BUFFETT: Well, you're 0 for 2 at the head table. So, you better explain it. (Laughter)

AUDIENCE MEMBER: This morning, I had to chide some of the fellows down the stairs at the Kirby. A couple of weeks ago, there was a stain — or a tarnish — appeared on the Berkshire Hathaway name, and a little crack appeared in the charisma. Did you happen to see the program?

WARREN BUFFETT: Yeah, I saw the program. And it was interesting because it was focusing on the sales practices — or alleged sales practices — of some people that don't work for us, but work for distributors, just like salesmen work for Ford dealers or something of the sort.

And particularly, it was talking about them selling to older people. And interestingly enough, over 10 years ago, we put in a policy, which to my knowledge is the only one like it in the country, in that anybody, anybody over 65 who buys a Kirby vacuum and is unhappy for any reason, any time, up to a year, 11 months and 29 days later, can tell us so and they get their money back without question.

And I don't know of another consumer durable sold like that in the country. And one of the interesting things was that the fellow they interviewed, who talked about his mother having bought one and being terribly unhappy about it, had actually used the product for eight or nine months and gotten a full refund.

And that fact was not mentioned on the program, nor was the fact even that we had this policy. And I really regard that as rather extraordinary journalism.

AUDIENCE MEMBER: I trust you're not dusting off — (applause) — your Salomon notes then to read to the Kirby people.

WARREN BUFFETT: No, I can understand your reaction to the program, because it was pointed out to ABC News several times prior to the program, that this policy existed, that 300-and-some people in the previous year, and if they gave us a trade-in on the — on it and we — and they decided to call it off 11 months later, we gave them their money back, plus a machine equal to the — or better than the machine they gave us. And not a word was said about that in the program.

So, it — I do not regard it as a great moment in ABC journalism.

AUDIENCE MEMBER: Anyway, thanks for (Inaudible) —

Morning Session - 2003 Meeting

1. Buffett welcomes "real shareholders"

WARREN BUFFETT: (Applause) Thank you. We promise not to sing. (Laughter)

Good morning, and we're delighted to have you all here.

One of the things that makes it fun to run Berkshire is that we see real shareholders. We have — we probably have a larger proportion of our shares held by individuals and not by institutions than virtually any large company in America. And that's the way we like it.

We love it when you come, we get to see you, you buy our products. You know, there's still a few things left downstairs so — (laughter) — feel free to leave anytime during the meeting when Charlie's talking — (laughter) — to go down and make a few purchases.

2. Andy Heyward and "Liberty's Kids"

WARREN BUFFETT: Now, we're going to do as we've always done.

First of all, I'd like to — I would like to give very special thanks to Andy Heyward. Andy, would you stand up if you will please? (Applause) Andy is the man that — there he is. (Applause)

Andy does those cartoons, he recruits Walter Cronkite and Bill Gates, and he does the script. He gets Charlie and me to do recordings. And it's just wonderful the production he's put on.

And for those of you — last year I mentioned a program that's on public broadcasting called "Liberty's Kids."

It's running in — consecutively. There's, I think, 40 episodes. It tells the story, really, of the founding of the country, and it's a marvelous way to learn history.

I've watched a number of the sessions myself, and it kind of comes back to me from my early days, grade school and high school.

And Andy's done, I think, the parents of America and the country, a real service in producing this. And I will predict that a hundred years from now, people will be watching "Liberty's Kids."

So I really salute Andy Heyward, and be sure to catch it on public broadcasting. And Andy, thanks for a wonderful production. (Applause)

3. Day's agenda

WARREN BUFFETT: Now, we're going to follow our usual procedure of leisurely proceeding through the formal part of the business in three or four minutes. And — (laughter) — then we will —

I'll have a few comments, actually, on our business, and then — and a couple of acquisitions — and then we will spend the rest of the day, until 3:30 with a break for lunch, we will spend here to answer any questions you have.

We have microphones in various zones, and we will proceed around and try to get every — any subject that's on your mind, fire away and I'll answer the easy ones and Charlie will answer the tough ones. (Laughter)

4. Calibrating Munger's answers

WARREN BUFFETT: So now we will go through the formal part of the business, they've written a little script for me and I will go through this. The meeting will now come to order.

Oh, I should introduce Charlie over here, not that he needs an introduction. But Charlie — (Applause)

Charlie and I have been partners of one sort or another since 1959. We both grew up a good bit here in Omaha, but we didn't know each other at the time.

We both worked at the same grocery store. We had a similar experience, we found that neither one of us liked hard work. (Laughter)

And if you go down to the Western Heritage Museum, they just opened an exhibit of that grocery store. It's a permanent exhibit, and actually, I loved it. Charlie worked there a few years before I did in the past, but we didn't actually meet until I was 28 or 29, and Charlie was a few years older, as he still is.

And — (laughter) — we have worked together now for — in one way or another — for 44 years. We've never had an argument. And we disagree sometimes on things.

He — you have to learn to calibrate Charlie's answers. He — when I ask him whether he likes something, if he says, "No," that means we put all our money in it. I mean, that is a huge — (Laughter)

If he says, "That's the dumbest idea I've ever heard," that's a more moderate investment that we make. And then you have to calibrate his answers, but once you learn to do that you get a lot of wisdom.

5. Berkshire directors introduced

WARREN BUFFETT: We have our directors with us, and I'll introduce them. We have, if you'll stand please as I call your name and then you can — it'll be hard to do — but you can withhold your applause till they're all standing.

Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Ronald L. Olson, and Walter Scott Jr., in addition to Charlie. Those are the directors of Berkshire Hathaway. (Applause)

As we mentioned in the annual report, we will be adding some directors who meet the four tests that I laid out in the report. We'll be adding some of those, probably within the next year. When we're required — whenever we're required to do so, we will be doing it.

And we will have people who have a lot of their own money on the line, just like you do, in Berkshire. And they will prosper or suffer in relation to how Berkshire does, and not in relation to their directors' fees or other things.

So they will be selected for business savvy, which they will have.

They will be selected for interest in the company, which is almost guaranteed by their holdings.

They will be selected by their shareholder orientation, which, again, I think that their holdings will produce. And we will have those people on board, probably by our next meeting.

6. Formal business meeting begins

WARREN BUFFETT: Also with us today are partners in the firm of Deloitte and Touche, our auditors. They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire. And I might say that almost any question would be appropriate.

Mr. Forrest Krutter, secretary of Berkshire, he will make a written record of the proceedings. Miss Becki Amick has been appointed inspector of elections at this meeting, and she will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg. We will conduct the business of the meeting and then adjourn to the — adjourn the formal meeting. After that we will entertain questions that you might have.

WARREN BUFFETT: Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 5, 2003, being the record date for this meeting, there were 1,309,423 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting.

And 6,763,493 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number 1,071,967 Class A shares and 5,228,705 Class B shares are represented at this meeting by proxies returned through Thursday evening, May 1.

WARREN BUFFETT: Thank you. That number represents a quorum and we will therefore directly proceed with the meeting.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes approved.

WARREN BUFFETT: Do I hear a second? Motion has been moved and seconded. Are there any comments or questions? We will vote on this motion by voice vote. All those in favor say “aye.”

VOICES: Aye.

WARREN BUFFETT: Opposed? You can signify by saying, “I’m leaving.” (Laughter)

The motion is carried.

7. Berkshire directors elected

WARREN BUFFETT: The first item of business at the meeting is to elect directors. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so. If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you.

Will those persons desiring ballots please identify themselves so we may distribute them?

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren E. Buffett, Charles T. Munger, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Ronald L. Olson, and Walter Scott Jr., be elected as directors.

WARREN BUFFETT: Sounds good to me.

It has been moved and seconded that Warren E. Buffett, Charles T. Munger, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Ronald L. Olson, and Walter Scott Jr., be elected as directors.

Are there any other nominations? Is there any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors voting and proxies in accordance with the instructions they have received?

Miss Amick, when you're ready you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders, in response to proxies that were received through last Thursday evening, cast not less than 1,058,098 votes for each nominee.

That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss. Amick. Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, Charles T. Munger, Ronald L. Olson, and Walter Scott Jr., have been elected as directors.

8. Proposal to include Class B shares in charity program

WARREN BUFFETT: The next item of business is a proposal put forth by Berkshire shareholder Christopher J. Fried, the owner of two Class B shares.

Mr. Fried's motion is set forth in the proxy statement, and provides that the shareholders request the company allows Class B shareholders who own at least seven registered shares of Class B stock to become eligible to participate in the shareholder-designated contributions program.

The directors recommended that the shareholders vote against this proposal.

We will now open the floor to recognize Mr. Fried, or his designee, to present his proposal.

CHRIS FRIED: Thank you, Mr. Buffett. Good morning, my fellow shareholders.

My name is Chris Fried, and I am here to present a shareholder proposal.

This proposal is designed to extend the shareholder-designated contribution program to include Class B shareholders.

Let me first start off by saying in our shareholder's "Owner Manual," there is a statement that I'd like to quote at this time.

"Although our forum is corporate, our attitude is partnership. Charles Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners.

"We do not view the company, itself, as the ultimate owner of our business assets, but instead view the company as a conduit through which our shareholders own the assets."

With that in mind, I present the following proposal for a vote.

This proposal would extend the shareholder contribution program to Class B shareholders who own at least seven registered shares of Class B stock. Under my proposal, each Class B stock would be allocated 1/30th the value to Class A donation rate.

Currently the Class A rate is $18 which translates to 60 cents per Class B share. The required minimum seven registered shares results in no less than $4.20 being donated by a Class B shareholder.

This figure is important, for when inflation is taken into account, the donation rate will be on par with the original 1981 donation level when the shareholder — proposal — designated program was initiated.

I do understand that there are certain perks involved with owning a Class A share. However, those perks should only be limited to voting rights and the ability to convert Class A shares to Class B shares.

Therefore, I believe that is an appropriate — to extend the shareholder-designated program to Class B shareholders.

If Berkshire Hathaway is to truly follow — truly follow what it preaches about this firm being a partnership among all of its shareholders, then Class B shareholders must have the right to at least have the option to take part in the shareholder-designated contribution program.

Thus, I ask my fellow Berkshire Hathaway shareholders to vote in affirmative on this matter. Thank you for your time.

WARREN BUFFETT: Thank you, Mr. Fried. And you're absolutely right that Charlie and I do regard our shareholders as partners, and we have ever since we really started.

In fact, Berkshire, in a sense, evolved out of a couple of partnerships. Charlie had a partnership, I had a partnership, we made an investment in certain things. And a lot of our original partners are still with us as shareholders.

The partnership — but partnerships have partnership agreements, and when we set forth — or when we issued the Class B shares some years ago, we set forth the relative terms of the partners. And the Class A and the Class B are quite similar in economic terms, but they're not identical.

And at the time we issued those shares to a new group of partners, Class B partners, we explained, quite clearly I believe, exactly what differences there were.

There was a difference in voting rights, there was a difference in that the Class A could be converted to B, but not the reverse. And there was a difference in the shareholder-designated contribution program.

Ever since we issued those shares, I don't know, maybe six or seven years ago, we, in effect, have had a compact with both the A and B shareholders that they — that we would treat the two classes in a way consistent with what was explained at the time of issuance.

So if we were to change the vote, the conversion ratio, or the shareholder-designated contribution program, we would, in effect, be changing a deal that was made, and that has been recognized as having been made, ever since the B shares were issued.

People have bought the A shares in preference to B because of certain reasons. People have bought the B shares for other reasons. But they have relied on the fact that we would abide by what we said we would do at the time we issued those shares.

We'll not take anything away from the B, we'll not take anything away from the A. We'll run things just as they are.

And in the future, you know, I happen to have shares — my holdings — concentrated in A shares.

But the A will never get any advantage over the B except for the ones we laid out at the time of issuance of the B.

It would actually be unfair to A shareholders, and particularly to A shareholders who have bought since the B was issued, to tell them that the economic relationship between the A and B was being changed, even though only in a slight way, to the benefit of the A — benefit of the B — and the detriment of the A.

We wouldn't do that in either direction, so that's why we recommended to vote against it.

Charlie, do you want to add anything?

CHARLIE MUNGER: Well, not only is all of that true, but the cost of getting down to all of B would — it would be a very inefficient process.

WARREN BUFFETT: Yeah, well of course — and that's the reason, back when we issued the B, I mean, we anticipated that.

So it seemed like something that would offer very little value to the B at a significant cost to the company, and therefore we spelled it out quite clearly, I believe, in the original prospectus, and it's been spelled out in every annual report subsequently.

So it's the deal, and the deal is that — is also that we never change things to benefit the A in any way over the B, except as originally explained in the original prospectus, and subsequently in all the annual reports.

Is there a second to Mr. Fried's motion?

What do we do if we don't get a second, Charlie?

CHARLIE MUNGER: It dies.

WARREN BUFFETT: OK. I guess it just died. (Laughter)

But, there's nothing inappropriate about bringing something like that up (inaudible).

I mean, I understand exactly, you know, what you're thinking about. But I think you have to think of fairness to both classes.

Moving right along — figuring out where we are.

9. Formal business meeting adjourned

WARREN BUFFETT: I guess we're moving along to adjournment of the meeting. And after that we will have the questions we talked about, and I'll also tell you a little bit about the business, since the annual report come out — came out.

Walter Scott, do you have a motion to put before the meeting?

WALTER SCOTT: I move we adjourn the meeting.

WARREN BUFFETT: Do we have a second?

VOICE: I second.

WARREN BUFFETT: Motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say, "aye."

VOICES: Aye.

WARREN BUFFETT: All opposed say, "No." The meeting's adjourned. (Laughter and applause)

10. Microphones for questions

WARREN BUFFETT: Now, I'd like to bring you up to date on a couple of things, and then we will proceed with questions.

We have eight microphones placed around the auditorium here, and we will proceed regularly around and just keep going around, and around.

And Marc, do we have anything in the — any microphones in the Music Hall or not? I'm not aware. Maybe if Marc could come up and inform me whether there's (inaudible) Music Hall or not, we can —

VOICE: There's two in there.

WARREN BUFFETT: There's two microphones in the Music —

VOICE: Yes, nine and 10.

WARREN BUFFETT: Nine and 10 are in the Music Hall. And are there quite a few people there?

VOICE: Yeah, it's full. It's full.

WARREN BUFFETT: It's full?

VOICE: Yeah.

WARREN BUFFETT: Oh OK.

We haven't put microphones out on the sidewalks yet, but we'll get to that someday. (Laughter)

11. McLane acquired from Walmart

WARREN BUFFETT: We've made — we've contracted to make — two acquisitions this year.

You just read about one, perhaps, in this morning's paper, but it went on the tape at 7:45 yesterday morning, Central Time, and that involved the contract to buy McLane's from the Walmart company.

McLane's is the very large wholesaler to all kinds of institutions, but convenience stores, quick-serve restaurants, the Walmart operation itself, theaters, restaurants.

And this year we'll probably do something like 22 billion of business. So it's a very substantial enterprise, with distribution centers around the country, with much in the way of transportation equipment.

Walmart had owned McLane's since about, I believe, 1990. It grew substantially while they owned it. It's been run by a terrific manager who's here with us today, Grady Rosier, and Grady took the business from 3 billion to 22 billion, or thereabouts.

Walmart, for very good reasons, wants to specialize in what they do extremely well, and through Goldman Sachs and Company, we were approached by them a little while back about the possibilities of buying the business.

It's a — it really makes sense for both sides, because Walmart knows what to do with the capital very, very well in their own business, and has lots of opportunities. And this was something of a sideline to them.

On the other hand, their ownership of McLane's resulted in certain people that would be logical customers of McLane's not wanting to do business because they didn't want to do business with a competitor.

And we plan to see all those people very soon, and explain to them that that's no longer the case, and they can sleep well at night doing business with us and not worry about benefiting their competitor, Walmart.

So this deal — a representative of Walmart came up last Thursday to Omaha, a week ago this past Thursday, a CFO. And we made a deal in, maybe, an hour or two and shook hands. And when you shake hands with Walmart, you have a deal.

And so the time remaining until yesterday morning, a contract was put together and it must go through the Hart-Scott-Rodino process in — to be cleared. But there's obviously no conflict, so we fully expect that, in just a few weeks, that McLane's will become part of Berkshire.

It serves, presently, about 36,000 of the 125,000 or so, convenience stores. If you take the 50 largest convenience store chains in the country, it does 58 percent of the business with those companies. Sells each convenience store an average of, perhaps, 300,000 or a slight bit more of product a year, which those convenience stores then resell to the consumer.

It also serves about 18,000 quick-serve restaurants, primarily those operated by Yum! Brands: the Taco Bell, and Pizza Hut, and Kentucky Fried Chicken group.

And it will have opportunities to serve many more as we go along. So we're delighted.

If any of you get a chance to see Grady, or better yet, if any of you own a convenience store, step forward and we'll be glad to give you our card. (Laughter)

It's really — you know, Walmart knows that we will be a good owner, they know we'll be good for the people that work at McLane's.

They know our check will clear, that we won't, you know, make a proposition and then run into financing difficulties, or try to jiggle around the contract later on.

And it's just an ideal way to do business, and we're delighted to add McLane's to the Berkshire group of companies.

It's a very narrow-margin business, obviously. I mean, when you get up to 22 billion of sales and you've got Hershey, and Mars, and people like that on one side, and you've got buyers like 7-Eleven and Walmart on the other side, they're not going to leave a lot in between.

But you have to perform a valuable service for them in order to earn, you know, say, one cent on the dollar, pre-tax.

But McLane's knows how to do it. It's a very efficient operation, and it will continue to deliver value to both their vendors and their customers.

12. Clayton Homes purchase

WARREN BUFFETT: The other acquisition that is in the works is Clayton Homes. Clayton is the class of the manufactured home industry, and the acquisition came about in kind of an interesting way.

Every year for the last five years, a group of about 40 finance students from the University of Tennessee in Knoxville would come up to Omaha, and they would have a lot of fun in Omaha. They'd go to the Furniture Mart.

And then in the afternoon they'd come to Kiewit Plaza and the 40 students or so, with their professor, Al Auxier, would have a session with me. We'd just have a classroom session for a couple of hours, and wonderful group of students.

And generally at the end of the session they would give me a football, or a basketball, they've got a great women's basketball team at the University of Tennessee, and so we'd have a good time together.

And, matter of fact, a year ago, when they came up, Bill Gates, by chance, was in town. So I presented him as a substitute teacher, which is a post he's always wanted. (Laughter) And students got quite a surprise.

This year when they came, 40 or so students, we had a good session together, a couple of hours at Kiewit Plaza. And when they got through, they gave me a book. And it was the autobiography of Jim Clayton, who started and ran Clayton Homes, and built it into a huge success.

And he'd written a nice inscription inside, and I mentioned to the students and the professor that the — that I was an admirer of Clayton. I'd followed the manufactured home industry in other ways, not always so successfully, and I'd seen what Clayton had done.

And so I said I look forward to reading the book, which I did. And then I called Kevin Clayton, Jim Clayton's son, and Kevin is the CEO of the company. And I told him how I'd enjoyed his dad's book.

And I said we still had a little money left in Omaha — (laughter) — and, if they ever decided to do anything, you know, we would be interested. And I suggested at what price we might be interested in.

A phone call or two later, a couple of phone calls, we made a deal.

And I had not been to Knoxville. You know, I checked out a few manufactured homes. Suggested that my family buy a repo. (Laughter)

But that deal came about in that manner. And that's the way things tend to happen at Berkshire.

It, you know, the phone rings or we pick up the phone, in this particular case. And the manufactured home industry got into significant trouble, very significant trouble, because credit terms — well, they went crazy on credit four or five years ago.

And when you go crazy on credit, you suffer in a very big way, and that's what happened to that industry.

Conseco, that some of you may have read about, ended up holding — or servicing I should say — $20 billion worth of manufactured home credit and they got in big trouble, for that and other reasons.

And Oakwood, where we own some junk bonds, went into bankruptcy. They're a big operation in the country, most of the — couple of the other biggest players in the industry are losing significant money.

Manufactured home companies have lost the ability to securitize the receivables they get when they sell these — when they sell homes. And so the industry's been in the tank.

This year, or this past year, there were maybe 160,000 new manufactured homes sold, but there were also about 90,000 repos came back and that depresses the market enormously. And like I say, financing sources have dried up. A lot of people that lent money have left the field.

So for the strong, as Clayton is, and particularly with the financial backer like Berkshire, it should be a good field. Twenty percent or so of all the new single-family homes are manufactured homes in this country.

I mean, you can — we can put you in one for about $30 a square foot, and if you compare that to a site-built home, it's quite a deal. I mean, I was amazed.

They have 2,500 square foot homes, two stories, I mean, it's changed a lot over the last 30 or 40 years.

And we've got an operation that is, even the competitors would admit, it's clearly the class of the field.

But even for Clayton, financing was getting more difficult. I mean, the lending community got burned very badly in manufactured homes, and people have sworn off them, from the lending standpoint.

And Clayton did securitize an issue in February this year, but they had to keep more of the bottom layers of the securitization themselves.

So it's a good marriage, and it's one where we will be useful to them. And we should do very well together in the future.

13. Earnings get insurance boost

WARREN BUFFETT: The first quarter, I'll just — I don't have final figures yet, and we'll put this — what I say today — we'll put it on the website so that everyone has the information before the opening on Monday.

But the economy, as you know, has been quite sluggish. It's really been sluggish for a very long time.

It's interesting, I wrote in a letter that's also on the website, right after September 11th, I put something up there.

And I said that we were in — we had been in a recession, which was not something that was generally acknowledged at that time, and I thought would be longer and deeper than most people anticipated.

And what has happened is that, really since late 2000, housing and autos have done quite well, but the rest of the economy has just been plain sluggish. And it continues.

During that time we've dropped the federal funds rate dramatically down to 1 1/4 percent. Charlie and I weren't — probably wouldn't have predicted that we might ever see that in our lifetime, and maybe it'll even go lower.

And we're running a huge budget deficit now, but business continues to be sluggish.

So our non-insurance businesses generally did not do great in the first quarter.

Our insurance businesses did extraordinarily well. And we will show — when the first quarter report is published — we will show an underwriting profit of about 290 million pre-tax, which is after about 140 million of charges for retroactive insurance, the acquisition costs on that — which I'm sure many of you that don't love accounting — all I can tell you is that it's a charge that many companies don't bear but that we willingly bear because it gives us benefits.

But our $290 million is after that charge.

Our float grew by, probably, at least 1.3 billion, so we're up to 42 1/2 billion or so of float. And people — that means people have — are letting us use that money.

And as I said in the first quarter, did it not only cost us nothing to use the money, but, in effect, people paid us to use the money, which we would like them to continue to do. (Laughter)

And I don't see our float growing much from this point. Charlie said last time that it was impossible for it to grow, but it probably would. I don't know whether he'll change his opinion on that, but I think — I really think our insurance businesses are in exceptionally good shape.

We have some of the best insurance businesses in the world.

GEICO's premium volume was up a little over 16 percent in the first quarter, and in April it was up just right at 17 percent. It had a 6 percent, roughly, underwriting profit in the first quarter.

Gen Re, thanks to an incredible job by Joe Brandon and Tad Montross, has turned the corner in a big, big way, and it showed an underwriting profit in the first quarter.

Ajit Jain made so much money I don't want to even tell you about it. (Applause)

Some of our primary operations — yeah, you should give him a hand. I mean, that — (Applause)

When you get Charlie to clap, you know he's made us a lot of money. (Laughter)

And our primary businesses, particularly U.S. Liability and National Indemnity primary operations, and our Homestate Company, they've all done — they're all doing remarkably well. And I —

You never know what's going to happen in insurance. I mean, there could be an 8.0 earthquake in California or Tokyo, or there could be one in New Madrid, Missouri, as there was a couple hundred years ago. And it could happen tomorrow, there could be huge hurricanes this summer, whatever.

But I can't imagine having a much better group of companies or managers than we have, and they're all working well now.

For a while, Gen Re was a drag, but that's not true now. And I think that we have an excellent chance of having very low cost, and perhaps even no-cost or negative cost float over the next five years or so, or really as far as the eye can see.

Now, that doesn't mean it won't fluctuate around. But if you average it out, I think we will have our float at a very cheap price. And it's — you know, as [TV personality] Martha [Stewart] would say, "Having 42 1/2 billion for nothing is a good thing." (Laughter)

Now, with that, I think we've covered — the first quarter was a good quarter. Overall, it's the best operating earnings we've ever had. Now, we've got more capital now than we've ever had, but nevertheless it will be a good quarter.

And I would estimate, I think it's fair to say, Marc [Hamburg], that from operating earnings we will have something like 1.7 — in the range of 1.7 billion. We had some securities gains too, but I don't count those because they can do anything from quarter to quarter. We don't pay any attention to the timing of those.

But we — from a straight operating standpoint, 1.7 billion or so after-tax. Am I safe with that number, Marc? Or — OK. What could he say? (Laughter)

We don't change numbers at Berkshire, I promise you that. There are — a lot of companies do, but fewer now than did a few years ago. (Laughter)

So, we're going to get the questions in. Charlie, do you have anything to add about acquisitions or operations, or anything else you'd care to say?

CHARLIE MUNGER: Well, I hate to be an optimist, but — (Laughter)

WARREN BUFFETT: Does he ever. (Laughs)

CHARLIE MUNGER: We really added a lot of wonderful businesses to Berkshire in the last few years. It's been some delightful business.

WARREN BUFFETT: That's all you're going to get out of him, folks. (Laughter and applause)

14. Bright future for NetJets but no profit this year

WARREN BUFFETT: OK we're going to start around and we — as we've added two microphones to the Music Hall — and let's start with zone 1, which is over on my right. And do we have the first question?

AUDIENCE MEMBER: Good morning. I'm George Brumley from Durham, North Carolina.

My first question is related to Executive Jet. It's been almost five years since the acquisition of Executive Jet, a purchase in a much different economic and geopolitical environment.

What business metrics do you use to measure success in an industry with as much flux as this one, and what has changed in those metrics since the time of acquisition?

What are the prospects for Europe, and have those prospects changed?

While none of the competitors approach Executive Jet in terms of scale and scope, what impact are they having on the competitive environment?

And lastly, would you please explain the long-term aspect of the business model, as many of the jets age out of the program?

WARREN BUFFETT: OK George, I got through college answering fewer questions than that. (Laughter)

But George's uncle [Fred Stanback] was best man in my wedding, so he gets all he wants.

The — NetJets, as you will see in the first quarter, had a significant loss. A large portion of that loss was caused by the write-down of planes because there — of —

I love it, they call it in the trade, they call them pre-owned planes. I call them used planes. But the — they did the same thing in manufactured homes, so they call them pre-owned homes instead of used homes.

But in any event, putting aside the euphemisms, there — the used plane market, well the entire business aircraft market, is very soft. The used plane market has far more planes for sale than, say, three or four or five years ago.

That's going to affect the production of new planes — already has. And it affects pricing in used planes, and we have bought back planes from people leaving the programs, which we do and will continue to do.

But we have bought during a declining market, some of those, and we have had write-downs in connection with those planes. And you will see in our first quarter report, I believe that that's probably the only operation we have that's losing money.

And we have — it's a popular product, it's a growing business, it's going to be a very big business in my opinion over the years. And we see it every day. I mean, we write a lot of business, and customers are joining us.

There are three main competitors. I think it's fair to say that they're losing significant money from operations, forgetting about any markdowns they might have on their own inventories.

Our market share, we get figures from the FAA as to registrations and as to people that are selling their planes.

And our share of market, which was always the largest, has gone up dramatically in the last couple of years. It's gone up to roughly 75 percent, in terms of value of planes. And we're talking 75 percent of the four-company market. It's gone up even higher than that, in terms of net planes. In other words, new planes sold, less planes coming back.

But the pricing we are receiving does not — in the U.S. it would be — absent this one write-down — it would be very, very modestly profitable.

In Europe, we have lost and we are losing significant amounts of money. Business jets in Europe, the total is about one — and I'm not talking about ours, I'm talking about all — are about roughly 1/10th the number as in the United States, even though the population is similar.

So we have grown from a small base quite rapidly over there. Nobody else will be taking us on. It's part of a service that will be part of a very big business worldwide, in my view, over the years. I don't think anybody else can come in after us.

So I think it's integral, and it is integral, to our operation. Half the — roughly half the miles flown in Europe arise from American owners. And that will just do nothing but get bigger over the years, because our number of — every month our number of owners goes up, goes up significantly.

We have people here from Marquis, who have essentially — they've become a customer of ours, and then they resell cards for 25 hours. And they have added 40 or 50 customers a month in recent months. So it's a popular service, it will be a much bigger business.

I think there will be a shakeout at some point, and maybe fairly soon. You can look at the Raytheon prospectus and — or the Raytheon 10K, and you will find some interesting information about their operation. And you can — it's not hard to figure out what's going on.

I don't know the answer as to when the shakeout will occur. But I can assure you that we will not be one of the shook. (Laughter)

Charlie, do you want to comment on it?

CHARLIE MUNGER: No. (Laughter)

WARREN BUFFETT: He'll comment on the profitable operations. He gives me the one —

The long-term business model is that, basically, we believe that, you know, perhaps 10 times the number of people that are now flying with us will be flying with us some years in the future.

That having the best service, the best record, and the best policies for safety and security, will leave us very dominant in the field, and that people will pay an appropriate price for the service.

And we see all kinds of evidence of that. But we do not see a profit this year, in my view, at NetJets.

15. "What we really want is cost-free float"

WARREN BUFFETT: Let's go to number 2.

AUDIENCE MEMBER: Good morning. I'm Marc Rabinov from Melbourne, Australia.

I had two related questions for you gentlemen, basically both related to float.

Float, as you indicated, has become a very large part of our asset base. Assuming our policy holders continue to renew with us and we keep control of our combined ratio, can we count the float as pseudo equity when calculating the intrinsic value of Berkshire?

And the related question was, can we not expect the float to keep growing at, say, 10 percent per annum for the next five to 10 years given that we're still really a minority player in this segment? Thank you.

WARREN BUFFETT: Well, I wish it would grow at 10 percent or so, at least if it were profitable, which I do have a belief that it's likely to be.

Our float is 42 1/2 billion on March 31st, roughly.

I think the entire float of the American property-casualty industry, you know, could be something in the — roughly — in the area of 500 billion. So we may be some figure like, you know, 8 percent or a little bit more, maybe even 9 percent, somewhere in that range.

Of the total P-C float in the United States — now, it's true we have a little outside the country, too, but the big part of the world P-C market is in the United States.

When we started out in 1967, I think maybe we had 10 million of float. So to go from 10 million to 42 billion, frankly, surprises me. But it also — it's going to be much harder to grow at significant percentage rates in the future.

And our goal — we love the idea of growing — but what we really want is cost-free float. I mean, that is the goal, and growth is not a — not at the top of the list at all. I mean, I hold our managers responsible, not for delivering more float. I hold them responsible for delivering profitable float.

And that is key in our mind at all the time. If it comes along, we love it. But we will find out whether it comes along or not.

The first part of your question, if indeed 42 1/2 billion can be obtained at no cost, or even better yet at a profit, its utility to us is like equity.

Now, you couldn't realize it upon liquidation, necessarily. Oh you wouldn't realize it on liquidation. And you couldn't necessarily realize it on sale, that would depend. So I'm not telling you how to count it as in terms — whether you count it in terms of intrinsic value, you have to make that decision.

But it has the utility to us of 42 1/2 million — 42 1/2 billion — of funds derived from equity without issuing common shares. And that's one of the reasons we've always been so enthused about it now for, what, 35 or 36 years. It's a great business for us.

And every now and then we got off the track. You know, we got off the track in the early '80s, we had a problem or two in the mid '70s, and we had a problem with Gen Re for a few years.

So it — there's nothing automatic about it, and I will say this: I think, for most companies in the P-C business, that — the P-C business is not a great business. It's a commodity business to too big a degree.

So I do not think most companies in the P-C business will get float at an attractive cost. We have to be an exception.

But we have some exceptional companies and some exceptional managers, and I truly believe that we will obtain our float at considerably less cost than the industry. And that is the goal.

GEICO, if it would continue to grow at 16 percent, for example, this year, that adds a billion of premium volume. Well that doesn't generate as much float at GEICO as it generates at Gen Re, but it generates float. So GEICO's float will grow. I would, you know, I'd bet my life on that.

But certain of our other transactions are more opportunistic in nature, and that float could even shrink.

And if the float shrinks, you know, that is fine with me as long as we produce underwriting profits. We'll go wherever it goes.

Charlie?

CHARLIE MUNGER: Yeah, with interest rates as low as they are now, this float we have so laboriously built up isn't worth so much to us on a short-term basis. After all, what — if — what do we have, $16 billion of cash on hand earning a very low rate of return?

So the incremental dollar of float doesn't look all that advantageous now. But we have a more long-term view than that. We figure that eventually, we'll do a hell of a lot better than 2 percent.

WARREN BUFFETT: We're not getting 2 percent on that 16 billion, Charlie. (Laughs)

We have — we do have, incidentally on March 31st, we have roughly 16 billion in cash, not counting any cash in the finance operation, because that's a little bit phony in terms of its utility. I mean, it's offset by borrowed money.

But it — other than the finance operation, we have right at 16 billion in cash and cash equivalents, and we also have a lot of bonds and things of that sort.

On that 16 billion, you know, we are probably getting about 7/10ths of 1 percent, three-quarters of 1 percent, call it, after-tax on $16 billion, which does not make us salivate.

But — (laughter) — we would rather, you know, avoid salivation than to encounter problems. And we will use — Walmart put out the figure yesterday of roughly 1 1/2 billion for a combination of a small trucking company, plus what they sold us.

And we will, you know, we will use money, but money keeps coming in, too. If we earn a billion-seven in the first quarter, that billion-seven is pretty much all cash. And then on top of that we had the billion — billion-three or so float increase.

So float increase plus retained earnings, not counting securities gains, maybe $3 billion. Now we're not going to keep that up, but there's a lot of money coming in.

And — but we are getting some chances to deploy it. And if we deploy — if we get it at less than — at zero or less cost, it has —it's very close to, in our — it has the utility of equity in a very big way.

16. Black-Scholes option pricing model is "insane"

WARREN BUFFETT: Let's go to number 3.

AUDIENCE MEMBER: Good morning, gentleman. My name is Hugh Stephenson (PH). I'm a shareholder from Atlanta.

You had indicated in the past that you did not think that the volatility base to Black-Scholes models for options pricing was correct.

Would you share with us how you would evaluate those options as you use them in the business or see them in the marketplace?

And also if you would update us on your thoughts on the asbestos tort situation, given the recent development of national settlement trusts, et cetera?

WARREN BUFFETT: Yeah, we — Charlie and I have thought about options all our life. I mean, my guess is Charlie was thinking about that in grade school.

And — (laughter) — you know, and I — you have to understand— you don't have to understand Black-Scholes at all — but you have to understand the utility and, in a general sense, the value of options. And you have to understand the cost of issuing options, which is very unpopular subject in certain quarters.

Any option has value. I mean, I bought a house in 1958 for $31,500. And let's assume the seller of that house had said to me, "I'd like an option on it, good in perpetuity, at $200,000." Well, that wouldn't have seemed like it'd cost me much if I'd give it to him, but an option has value.

Any option has value, and that's why some people who are, you know, kind of slick in business matters sometimes get options for very little or for nothing. I'm not talking about stock options. I'm just talking about an option to purchase anything.

They get options for far less than, really, a market value would be. Black-Scholes is an attempt to measure the market value of options, and it cranks in certain variables.

But the most important variable it cranks in that might be subject — well, might be a case where if you had differing views you could make some money — but it's based upon the past volatility of the asset involved. And past volatilities are not the best judge of value.

I mean, if you had looked at a five-year option at — on Berkshire stock — at various times Berkshire stock's had a fairly low beta, as they call it. Beta is a measure that — people in academia always like to give Greek names to things that are fairly simple, and so that they have sort of a priesthood. (Laughter)

You know, it's — so it's like priests talking in Latin or something. I mean, it kind of cows the laity.

But they — beta is a measure of past volatility. Berkshire's had a low volatility, but that didn't mean that the option value of it, to anybody that really understood the business, was lower than a stock with a higher beta.

And I think Charlie — what Charlie said is that — last year, is that for over — that for longer-term options in particular, Black-Scholes can give some silly results.

I mean, it misprices things, but it's a mechanical system. And any mechanical system in securities markets is going to misprice things from time to time, and that's —

We made one — as I mentioned last year — we made one large commitment that basically was — had somebody on the other side of it using Black-Scholes and using market prices — took the other side of it and we made $120 million last year.

And we love the idea of other people using mechanistic formulas to price things, because they may be right 99 times out of 100 but we don't have to play those 99 times. We just play the one time when we have a differing view.

Charlie, do you want to comment on —?

CHARLIE MUNGER: Yeah, Black-Scholes is a — what I would call a know-nothing value system.

If you don't know anything at all about value compared with price — in other words, if price is teaching you all that can be known — then Black-Scholes, on a very short-term basis, is a pretty good guess, you know, for what a 90-day option may be worth in some stock or another.

The minute you get into longer-term options, or you don't have the know-nothing factor so extreme, it's crazy to use Black-Scholes. People use it just because they want some kind of a mechanical system.

But at Costco, for instance, within a fairly short period, we issued stock options at 30, and we also issued stock options at 60. And Black-Scholes valued the options we issued at 60 as the strike price way higher than the options we issued at 30. Well, this is insane.

WARREN BUFFETT: But we like a certain amount of insanity. (Laughter)

CHARLIE MUNGER: Yeah, well, it's good for Warren who picked up this extra $120 million. But —

WARREN BUFFETT: I mean —

CHARLIE MUNGER: — so he's fonder of this kind of insanity than I am. (Laughter)

WARREN BUFFETT: No, we will pay you real money if you will deliver to our offices at Kiewit Plaza somebody who wants to use the Black-Scholes model and is willing to price 100 options for three years, willing to — using the Black-Scholes model — and letting us pick and choose among those.

Because, as Charlie says, it's a know-nothing affair. And we are know-nothing guys, in respect to an awful lot of things, but every now and then we find something where we think we know something, and anybody that's using a mechanistic formula is going to get in trouble in that situation.

But options have value. I mean, we issued options, in a sense, last year when we when we sold those — the 400 million of bonds. And we know what we're giving up when we sell those bonds.

I mean, we may have gotten, what — a negative coupon of sorts, but that's because we gave up option value. And it, you know, it wasn't — it isn't truly a negative cost instrument at all, because options have value.

17. Buffett recalls sneaking out to race tracks with high school golf coach

WARREN BUFFETT: Let's go to number 4.

AUDIENCE MEMBER: Hello, my name is Martin Wiegand from Bethesda, Maryland. And first I'd like to thank you, and all the folks working here at the microphones and staffing the booths, for hosting this wonderful shareholders' weekend. We enjoy your efforts. (Applause)

WARREN BUFFETT: Thanks, Martin.

AUDIENCE MEMBER: My question is about a company getting its employee compensation aligned with shareholder interest.

Charlie Munger, in one of his "Outstanding Investor Digest" interviews, cites the case of FedEx getting it right.

In the newspapers, we've all just read about American Airlines, Bethlehem Steel, and a lot of other companies getting it wrong. I find precious little written about compensation systems.

Would you share with us how you get it right at Berkshire companies?

Also, your old golf coach and racetrack friend, Bob Dwyer, asked me if you would like to share with us your pick in the Kentucky Derby. (Laughter)

WARREN BUFFETT: Is Bob back there with you, Martin?

AUDIENCE MEMBER: No, in the middle.

WARREN BUFFETT: Oh. Bob and I did spend a lot of time at the racetrack in high school. He was not only the basketball coach at Woodrow Wilson High, but he was also the golf coach.

And whenever I wanted to go the races he would write an excuse to my other teachers saying that we had to go out for the golf team. (Laughter)

And then we would head off to Charles Town, or Havre de Grace, or Pimlico or someplace.

And he cleaned up his act subsequently. (Laughter)

It's good to have Bob with us. He was known for his famous three-iron shots. He was known as "Trolley Wire" Dwyer in those days.

18. "Crazy" to use stock options as compensation

WARREN BUFFETT: Charlie, do you want to talk about comp a little?

CHARLIE MUNGER: Well, as the shareholders know, our system is different from that of most big corporations. We think it's less capricious.

The stock option system will give extraordinarily liberal awards sort of by accident to some people. And it'll deny other people any reward at all at some different time, in spite of great contributions made by the people who are getting nothing.

So except where we inherit it, we just don't use it. But we must be in a minority — far less than 1 percent, right?

WARREN BUFFETT: It's where we like to be, right.

It's interesting, we inherited some stock options at Berkshire, primarily in the General Re transaction. And, not through any failing of anybody or — there's no aspersions to be cast at all, but those options turned out to be quite valuable.

They would not have been valuable if General Re had been left alone as a standalone company. They were — they profited from the fact that other parts of Berkshire did well, and the money went to the people that had these options who delivered nothing to the performance of Berkshire for a while.

Now, that's — that is not an indictment of anybody, in the least, at Gen Re. It's an indictment of an options system which represents a lottery ticket, and also a royalty on the passage of time.

Because as you know, an option holder has benefits from retained earnings and benefits not at all from dividends. And that puts his interest, maybe, quite contrary to that of the shareholders.

So we believe in paying for performance, but we believe in tying performance to what is actually under the reasonable control of the person that's being measured.

And we — to give a lottery ticket on the overall results of Berkshire Hathaway to someone who is running a business that's 1 percent of the whole is really crazy.

And I would say that you have seen probably more misdirected compensation throughout the corporate system — corporate America — in the last five years, you know, than in the hundred years before that. It's been extraordinary.

There was wealth creation in the '90s, just like in the '80s, in the '70s, in the '60s, in the '50s. But there was a wealth transfer like had never been experienced before.

And, you know, you can't blame people for wanting to cash in on it. You know, if anybody wants to walk up and hand me a half a dozen lottery tickets for the Nebraska lottery, you know, I'll accept them. But it will have nothing to do with how I do in terms of running Berkshire.

Actually, Charlie and I think a properly designed options system, which includes cost of capital and some other factors, and ties it to the performance of the people involved, we think that can make sense, when we've used various incentive programs that are similar to that.

But the idea of just passing them out and telling people that for 10 years they get a free ride and then repricing — you know, if your stock goes down, their stock doesn't go down, their option price goes down. You know, that is not our idea of a great compensation system.

CHARLIE MUNGER: Yeah, if we are right with our general approach, it has considerably important implications.

Because the natural implication is that more than 99 percent of corporate compensation systems are more than a little crazy in America.

And I want to emphasize that Berkshire is not illiberal. I mean, we've got various incentive systems out where people make tens of millions and may make hundreds of millions.

And so, we're not against rewards for people who make vast contributions.

But a system that's basically capricious, and which doesn't tailor the results per person and per activity very well, we just think it's crazy.

WARREN BUFFETT: We love to see people that are associated with Berkshire making money, as long as they're making money for you at the same time. It's very simple.

And — but we don't want them to get a free ride off your money. (Applause)

Compensation's an interesting subject and I'm going to write about it next year, some. But, you know, it's not a market system. You can read all you want. I mean, you know, the PR people will tell you, you know, that "Joe Smith's compensation was determined by a market system and he's just like a baseball player," anything of the sort.

But he's not just like a baseball player. You know, the baseball player negotiates with somebody who's spending his money to hire the baseball player, and making a calculation whether he's better off laying out the money out of his own pocket — the owner of the team — to get that player.

But when you get a comp committee at a large American corporation, you have somebody with an enormous interest in the amount of comp on one side of the table.

And you've got somebody on the other side of the table, who was not picked because they were the Doberman of the board, believe me — and who is dealing with what — many times is what my friend, Tom Murphy, used to call "play money."

I mean, you know, it's almost meaningless to the person on one side of the table whether somebody gets 100,000 shares of restricted stock or a million shares of restricted stock, and it's not meaningless to the guy on the other side of the table.

Almost every other negotiation in American business, you have some parity of concern. But you do not have a parity of concern, you know, in terms of the — in terms of comp at the top levels.

You have a parity of concern when you get down to labor unions. I mean, the management wants to keep down the prices and the union wants to get more money. And that's a real negotiation.

And you have, you know, you have lots of other real negotiations in American business, but the compensation in many companies — not all, obviously — but in many, many companies has not been a real negotiation at all.

And the management has hired comp consultants to come in, and I have never seen a comp consultant come in and say, "We ought to reduce this guy's salary."

I’ve also never seen a comp consultant come in and say, “Why don’t you get rid of this bozo?” You know, I mean — (laughter) — they can’t all be wonderful.

But — you know, can you imagine a comp consultant doing that and ever getting another assignment? It wouldn’t happen.

So it’s a bad system, and it needs improvement. And it may be getting a little improvement. And as I wrote in the annual report this year, what happens with comp is the acid test of corporate reform.

Because frankly, the CEOs of America, they don’t care whether their boards are diverse, or not diverse, or anything of the sort. They care about how much money they make, in a great many cases.

And you, the owners, and big owners in particular, you know, have to provide some countervailing force, or you’ll have what you’ve had in the last 20 years, which is an enormous disparity in the rates of compensation of people at the top compared to people at the bottom.

And also a disconnect between the comp of people running businesses and the results of the owners who gave them the money. So arise, (inaudible) shareholder. (Applause)

19. Low inflation helps investors, but keep expectations low

WARREN BUFFETT: Let’s go to number 5.

AUDIENCE MEMBER: Good morning. Good morning, my name is Matt Sauer and I’m from Durham, North Carolina.

In a 1977 Fortune magazine article titled “How Inflation Swindles the Equity Investor,” you argued that corporate earnings in aggregate acted like a bond coupon, and thus, were negatively impacted by high inflation.

Due to high inflation at the time, you posited a world where a 12 percent return on corporate equity would —was reduced to 7 percent after taxes, and netted out to 0 percent in real terms.

You have been sounding downcast about the prospects for equities for several years, much of which we assume relates to extreme starting valuations.

If inflation was decidingly bad for investors in 1977, isn’t the relative lack of it in today’s economy at least one mark in the plus column for equity owners?

Is there also a future inflation expectation component in your warnings that investors are likely to be disappointed by equity results?

WARREN BUFFETT: Well, I would — there's no question that the lack of inflation is a plus for owners. I mean, the real return you will obtain, in my view, from owning American business — if purchased at similar prices — the real return will be higher if we have long periods of lower or close to no inflation, than if we had long periods of high inflation.

I don't think there's any question about that. Because that article went onto explain how you got taxed on nominal returns and fictitious returns in real terms.

So your question about which period is better for investors — a low inflation period over any long period is better for investors.

And the problem, as you pointed out also, was the starting point, in terms of predicting modest returns for equity investors.

The returns weren't necessarily so modest, I predicted. They were just modest compared to what people had begun to think returns would be during that long bull market from 1982 to 1999.

There were polls taken by Gallup working with, I think, PaineWebber at the time — now they've moved it over to UBS Warburg — that showed the expectancy of people in the stock market. And those returns that people expected got up to 14 or 15 percent, as I remember.

And they were thinking they were going to get 14 or 15 percent in a low-inflation environment.

Well that, you know, that was dreaming. And there's nothing wrong, in a low-inflation environment, at all, in earning, you know, 6 or 7 percent. That's probably as well —

Well, it is as good as will happen, because in a low inflation environment how much is GDP going to grow? Well, GDP, you know, if you have a 2 percent inflation and even 3 percent real growth, you're talking about 5 percent, in nominal terms, GDP growing.

If GDP grows at that rate, over time corporate profits will grow at — more or less, at that rate.

And if corporate profits grow at 5 percent a year, the value of those corporate profits, the capitalized value, will probably grow at something like that over any long term with sort of a normal starting point.

And add that to dividends and, you know, you will get 6 or 7 percent before frictional costs. Investors incur a lot of frictional cost. They don't have to, but they do. And that often is 1 1/2, 2 percent of their investment.

So the math isn't bad, it's just bad for those people that got used to, or expected, very high returns based on looking in the rearview mirror back in 1998 or 1999.

Charlie?

CHARLIE MUNGER: My general attitude is just slightly more negative than Warren's. (Laughter)

WARREN BUFFETT: You've heard it, folks. (Laughter)

That isn't the end of the world. I mean, in effect, if the people who own American business get 5 to 6 percent of the pie — $10 trillion economy now, someday a $20 trillion economy.

But if we get 5 or 6 percent of the pie, those of us who put our capital out to produce goods and services for American business — for American consumers, American population — is that a, you know, I don't know whether that's — you know, that's exactly what somebody who designed the universe would come up with.

But it doesn't strike me as crazy in either direction. You know, I think that — that's a lot of goods and services to go to people that put up the capital, but you — and you've got, you know, a hundred million-plus people in the working force that are working to turn that out for you, using your capital.

And it provides a — what I would regard as a pretty decent real return if you have low inflation.

If you get into high inflation, as I wrote about back in '77, you could easily have the real return, to investors, get to a very, very low number, and perhaps negative.

I mean, inflation can swindle the equity investor, as I wrote back then, and I used 7,000 words to explain why, and will be glad to send you a copy of that article if anyone's still interested.

But inflation is the one thing that, over a long period of time, can turn investors' results, in aggregate, into a negative figure. And it's the investors' enemy.

Charlie, does that bring forth any further thoughts?

CHARLIE MUNGER: I don't think you'll get perfect help on these subjects from the economics profession, either. They have certain standard formulas.

To an economist, when a manufacturing job goes to China, that's just so much productivity increase. And if you ask one, well suppose all of the manufacturing jobs in America went to China. Wouldn't that be a little too much efficiency increase?

And the answer would be no. And people actually get paid for thinking like this in major universities. (Laughter and applause)

WARREN BUFFETT: Yeah, if — what would get across the point, of course, is if all the teaching of economics got exported to China, in which — (laughter) — at that point a new insight would appear.

20. Managers decide whether to come to annual meeting

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Jack Hurst (PH), Philadelphia. I have a question about the managers, and a comment and a question about the insurance operation.

These meetings are a lot more fun with more subsidiaries and more managers. I also think more educational, because you get to interact with them.

Is there any feed — do you get any feedback from the managers that they enjoy coming here and they get anything out of the meeting?

WARREN BUFFETT: Well, we have a number of our managers here and I — but we don't require anybody to come. I mean, we have managers that, very, very seldom have come to a meeting.

And I don't keep names, I can't even tell you which ones they are. But you know, if they enjoy it, they come.

Many of them, of course, have operations down below, selling you things, and some of them come to help out in that respect. But we've got a — you know, we have a sensational group of managers.

They run their own businesses, they're extraordinary at doing what they do and we don't get in their way. We don't demand that, virtually, that they do anything, except work for the owners.

But you will — I hope you meet some of them here today because they — you know, the ones that are here, obviously, enjoy interacting with the shareholders.

And it's fun to put faces to functions. I mean, it — I enjoy it, I think a lot of them enjoy coming here.

And the people that are working downstairs, you know, they volunteer to come. And they enjoy seeing the shareholders, and they enjoy bragging about their companies, and they've got a lot to brag about.

And I hope you thank them when you see them because, you know, it's a lot of effort for them.

I got here at six o'clock this morning, but there were people that were here a lot earlier than that, and they were working yesterday to get ready for this. And I want to thank them myself.

Charlie? (Applause)

CHARLIE MUNGER: I don't think our managers who come to this meeting are picking up new tricks. Most of our managers know all the tricks that are related to their businesses.

But this is a very interesting place, and it gets more interesting every year. And part of what makes it interesting is not discreditable, and I think people like being part of it.

WARREN BUFFETT: Yeah, our managers — in a few respects, we'll occasionally work together.

Sometimes a manager of subsidiary A will check with some of the others, not through Omaha, directly themselves. And they will say, you know, "What are you paying for software?" or "What are you paying for UPS?" or whatever it is, and "Can we make a better deal if we pool our efforts?"

There are times when we have saved money, sometimes pretty real money. But that has never been instituted by Omaha, it's never been overseen by Omaha.

It's because manager A decides to call manager B. And you know, they like each other and they can make their own operation better, sometimes by combining purchasing power, and occasionally by just having an idea here or there. But there's no organized way of going at that in Berkshire and nobody has to play.

21. Decisions not based on "sweeping future projections"

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: I'm John Bailey (PH) from Boston.

I'd like to ask about our consumer businesses, which means that I have to ask about the consumer in general.

The situation, as I understand it, is that over the last 30 years or so the median consumer has seen his income rise only a little faster than inflation, and much slower than GDP, overall.

Income inequality is at a 400-year high. The present value of lifetime income for the median person has improved slowly. Yet the size of his lifetime liabilities, such as health care, housing, education, and retirement, has ballooned.

The economic net worth, then, of the consumer may be poorer than they think.

To cope, the median guy has put his wife to work, borrowed against the house, and also the credit cards.

So I think this may have some implications for the sustainability of consumer businesses. And seeing that we've been buying a number of them recently, how do we think about this problem? And are there any non-obvious risks that we should be considering?

WARREN BUFFETT: The American consumer, overall, is better, but not dramatically better off than 10 years ago. Even somewhat better off than 20 years ago. But you're quite right in that there's been considerable inequality, in terms of the progress of people financially during that period.

We don't have broad ideas about — I mean, we don't make decisions on what business we buy based on some sweeping future projections about things.

We think America will do pretty well over time. In fact, we'd — we're quite sure it will do pretty well over time and that our kids will live better than we live. My kids would say that wouldn't be so difficult. (Laughter)

But the — and the grandchildren will live better. You know, that has been the history of the American economy. The real income per capita grew sevenfold, I believe, in the 20th century. That is huge.

You know, it cost $18, as I remember, to make a three-minute station-to-station call from New York to San Francisco 40 years after the telephone was invented. And at the time the $18 was more than the average weekly wage in the United States.

You know, think if some little kid had picked up the phone on the other end and there went the whole weekly wage while you tried to get, you know, your daughter on the phone, or whatever.

So it — people will be better off in this country decade after decade. But we don't — we're not big on being futurologists or anything at Berkshire.

I will tell you this, in terms of our consumer businesses, right now, they're very soft.

Our furniture and jewelry businesses generally — candy business, businesses dealing with the consumer day by day — are soft, and the first quarter the earnings were down.

22. "Desirable" GDP shows how economy affects households

WARREN BUFFETT: One of the things you have to think about — and people don't — they don't focus on this very much. But you read about GDP, and this is one reason I think — I really think we've been in a recession now — not a huge one, but — or not a violent one — but for over two years.

When the government talks about GDP, A, they talk about GDP, we'll say, going up 2 percent. But of course, the population of the country, you know, goes up something over 1 percent per year. So it's per capita GDP that counts. And that has gone very close to no place.

But the more important factor, to some extent, is that GDP counts the people that, you know, have you take off your shoes when you go to get on an airplane. You know, it counts extra police. It counts all of these things that don't really translate into — they translate into goods and services that the country wants, but they are not goods and services — I mean, they're goods and services we wish we didn't want. And they — all of that counts the same way.

If there's a — 20 guards at the airport instead of three guards, that goes into GDP. But does it make you feel any better about how you're spending your paycheck every month? Probably not.

And when you get into a war, for example, if you drop planes into the ocean, you know, that's part of GDP, the cost of manufacturing those planes. But it doesn't do anything for you at your house.

So in terms of what I would call "desirable GDP," I think my guess is that, on a per capita basis, that has gone no place in the last few years as we've diverted resources to other things that don't really translate to what goes into your house or onto your table.

And the quality of GDP is something that is not really talked about very much when you pick up the economic reports every day.

Charlie?

CHARLIE MUNGER: Yeah, and the type of figures you gave us about inequality tend to obscure a basic and important fact. If the same families were permanently at the top of the economic heap there would be huge resentments about current inequality.

But when the coupon clippers and the DuPont family go down, and somebody creates something like Pampered Chef and comes up, in a real sense, something wonderful is happening in terms of equality, even though at the end it looks like there's been no progress.

That much churn makes people think the whole system is fairer. (Applause)

WARREN BUFFETT: We prefer not to be part of the churn, though, actually, at this point, I think. (Laughter)

We were much more in favor of churn 30 or 40 years ago. (Laughter)

23. Buffett didn't learn accounting from books

WARREN BUFFETT: Number 8, please.

AUDIENCE MEMBER: My name is Johann Freudenberg (PH). I come from Germany.

I would like to know the accounting book you like best. Thank you. (Laughter)

WARREN BUFFETT: Well, it's been a long time since I've read an accounting book. I read Finney back when I was in college, I remember that. And I always liked accounting. And for any of you in business, you know, you basically can't get enough accounting.

But I don't — you know, I am not really up to date on accounting books. Maybe Charlie's been reading some of those lately.

I would hope, actually, that if you read the Berkshire reports over time that you get certain, perhaps, lessons on accounting.

But I think you learn more accounting, probably, in terms of — well I mean, once you know the basics of it, by reading good business articles that deal with accounting issues, accounting scandals, that sort of thing.

I mean, what you really need to know is you need to know how the figures are put together, the underlying principles of it, and then you have to know what can be done with those.

And — you start with the accounting figures as the raw material of understanding a business, but you have to bring something additional to that.

And I can't think of any good books on that subject. I think I've read a lot of good magazine articles that contributed to my knowledge over the years.

And I've just, you know, I've read a lot of annual reports, and seen what people can do with accounting.

And as I've said before, if I don't understand it, I figure it's probably because the management doesn't want me to understand it.

And if the management doesn't want me to understand it, there's probably something wrong going on. I mean, people don't obfuscate with numbers, usually, without a purpose. And when you run into that the best thing to do is you stay away.

Charlie?

CHARLIE MUNGER: Yeah, asking Warren, you know, what good books he knows about accounting would be — it's like asking him what good books does he have about breathing. (Laughter)

The — and — (applause) — what the implication of that is, is that you start by learning the basic rules of bookkeeping, which are sort of like the basic rules of addition and subtraction. And then you have to spend a lot of time before that accounting gets related to the larger reality, and that's a lifelong process.

24. Many credit insurers "don't really know what they're doing"

WARREN BUFFETT: OK, we're going to try to go to the Music Hall. Number 9. Is this working?

AUDIENCE MEMBER: I believe so.

WARREN BUFFETT: OK, good.

AUDIENCE MEMBER: Bill Ackman from New York City, and my question is as follows:

Insurance companies — could you comment on insurance companies taking on credit risk through the sale of credit derivatives, the adequacy of the accounting for these derivatives?

And finally, could you explain why the financial guarantee insurers, who are the primary sellers of these derivatives, have the same triple-A rating Berkshire has, despite their more than 140-to-one leverage, and the correlated nature of the risks that they take on?

WARREN BUFFETT: Well, I think you should go to work for Standard and Poor's or Moody's.

The question about credit insurance or credit guarantees of one sort or another, you know, that's become very popular.

And it's become — actually, popular with, sort of, the standard insurance, property-casualty insurance, companies in recent years.

And I would say that, in many cases, the people participating in that business don't really know what they're doing.

It's so easy in the insurance business — it's the curse of the insurance business — it's also one of the benefits of it — is that people hand you a lot of money for writing out a little piece of paper.

And what you put on that piece of paper is enormously important. But the money that's coming in that seems so easy can tempt you into doing very, very foolish things.

We had a situation here in Omaha 15 or 20 years ago in the mid-'80s where Mutual of Omaha — largest health and accident association in the world, at least at one point — and they decided to go into the reinsurance — property-casualty reinsurance business.

And in a very, very, very short time they wrote not very many contracts, and it resulted in wiping out half of the net worth of everything that had built up over many, many decades.

If you are willing to do dumb things in insurance, the world will find you.

I mean, you do not — (Laughter)

You can be in a rowboat in the middle of the Atlantic and just whisper out, “I’m willing to write this,” and then name a dumb price, and you will have brokers swimming to you, you know — (laughter) — with their fins showing, incidentally. (Laughter)

It is brutal. I mean, if you are willing to do dumb things, there are people out there, and it’s understandable. But they will find you, and you will get the cash up front.

You will see a lot of cash and you won’t see any losses, and you’ll keep doing it because you won’t see any losses for a little while. So you’ll keep taking on more and more of this, you know, and then the roof will fall in.

And I mentioned in the annual report how GEICO had taken in, you know, 70-odd thousand dollars — $70,000 — of premiums in the early ’80s for a few policies, and they thought they were just picking cherries at the time, and they reinsured a lot of it. And so far we’ve lost $93 million.

Now, the most we could make was 70-odd thousand, and I don’t know what the most we can lose is. But I know that 93 million has gotten my attention. (Laughter)

When you’re playing in a game like that, you can’t afford to make a mistake. I mean, it’s — the mistake — a single mistake or a few mistakes that are correlated, as you’ve mentioned — because these things do correlate — a few mistakes will overcome a lifetime of savings.

I mean, it is — you will make a few cents on the dollar when you’re right, and you will lose incredible sums when you’re wrong.

And in credit insurance, when you go around — a lot of people went around guaranteeing credits based on ratings.

And they said, well, we’ll guarantee a whole bunch of single-A ratings, or we’ll create these structured arrangements that involve A-rated credits.

And they would use a lot of studies that would show that X percent of A-rated credits defaulted per year, and you go back to the ’30s, and all these back-tested arrangements.

But the problem with that is that what the questioner mentioned is correlation. And when things go bad, all kinds of things correlate that no one ever dreamed correlated.

And what you had, of course, in the debt field was you had a whole bunch of, say, telecoms or energy companies, that were all rated similarly. But they were correlated in a huge way and you weren't getting a diversification. You were getting a concentration that would — you didn't realize.

And there's nothing more deadly than unrecognized concentrations of risk, but it happens all the time.

So I would say we see a B-double-A credit enhanced to a triple-A credit by somebody guaranteeing it, and they may guarantee it for 10 or 15 basis points. And yet the spread in market yield might be 100 basis points.

That does not strike us as smart.

And I would say this about the triple-A rating. They have a triple-A rating for claims paying, but they don't carry, I don't think, general triple-A.

There's only, I think, eight or nine triple-As left in the United States. Berkshire Hathaway's one of them. But I believe there's only one other insurance company, which is AIG, and then there's a half a dozen other companies.

So those companies are not in the same class, credit-wise, as Berkshire, nor are they recognized as being in the same class.

But I would say you could get into a lot of trouble at 140-to-one — at some point — insuring credits.

Charlie?

CHARLIE MUNGER: Yeah, he also asked about the quality of accounting. And in my view, at least, the quality of accounting in America for derivative transactions is still terrible. And it's terrible in that it's too optimistic.

And one of the places where it's most terrible is when you talk about guaranteeing future credits way, way out — years ahead.

That sort of thing just lends itself to people getting very optimistic in their assumptions and in their audited figures.

And people pay attention to the audited figures, not the underlying reality. So therefore, if the accounting is lousy, the business decisions are lousy. And I think that's going on mightily as we sit here.

WARREN BUFFETT: Yeah, there are dozens of insurance organizations or trading organizations in the country that have written credit guarantee contracts in derivative form in the last few years, in fact, on a huge scale.

I will guarantee you, virtually, that every single one of those contracts that was written, in the first week, whoever wrote it, you know, recognized some sort of an income account or an income entry, and that somebody got paid a little bit of money for writing each one of them.

And you know that many of those are going to go bad, and maybe, as a category, that it's going to be a terrible category. But nobody ever wrote a contract and recorded a loss at the time they wrote it. I mean, they just don't do it.

And I will tell you that there are a lot of those contracts that if somebody wrote them for me, 10 seconds later I would've paid somebody to take them off my hands, so that I would've regarded them as having a built-in loss. Nobody ever records a built-in loss on a derivative contract.

In fact, I find it extraordinary that you have two derivative dealers, and dealer A and dealer B write a ticket, and dealer A records a profit and dealer B records a profit, you know, particularly if it's a 20-year contract, you know? I mean, that is the kind of world I'd love to live in, but I haven't found it yet.

25. We try to look "a long way into the future"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Hey, good morning, Charlie, Warren. Jerry McLaughlin from San Mateo checking in from the Music Hall.

You should see yourselves over here. We're about 12 feet from wall-size images of both of you, which is interesting, but the See's Candy box is so big, I understand what Tantalus went through now.

WARREN BUFFETT: How many people do you have in the Music Hall?

AUDIENCE MEMBER: We probably want to get a cop to estimate, but I'd say it's a couple of thousand.

Anyway, moving right along — hoping I can get a twofer here.

One is, at Branders, small company we run, we're seeing — we're spending a lot more on employee benefits anymore.

Health insurance in particular is going up and up again. And lots of times, in the press years ago and now again a little bit, you're hearing the drumbeat of a health care crisis and what it costs employers to provide health insurance.

I got to figure that's on the minds of a lot of Berkshire operating company managers. I'm wondering whether both of you feel — I mean, is crisis the right word, with respect to cost?

Looks like bigger percentages of our GDP are going to health care. Is that because we think we're getting better health care, or is it really just sort of inflationary?

Second thing is, at the risk of you thinking we're all a bunch of kooks over here, a couple of people over on this side of the hall have asked me to ask you, Warren, whether you're seriously considering being cryogenically frozen at some point — (laughter) — I think, hopefully, in the distant, distant future.

WARREN BUFFETT: What —?

CHARLIE MUNGER: Cryogenically frozen.

WARREN BUFFETT: Oh, we had that last year.

AUDIENCE MEMBER: Yeah, and the guy who asked the question last year has put me up to a follow-up for him.

Hey, and finally, unrelated to those two —

WARREN BUFFETT: Do I look like I'm closer to where I need it? (Laughter)

AUDIENCE MEMBER: Last thing is, when you guys look at companies and you're thinking about earnings into the future, just do you have any rule of thumb? How far in the future do you think you can look, typically, with a company you believe in, you think you understand the business?

Is it five years, 10 years? Do you really think you've got, you know, sort of the perpetual, into infinity income stream to calculate the value on? Thanks.

WARREN BUFFETT: Yeah, well we don't project as far out as we might have to if we thought we could be successfully frozen. (Laughter).

But we really — you know, we're going to own these businesses forever. So, we want a business that we think is going to have, if run well, some kind of competitive advantage — over many decades.

I mean, we're not going to resell them. And we better have something that is not only good now but that's going to stay good.

So we don't buy hula-hoop companies or pet rock companies, and we don't buy companies in industries that we think will have great explosions in demand, but where we don't know who the winners will be.

So we look a long — we try — we like to think we're looking a long way into the future.

26. Munger: 15 percent of GDP for health care is "not crazy"

WARREN BUFFETT: On health care costs — the only company-wide managers meeting — and we had far fewer managers then — but we had a meeting of most of the then-smaller number of managers 15 or 20 years ago where we did talk about what the various companies were doing on health costs, because they were then the fastest increasing part of our cost structure.

And today, workers' compensation costs would probably be — and some other insurance costs unrelated to health would be also — would, at least in the last couple of years, have moved up even more dramatically than health costs.

But health costs are huge for us. In many cases, you know, running 6- or $7,000 per employee, but moving up at a fast rate.

And you know, that is an inflationary part of the U.S. economy that we can't solve and our employees can't solve. And it becomes a big part of the kind of cost — it's a raw material cost — we had higher energy costs in the first quarter.

But health costs are the ones that are going to just keep coming and coming, in my view, and I don't have any great answers for it.

Charlie runs a hospital and knows a lot more about the health system than I do, so we'll see what he has to say.

CHARLIE MUNGER: Well, I would argue that the quality of the medical care delivered, including that from the pharmaceutical industry, has gone up enormously. And, of course, the cost has, too, but it's a much richer country.

And I don't think it's crazy if the United States wants to spend 15 percent of GDP on health care. If it went to 16 or 17, I wouldn't consider it the end of the world.

Eventually, of course, there would be a place where it wouldn't be smart to spend so much.

WARREN BUFFETT: Do you think, if we're spending 13 or 14 percent and other countries that seem to have fairly good systems are spending 7 or 8 percent, that we're getting our money's worth, relative to them?

CHARLIE MUNGER: Well, certainly they're getting more value per dollar out of their 7 percent than we're getting out of our 15. But does that mean that it's crazy for us to spend 15? I don't know.

I would guess not. But I don't see any sign from anything I see that it isn't continuing to go up.

WARREN BUFFETT: It's a — I don't know how much we — we never aggregate figures around Berkshire from the various companies because it wouldn't mean anything. But we spend a lot of money on health care.

And certain states, it's far higher than others. It makes a lot of difference where you're located.

27. Buffett: Giving and getting love is true success

WARREN BUFFETT: Number 1?

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name is Justin Fung (PH). I am 13 years old, from California. This is my third consecutive year in attendance.

First of all, I would like to wish you the best of health so we can continue to come to Omaha for many years to come. (Applause)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Thank you for answering my question on friendship last year. My question this year is, how do you define success and happiness? Are they related? And how would one achieve that? Thank you.

WARREN BUFFETT: Well, I tell college students that when you get to be my age, you will be successful if the people that you would hope to have love you, do love you.

I mean, you — if — Charlie and I know a few people that have got a lot of money, and they get testimonial dinners, and they get their names on buildings, and the truth is, nobody loves them.

And you know, not their family, not the people who name the buildings after them. You know, it's sad.

And it's — unfortunately, you know, it's something you can't buy. I mean, Charlie and I have talked a lot of times, if we could just buy a million dollars' worth of love, you know, I mean? It would be so much more satisfactory than to try and be lovable. (Laughter)

But it doesn't work that way, you know?

The only way to be loved is to be lovable. It's — and I hate to tell you that at 13, and — but the nice thing about it, of course, is that, you know, you always get back more than you give.

I don't know whether it was Oscar Hammerstein or who said, you know, "A bell's not a bell till you ring it, a song's not a song till you sing it. Love in the heart isn't put there to stay. Love isn't love till you give it away." And basically you'll always get back more than you give away.

And if you don't give any, you don't get any. It's very simple.

I don't know anybody my age that is loved by a lot of people — we had a dinner the other night, Don Keough was there — everybody loves Don Keough, you know, and for good reason.

And there is nobody I know that has — that commands the love of people around them, people they work with, their family, and their neighbors— that is other than a success or feels other than a success.

I don't know how the people feel that — where they know that nobody loves them, but I can't believe they feel very good.

So it's very simple. You can't get rid of love. If you try to give it out, you get it back more than you've given. And it's the best thing.

Charlie, what do you speak for? (Laughter)

CHARLIE MUNGER: Well, you don't want to be like the motion picture executive in California, and they said the funeral was so large because everybody wanted to make sure he was dead. (Laughter)

And there's a similar story about the minister saying at the funeral, "Won't anybody stand up and say a good word for the deceased?" And there was this long silence, and finally one guy stood up and he said, "Well," he said, "his brother was worse." (Laughter)

WARREN BUFFETT: Look, I would say this. Look around at, you know, people older than you are, look around at, you know, your older relatives or whatever, and you will not see a — an unhappy person who is loved by those around them.

I mean it — and it's — most people in this room are going to do very well financially. Most of the college students I talk to are going to do well financially.

And some of them are going to have very few friends — real friends — as they get older, and others, people won't be able to do enough for.

And I see it around me all the time. So that's our advice for the day on that.

28. Buffett doesn't remember giving advice to Richard Rainwater

WARREN BUFFETT: Number 2. (Applause)

AUDIENCE MEMBER: Hello, my name is Kevin Truitt (PH) and I'm a shareholder from Chicago, Illinois.

Mr. Buffett and Mr. Munger, thank you for putting on this marvelous event for your shareholders and partners. I thoroughly enjoy and love coming here.

I get so much education from this, in that the people here are just wonderful.

I have three, hopefully short, questions. The first two questions are for you and Mr. Munger, and the third question is for you.

My first question is, Mr. Munger, you are largely credited with moving Warren away from the cigar-butt approach to investing, as it was practiced by Ben Graham. It's been stated that it was the purchase of See's Candy that taught you this important lesson of buying good businesses.

At what point did you realize that this concept of buying good businesses was a better long-term investment strategy? And what was it in your discussions with Warren that allowed you to persuade him to move in that direction?

Mr. Buffett, what was it in Mr. Munger's arguments for buying good businesses that persuaded you to abandon the cigar-butt approach and move in his direction?

My second question is, in both your experience have you or Mr. Munger ever known of a company that has regained or replaced its competitive advantage once it was lost?

My third question for you, Mr. Buffett, is, early in his career Richard Rainwater sought you out and asked you what it took to become a successful investor. Can you tell us what he asked you and what you told him? Thank you. (Applause)

WARREN BUFFETT: The last question, I don't remember at all. I mean, Rainwater called me a couple of times, but I don't really remember the conversation.

That was a lot of years ago and I probably said the same — I would have said the same thing to his as if I got a question asked in this meeting.

So I've really had no contact with Richard Rainwater over the years. Like I say, I think I met him once, I believe, and he called a couple of times, so —

29. See's Candies lesson: listen to criticism

WARREN BUFFETT: Charlie, do you want to answer the first question about how you —

CHARLIE MUNGER: Yeah, well, I think there's some mythology in this idea that I've been this great enlightener of Warren Buffett. (Laughter)

Warren hasn't needed much enlightenment, but we both kept learning all the time, so that the man we were five years earlier was less sensible than the man who ultimately was there.

And See's Candy did teach us both a wonderful lesson. And it'll teach you a lesson if I tell you the full story.

If See's Candy had asked $100,000 more, Warren and I would've walked. That's how dumb we were at that time.

WARREN BUFFETT: Ten-thousand more. (Laughter)

CHARLIE MUNGER: And one of the reasons we didn't walk is while we were making this wonderful decision we weren't going to pay a dime more, Ira Marshall said to us, "You guys are crazy. There are some things you should pay up for," quality of business — quality, and so forth. "You're underestimating quality."

Well, Warren and I instead of behaving the way they do in a lot of places, we listened to the criticism. We changed our mind.

And that is a very good lesson for anyone. The ability to take criticism constructively is — well, think of all the money we made from accepting that one criticism.

And if you count the indirect effects from what we learned from buying See's, you can say that Berkshire's been built, partly, by learning from criticism. Now, we don't want any more today. (Laughter)

WARREN BUFFETT: We also like the peanut brittle, too. (Laughter)

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

WARREN BUFFETT: The — Charlie explained, I had learned investment, and got enormous benefit out of that learning, from a fellow who concentrated on the quantitative aspects, Ben Graham.

And who didn't dismiss the qualitative aspects, but he said you could make enough money focusing on quantitative aspects, which were a more sure way of going at things and would enable you to identify the cigar butts.

He would say that the qualitative is harder to teach, it's harder to write about, it may require more insight than the quantitative. And besides, the quantitative works fine, so why try harder?

And on a small scale, you know, there was a very good point to that.

But Charlie really did — it wasn't just Ira Marshall — but Charlie emphasized the qualitative much more than I did when I started.

He had a different background to some extent than did, and I was enormously impressed by a terrific teacher, and for good reason.

But it makes more sense, as we pointed out, to buy a wonderful business at a fair price, than a fair business at a wonderful price.

And we've changed our — or I've changed my focus anyway, and Charlie already had it — over the years in that direction. And then of course, we have learned by what we've seen.

I mean, we — it's not hard when you watch businesses for 50 years, you know, to learn a few things about them, as to where the big money can be made.

Now, you say when did it happen? It's very interesting on that. Because what happens, even when you're getting a new, important idea, is that the old ideas are still there. So there's this flickering in and out of things. I mean, there was not a strong, bright red line of demarcation where we went from cigar butts to wonderful companies.

And it — but we moved in that direction, occasionally moved back, because there is money made in cigar butts.

But overall, we've kept moving in the direction of better and better companies, and now we've got a collection of wonderful companies.

31. Hard to regain a lost competitive advantage

WARREN BUFFETT: In terms of competitive advantage and then regain — lost and then regained — there aren't many examples of that. In the property-casualty company, I've got a friend who always wants to buy lousy companies with the idea he's going to change them into wonderful companies.

And I just ask him, you know, "Where in the last hundred years have you seen it happen?"

I mean, GEICO got into trouble in the early '70s, but it had a wonderful business model. It did get off the tracks, but it wasn't because the model went astray, it's because they'd started reserving incorrectly and went crazy on growth, and a few things like that. But the basic model was still underlying it.

You might argue that one company that lost its competitive position and then came back in a different way, actually, was Pepsi-Cola. I mean, they were "Twice as much for a nickel, too."

They were selling on a quantitative basis, the fact that you got to guzzle more of the stuff for a nickel — twice as much, as the slogan went — and they lost that edge, post-World War II, when costs went up a lot.

And so they basically changed their marketing approach successfully, and that's very, very seldom done. But you have to give them credit for that.

To some extent, Gillette lost its competitive position somewhat in the '30s, lost market share against what they called penny blades and all that, and then regained it in a very big way in the next 10 or so years when their market share went up enormously.

But generally speaking, if you lose your competitive position — the Packard Motor Company had the premier car in the mid-'30s. The Cadillac was not the premier — it was the Packard.

And then they went downscale one year and they never came back. They jumped their sales that one year because everybody wanted to own a Packard, and now you could own one a little cheaper. But they never regained that upscale image again.

And certain department stores have done that, too. They've had a upscale image. And you can always juice up your sales, particularly if you've got a great upscale image, by having, you know, this sale or that sale, and going downmarket.

It's very hard to back upmarket again, and you've seen some great department stores that have had that — or specialty stores — that had that problem.

Charlie, you got any thoughts on that?

CHARLIE MUNGER: No more.

WARREN BUFFETT: OK.

32. "Fretful disposition" will hurt your long-term performance

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Hi. I'm Bruce Gilbert (PH), a stockholder from New York City.

And about four or five years ago, I put most of my family's portfolio — actually all of it — into Berkshire Hathaway.

And over the past four or five years, the stock price has remained rather steady, and I've withstood the year 2000, when friends were making 50 percent and I was losing 50 percent on my investment.

But I have to admit, when I read your Fortune article last year and you referred to the stock price as expensive, I felt badly.

Now I spend my days sometimes having fun, figuring out the value of Berkshire Hathaway.

But at night after that comment I could also wake up in worry and fret. And I realize you talked, recently, a lot about the qualitative and quantitative aspects of things.

And I guess I would like you, with your self-reflective position, and knowing that I'm asking you to do something like maybe talking about your breathing, what went into that comment to call the stock price expensive, in terms of your weights and measures?

What price, what value? What do you think about the company and its stock price when you say it's expensive?

WARREN BUFFETT: I think if you — I don't remember the exact wording of that article, but I'm quite sure that I told the author of that article, and I'm almost positive it was in the article, that said I thought it was more attractive than owning the general market or the S&P.

So I was saying that I preferred it to the general market. I'm certainly happy having 99 and a large fraction percent of my net worth in it. I've never sold a share, I am not the least bit uncomfortable about holding it until the day I die, and quite a bit thereafter. (Laughter)

But I have not thought stocks were cheap at all for some time. And I've never wanted to encourage anybody, particularly in the last few years, to buy Berkshire or any other stock because — the market — I felt that the — you know, I felt we had a great bubble.

And you know, I think Berkshire's value has improved — I think Charlie does, too, fairly significantly — in recent years.

And I would — if I had a chance to swap, tax-free, my Berkshire for the S&P 500, or for any mutual fund or anything, you know, I wouldn't even give it a thought. But that does not mean I think, you know, either Berkshire or stocks are cheap.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that.

WARREN BUFFETT: I don't think we've ever recommended the purchase or sale of Berkshire, that I can remember. We did say at one time we would repurchase shares, which has a certain underlying message to it.

And we said at other times we wouldn't buy shares. That doesn't mean we'd sell shares at all, but we wouldn't have bought them under the prevailing conditions.

But we have stayed away from recommending, actually not only the purchase or sale, not only of Berkshire, but just of any other specific shares.

We've only given our views, occasionally, on what we think about the level of the stock market, generally.

But I do think, if you go back and look at that article — I wish I had it here. But I think you'll find that I said I preferred it to equities, generally. It —

CHARLIE MUNGER: I do think that there's a lot to be said for developing a temperament that can own securities without fretting. I think that the fretful disposition is the — it's an enemy of long-term performance.

WARREN BUFFETT: Well, it's almost — I think it's almost impossible if you're — to do well in equities over a period of time if you go to bed every night thinking about the price of them. I mean, Charlie and I, we think about the value of them.

But we would be happy, just as in that movie — if they closed the Stock Exchange tomorrow, you know, Dick Grasso wouldn't be happy and Jimmy Maguire, our specialist, wouldn't be happy.

It wouldn't bother me and Charlie, at all. We would keep selling bricks, selling Dilly Bars, selling candy, writing insurance. You know, a lot of people have private companies and they never get a quote on them.

You know, we bought See's Candy in 1972. We haven't had a quote on it since. Does that make us wonder about how we're doing with See's Candy? No, we looked at the company results.

So you — there's nothing wrong with focusing on company results. Focusing on the price of a stock is dynamite, because it really means that you think that the stock market knows more than you do.

Now if the stock market may know more than you do, but then you shouldn't be in stocks. I mean, you should have — the stock market is there to serve you and not to instruct you.

So you need to formulate your ideas on price and value, and if the price gets cheaper and you have funds, you know, logically, you should buy more, if — and we do that all the time.

Where we make our mistakes, frankly, is where we focus on price and value and we start buying, and the price goes up a little and we quit, you know, like Charlie referred to, we might have done on See's Candy.

A mistake like that cost us $8 billion in the case of Walmart stock a few years ago, because it went up in price. And you know, we are not happy when things we're buying go up in price.

We want them to go down, and down, and down. And we'll keep buying more and — hopefully we won't run out of money. Of course, that's a different story.

Charlie?

CHARLIE: No.

33. Triple-A rating won't "cause us to do anything stupid"

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi. David Anglin (PH) from St. Louis, Missouri. Thanks for the weekend, it's very nice. It's always entertaining here.

According to an article in The Economist, the triple-A rating is very important quality for reinsurance to have. Swiss Re, Munich Re have lost their triple-A ratings. Gerling is out of the ballpark.

Will the reinsurance business at Berkshire become unintentionally exposed to higher risk because it is now a major reinsurer still holding a triple-A rating, even though it practices a very severe underwriting discipline?

WARREN BUFFETT: No, the triple-A can't increase our risk, because it should not affect what we do.

It may affect what gets offered to us. I mean, logically we should get business offered to us first, and last. I mean, we are the reinsurer that's going to pay for sure, five years from now, 10 years from now.

So when — I mean, we have contracts, we have structured settlements with paraplegics that are counting on us to make a payment to them 50 years from now.

And those people are in wheelchairs, they may be on — you know, they may be on oxygen, all kinds of things. And they are depending on a little piece of paper that has our name on it, and it says we're going to pay them for the rest of their life. And it's very, very important to them whose name is on it.

But that shouldn't cause us to do — it shouldn't cause us to do anything at all stupid. It just means that people that care about security of future promises should come to us.

But there's no reason at all, because Munich or Swiss Re loses their triple-A, that we should underwrite in any way differently than we do now. It just should mean that we have more to choose from.

And I can assure you that, as these companies lose their triple-A — and a number have in the last year or year and a half — we have been tightening our underwriting very materially at Gen Re.

Now, it needed tightening — but we are now, in my view — we have the right — we have a great underwriting culture at Gen Re, and historically it had it most of the years. It drifted away from that, but I think it's back in spades now. So I don't think you have to worry about that.

Charlie?

CHARLIE MUNGER: Well, I certainly hope we are better underwriters than Munich Re.

WARREN BUFFETT: Well, let's not name names. (Laughter)

No, no, Munich is a fine company. (Laughter)

The rule at Berkshire is we praise by name and we criticize by category. (Laughter)

And I do think Munich is a fine company, but they lost their triple-A, frankly, because they probably had — they were too exposed on the equity side — on the asset side — in equities, relative to net worth, and I think they probably agree with that.

But they have a very strong and important position in insurance. And we do a lot of business with Munich Re, and will continue to do so. But there are others we won't do business with, incidentally.

I mean, there are some very weak reinsurers in the world and if there were to be a major natural catastrophe, or if there were to be a major financial catastrophe, there are a number of reinsurers, in my view, that would not pay. And we conduct our affairs so we'll always be able to pay.

34. Planned all along to exercise Cologne Re buy option

WARREN BUFFETT: Number 5?

AUDIENCE MEMBER: Good morning, gentlemen. My name is Olaf Heine (PH) from Germany. And not surprisingly, I have a question concerning the German reinsurance market, fitting nicely in the context of the questions before.

When you acquired General Re, I believe you inherited, also, a substantial stake in Cologne Re. Now in your last letter to your shareholders, you hinted that a major reinsurance company might be in trouble, widely believed to be Gerling Re, just mentioned.

You also mentioned, about an hour ago, that Germany was kind of a drag insurance-wise — (laughs) — if you are — if I understand you correctly.

WARREN BUFFETT: I don't — I mean, I don't believe I — I didn't mean to say that.

AUDIENCE MEMBER: OK, but it helps to formulate the question. (Laughter)

WARREN BUFFETT: OK, well, for the purpose of your question we'll assume I said it — (laughter) — yeah. But I didn't say it.

AUDIENCE MEMBER: So now Gen Re decided to exercise a call option on the remaining shares of Cologne Re, another German reinsurance company. And my question simply is, what motivated you to do so?

WARREN BUFFETT: Yeah, that's a good question. And it was mis — it was sort of somewhat misreported in the press, what happened on that.

What really happened is that Gen Re — I don't know whether it would be about six or seven years ago now — acquired a significant position in Cologne from the controlling shareholder, with a put and call arrangement for the remainder.

I don't even know the history, exactly, of why they went for this two-step transaction, but basically it was a two-step purchase.

So that all along we have accounted for Cologne as if we were going to exercise the option. Because, in effect, if we didn't exercise, they would exercise. And it was fait accompli that we would buy that stock right from the start.

So we made no affirmative — we made an affirmative decision six or seven years ago to buy a very significant percentage of Cologne. We now have — will have about 89 percent when the option's exercised.

But there's nothing new in the fact that we are now doing it. The put and call arrangement, as I remember, became effective, essentially, this year.

So this was the year that something had to be done, and was planned to be done all along. And it reflected no new judgment, no new decision about Cologne in the year 2003.

It reflects a decision that was made in 1996 or ’97, whenever the original purchase was made.

And Cologne is an integral part of General Re. I mean, we knew all along that we would own 89 percent of it, pursuant to this contract. And it — that’s always been in our thinking, from the moment we sat down with the Gen Re management to make a deal some years ago.

So the press has sort of implied that there’s something new in this transaction that’s occurring this year, and there really isn’t.

35. Berkshire buyback is possible, but not likely

WARREN BUFFETT: Number 6. Charlie, you don’t have anything on that? No.

AUDIENCE MEMBER: Good morning — Mr. Buffett. This is Abhishek Dalmia coming from the land of Mr. Ajit Jain, (inaudible) India. The question is —

WARREN BUFFETT: If you have any more like Ajit over there, send them. We need them. (Laughter)

AUDIENCE MEMBER: Right. My question pertains to the allocation of a company’s free cash. And the question is, under what circumstances would Berkshire consider parting with its money for a share buyback program, as opposed to retaining it for future acquisitions? Thank you.

WARREN BUFFETT: Yeah, that’s a good question and we addressed that a bit back a couple of years ago. In fact, I think our annual report for 1999 came out on March 12th — I believe it was March 12th — on a Friday night or a Saturday morning.

That was the day the NASDAQ hit its high and Berkshire hit its low, on that exact day. And we said we would — the next morning, on the internet — on a Saturday morning — we said we would repurchase, but we wanted you to have the annual report first, but we might repurchase at those levels.

And the NASDAQ never saw its level of 5100 again, and Berkshire never saw its level of whatever it was, 41,000 or thereabouts.

Our preference — and we stated this 20 years ago, even to — is to buy businesses. We are — we want to add businesses of a quality with managers of a quality equal to those we already own, at prices that make sense. And that’s our number one preference.

If we thought Berkshire was significantly undervalued and we thought the likelihood of using the money to buy businesses — the probability was low — we would be buying stock in — we probably wouldn't be able to buy a lot of stock in, but we would only buy stock in if we thought the stock was selling significantly below intrinsic value.

And there's no magic figure for intrinsic value. Intrinsic value is a range. Charlie would name a different number than I would name, but our ranges would be quite similar, if we were to write them down on a piece of paper now. But they wouldn't be identical.

So we leave a — we would leave a significant margin of safety and would want to buy at a — what would be a clear-cut, to us, discount from the lower levels of intrinsic value we might calculate.

It's not our number one preference. We would rather add — we love it when we add good businesses to Berkshire.

But we would have to — if the stock — if we could add intrinsic value per share by repurchasing, and we've given all the shareholders relevant information about the value so that we weren't putting anything over on them, that they had the same information we had, we would buy in stock.

I think it's unlikely that happens, that we don't find other opportunities to do things at a time like that. But it could happen, and it almost happened in March of 2000, and then things turned around very, very abruptly.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

36. MidAmerican will grow, even if utilities law isn't repealed

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good morning. My name is Ken Goldberg (PH) from Sharon, Massachusetts.

What is your long-term vision for MidAmerican Energy?

And specifically, assuming the repeal of the Public Utility Holding Company Act, what is the nature of the type of assets that you would be interested in acquiring, be they generation, transmission, distribution-type properties?

WARREN BUFFETT: Yeah, MidAmerican already is a big part of Berkshire. I would say it's likely to become much bigger. It will be easier to have it become much bigger if the Public Utility Holding Company Act, which was enacted in 1935 — if it were repealed.

Public Utility Holding Company Act, which is a melodiously named — called PUHCA — (laughter) — was enacted in 1935 in a reaction to what Sam Insull and people like that had done in the 1920s. It was very understandable.

But I really think it is quite outdated now. I mean, it is now 68 years later.

And I think we bring something to the utility field. In fact, I think we brought it in the last year.

There might well be a couple of companies that wouldn't — would be in bankruptcy now if we hadn't been in a position to act very quickly on certain things.

So — but with or without the repeal — and I think there's a reasonable chance it'll be repealed. But with or without repeal, MidAmerican, which is big now, will become quite a bit bigger. And it could become a whole lot bigger.

Now, in terms of what kind of assets we'll buy, we don't have a —any clear-cut preference, for example, as to whether it would be a natural gas pipeline, or whether it would be a domestic utility, or conceivably, a utility, even, in some country that we felt good about.

We will look at things as they come along. We're always ready to act. I would say that it's certain we'll look at a few big deals this year. Whether we get one done or not depends on competition, depends on the sellers, and some things like that.

But something will happen with MidAmerican — over — you know, whether it's this year, or next year, or the year after, we'll get a shot at doing something significant.

And the nature of the energy field is you're talking big money, always. I mean, these are not lemonade stands. And you know, we're talking in the billions, frequently, on the kind of assets involved.

So it will be a — we've got a fabulous management — we've got two people running that in Dave Sokol and Greg Abel, who are — they're terrific businesspeople.

You know, they — and, incidentally — I should mention this publicly — they have done things that have made Berkshire significant money that had nothing to do with MidAmerican.

In other words, they have spent their time and energy, weekends, putting together a couple of things that MidAmerican itself could not do, but Berkshire could. And they didn't get paid a dime for that and MidAmerican did not get paid a dime for that.

So they have contributed to Berkshire's welfare beyond what they've contributed simply as managers of MidAmerican.

So it's a terrific asset. We love the idea of pouring money — (applause) — behind them, and you'll see something happen.

Charlie?

CHARLIE MUNGER: Well, I — the really interesting thing about it is the fact that the field is so big. I mean, you're talking about an enormous field.

One thing a modern civilization needs is energy, so we'll be very disappointed if there aren't more activities.

37. Why Buffett doesn't get a performance fee

WARREN BUFFETT: Number 8.

When we get through with number 10 we're going to break for lunch, and then we'll come back and start all over again after 30 or 40 minutes. But I'd like to get through 8, 9, and 10.

Eight.

AUDIENCE MEMBER: I'm Norman Rentrop from Bonn, Germany.

Mr. Buffett and Mr. Munger, I have a thank you and a question for you. Thank you for allowing us shareholders to invest with you on equal terms, with almost no management fee and no performance fee. (Applause)

I came to fully appreciate it when I compared my 10 years of holding Berkshire Hathaway to a private equity fund, which over the same 10 years earned 19.8 percent before fees, and 11.2 percent after fees. — (Buffett laughs)

Now my question. Back in the 1950s and 1960s when you had a partnership, Mr. Buffett, you asked for and got a performance fee of 25 percent of what was earned above 6 percent a year.

WARREN BUFFETT: Correct.

AUDIENCE MEMBER: What caused you to switch from that performance fee to that no fees we are enjoying today? Was it the wisdom that to give is better than to receive? (Laughter)

WARREN BUFFETT: Try again. (Laughter)

AUDIENCE MEMBER: And do you feel that this switch from performance fee to no performance fee, that that is fully appreciated? And what did it mean to you personally?

WARREN BUFFETT: Well, I appreciate what you had to say, and I will — I would pay to have this job I have. I would pay a lot of money. And I hope I don't get tested on that, but you know, it's —

Why in the world — if I can work with people I like, and get the same result they have, and end up with all kinds of money, you know, why do I need to make some further override on them?

I was changing my position in life significantly when I started that partnership in 1956. A couple of the people that — well I guess, yeah, [Buffett's sister] Doris may be the only original partner here. But Doris, would you stand up? She joined on May 5th, 1956, wherever she is.

And the — you know, those people gave me their money but I wasn't — I needed some money then, too. And I did get an override, which I thought was fair.

I got no management fee at all, though. I never charged — today, most of the people who run hedge funds charge 1 percent a year, and then some percentage of the profits. I did not do that.

And I did have all my money in after 1962, so that the downside would be equal to the upside.

But I've always felt about the people as partners. And when we got into Berkshire — originally we got into Berkshire, Berkshire was owned by the partnership. So if I had taken a salary then I would've been double-dipping, in effect, by getting money out of Berkshire before, in turn, the partnership participated.

And frankly, by the time I got — where I was running Berkshire I had all the money I needed. And you know, I'd rather get the same result as my partners than have me get a different result. And it can't make any difference.

I mean, it'll make a difference in the size of my foundation someday, perhaps. You know, but so what? I like living the way I live.

Charlie?

CHARLIE MUNGER: Well, you raise a very interesting question, and it has parallels, if you go back.

[Andrew] Carnegie was always very proud that the bulk of his fortune had been earned where he took no salary at all from Carnegie Steel. John D. Rockefeller the First took practically nothing in salary.

Over the years — the original Vanderbilt prided himself on living on his dividends and taking no salary.

It was a common culture in a different era. And you realize that all those people had the psychology of being the founder, and maybe that's what influenced Warren.

WARREN BUFFETT: What influenced you, Charlie?

Charlie doesn't take anything either, so —

CHARLIE MUNGER: I was delighted to get rid of the psychological pressure brought by — brought on me by getting fees based on performance. I think Warren was, too.

If you're highly conscientious in your relations with other people, and you hate to disappoint, you're going to suffer more if you are liberally rewarded with performance fees.

So I think there was an enormous advantage to us, so I guess we should be thanking you.

WARREN BUFFETT: I should — (Applause)

Bill Gates has never taken an option at Microsoft, and takes a very small salary. And you'll find it interesting. The only reason he takes the small salary is if there — he feels that, if there's a bad year at some time in the future, he wants to be able to take a cut in salary at the same time he's asking other people to cut back.

And that is the reason. I mean, he takes peanuts as it is, but he just figures that — Bill is a very conservative guy, and he figures that some year there'll be a bad year. And he wants — if he's asking other people to take a 5 percent cut, he wants to be able to take a 90 percent cut, or something, himself.

But he's never taken an option, and I don't believe [Microsoft CEO] Steve Ballmer has either. They have gotten rich with their shareholders and not off their shareholders, and that's an attitude we admire.

38. "Mild wakeup call" on derivatives

WARREN BUFFETT: Number 9? (Applause)

AUDIENCE MEMBER: Good morning. I'm Whitney Tilson, a shareholder from New York City.

There was a lot of talk among the Berkshire faithful when you took what I believe was the unprecedented step of pre-releasing a portion of your annual letter, published in Fortune, which focused primarily on the dangers of derivatives — which you called "financial weapons of mass destruction."

I have two questions related to this — the first to you, Mr. Buffett.

Could you tell us the story of how the Fortune article came about? Were you trying to draw extra attention to something that you feel strongly is a great risk to our financial system?

And the second question to both of you, since you're warning about derivatives, there's been a huge rally in the credit markets, in general. Does this reflect investors' lack of concern for these systemic risks or is it caused by other factors?

WARREN BUFFETT: The first question, my friend [Fortune Magazine journalist] Carol Loomis is the editor of the Berkshire report. And we wouldn't get out the report without her. I mean, she is the world's greatest editor, in addition to being the world's greatest business writer.

So when I gave the report to her to edit — and it did not come back unmarked, I might add — she and I talked about — I mean, I was interested in having the section on derivatives because I thought it had a broader — I hoped it would have a broader audience than just the Berkshire annual report.

And I felt that publishing it, which had no relationship to the Berkshire business, basically, except the history of Gen Re's involvement, would not be, in any way, compromising fair disclosure, in terms of Berkshire's results itself.

So the primary reason for having it in Fortune was I hoped for a wider audience, basically, by having it in Fortune.

And you know, Charlie and I think there is a low, but not insignificant, probability — and low — that sometime, maybe in three years, maybe in five years, maybe in 20 years, and very possibly never, that derivatives could accentuate, in a major way, a systemic problem that might even arise from some other phenomenon.

And we think that's inadequately recognized. We think the problem grows as derivatives get more complex and as their usage increases.

So it was a call — what we hope was a mild wakeup call — to the financial world that these things could be very troublesome.

And of course, we saw it in the energy field in the last two years. It almost destroyed, or destroyed certain institutions that never should have been destroyed.

And the — we also saw, in 1998, the whole financial system almost become paralyzed, particularly in the credit markets, you know, by the action of a firm, which was not solely based on derivatives, but would not have gotten into as much trouble as it did without derivatives.

So it's a subject that no one quite knows what to do with. Charlie and I would not know how to regulate it, but we think we have had some experience in seeing both the firm's specific dangers in that field, and we think we have some insight into the systemic problems that could arise.

And you know, that people really — they don't want to think about it until it happens. But there are some things in the financial world that are better thought of before they happen, even if they're low probabilities.

And we're thinking about low probabilities all the time, in terms of Berkshire. I mean, we don't want anything to go wrong in a big way at Berkshire. And we therefore, I think, think about things that a good many people don't think about — simply because we worry about that.

And when we get our social hats on we think about it in terms of something like derivatives for financial systems of the world. And we have had some experience at both Salomon and at Gen Re.

And Charlie was on the audit committee at Salomon, and he saw some things in the audit committee in relationship to trading itself, and derivatives in particularly, that made him wonder why in the world people were doing these sort of things. I'll let Charlie expand on that.

CHARLIE MUNGER: Yeah, in engineering, people put big margins of safety into systems — atomic power plants being the extreme example. And in the financial world, in derivatives, it's as though nobody gave a damn about safety.

And they just let it balloon, and balloon, and balloon in usage, and number of trades, and size of trades.

And that ballooning is aided by this false accounting, where people are pretending to make money they're not really making.

I regard that as very dangerous, and I'm more negative than Warren in the sense that I'll be amazed, if I live another five or 10 years, if we don't have some significant blow-up.

WARREN BUFFETT: They've been advertised, and sometimes in a fairly prominent way — they've been advertised as shedding risk for participants in the system, and reducing risk for the system.

And I would say that I think they have long crossed the point where they decrease risk to the system, and now they enhance risk. Because you have — the truth is, the Coca-Cola Company couldn't bear the foreign exchange risk that they run, or the interest rate risk that they run, and all of that sort of thing.

But when the Coca-Cola Company starts laying those off, and every other company in the world — major company — does with just a relatively few players, you have now intensified the risk that exists in the system.

You have not shed risk at all, you have transferred it, and you have transferred it to very few players. And those players have huge interdependencies with each other, and to some extent, central banks and all of those similar institutions are vulnerable to the weaknesses of those institutions.

When Charlie and I were at Salomon, you know, they hated it if we brought up — and so therefore, we didn't do it — that we were too big to fail.

But the truth was that if Salomon failed at that time, the problems for the rest of the system could well have been significant. They might've been — who knows exactly what they would have been? But they could have been quite significant.

And when you start concentrating risks in institutions which are highly leveraged, and who intersect with a few other institutions like that — all bearing same risks, all having the same motivations in the trading departments — to take on more and more esoteric things because they can book more and more immediate profits, you are courting danger.

And that's why I wrote about it this time. And I — it's not a prediction, it's a warning.

39. Do managers love the business or the money?

WARREN BUFFETT: Number 10, and then we will break for lunch right after this.

AUDIENCE MEMBER: Good morning, my name is Ho Nam from San Francisco, California. I have a two-part question regarding how you evaluate your managers.

In your annual report, you wrote that Berkshire Hathaway owns "good to great" businesses and employs "great to great" managers, and we're thankful for that.

When you hire a manager, or are evaluating the management team of a business you're thinking about buying, what are the qualities you look for?

And some of your managers were entrepreneurs who started their businesses from scratch when their business models were unproven, and some of them took over businesses that were already performing well when they took charge.

What are the qualities of a great entrepreneur that might be different from those of a manager who can be great at running a company that's established, but may not be able to start a business from scratch and tinker around with a business model and figure out how to make it successful?

WARREN BUFFETT: Yeah, well we love managers that have a passion for their business. And when we're buying a business we have to ask ourselves, "Do they love the money or do they love the business?"

If they love the money, there's nothing wrong with that, but they probably wouldn't be running the business for us a year or two down the road.

I think one difference is that people that create their own businesses, the entrepreneurs, probably, on average would have a significantly greater degree of passion for those businesses than somebody that was just brought in a few years ago and sees themselves as making a profit in a few years on reselling the business and leaving.

I — you'll find exceptions in both camps. But we've had terrific luck with the entrepreneurs who basically love their businesses the way I love Berkshire. I mean, they are not going to let anything happen to their businesses.

They can — you know, they'll tell me to butt out if I'm going to screw up something in their operations, and they don't regard them — I mean, in a certain sense, I mean, they know they're part of Berkshire.

But they regard them in a certain jealousy, almost, as being their businesses, and we love it that way.

And you know, we can spot it when we see it. And we also can avoid it.

We have never — I just got one in the other day, something from an investment banker on somebody that wants to resell a business they bought a few years ago.

Well you know, the chances that they haven't doctored up the figures in some way or are trying to sell, I mean, you know, they're — it's a piece of meat to them. And if it's a piece of meat to them, you know, what am I going to do with it?

So we — if we make the proper judgment about the passion they have for their business, they're going to keep running — they may have a lot of money in the bank — but they're going to keep running the businesses for us, because they love those businesses.

And they really are motivated the same way I am. You know, it wouldn't make any difference what I get paid, you know. I'm identified, in my own mind, with how Berkshire does.

I really don't care how the rest of the world thinks about how Berkshire's doing. I mean, in other words, when we looked like we were out of step a few years ago, that really doesn't make any difference to me, as long as I feel OK about how Berkshire is doing.

But I do — you know, that's how I measure what I'm doing every day — not by the price of the stock, but by what's going on in the business. And that's what — we have a group of managers like that, and there —

I don’t think there’s — well, there can’t be a company in the country, in my view, that, if you could figure out some way to measure the passion involved, in terms of running their business, I don’t think there’s anybody that could come close to matching the quantity that we have managed to marshal together at Berkshire.

It’s been accidental over time, but it’s really almost unique. I think it is unique.

Charlie?

CHARLIE MUNGER: Well, it’s very interesting to think about what matters most, the passion or the competence that was borne in?

Certainly Berkshire is full of people who have a peculiar amount of passion in their love for their own business. And I would argue that probably the passion is more important than the brainpower.

WARREN BUFFETT: Yeah, and by the time they get to us, if they were passionate but incompetent, they don’t get to us.

I mean, they’re not going to be there unless they’re competent, but the question is whether they had a passion for money or a passion for their business, to some degree.

And they all like money, and the reason — and they like it, partly, because it enables them to build the business they love.

But they don’t — we’re not going to see an incompetent, but passionate, manager by the time we start laying out a lot of money for a business.

They got weeded out a long time ago. So I don’t have to weed those out, but I do have to weed out the ones who want to cash a big paycheck and go off and do something else at some time. And like I say, we’ve had great luck at that.

But we have literally — I mean, we see lots and lots of businesses owned by — usually owned — by financial operator types, where it’s absolutely clear that, you know, they have come in, they’ve leveraged it up, they’ve played games with the accounting.

They — that has about run out, you know, and they want to sell it. And interestingly enough, fairly often, those are built by — bought by — other financial operators who think they’re going to play the game a second time.

Afternoon Session - 2003 Meeting

1. Pretax operating profits clarification

WARREN BUFFETT: OK. We have no afternoon movie, so we'll get to business in a second. And if everybody will just find their seats, please.

I've been advised by [Berkshire CFO] Marc Hamburg to make sure I make clear what I may not have made clear earlier.

In terms of the figures we gave you about the first quarter: A, I think I said we had 16 billion of cash or cash equivalents, which is correct. We had a $290 million pretax underwriting profit. I think I said that.

What possibly I may have misstated, we had a billion-seven-hundred million, pretax operational gain. We had actually also, by coincidence, very close to a billion-seven of after-tax, counting securities gains. But our operating gain, excluding security gains, was about a billion-seven, pretax.

2. Read everything, ignore management, wait for "fat pitch"

WARREN BUFFETT: Let's start right in at number 1.

AUDIENCE MEMBER: Yes. My name is Oliver Graussa (PH), and I'm from Vienna, Austria.

And my question has two parts. And so, the first part is, how do you get a few excellent investment ideas to be so successful? Do you read any special newspapers or industry magazines? Or do you visit the headquarters or any subsidiaries of companies?

And which sources of information, like books, for example, Value Line, Standard and Poor's, Moody's, databases like Reuters, Bloomberg, DataStream, annual reports, internet, and so on, do you use to get the right impression of a company?

And the second part, if you (crowd noise) think that a company like The Washington Post, GEICO, or Gillette has a very competitive product, what are the steps before you ultimately decide to invest in the company?

Which publications do you read to get the best knowledge of the product? And how important is the balance sheet and profit and loss account statement of the company? Thank you very much.

WARREN BUFFETT: Thank you.

The answer to the first part is sort of — and maybe the second part — is sort of all of the above. I mean we — (laughter) — read a lot. And we read daily publications, we read weekly or monthly periodicals, we read annual reports, we read 10-Ks, we read 10-Qs.

And fortunately, the investment business is a business where knowledge cumulates. I mean, everything you learn when you're 20 or 30 — you may tweak some as you go along, but it all kind of builds into a knowledge base that's useful forever.

And we — at least, you know, I read. Charlie used to read. May still read a fair amount.

But I read a lot of 10-Ks, read a lot of annual reports. Forty or 50 years ago I did a lot of talking to managements. I used to go out and take a trip every now and then and really drop in on maybe 15 or 20 companies. I haven't done that for a long, long time.

I find — everything we do, pretty much, I find through public documents.

When I made an offer for Clayton Homes, I'd never visited the business. I'd never met the people. I'd done it over the phone. I'd read Jim Clayton's book. I looked at the 10-Ks. I knew every company in the industry. I look at competitors.

And I try to understand the business and not have any preconceived notions. And there is adequate information out there to evaluate a great many businesses.

We do not find it particularly helpful to talk to managements. Managements frequently want to come to Omaha and talk to me, and they usually have a variety of reasons that they say they want to talk to me, but what they're really hoping is we get interested in their stock. That never works.

You know, managements are not the best reporting parties in most cases. The figures tell us more than a management does. So we do not spend any real amount of time talking to management.

When we buy a business, we look at the record to determine what the management's like, and then we want to size them up, personally, as I said earlier, whether they will keep working.

But we don't give a hoot about anybody's projections. We don't even want to hear about them, in terms of what they're going to do in the future. We've never found any value in anything like that.

But just a general business knowledge, you know, what we've seen work, what we've seen has not worked. There's a lot you absorb over time. Charlie?

CHARLIE MUNGER: Yeah. The more basic knowledge you have, I think the less new knowledge you have to get.

And the game is a lot like that fellow that plays chess blindfolded. He's got a memory of the board and everything that happened before. And that enables him to do the next move in a way he never could if you just showed him the board midgame, cold.

And so there — and in terms of what publications, I don't know, Warren. I would hate to give up The Wall Street Journal.

WARREN BUFFETT: Oh, you'd also hate to give up The Buffalo News.

CHARLIE MUNGER: Yeah. (Laughter)

WARREN BUFFETT: But you could — well, you want to read lots of financial material as it comes along.

And actually, The New York Times has a far better business section than they had 25 years ago.

But you want to read Fortune, you know. You want to read lots of annual reports. You really want to have a database in your mind so that you can tell what kind of a business you're looking at, in general, by looking at the figures.

It's far overrated — we never look at any analyst reports. I mean I don't think I've, you know, if I read one it was because the funny papers weren't available, you know — (Laughter)

It just isn't — I mean, it — I don't understand why people do it.

But there's a lot of data out there. And, you know, the beauty of it is — it's really what makes the investment game great — is you don't have to be right on everything.

You don't have to be right on 20 percent of the companies in the world or 10 percent of the companies in the world or 5 percent. You only have to get one good idea every year or two.

So it's not something — you know, when — I used to be very interested in horse handicapping, and the old story was — and I hope Bob Dwyer is still here — that, you know, you could beat a race but you can't beat the races. And you can come up with a very profitable decision on a single company.

I would hate to be measured — if somebody gave me all 500 stocks in the S&P and I had to make some prediction about how they would behave relative to the market over the next couple years, I don't know how I would do.

But maybe I can find one in there where I think I'm 9 in 10, 90 percent, in being right.

It's an enormous advantage in stocks, is that you only have to be right on a very, very few things in your lifetime as long as you never make any big mistakes.

CHARLIE MUNGER: What's interesting is that at least 90 percent of the professional investment management operations don't think the way we do at all.

They just think, if they hire enough people, they can be better at determining whether Pfizer or Merck is going to do better over the next 20 years.

And they can do that, stock by stock, all through the 500 and have wide diversification. And at the end of 10 years they'll be way ahead of other people, and, of course, they won't.

Very few people have this idea of searching for just a few opportunities.

WARREN BUFFETT: Yeah. You wait for the fat pitch. Ted Williams wrote about that in a book called "The Science of Hitting." He said the most important thing in being a good hitter, you know, is to wait for the pitch in the sweet spot, basically.

But, you know, I've always said that the way to get a reputation for being a good businessman is to buy a good business. You know? (Laughter)

It's much easier than taking a lousy business, you know, and showing how wonderful you are at it, because I haven't seen that done very often.

3. "We do our best to explain" Berkshire

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Good afternoon. David Winters. Mountain Lakes, New Jersey. Thank you again for hosting the Berkshire weekend. It's just great.

Interest rates are the lowest they've been in, I think, two generations. Equity values, in aggregate, are still high. Berkshire has meaningful free cash flow, a short-duration bond portfolio, and you're a buyer of low-multiple, high-quality private businesses, and a few stocks.

Assuming that the stimulative economic policies to deal with the recession eventually cause interest rates to go up and, maybe, equity values to come down, Berkshire seems very well positioned to benefit. Would you comment?

And also, are there any concerns on both of your parts about investors inadequately understanding the conglomerate structure of Berkshire and, therefore, improperly pricing the shares?

WARREN BUFFETT: Well, to answer the second question first, we hope the latter wouldn't be true, because we do our best to explain it. I mean I used 14,000 words in the last annual report, which caused certain members of my family to ask whether I was getting paid by the word. (Laughter)

The — we want you to understand Berkshire, and I hope that comes through. That's why we have these kind of meetings. That's why we spend a lot of time writing an annual report. We try to tell you what we would like if the position was reversed — if our positions were reversed.

And we think that the information in the annual report, if read by somebody that — they have to have some understanding of business and accounting, but if they don't, you know, nothing is going to help, really, in terms of helping them with the business.

But we think if they have some understanding of it, we have given them the information that Charlie and I would need in order to come up with our rough ideas of a valuation of Berkshire, and we hope we get across what it's all about.

You know, there are a lot of companies in Berkshire, but it's not important that you understand the nuances of every single one. Looking at what happens in aggregate, in many cases, will be sufficient.

4. "Strange things happen" in markets

WARREN BUFFETT: In terms of how we're positioned, you know, we have 16 billion of cash, not because we want 16 billion of cash, or because we expect interest rates to go up, or because we expect equities to go down.

We have 16 billion in cash because we don't see anything that makes us want to part with that cash where we feel we're getting enough for our money.

But we would spend — we spent a Monday morning on the right sort of business, or even if we could find equities that we liked, or if we could find — like last year we found some junk bonds we liked. We're not finding them this year at all, because prices have changed dramatically.

So, we're not really ever positioning ourselves. We're simply trying to do the smartest thing we can every day when we come to the office. And if there's nothing smart to do, cash is the default option.

Charlie?

CHARLIE MUNGER: In terms of future opportunities, the issue is, is it at all likely that there'll be an opportunity like 1973-4, or 1982, even, when equities generally are just mouthwatering?

I think there's a very excellent chance that neither Warren or I will live to see either of those occasions again.

If so, Berkshire's not going to have a lot of no-brainer opportunities. We're going to have to grind ahead the way we've been doing it recently, which is not all bad.

WARREN BUFFETT: It's not impossible, though, we'll get some mouthwatering opportunities. I mean you just don't know in markets. It's unbelievable what markets do over time.

And since you brought up interest rates, you know, in Japan the 10-year bond is selling to yield 5/8ths of 1 percent. Five-eighths of 1 percent.

I don't think there's anybody in our annual meeting of 20 years ago, certainly including Charlie and myself, who would have dreamt that a 10-year bond of a country, you know, running a significant deficit would be selling at 5/8ths of 1 percent.

I mean would you say so, Charlie? (Laughs)

CHARLIE MUNGER: Would I ever. But strange things happen.

WARREN BUFFETT: Strange things happen.

CHARLIE MUNGER: But if that could happen in Japan, something much less horrible for the investing class could happen in the United States. It's not unthinkable.

I mean we could be in for a considerable period when the average intelligent, diversified investor in common stocks, using fancy paid advisors, just doesn't do very well.

WARREN BUFFETT: But you could argue that if what we warned against, and hope doesn't happen, with derivatives should happen, it might create enormous opportunities for us in some arena. I mean, you know, but we — wouldn't be good for society, but it might very well turn out to be good for us.

If you get chaotic markets — you had a somewhat disorganized market in junk bonds last year, because there were a lot of them created much faster than the funds available to absorb them were coming in.

Now, this year you have just the opposite situation. You have money pouring in to junk bond funds. Billion dollars a week, roughly, and that's changed the whole price situation. The world hasn't changed that much. It's just that the chaos has left the market for those instruments.

5. "Intrinsic value is terribly important and very fuzzy"

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Yes. Hello. Paul Tomasik. Thornton, Illinois.

Ben Graham and the model of value investing — I'd like to bring the discussion back to that.

And what's interesting and exceptional about you, and Charlie, and Ben Graham, is the self-discipline. The incredible self-discipline.

And if you look at the model and try to think how to present it to teach others that self-discipline, I think you have to make a little tweak to it in two areas. And that's what I'd like you to comment on.

One, intrinsic value. It's always discussed that you calculate intrinsic value. But in practice, I think you find a number that is guaranteed — 99 percent likely — to be less than intrinsic value.

Classic example was in 2000 when you said you'd buy shares back at 45,000. You weren't saying that Berkshire Hathaway's intrinsic value was 45,000. You were saying it was significantly more. And anyone who bought it for less than 45,000 is grateful to you.

The other area is the hidden assumption in the model. And that is, it's assumed that once you find a value stock and you buy it, that the intrinsic value isn't going to go down. And that's a second part of the analysis that has to be part of the discipline.

So even though you found a value stock, you still haven't done all the work. You have to analyze, is the intrinsic value going to go down. In particular, companies throw away intrinsic value is the most common. Management gives it away.

That hasn't happened at Berkshire Hathaway, although I don't want to give an unqualified comment on that, since I see you're remodeling the offices, so we don't know how much intrinsic value's been thrown away there.

So, if you could comment on the two things. Do you calculate intrinsic value, or a number that's absolutely positivity under intrinsic value, that's the number you put in the equation?

And even when you find a stock selling for less than this lower bound of intrinsic value, do you still do the homework on the second part and analyze, will the intrinsic value go down in the future? Thank you.

WARREN BUFFETT: Yeah, I would feel somewhat better qualified to speak on self-discipline if I weighed about 20 pounds less, but — (laughter) — for the moment we'll ignore that.

The second part of your question, relating to intrinsic value going down. Actually, if you compute intrinsic value as reflecting the discounted value of future cash flows, that should have, built into it, a calculation that allows for the fact that certain businesses are going to earn less in the future than now.

It isn't that their intrinsic value goes down then, because you should build it into your calculation right now.

But, you know, as we point out many times in the past, intrinsic value is terribly important and very fuzzy, and we do our best to work with — in the kind of businesses where we think that we have the highest probabilities — where our predictions are of a fairly highly probable nature. And that leaves out all kinds of companies.

It's pretty good. We'll say it's something like a natural gas pipeline. I mean the chances of big surprises in a pipeline should be relatively small. That doesn't mean they're zero, but they're relatively small.

Now, let's assume that you had a gas pipeline, which some have, where either the supply of gas is going to run down or where there are competitive pipelines that may be trying to take away your contracts that you wrote 10 years ago and expire in two years and you're going to have to cut prices.

I would say that two years from now, when you have to cut prices, the intrinsic value hasn't gone down from today, if you properly calculate it today and build in the fact that profit margins in the future will be lower than today.

We looked at a pipeline recently where we think they are going to be vulnerable to competitive price pressures because of alternate ways of getting gas to market through other pipelines.

And the calculation is entirely different — the calculation isn't different — the results are different, in terms of that pipeline versus the pipeline that is the low-cost way of delivering gas from one market to another, and will remain the low-cost producer.

But it isn't — if properly calculated, you build in the prediction of decline in future operating years. You don't wait till you get there to anticipate it.

You know, Charlie's famous for saying that all he wants to know is where he's going to die so he'll never go there. (Laughter)

Well, that's part of predicting in business. I mean, there — I love the — I really have never seen an investment banker's book. I hope to see one someday, and I hope I can survive the shock when I do see it, where the earnings of the business being offered go down.

Lots of businesses' earnings go down. And they're going to go down. And I get all this nonsense, you know, where they project it out for 10 years and it always goes up. It just isn't the real world.

And you have to analyze businesses — some businesses are going to be subjected to enormous competitive pressures that aren't extant today.

And we made that mistake, for example, at Dexter Shoe. I mean we bought a business that was earning $40 million, or so, pretax. And we assumed that the future would be as good as the past, and we couldn't have been more — I couldn't have been more wrong.

So that was a case of projecting into the future, conditions which were not going to exist in the future — competitive conditions. That's part of, you know, that's part of business.

And I will tell you that, you know, 20 percent of the Fortune 500 — but I don't know which 20 percent — are going to be earning, you know, significantly less money probably five years from now than they are today.

And that's what the game is all about. Figuring out what those future cash flows are likely to be. And when you can't — when you feel you can't come up with reasonable estimates in that respect, you move onto the next one.

Charlie?

CHARLIE MUNGER: Yeah. We have this simple, old-fashioned discipline, which Warren likens to Ted Williams waiting for a fat pitch.

I don't know about Warren, but if you said to me, "Charlie, you can go into the business of managing money the way other people do, where you're measured against indexes and you got consultants choosing consultants that are reviewing you to committees," I would just hate it.

I would regard it as being put into shackles. And shackles where the very system was preventing me from delivering value. Warren, how would you feel about that —

WARREN BUFFETT: Yeah, we wouldn't

CHARLIE MUNGER: —chore?

WARREN BUFFETT: — do it. We wouldn't do it. We never did do it, as a matter of fact.

And one of the, you know, the initial — when we formed the partnership on May 5th, 1956, I passed out to the seven limited partners something called the "ground rules."

And, you know, I said, "Here's what I can do and here's what I can't do. And here's some things I don't know whether I can do or not, maybe." It was fairly short.

But the idea of setting out to do something that you know you can't do, that can't be — you know, that's got to lead to problems.

I mean, if somebody tells me I have to high jump seven feet, and we could even move that down to four feet now — (laughter) — you know, between now and sundown or I'll be shot, you know, I will go out and buy a bulletproof vest. (Laughter)

CHARLIE MUNGER: Yeah, the general system for money management requires people to pretend that they can do something that they can't do, and to pretend to like it when they really don't. And I think that's a terrible way to spend your life, but it's very well paid. (Laughter)

6. Freddie Mac, Fannie Mae, and systemic derivatives risk

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi. I'm John Golob from Kansas City. I have a follow up question on derivatives.

After the press zeroed in on the comments in your annual letter, the head of Fannie Mae got up and said, well, Mr. Buffett's criticisms don't apply to Fannie because, number 1, we have simple vanilla derivatives that are priced in the market. And secondly, we need derivatives to protect against interest rate risk.

And I guess, given what happened to the savings and loan industry back in the '80s, that seems reasonable.

So my first question is what is your rejoinder to Mr. Raines?

And the second part of my question gets to your concern about the connection between derivatives and systemic risk. And that is, do Fannie and Freddie play a particularly prominent role in this concern? Thank you.

WARREN BUFFETT: Yeah. I have a lot of respect for Frank Raines. I think he's done a good job at Fannie Mae. I don't know the situation intimately.

The problem, as you mention, is that an operation like Fannie Mae or Freddie Mac, or savings and loans in the past, had this problem, which is inherent in the mortgage instrument, in matching — or coming close to matching — assets and liabilities.

And the reason they had that terrible problem, which did in many institutions, was the optionality in a mortgage instrument.

And in a mortgage instrument, particularly as the years have progressed, you buy a — you know, if you buy a mortgage — or somebody else takes out the mortgage, you own it — you have a 30-year instrument if it's a bad deal and you have about a 30-minute instrument if it's a good deal.

The buyer — the person who takes out the mortgage — can call off the deal at any time at relatively low cost. And the public has been sensitized to that more and more as time has gone by, so they've been quicker to refinance for very small differentials.

Now, many years ago, they had what they called due-on-sale clauses in California. I think — were they invalidated, Charlie, or what happened with those? So that there were ways of shortening up the mortgage expected maturities.

But it's a fundamental problem when you are operating on borrowed money in a very big way, which is what S&Ls did and what Fannie does, and Freddie, that you have this very long-term instrument, and it — but it can be very short-term if it becomes advantageous to you, and rates go down and you want to keep it. Or it becomes very long-term if rates go up and nobody wants to refinance.

And under those circumstances, if you run a huge institution, or even a smaller one, but that has a high — highly leveraged, you are going to look for one way or another to try to match the duration of your liabilities as close as you can to the duration of your assets, and have various methods to protect yourself against the optionality that exists with the counterparty, in effect, your asset.

That's not easy to do. And Fannie, and Freddie, and other institutions, attempt to do that through various types of derivative instruments, as well as other things, in terms of the kind of debt they issue themselves and so on.

And they're very smart, and they do it — you know, my guess is they do a better job than Charlie and I could do at it, but it can't, by its nature, be perfect.

And under some circumstances, where you get large gaps — the thing you worry about in financial markets, and it doesn't happen very often, but your — the thing that really destroys people are what the academics would call six-sigma, or five-sigma, or seven-sigma events, which are things that are never supposed to happen, basically.

And sigma is a method of describing the probabilities that they will happen in any given period — the number of sigmas.

Financial markets don't lend themselves well to modeling based on that. You know, they do most of the time, until it doesn't work. And when it doesn't work, you know, chaos reigns.

And there are more six-sigma events that happen in financial markets — or theoretical six-sigma events — than any study of probability curves would ever come up with.

And that's — when you have gaps or discontinuities, when markets close, whatever it may be, those are what cause institutions to go out of business.

And derivatives, in my view, anyway, accentuate the possibility of it happening and the extent of the damage, if and when it should happen.

Again, we don't think we mathematically can tell you what the probabilities are of something like that, and we think anybody that does tell you, you know, is kidding you.

And I've had managers of hedge funds sit down with me and tell me that they had, you know, a 28 percent probability of returns between 30 and 40 percent. Come up with all these exact figures. Anybody comes up with exact figures in finance, watch out.

So, I would say that if I were running Fannie or Freddie, I would be terribly conscious of what was happening in there, and I would understand this basic problem I have, which I can guarantee you, Frank Raines understands extremely well, of the optionality built into his assets.

And I would try to come as close to matching that. And if I did it through derivative instruments or whatever, I would try to match — I would try to reduce the troubles that could be produced by that optionality to a minimum.

And then I would get very worried about who the counterparties were, because anytime somebody promises to pay you a lot of money if something terrible happens to you, you better be very sure that they can and will pay, because the terrible thing that's happening to you may be presenting terrible things to them.

You know, that will happen in the insurance industry from time to time. And that's why reinsurance recoverables are a dangerous asset to have.

It will happen in the derivative markets.

When LTCM had troubles with one type of asset, they had troubles with a lot of types of assets, and everybody else they were doing business with was having a lot of troubles with those same things.

And that's why the Federal Reserve stepped into something they never dreamt they would have stepped into. They stepped in to force, essentially, a solution, which may have been the right thing to do, incidentally.

But they — for some obscure hedge fund that nobody in the world virtually had heard of, until that point, and had started threatening the U.S. — the stability of the U.S. financial system.

Charlie?

CHARLIE MUNGER: Well, I think you're right to point to this creditworthiness of the counterparty risk.

My guess is that both Fannie and Freddie have been pretty intelligent at thinking through a whole lot of different scenarios where they'll be OK, or close to OK, if all the counterparties pay.

And I would bet a lot of money that they weight the possibility that counterparties won't pay a lot lower than we do.

I think a lot of the counterparties are behaving in a lot more dangerous way than Fannie and Freddie are, and that — and the counterparties can get in trouble because of that. And they can translate that trouble to people who assume that they're hedged.

WARREN BUFFETT: And that's true of the mortgage guarantee institutions that take part of the risk away.

Fannie and Freddie are very sophisticated institutions. Very, very sophisticated institutions.

But if you depend too much on other people, there can be periods in financial history where all the sophistication in the world may not save you. The best thing to do is to be able to count on your own resources.

And at Berkshire that's basically the way we operate. And it may be safer than necessary, but, you know, Charlie and I are rich enough already. We do not need to stay up at night.

7. "We do not run a big currency risk"

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: My name is Joseph Lapray (PH). I'm a shareholder from Minneapolis, Minnesota. Thank you for this opportunity to present a question.

At last year's meeting, I believe that Mr. Munger made a comment to the effect that it was not inconceivable that the U.S. dollar could someday suffer a collapse in value, similar to that which had recently befallen the currency of Argentina.

I am concerned that in the event of a collapse in the value of the dollar relative to foreign currencies, that Berkshire Hathaway's insurance operations may find themselves having to pay for replacing property whose cost is denominated in sharply-appreciated foreign currency.

I have two specific questions. First, does Berkshire Hathaway have any way to protect itself from the effects of inflation induced by a possible currency collapse?

And second, do you have any ideas about how individual investors can protect themselves from currency risk? Thank you.

WARREN BUFFETT: Yeah. I'll ask Charlie first to comment on whether he said exactly what the gentleman said last year.

CHARLIE MUNGER: Well, I don't — I wasn't predicting that the United States would go to hell as much as Argentina has. (Laughter)

What I was predicting is that all kinds of things could happen here that are unthinkable, based on past recent experience. And Berkshire, Warren, by and large, our liabilities are denominated in dollars.

WARREN BUFFETT: Right.

CHARLIE MUNGER: We don't have a huge foreign currency exposure at all.

WARREN BUFFETT: No, well, we have — you know, we may have — we have a few billion dollars, at least, denominated in liabilities in other currencies, but we also have assets in those currencies, pretty much.

So, we don't think about it day by day in terms of matching euro assets against euro liabilities. But in a general way, we don't get way out of whack, either.

I mean, we do not have lots of liabilities around the world in other currencies which are only matched by assets in U.S. dollars. Most of our assets and liabilities, overwhelmingly, are going to be in U.S. dollars.

But we'll have a — you know, we will have, maybe at the present time, a couple of billion that — of liabilities, primarily in euros, and we have at least that much in the way of assets.

So, we don't run big — we do not run a big currency risk at Berkshire.

Now, if you talk about the value of the dollar declining dramatically, you know, we all face that risk if we have a lot of dollar assets. I personally don't worry about the American currency getting worth far less, relative to other currencies, as much as I worry — I don't really worry about it.

But I think there's a probability that sometime in the next 20 or 30 years that you could have rampant inflation in this country again. You'll have probably have it around the world. And it's probably more likely in a good many other countries than it is in the United States.

But inflation is always a latent danger to an economy. I mean I always think of inflation as being in remission at all times, because it's something that has a cause that will recur, in terms of human behavior, from time to time, I think, in terms of how legislatures behave and governments behave.

So, I think that the probability of high inflation at some point during the next, say, 20 or 30 years is — it's not a low probability. I hope it doesn't happen.

Charlie, do you have anything?

CHARLIE MUNGER: Well, in the long-term practically all currencies go to hell. In other words, it's a product, like the Roman — what was it, denarius or something?

You take the British pound, you take the American dollar, so far.

And if you want to go out 200 years, will some politicians in the United States ruin the currency? I think the answer is yes. But I wouldn't anticipate some horrible event in the near future. And —

But if things really went to hell, Argentina started confiscating property of shareholders. And if that starts happening and the government is doing it, we probably won't be able to protect you. (Laughter)

WARREN BUFFETT: That sounds like kind of a nervous laugh to me. (Laughter)

8. Acquisition opportunities growing like a rolling snowball

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Yeah, hi. I'm Gautam Dalmia (PH) from India.

Sirs, if I would take you back to the start of your investing careers, I assume it would have been harder for potential acquisition opportunities to come by.

The question I would like to ask you sirs is, how did you ensure then that you had good enough deal flows coming to you to be able to choose from?

I have one more question. The Berkshire subsidiaries do not have a retirement policy. What are the implications of this on retaining and motivating employees who are potential successors to senior management?

WARREN BUFFETT: First question about deal flow. It's a term I actually don't like very much, because we don't think of them as deals, exactly. That has a little too much of the connotation of something to be bought, and then again something to be sold.

But we do like acquisition opportunities. And really that's just achieving that so that we get the calls when we should get the calls. And there aren't lots of those, because we're talking about good-sized businesses. We're talking about owners that love their businesses.

And it's going to happen occasionally, but it's going to happen a few times a year, probably.

I think in the U.S. now, that we get a pretty reasonable percentage of the calls that we should get, and that was not true 20 or 30 years ago. We didn't hear from anybody 20 or 30 years ago, to speak of, because we were looked at much more as being a marketable securities operation. And we just weren't as well known.

It feeds on itself, obviously. If we acquire companies, and the people from whom we acquire them are happy about the deal, you know, we're going to hear from more people.

We bought our first furniture operation in 1983. That really led to four other transactions, because the people in the first one were happy and they talked to us about the second one. And the people in the second one were happy and so on.

So, you know, it's like — Charlie always describes compound interest as being like, you know, being at the top of a very large hill with wet snow and starting with a snowball and getting it rolling downhill. And that's a little bit like the acquisition situation works.

We've been on a — by being around 38 years, it's been a long — it's been a high mountain, in terms of the length the snowball is going. By now, it's going at a pretty good clip, and it's a pretty good size, and it attracts a lot of snow. And that's good for us.

Outside the United States we do not seem to be on the radar screen, so we don't seem to hear about those as much. But we're hearing about enough in the United States.

It's not a flow, in the sense of — I don't hear about one a week. You know, I don't, probably, hear about one a month.

But the ones we want to hear about, most of them, I think, we're getting the calls now. I think we're getting a higher percentage of the calls now than ever in our history we would have gotten.

And, you know, that's all to the good. And if we can do the same thing outside this country, that would be a plus, too. But this country's a big market and we'll just try and spread the word further.

And Charlie, what was that other question?

CHARLIE MUNGER: Well, he talked some about deal flow, and there's a general assumption that it must be easy to somehow arrange things that you just sat behind a desk and people brought in one wonderful opportunity after another, and you finally selected two out of 100 and it would be a virtual cinch.

That was the attitude in venture capital until the last two or three years.

We didn't have any of that in the early days, right, Warren?

WARREN BUFFETT: No, that's right.

CHARLIE MUNGER: We were finding our own securities. And we were just looking at the public markets to see what was available in securities.

And when we started buying companies, there must have been 20 years when we didn't buy more than one or two a year.

WARREN BUFFETT: Yeah. They were fairly few and far between. And we didn't have the money to buy very big ones, either.

I mean it was a big deal when we bought Associated Cotton Shops for what, in effect, was 4 million, or when we bought Hochschild Kohn when we had to come up with 6 million of equity, as I remember, for that deal.

And National Indemnity, itself, was 7 million for National Indemnity, and I think a million-4, a million-7 for National Fire Marine. And I mean that was all we could handle in those days.

So the snowball has, you know, it's built up as it's gone down the mountain. And we hope there's a lot of mountain left and a lot of wet snow, and we're looking for it.

CHARLIE MUNGER: But it's fair to say that we were rooting around for those opportunities. We weren't sitting behind our desks and waiting for some commission salesman to come in and present us with opportunities to sign our name. I can't think of anything we bought in the early days that way.

WARREN BUFFETT: No, no.

CHARLIE MUNGER: Warren, you chased down Jack Ringwalt. Didn't you go to him?

9. Buffett tells how he didn't let Jack Ringwalt wriggle out of National Indemnity deal

WARREN BUFFETT: Well, Jack Ringwalt, who ran National Indemnity, and some of you here in the room knew, Jack was a very interesting guy and a friend.

And Jack, for 15 minutes every year, would want to sell National Indemnity. Something would make him mad. A claim would come in or something of the sort. (Laughs)

So, for 15 minutes every year he would want to sell. And a friend of mine, Charlie Heider — who may be here today — and I had discussed this phenomenon of Jack being in heat once a year for 15 minutes. (Laughter)

And I told Charlie if you ever caught him in this particular phase to let me know.

And there was a day that Charlie called and said, "You know, Jack's ready." And I said — (laughter) —"Well, get him over here." So, he came about 11:30 and we made a deal in that 15-minute zone. (Laughter)

And this is absolutely true. It's a fascinating story, because Jack, having made the deal — and we really did make it in 15 minutes — Jack, having made the deal, really didn't want to do it, and — but he was — he wouldn't have backed out of a deal.

But he said to me after we'd shaken hands, he said, "Well," he says, "I suppose you'll want audited financial statements." And if I'd said yes, he would've said, "Well, that's too bad then. We can't have a deal." (Laughter)

So, I said, "I wouldn't dream of looking at audited financial statements. They're the worst kind," you know. (Laughter)

And then Jack said to me, he says, "I suppose you'll want me to sell my agencies," and, "— to you as well." And I said, "Jack, I wouldn't buy those agencies under any circumstances."

If I'd said yes to that, he would have — that I wanted him to sell the agencies — he'd say, "Well, yeah, I wouldn't be able to do it, Warren. We must have misunderstood each other."

So, we went through about three or four of those. And finally, Jack gave up and sold me the business.

He was an honorable guy, because he really, I don't think, wanted to do it, but we met down at Charlie's office at 19th, I think, and Douglas, and Jack was about 10 minutes late picking up this 7 million for National Indemnity.

He was about 10 minutes late, because he was looking for a parking meter with a few minutes left on it. (Laughter)

And that's when I knew he was my kind of guy. (Laughter)

CHARLIE MUNGER: But at any rate, this process is not easy, and practically anything where you sit behind that desk and this wonderful deal flow is just coming by, you're in a very dangerous seat.

10. No telecom stocks, but maybe junk bonds

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Gentlemen, my name is Jim Maxwell (PH). I am from Omaha, Nebraska.

You put your toe in the water, so to speak, with Level 3 when you gave a deal, or, you know, got involved in that deal with them.

And I'm wondering if there's anything — any area — in the telecommunications industry that appeals to you now, or any specific company that appeals to you?

Much more importantly, I want to ask about Global Crossing. They're in bankruptcy court right now. The U.S. military uses them for communications. Data, telecommunications, or something like that.

There are two companies that want to buy their assets out of the bankruptcy court. One is a Chinese company. One is a company from Singapore. The U.S. says, "No way, José." They don't want China to get control of the assets of Global Crossing, mainly because of the military security.

In the last week, the Chinese company has backed out. The Singapore company has come in and said, "We will buy the 80 percent stake and — that is now available." But still, if that sale goes through Global Crossing will not be in U.S. hands.

Part of my concern is, if these two companies were in a relationship that was friendly, they were willing to be together, I could see the possibility that they would — the Singapore company would sell, later, its portion to the Chinese company.

Have you ever considered — and if not, why not — buying the assets out of the bankruptcy court, which would be a fire sale? I think that would be good for Berkshire Hathaway.

In addition, it would be good for the United States and for future generations. I would suggest that would be your civic duty, gentlemen. (Laughter)

WARREN BUFFETT: Well, I hope I don't get arrested for leaving without doing this. (Laughter)

I, frankly, don't have the faintest idea how to evaluate telecommunications companies down the road. That doesn't mean I don't understand, at all, what they do. I probably understand a little bit of what they do.

But in terms of figuring out the future economics in that business, what they're going to — this player or that player is going to look like five or 10 years down the road, I simply don't know.

And I think it's — it looks like the people who thought they knew three or four years ago didn't know either, I might add, but that's another question.

Charlie, what do you know about the telecommunications business?

CHARLIE MUNGER: A little less than you do. (Laughter)

WARREN BUFFETT: He's in trouble. (Laughs)

We don't have any idea. You know, if you take — pull out a name, BellSouth, Verizon, I have no idea how that all comes together five or 10 years from now.

I mean, I know people are going to be chewing Wrigley's chewing gum or eating Hershey bars or Snickers bars five, or 10, or 15, or 20 years from now.

They're going to be using Gillette blades, they'll be drinking Coca-Cola, you know. And I have some idea what the profitability of each one of those will be over time and all of that.

I don't have any idea how telecommunications shakes out. And I wouldn't believe anybody in the business that told me they knew because, you know, what would they have been telling me five years ago? So, it's just a game I don't understand.

That isn't — there's all kinds of things I don't understand. I don't know what cocoa beans are going to do next year. You know? I mean, it'd be a lot easier if I did. I could just make all my money on cocoa beans and be much simpler than trying to run a whole bunch of businesses out of Berkshire.

But there's — I don't worry about what I don't know. I worry about being sure about what I do know. And telecommunications doesn't fall within that group.

CHARLIE MUNGER: Mostly, Berkshire, in its history, has bought common stocks that practically couldn't fail.

But occasionally, Berkshire just makes an intelligent gamble where there's plenty of chance of failure, but there's enough chance of success so the gamble is worth taking. And I think it's fair to say that telecommunications falls in that so far.

WARREN BUFFETT: Yeah. We might buy some junk bonds in that business. In fact, we have in several areas.

But as I put in the annual report, we expect losses in junk bonds. We expect, over all the probabilities, we'll have a decent result — maybe better than decent.

But we do expect losses, because we are dealing with institutions that have demonstrated that they don't have large margins of safety in their operations. Sometimes — not at all in Level 3, but sometimes, we're dealing with managements that are quite suspect.

And I would say that in the history of Global Crossing you had that, although that doesn't attach itself to the assets now.

But very often in the field, when people get highly leveraged, sometimes they get tempted to do things that they wouldn't be tempted to do otherwise. And that's happened in the junk bond field, obviously, and always will happen.

But that's the reason we expect to have significant losses, and actually we've — they haven't been that significant.

We've had losses. And — but they — we haven't seen our biggest loss yet, believe me, in junk bonds. But we'll make a lot of money out of some of them, too.

It's a different field. It's like being an insurer of substandard risks. You'll have more accidents, but you can charge a premium that makes it work out.

But our business — in general, when we buy businesses, we want to buy superior risks.

We don't want to buy a hundred businesses for operation by ourselves, with the idea that 15 of them are going to be train wrecks and that the other 85 will take care of it. That's not our approach to building Berkshire.

Charlie, got anymore?

CHARLIE MUNGER: No.

11. Nobody can "successfully dethrone Coca-Cola"

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Yes. My name is Pete Banner (PH) from Boulder, Colorado.

First of all, Mr. Buffett and Mr. Munger, most of us consider you fellows our heroes, and thank you for that. (Applause)

WARREN BUFFETT: Well, thank you.

AUDIENCE MEMBER: Yes. On a lighter note, versus the chaos —

WARREN BUFFETT: You can stay on the same note. It doesn't bother us. (Laughter)

AUDIENCE MEMBER: I wanted to ask what prompted you — considering your general aversion to technology — what prompted you to invest $100 million in Level 3 Communications convertible bonds?

And if I get a twofer, I'd like to know, do you still consider Coca-Cola as you once described as "The Inevitable."

WARREN BUFFETT: Yeah. The answer to the second one first.

The — Coca-Cola I think has — ever since I described it that way, in terms of the — I talked about in terms of the probabilities that they would dominate the soft drink market and not lose market share in any way. That they would grow over time.

You know, it's happening year after year. I don't think the global market share of Coca-Cola products has ever been higher than it is now, and I don't see anything that changes that in the future.

I mean, it is a huge distribution system that has been getting into the minds of more and more consumers since 1886, when John Pemberton, you know, Jacob's Pharmacy in Atlanta, first served up the first one.

It is in the minds of people, the product, all over the world, and it — there'll be more people and it will be in their minds more firmly. And over time, they should make a little more per drink.

So, I don't know how in the world anybody would successfully dethrone Coca-Cola.

12. Buying Level 3 bonds is a "bet on the people"

WARREN BUFFETT: In terms of Level 3, we like the people. We think they're smart people, and they owed too much money, you know. And they recognized it. And they've done some very intelligent things, in the way of attacking that problem, and, you know, we bet on the people.

Charlie knows way more about the physical world than I do, but, you know, I have yet to see an electron. And I just have no working relationship with them at all. I can't identify with them. So, I do not know a lot about the technology. I never would.

I mean you could explain it to me and I could probably regurgitate it on some test or something, but I wouldn't really understand it.

But I think I understand the people involved, and we were quite willing to make that bet. It's of a different sort than we usually do, but we did it and we're happy we did it.

Charlie?

CHARLIE MUNGER: Nothing more to say.

13. Why Berkshire invested in Mark Byrne's hedge fund, Value Capital

WARREN BUFFETT: Number 9, please.

AUDIENCE MEMBER: Hi, this is Steve Rosenberg (PH) from West Bloomfield, Michigan, now living in New York.

Mr. Buffett, the values that you and Charlie stand for and your supreme integrity are an inspiration. Thank you both for serving as such exceptional role models.

I have three quick questions for you. The first involves Value Capital — (applause) — L.P. Your preliminary FIN 46 disclosure appears to indicate leverage employed of roughly 20 billion in assets, 60 million in equity, or 30 to 35 times.

Without revealing any proprietary strategies, how do you derive comfort from this investment given your aversion to risk, other highly-levered partnership blowups, your enthusiasm in shutting down Gen Re Securities' black box activities as soon as possible, and all of this, aside from the fact that it's less than 1 percent of Berkshire's equity, and that Mark Byrne is running it?

My second question involves manufactured housing. Can you comment some more on your enthusiasm for the underlying economics of the business, given what appears to be a commodity product with a high level of seller fragmentation, over-capacity, and large blowups on the financing side?

And what advantage — even if Berkshire's advantage is in the financing, why not stick only to the financing and not the manufacturing?

And my final question involves the gains on securitization that you see in that segment.

Does the preponderance of gains reported indicate a mispricing of credit risk somewhere in the chain, perhaps analogous to the disconnect you were talking about between triple-B and triple-A spreads in the synthetic market and in the bond market? Thank you.

WARREN BUFFETT: Why don't you elaborate on that third point on securitizations just a bit more? I'm not sure I totally have your point on that.

AUDIENCE MEMBER: Just the fact that usually you see gains rather than losses on securitization —

WARREN BUFFETT: Oh yeah.

AUDIENCE MEMBER: — all the time. Does that indicate that somewhere, when you're slicing and dicing it, someone is paying too much, not taking the credit risk into — not valuing it properly.

WARREN BUFFETT: Yeah. OK. Three questions.

Value Capital is run by Mark Byrne, as you mentioned.

We've made a lot of money with the Byrne family. We made money with Jack, and we like Mark and Patrick, who we know — Charlie and I know very well.

And Mark is a very, very bright guy who runs what is, in effect, a hedge fund specializing in fixed income-type securities around the world.

And Mark and his family have significant money of their own in Value Capital, but we have 95, or so, percent of the capital in there. And we do not in any way guarantee their obligations.

Mark operates with a degree of leverage that is less than most people that operate in that field, but it's a lot compared to the way we operate at Berkshire.

And that's OK with us. We wouldn't do it with a hundred percent of our money. We wouldn't do it with 50 percent of our money. But we think it's a reasonable business, as run by Mark, as long as he's got a lot of money on the downside as well as the upside, which he does.

And he's a very decent guy, in addition to being a very smart guy. So, we're comfortable with that. It may have to get — the figures may have to get consolidated in our balance sheet.

We disclose them all now in our first quarter report. You will see them set out. And, in effect, we've got 600 and some million, a couple hundred million of retained earnings that Mark has earned for us, and we feel quite comfortable with that as an investment.

We do not regard it as a business part of Berkshire. The consolidated financial statements may make it look like we do, but it is not. We are a limited partner. We have a corporation in between. We have no guarantees of anything they do.

And we're very happy with Mark running that piece of money, even though he does it, as you say, in fixed-income strategies that involve a lot of — they involve derivatives, they involve borrowed money. But I've looked at the positions and they all make sense to me.

And they would make sense, because Mark is a very smart guy, and the money means a lot more to him than it does to us. So, we feel OK with that.

We don't like the idea of consolidating, in the sense that we don't think it will make — we think it makes our figures less representative of what's really going on than the way we handle it presently, but the rules are the rules and we'll do what they say.

The second point. Charlie, do you want to comment on Value Capital at all?

CHARLIE MUNGER: No.

14. Clayton Homes is "class player" in manufactured homes industry

WARREN BUFFETT: OK. (Laughter)

The second. Manufactured housing. You know, it is — I mean practically everybody in manufactured housing is losing money now, and Clayton is making money.

They've had much sounder policies, in terms of how they've operated over the years.

One of the things they do — most of their houses are sold through their own retail units. They have about, I think, 297 or so retail outlets of their own. And those managers are on a 50/50 profit split, basically, as I remember it, with Clayton. And they're responsible for all of the paper they generate.

So, unlike what was going on a few years ago in manufactured housing, where a manufacturer would sell a house, maybe a floor plan, to a dealer. And then that dealer could borrow, maybe — if I he got some kind of a purchaser on the note, maybe 125 or 130 percent of invoice price, if he could just create a warm body out there someplace that would give him some apparent down payment. That situation was just built for disaster.

But at Clayton, the profit or loss off that person who buys the product goes till the obligation is fully paid for.

So if a dealer takes inadequate down payments or sells to people he shouldn't be selling to, it's going to be his problem, and he's going to get the repo back. He's going to have to sell it himself. He's going to get the loss on the paper charged to him. And that produces an entirely different kind of behavior at the retail level than occurred with many of the other manufactured housing manufacturers.

But it's not an easy business. It's — Clayton does it the right way. And in fact, if you read Jim Clayton's book, he will — he tells in there about the time he bought his first home in Indiana. And he tells about a little of the funny business that went in, in terms of how the manufacturer behaved.

And he described some of the systems that people use to gain the financing. And those activities are coming home to roost in a huge way for both the manufactured housing companies and for the people that finance the retail paper.

Clayton did it right, basically, and they'll continue to do it right. Even so, there is such a stain over the whole manufactured housing industry, in terms of financing, that even — Clayton is the only one that has — is able to securitize.

And, as I said earlier, they cannot securitize to the extent — without us — they wouldn't be able to securitize to the extent that they could have a year ago.

It's an industry in big trouble. I think we'll do fine in it, because I think we're in with a class player. I think they've got these systems in place that have the right incentives, which you need all the way through the system. And I think Berkshire will make them even stronger, because we will not securitize. We'll keep it for the portfolio.

The gains on securitization — the point you made is essentially correct, that some of the — when you see a company with lots of gains on securitization, you ought to get a little suspicious. I don't want to get into more detail than that because it's an accounting question.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that, either.

15. Goodwill impairment charge not needed for Gen Re

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Phil McCaw (PH), Warren, from Connecticut.

Could you comment on Gen Re and goodwill impairment charges since you purchased it, and how it's evolved in your thinking, and if it even became a part of your thinking?

WARREN BUFFETT: Sure. The question is — relates to the fact that, if you buy a business at a price over tangible assets, that you set up a goodwill account.

And if at any time in the future that that goodwill becomes impaired, you should, and must, if the accounting is proper, run a charge to reduce that goodwill item. You run a charge through the income account.

We have a large goodwill item for Gen Re, because it was the biggest acquisition we ever made. We paid substantially more than book. And the question is whether that goodwill is impaired.

And certainly, if the operations of Gen Re of the last couple of years — not including this year — but of the years '98 through 2001, more or less, were representative of the future, you would say that there has to be a big goodwill charge there, and I would agree with you.

I think that as Gen Re is operating now, and had the capacity to operate — and it's being realized now, thanks to a couple of great managers we've got there — I think that — I personally think that Gen Re is worth more now today than at the time we bought it. And I think you will — its float has increased substantially, and I think that you will see the float turn out to be cost-free over time.

One thing I should have mentioned, actually, is — and I looked at a draft of our 10-Q. We have to — I think we should put this in there. We — Gen Re, up until this year, was discounting worker's comp reserves at 4 1/2 percent, which was not conservative. That — we inherited that situation.

But we have changed that to discounting comp reserves going forward at 1 percent. So the accounting is more conservative going forward now — 2003 — by a fair margin, than it was in prior years and in a method we inherited.

So that the figures you see would be somewhat better if we had continued the old discounting at 4 1/2, rather than go to the new discount rate. And in the draft I saw, the 10-Q, that wasn't in there. I think we should get that in there, [Berkshire CFO] Marc [Hamburg], while I think of this.

Charlie?

16. We "deplore solving operating problems by accounting maneuvers"

CHARLIE MUNGER: Yeah. That accounting issue is of a type that is very common within Berkshire. We are so horrified by the terrible business decisions we see made all around us by people who are relying on over-optimistic accounting, that we tend to almost reach for opportunities to make our accounting very conservative. Way more than other people.

We think it protects our business decision-making, as well as our financial integrity.

I don't know why we ever got into this business of trying to get the accounting result as close to the chalk as we could possibly get it. What is wrong with the world when everything is a little bit under-reported? I mean —

WARREN BUFFETT: Yeah, generally people think that reporting, you know, and transparency and all that, has improved over the years. And I felt much better working with the financial statements in 1960 than I feel working with financial statements in 2000.

And, frankly, in many ways I thought they taught me more about what the company was really about than the current ones do, even though there was far less detail.

And what we really deplore is solving operating problems by accounting maneuvers.

And, you know, Gen Re had some problems in the mid-'80s, when everybody did, and they went to discounting their worker's comp reserves. And they — you know, it was a quick fix, but it's like heroin. And you get on it and it's not easy to get off.

And we — Charlie and I have seen that time and time again. People that think, you know, trade loading, whatever it may have been, they think they're going to solve something by paying accounting games.

And they're encouraged by their CFOs sometimes and frequently they were encouraged by their big-name auditors, in one way or another, to really play with the numbers.

And it catches up with you. You might as well face reality immediately, and take whatever operating steps are necessary to solve problems. Or, if you can't solve them, just give up on them.

But whatever you do, playing with the numbers, it never works, although I guess if you're 64 1/2 and you're going to retire at 65, it might get kind of tempting. (Laughs)

17. Munger on recognizing "bullshit earnings"

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Good afternoon, gentlemen. Andy Marino of Chapel Hill, by way of Boston.

You have argued against the use of alternate measures of profitability, such as earnings before interest, tax, depreciation, and amortization, as measures of business performance.

At the same time, you have frequently cited the incompleteness of generally accepted accounting in reflecting economic reality for some businesses, implying that there are some necessary and proper adjustments.

Beyond what you recently described in the annual report as the folly of omitting depreciation, could you elaborate on your thoughts on other pitfalls of alternative financial presentations?

Is EBITDA, in your view, just too often used as a shorthand for cash flow, or is the entire concept of recasting accounting data a suspect exercise?

And which revisions might be appropriate, if any? And what might be viewed as red flags? And does it matter to you who is making those adjustments? Analysts, investors for their own purposes, or company managements, in terms of how that information should be viewed?

WARREN BUFFETT: Yeah. We regularly told you, for some years before the accounting change was made here a year or so ago — we told you, you should not count goodwill amortization.

You know, it was required under GAAP, and we, obviously, complied with GAAP, but we told you every year, virtually, that I can remember, we said, "This is not really an economic expense."

And we ignore it in our own calculations of earnings, in terms of what we will pay for businesses. We don't care whether there's a goodwill item or not, because it's immaterial to economic reality.

So, we have been quite willing, at Berkshire, to tell our own owners to ignore certain things. And if they disagreed with us, they could look at the GAAP figures. But we felt they were getting misled by looking at the amortization of intangibles.

That doesn't mean we think all intangibles were good, but we just — we did feel that that was a — that was an arbitrary decision that didn't make any sense at all.

And we felt — obviously, as we've talked about — we felt the crazy pension assumptions have caused people to record phantom earnings, in many cases.

So we're willing to tell you when we think there is data that is more important in economic analysis than GAAP figures. We'll talk to you about it.

Not thinking of depreciation as an expense, though, strikes us as absolutely crazy.

I can think of very few businesses — I can think of a couple — but I think of very few businesses where depreciation is not a real expense.

Even at our gas pipelines, I mean, you know, at some point, A, they'll need repairs, but beyond that, at some point they become obsolete. I mean there won't be gas there 200 years from now, we know that.

So, it — depreciation is real, and it's the worst kind of expense. It's reverse float. You know, you lay out the money before you get revenue. And you are out cash with nothing coming in.

And depreciation — any management that doesn't regard depreciation as an expense, you know, is living in a dream world, but of course they're encouraged to do that, you know, by investment bankers who talk to them about EBITDA.

And then, you know, certain people have built fortunes on misleading investors by convincing them that EBITDA was a big deal.

And when we see companies that say, "Hey, we don't pay any taxes, you know, because we don't have any earnings for tax purposes, and don't count depreciation and all of that," you know, that's coming — in our view, many times that's coming very close to a flimflam game.

You know, I get these people that show me — you know, they want to send me books with EBITDA in it, and I just tell them, you know, "I'll look at that figure when you tell me you'll make all the capital expenditures."

If I'm going to make the capital expenditures, there's very few businesses where I think I can spend a whole lot less than depreciation year after year and maintain the economic strength of the business.

So I think the EBITDA has been a term that has cost a lot of investors a lot of money.

You saw it in the telecom field. I mean the idea — they were spending money so damn fast, you know, I mean they couldn't have it coming in the door fast enough from investors.

And then they pretended the depreciation was not a real expense. That's nonsense. I mean it couldn't be worse. And a generation of investors where sort of brought up to believe in that.

We, at Berkshire, will spend more than our depreciation this year. We spent more than our depreciation last year. We spent more than our depreciation the year before that. You know, depreciation is a real expense, just as much as, you know, the expenditure for lights.

It's not a non-cash expense. It's a cash expense. You just spend it first, you know. I mean the cash is gone, and it's a delayed recording of cash. How anybody can turn that into something they use as a metric that talks about earnings is beyond me.

Charlie?

CHARLIE MUNGER: Yeah, I think you would understand any presentation using the word EBITDA, if every time you saw that word you just substituted the phrase, "bullshit earnings." (Laughter and applause)

WARREN BUFFETT: I knew he'd do it sooner or later, folks.

CHARLIE MUNGER: And the man —

WARREN BUFFETT: He made it through the morning, but never all day. (Laughter)

CHARLIE MUNGER: And the man asked the question also, says, "What remaining big accounting troubles exist?"

The real lollapalooza is pension fund accounting, and, to some extent, post-retirement medical liabilities. Those are horribly understated now in America, and they're very big numbers.

WARREN BUFFETT: I've looked at financial statements, and you've seen them too in the last few months, where companies are recording pension income in the hundreds of millions, while at the same time being underfunded in their pension plan in the many billions.

And, you know, they just aren't facing up to reality at all, and they don't want to because they want to take the hit. And they're this — you know, it's the same mentality as stock option expenses.

And they are paying people with stock options. But, you know, we pay people with cash bonuses, and I suppose, you know — well, it isn't really true, but we might like it if we didn't have to record cash bonuses as an expense. I mean it's a way we pay people.

And you can say, "Well, why don't you put it in the footnotes and leave it out of the income account like they do with option expenses," which is a form of compensation, too.

But the — you know, the answer is that a bunch of people who cared very much about having their stocks float to unreasonable prices, at least in our view, found they could do it a lot easier if they didn't count compensation expenses.

And, you know, why not put all expenses in footnotes? Just have an item there that says "sales" and then have the same figure for net profit. And then just have all the — (laughter) — expenses in the footnotes, you know.

And people with a straight face, you know, say, "Well, it's in the footnotes, so therefore everybody knows about it and we don't have to count it — put it in the income account."

It's amazing what people with high IQs will do to rationalize their own, you know, their own pocketbooks.

And Charlie has another explanation for why there's been this denial of the reality of expense — option expense — in terms of people's ego getting involved with their own records.

You want to elaborate on that, Charlie? Don't name names. (Laughter)

CHARLIE MUNGER: No, I'm so tiresome on this subject, and I've been on it for so many decades.

It's such a rotten way to run a civilization. To make the basic accounting wrong is very much like making the engineering wrong when you're building a bridge.

And when I see reputable people making these perfectly ridiculous arguments to the effect that it's unthinkable that options be expensed.

WARREN BUFFETT: Or it's too difficult to value them.

CHARLIE MUNGER: Well, because it's too difficult to value, or God knows what reason.

And a lot of them are people you'd be glad to have marry your daughter. (Laughter)

WARREN BUFFETT: Yeah, because they're rich, for one thing. (Laughter)

CHARLIE MUNGER: Yet, the truth of the matter is they're somewhere between crazy and crooked. (Laughter)

WARREN BUFFETT: Put him down as undecided. (Laughter)

It's really astounding. The interesting thing is, of course, now, is that the four auditing firms left, what they call the Final Four now in the auditing — (Laughter)

They have now — and listen, I'm glad they did it, too. And I tip my hat to them for doing it. But they've now said that they really do think options are an expense. So this is —

You know, it kind of reminds of you what happened during the Reformation, isn't it? You know, when you'd have these places sway back and forward, you know, as they get carried by one argument or the other.

In fact, I think there was that famous vicar of Bray who would swing from Catholicism to Luther, back and forth, as this little town went back and forth in Germany.

And finally, the townspeople gathered and they said to the vicar — they said, "It's understandable that we're confused by all that's going on in theology, and we really don't know much about it, and so we swing back and forth."

But they said, "We find it a little disgusting that you, a man of the cloth, would also keep swaying back and forth." And they said, "Have you no principle?" "And he said, "Yes, I have one principle." He says, "It's to remain the vicar of Bray." (Laughter)

I think we've seen a little of that in the auditing profession, but I think they've actually found the true religion now, so I don't want to sit here and criticize them.

But, you know, you now have four firms that lobbied against options being counted as an expense in 1993 that have written the FASB and say that options should be an expense.

And I don't know how in the world something could have not been an expense in 1993 and be an expense in 2003.

Certainly didn't apply to utility bills or, you know, raw materials or anything of the sort. But that's the human condition.

18. No comment on "opportunistic" bond strategies

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Yes, hi. Sam Kidston. I'm a shareholder from Cambridge, Massachusetts. I have a couple of quick questions for you guys.

First of all, other than your general criteria for investing in any company, what are your criteria for investing in banks? And has your general view toward investing in banks changed over time?

Second question would be, in terms of a discount rate, do you feel it's appropriate to use your cost of capital at the current risk-free rate?

And then in the past, you've mentioned that you do some sort of pseudo-bond arbitrage, and would you please specify what types of trades you do in this area?

WARREN BUFFETT: Oh, you would like our buys and sells for Monday morning? (Laughs)

We don't — we're not going to talk about specific strategies that, you know — we obviously they're profitable or we wouldn't be doing them, and we think other people might copy them if we talked about them, so —

And we have pointed out, incidentally, and we will continue to point it out, that there's not a long life to these bond strategies. That doesn't mean we might not reemploy them when circumstances called for it later on.

But they're not like earning money out of See's Candy or, you know, out of Fruit of the Loom or something. They're opportunistic situations that we're pretty well positioned to engage in at certain times.

19. Banks can be "surprisingly" profitable

WARREN BUFFETT: The question about banking, you know, banking — if you can just stay away from following the fads, and really making a lot of bad loans, banking has been a remarkably good business in this country.

Certainly, ever since World War II, it's — the returns on equity from — for banks that have stayed out of trouble has really been terrific.

And there are many — there are certain banks, I should say — in this country that are quite large that are earning, you know, maybe 20 percent on tangible equity.

And when you think you're dealing in a commodity like money, that's fairly surprising to me.

So, I would say that I guess I've been surprised by the degree to which margins in banking have not been competed away in something as fundamental as money.

How about you, Charlie?

CHARLIE MUNGER: Well, what you're saying, in fair implication, is that we sort of screwed up the predictions, because banking was a way better business than we figured out in advance.

We actually made quite a few billions of dollars, really, out of banking, and more in American Express. But basically that was while we were misappraising it.

We did not figure it was going to be as good as it actually turned out to be. And my only prediction is that we'll continue to make failures like that. (Laughter)

WARREN BUFFETT: It's fairly extraordinary, in a world of — particularly a world of low interest rates, that you'd find financial institutions basically doing pretty much the same thing, you know, where A competes with B, and B competes with C, without great competitive advantage, and having them all earn really high returns on tangible capital.

Now, part of it is that they push — they have pushed the loan-to-capital ratios higher than 30 or 40 years ago, but that — nevertheless they earn high rates of returns. They earn much higher rates of returns on assets alone, and then they have greater leverage of assets-to-capital so that produces returns on capital that really are pretty extraordinary.

And, you know, banks — certain banks — get into trouble because they make big mistakes in lending, but it's not required of you, in that business, to get into trouble. I mean you can — if you keep your head about you, it can be a pretty good business.

20. Look at opportunity costs, not "cost of capital"

WARREN BUFFETT: The question about a discount rate, when you talk about our cost of capital, that's worth bringing up, because Charlie and I don't have the faintest idea what our cost of capital is at Berkshire, and we think the whole concept is a little crazy, frankly.

But it's something that's taught in the business schools, and you have to be able to answer the questions or you don't get out of business school.

But we have a very simple arrangement in terms of what we do with money. And, you know, we look for the most intelligent thing we can find to do.

If we've got money around or — if we look — we don't buy and sell businesses this way, but in terms of securities we would — if we find something that's at 50 percent of value, and we own something else at 90 percent of value, we might very well move from one to another. We will do the most intelligent thing we can with the capital we have.

And so, we measure alternatives against each other, and we measure alternatives against dividends, and we measure alternatives against repurchase of shares.

But I have never seen a cost of capital calculation that made sense to me.

How about you, Charlie?

CHARLIE MUNGER: Never.

And this is a very interesting thing that's happened. If you take the most powerful freshman text in economics, which is by [Greg] Mankiw of Harvard, and he says on practically the first page that "intelligent people make their decisions based on opportunity cost."

In other words, it's your alternatives that are competing for the use of your time or money, that matter in judging whether you take action or not.

And of course, those vary greatly from time to time and from company to company. And we tend to make all of our financial decisions based on our opportunity costs, just as like they teach in freshman economics.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And the rest of the world has gone off on some crazy kick where they can create a standard formula, and that's cost. They even get a cost of equity capital for some business that's old and filthy rich. It's a perfectly amazing mental malfunction.

WARREN BUFFETT: Yeah, it's a — (Laughter)

21. PetroChina investment not a "big deal"

WARREN BUFFETT: Number 3. Is there anybody we've forgotten to offend? (Laughter)

AUDIENCE MEMBER: Hi. My name is Karen Kalish. I'm from St. Louis. And I think I'm the first woman to ask a question today. (Applause)

WARREN BUFFETT: We're all for that.

AUDIENCE MEMBER: My late uncle, Bill Shield at Robert W. Baird, first bought Berkshire for our family when it was $337.

And I'm very grateful to you two, because I've been able to start a foundation in St. Louis and give money away. And I give it to reading and literacy programs.

But I'm very curious about the Buffett-Munger philosophy and practice of philanthropy.

And my second question has to do with China. You made an acquisition recently, PetroChina, and I'm curious of what you think about China.

WARREN BUFFETT: Well, the second question, we have about — I think — about five equity investments in companies that are domiciled and that operate primarily, or entirely, outside the United States.

We don't list all our investments. We listed, I believe, last year, all those above $500 million. And we have never had — I think maybe since Guinness some years back — I don't think we've ever had one hit the threshold of reporting in the Berkshire report, although we've owned some.

And the Hong Kong stock exchange has just recently changed their requirements so that you have to report 5 percent of the holding of any company listed on the Hong Kong stock exchange.

And our PetroChina holdings, actually, are now, whatever it is, 13 percent, but they're only 13 percent of something called the H shares.

The Chinese government owns 90 percent of the company. The H shares own 10 percent. They sold that to the public a few years back. So we own 13 percent of a very small percentage. And it's kind of a fluke of reporting that we're required to report that particular holding. And like I say, we own four or so others in international securities.

We don't make any great judgment about China. You probably know more about China than I do. We simply look at investments around the world and we try to buy into things that we think offer the most value.

And if they're in the United — we might prefer, slightly, that they be in the United States, and we might have strong preferences against — or strong biases against certain countries.

We would regard the United States as number one because we understand the game the best here. We understand the tax laws and all that sort of thing, and the corporate cultures and so on. But we would regard a number of other countries as virtually equivalent to the U.S.

And there's others that would have been marked down some, and then we'd have a whole bunch we wouldn't go into under any circumstances because we just don't understand them well enough.

But, you know, we think we understand something like the oil business in China reasonably well. And at a price relative to what we think the future cash generation is, we would make a decision on something like that.

But it's not a big deal. It's a big — it became reportable because of this peculiarity of the law, where if you own a certain percentage of something that's only 10 percent of the whole pie, you still have to report it.

The Chinese government is firmly in control of PetroChina. I mean, if we vote with the Chinese government, the two of us will control PetroChina. (Laughter)

22. Why we're giving money "back to society"

WARREN BUFFETT: The question about philanthropy. Charlie, you want to swing at that one first?

CHARLIE MUNGER: I think it's fair to say that both of us feel that the very fortunate owe a duty to the general civilization, and even to the country of which he's a member.

Whether you give as you go along or have the Buffett system of moderate giving as you go along and immense giving in due course, I regard as a matter of personal taste.

I would understand the second position in that I would hate to spend all my time every day having people ask me for money. And I don't think Warren could stand it. Is that right, Warren?

WARREN BUFFETT: Let's not even try. Let's not even try, Charlie. (Laughter)

No, we — I mean, it's a matter of record, and it hasn't changed for, I don't know, 25 years, probably, but basically everything I have at the date of the later of the death of myself or my wife, goes to charity.

I mean 99 and a significant fraction. And since my children are here, I'm not going to carry it out to 8 decimal places. But — (laughter) — you know, why not? It —

Think of it this way. Here's — let's just assume that, instead of being born as I was in a single birth, that I were in the womb and there was an identical twin next to me. Same DNA. Same everything. Personality. Propensity to work. Propensity to say — whatever. Identical twin. Wasn't Charlie. Might look like him, but — (Laughter)

And there we are, the two of us. And a genie appeared. And the genie said, "I've got a proposition for the two of you. You're going to be born in 24 hours. Same talents. Everything identical. And one of you is going to be born in Omaha, and one of you is going to be born in Bangladesh.

"And I'm going to let you two decide which one gets to be born in Bangladesh and which one gets to be born in Omaha. And I've got this system. And I'm going to — the way I'm going to work it is that we start the bidding, and whichever one of you bids the highest proportion of your estate to go to society when you die, gets to go — be born in the United States." I think you'd bet a hundred percent, you know.

You hear all of this about, you know, grit and pluck and all of these things, and how, you know, you have applied yourself working all your life, and you've done all these wonderful things.

Well, just imagine if I'd been born in Bangladesh. You know, and I'd walked down Main Street and said, you know, "I allocate capital." You know? "Let me show my stuff." (Laughter)

I'd have died of malnutrition. I mean, it would — I wouldn't have made it through the first few months.

The society that Charlie and I work in, I mean we were luckier than hell. I mean when we were born, the odds were 50-to-1 against us being born in the United States. So we hit the jackpot.

And basically, it — you know, we've had all of the fun of working with this and working with good people. And money, obviously, opens lots of doors in life to interesting things.

And it goes back to society. Like Charlie says, it can go back on the installment system through life. It can go back in a lump sum at death.

I've mixed the two to some extent, but I weight heavily the lump sum.

But, you know, that's where it belongs. I mean, it — there's no reason why little — generations of little Buffetts, now and the next one, you know, and a hundred years from now, should all be commanding the resources of society just because they came out of the right womb. You know, what sort of justice is that?

So basically, it's going back to society. (Applause)

Were my children applauding there? Did we check that out? (Laughter)

23. Many great businesses can't boost profits by spending more capital

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi there. My name is Alex Rubalcava. I am a shareholder from Los Angeles.

I have a question about the financial characteristics of the businesses that you like to acquire and invest in.

In your reports and other writings, Mr. Buffett, you state that you like to acquire businesses that can employ a large amount of capital to high returns.

And in reading the writings and speeches of yourself, Mr. Munger, I've seen you say in Outstanding Investor Digest and other publications, that you enjoy investing in companies that require very little capital.

And I was wondering if these statements are at odds, or if they are two sides of the same coin? And if you could elaborate using Berkshire companies, that would be great.

WARREN BUFFETT: Sure. It's a good question.

The ideal business is one that earns very high returns on capital and could keep using lots of capital at those high returns. I mean that becomes a compounding machine.

So if you have your choice, if you could put a hundred million dollars into a business that earns 20 percent on that capital — say 20 million — ideally, it would be able to earn 20 percent on 120 million the following year, and 144 million the following year and so on. That you could keep redeploying capital at these same returns over time.

But there are very, very, very few businesses like that. The really — unfortunately, the good businesses, you know, take a Coca-Cola or a See's Candy, they don't require much capital.

And incremental capital doesn't produce anything like the returns that this fundamental return that's produced by some great intangible.

So we would love the business that earn — that could keep deploying, in fact, even well beyond the earnings. I mean we'd love to have a business that could earn 20 percent on a hundred million now. And if we put a billion more in it, it would earn 20 percent more on that billion.

But like I say, those businesses are so rare. There are a lot of promises of those businesses, but we've practically never seen one. There've been a few.

Most of the great businesses generate lots of money. They do not generate lots of opportunities to earn high returns on incremental capital.

You know, we can deploy X at See's and earn a lot of money, but if we put 5X in we don't earn any more money to speak of. We can earn high returns on X at The Buffalo News, but if we try to make it 5X we don't earn any more money.

They just don't have the opportunities to use incremental capital. We look for them, but they don't.

So, the great — you've seen — I mean, we will talk theoretically about the businesses that can earn more and more money with incremental capital at high returns.

But what you've seen is that we've bought businesses, largely, that earn good returns on capital, but in many cases, have limited opportunities to earn anything like the returns they earn on their basic business with incremental capital.

Now, the one good thing about our structure at Berkshire is that we can take those businesses that earn good returns in their business but don't have the opportunity for returns of those similar magnitude on incremental money, and we can move that money around to buy more businesses.

Normally, if you're in the — take the newspaper publishing business, which has been a fantastic business over the years — you earned terrific returns on your own invested capital.

But if you went out to buy other newspapers, you had to pay a very fancy price, and you didn't get great returns on incremental capital.

But the people in that business felt that the only thing they knew was newspaper publishing or media of one sort or another, so they felt that their options were limited.

We can move money anyplace that it makes sense, and that's an advantage of our structure. Now, whether we do a good job of it or not's another question, but the structure is enormously advantageous in that respect.

We can take the good business, the See's Candy — See's has produced probably a billion dollars pretax for us since Charlie and I wouldn't have gone up 100,000, you know, back in 1972.

If we tried to employ that in the candy business we'd have gotten terrible returns over time. We would have gotten anything to speak of. But because we moved it around it enabled us to buy some other businesses over time, and that's an advantage of our structure.

Charlie?

CHARLIE MUNGER: Yeah. And if you take a business that is a good business, but not a fabulous business, they tend to fall into two categories.

One is the business where the whole reported profit just sits there in surplus cash at the end of the year. And you can take it out of the business and the business will do just as well without it as it would if it stayed in the business.

The second business is one that reports the 12 percent on capital but there's never any cash. It reminds me of the used construction equipment business of my old friend, John Anderson. And he used to say, "In my business, every year you make a profit, and there it is, sitting in the yard."

And there are an awful lot of businesses like that, where just to keep going, to stay in place, there's never any cash.

Now, that business doesn't enable headquarters to drag out all the cash and invest it elsewhere. We hate that kind of a business. Don't you think that's a fair statement?

WARREN BUFFETT: Yeah, that's a fair statement. We like to be able to move cash around and have it find its best use. And, you know — but that's our job. And sometimes we find good uses.

It would be terrific if every one of our great businesses, and we've got a lot of great businesses, had ways to deploy additional capital at great rates, but we don't see it.

And, frankly, you know, it doesn't happen — I mean Gillette has a great razor and blade business, I mean, fabulous.

There's no way they can deploy the money they make in the razor and blade business to keep putting more money in that kind of business. It just doesn't take that kind of capital. They have to deploy some money of it, but it's peanuts compared to the profits.

And the temptation then is to go out and buy other businesses, and of course that's what Charlie and I do when we face that, but we don't think that, overall, the batting average of American industry in redeploying capital has been great. Nevertheless, it's what we try and do every day.

In a sense, we sort of knock the very procedure that has gotten us to where we are. Is that a fair statement, Charlie? (Laughs)

CHARLIE MUNGER: Absolutely. And that has always worried me. I don't like being an example of an activity where most people who try and follow it will get terrible results. And we try and avoid that by making these negative comments. (Laughter)

WARREN BUFFETT: We'd make negative comments anyway. (Laughs)

Number 5. It's more fun.

24. Buffett: I don't ask my friends for favors

AUDIENCE MEMBER: I'm Will Graves from Winter Park, Florida. I'm a graduate instructor with Webster University. And I'd like to address two questions to Mr. Buffett.

I appreciate the accessibility of Mr. Buffett. He makes us feel so warm here. Could I call you Dad?

WARREN BUFFETT: Yeah. (Laughter)

AUDIENCE MEMBER: I've got one question regarding a National Treasury situation and one considering a national treasure.

Back in September 11, you appeared on "60 Minutes" and performed a national service, taking your valuable time and giving up your private life for a few moments by speaking about the general stock market, and how people should not be getting too excited, and they shouldn't be worried about investing for the long-term.

And what I was wondering is, if you would ever consider making another appearance on “60 Minutes” at the time when whoever the president is at the time brings up the Social Security debate.

I spend a lot of time with non-profit organizations, and the outrage that you hear from the working poor is that we talk about the tech turnaround, the tech profits of the last few years.

They’ve gone through a whole cycle where people became multimillionaires at a time when the working poor never even got a minimum wage increase.

And if you think of people like this who have a net worth of a thousand dollars or less, just as an example, and just imagine what it’s like for them to be forced, in the future, to be horrible investors because the U.S. government forces them to have something called Social Security, which they can’t get out of, and they get a lousy return.

What I’m wondering is, if you would consider, when we have a candidate, whoever it might be at the time, say that you don’t want to put a small portion of Social Security into the long-term stock market because it’s a risky proposition? If you would take your track record on “60 Minutes” and say, “I don’t think so.” That’s the first question.

And number two, while I’m asking you to volunteer for something, I found myself being thrust into something in the last three weeks.

I went to Cypress Gardens the last day with about 20,000 people there. And the lady was handing out 15,000 fliers. Several weeks from now I’ll be before Governor [Jeb] Bush with the Friends of Cypress Gardens. We have a website, FriendsOfCypressGardens.org, trying to keep a developer from clear-cutting the trees in Cypress Gardens, a national treasure.

And my question is, would you consider contacting your cousin, [musician] Jimmy Buffett, about possibly helping us in some way? Doesn’t have to be money. It might be an appearance. Just might be some connections, where you might be able to help us in our efforts.

WARREN BUFFETT: I get asked to contact — probably the one I get asked to get contact the most is Bill Gates, but I get asked to contact all kinds of people.

And I mean, everybody is slipping me envelopes with letters in them, sending things to the office and saying, “Won’t you get this person?” and all they can say is no. I don’t do — I don’t make requests of my friends, basically, for anything.

And I just — I would spend the rest of my life doing it. They would feel — I would never know — (applause) — you know, what they were doing — you know, I would never know what they were doing because I was asking, versus what they really felt. I mean it’s an impossible — from my standpoint at least — that’s an impossible game to get into, in terms of that.

I mean when [Washington Post publisher] Kay Graham was alive, everybody, you know, wanted her for one reason or another. And they've all got causes.

And, frankly, they, you know, they want to use me to get her, or Jimmy Buffett, or whomever, to say yes to something that they're saying yes to, partially because they feel they don't want to say no to me.

And I, you know, that — I just don't want to use my friendship for that purpose, frankly. And I don't do it, even for things that I strongly believe in, myself. I do them — they may know what I'm doing, and if they want to pick up on it, fine.

But I have never — I can't remember ever requesting anybody to make a contribution or do anything myself. I mean what I do is a matter of record, and, you know, if other people want to pick up on it, fine.

But I've never had one of those honorary dinners where they send out, you know, to all the suppliers to Berkshire and everything and start leaning on them and saying, you know, "We're honoring Warren."

Well, hell, if they want to honor me they can honor me without soliciting all my friends for money. I mean, I don't consider that much of an honor if the reason they picked me was because I got rich friends. So, I just don't do that.

25. "There's something unattractive about a very rich guy that pops off on everything"

WARREN BUFFETT: On the public policy question, what I did on September 11th, when [former General Electric CEO] Jack Welch and [former Treasury Secretary] Bob Rubin and I went on there, you know, I will do those things occasionally. I've written some op-ed pieces.

I think — and I get tempted very often, in fact I've written some that I haven't sent in.

But I do think that there's something unattractive about a very rich guy that pops off on everything. And you may think, by listening to us today that you've got two guys up here that do like to pop off on everything. And we do have opinions on almost everything.

But I just think there are some things I get — you know, I wrote on campaign finance reform, and I've written on taxes. And I will do more of that, but I do try to hold myself in check, somewhat, because there's a little bit of, you know, this, "I'm rich, therefore I'm right"- type stuff that I don't think sits very well.

And I know when I see it in other people I don't like it that, you know, "I'm a celebrity therefore, you know, you got to listen to me on everything that I say." It just — it turns me off at some point.

But like I say, I have done it, and there could be occasions — and there will be occasions — I'm sure, when I'll cross my threshold level and figure I really want to say something and people can ignore it or otherwise.

And — but I think there's some danger of overexposure on that sort of thing, and I think you've seen it with certain people.

Charlie?

26. Keep Social Security money out of stocks

CHARLIE MUNGER: Warren, would you agree or disagree that forcing a certain part of Social Security into common stocks is a good idea?

WARREN BUFFETT: No, I would not. Actually, I would not agree with the one that the gentleman suggested.

I think that, actually, Social Security has been a tremendous thing for the working people of this country. It's been an intergenerational pact. It's not insurance.

It simply says, like a family might say, except it extends the concept of family to the whole United States, that if you produce for this country when you're between the ages of — and I think the upper age limit should be extended — but between the ages of X and 65, that society will provide some base level of income for you for the rest of your life.

And I think a rich society should do that. So, I think the when you have a $10 trillion society, you know — (applause) — we should do that.

CHARLIE MUNGER: I would agree. I think Social Security, you can argue, is one of the most successful governmental programs we have. And people treat it as a pure disaster coming or something like that.

That's not my view at all, and I wouldn't put it in common stocks, either. I think Social Security works pretty well just about the way we're doing it.

WARREN BUFFETT: Yeah, we will give a base income to every — and we should in this country — to everybody that leads a reasonably productive life. And they don't have to worry about how long — you know — whether they live to be 90 or 100.

And people do worry in their old age. And we don't need a bunch of people who, you know, go off to war when we need to defend, you know, the rights of our country, and act in every way as good citizens, but they just don't happen to have the ability to make a lot of money, you know, well, like maybe Charlie and I can.

I think they need a base level, and I think that an intergenerational compact like we have — it's really a magnificent idea. And I think the country's a lot better off for it.

I think that telling them that they can save 500 bucks or a thousand bucks and put it into stocks and have everybody lobbying Washington about, you know, who will handle it. You know, everybody thought it was a great idea a few years ago, and I think it's a very bad idea, frankly.

Charlie? (Applause)

CHARLIE MUNGER: I like it a lot less than you do. (Laughter)

27. Simple compensation plans and no consultants

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Good afternoon. My name is Ravi Gilani. I come from New Delhi, India.

I have questions regarding management policies. Since you follow quite different management policies, I would like to know the impact of them on the management CEO's motivation.

Mr. Munger has mentioned that where capital is unimportant in a business, you tend to give the CEO a part of the earnings. You have also mentioned that you do not greet good work by raising the bar. Clearly, static earnings over a period of time may become successively less valuable.

My question is in, now, four parts. Bearing the above in mind, could you give us an example of compensation policy in Berkshire subsidiaries which illustrate your thinking on the subject of executive compensation?

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

Number three, do you restrict yourself to setting compensation policy for the CEO, or do you involve yourself in larger part of the organization?

And finally, you do not have any retirement age for the CEO. Does it impact the morale, motivation, of the people below the CEO?

WARREN BUFFETT: Charlie? (Laughter)

He knew that was coming.

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

We don't have any one standard system. They're all different, based on accidents of history and circumstances.

But where capital's an important factor, of course, we take it into account.

As far as the effects on morale, as far as I've ever been able to see, the morale's pretty good in the Berkshire subsidiaries. And the Berkshire managers practically never leave. And my guess is we have about as low a turnover rate as any place around. Is that right, Warren?

WARREN BUFFETT: Oh, I'm sure of that. And besides, the "no retirement policy" is wonderful for my morale. (Laughter)

And Charlie's.

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

So, the subsidiaries set their policies for the pay of the people below the CEO, and the — all — they have all kinds of systems, because we have all kinds of businesses.

And, frankly, we've never had big problems with compensation because, I think, our arrangements are rational.

When capital is an important part of the business, we stick a charge for capital in. If it's an unimportant part of the business, we don't stick it in. We don't believe in making things more complex than needed.

So, we don't try for little — all kinds of little refinements — which a compensation consultant would come in and tell you was needed, because that's how he would justify a large bill. And he would also come in and tinker with it a little the following year, and the following year, and so on.

We have very simple systems on comp. But some of our businesses are terrific businesses, and so we have very high standards of performance before people get performance bonuses.

Some of our businesses are very tough businesses, and the threshold is much lower, but the managerial talent needed to reach that threshold is just as much as in the — with the higher threshold in other businesses.

It’s not a — compensation is not rocket science. I mean, people will want you to think it is, and you read these proxy statements and it blows your mind, what they get into. I mean, the proxy statements are thicker than the annual reports because they’re talking about the compensation of people.

And it is not that complicated. We’ve had — in 38 years, we have never had a CEO leave us to go to another business, except a few we’ve — where we’ve made the decision ourselves, but very few.

And it is — you know, I see all of the time and effort put in because, frankly, it pays off for the CEO to do it. And then they create a whole department that spends all their time attending conferences about, you know, compensation methods, and they have consultants in, and it becomes an industry.

And it isn’t going to break itself up. I mean you — when you get those — when you get a huge bureaucracy involved in making all kinds of pay determinations and everything, it’s never going to go away unless you do something about it. But that’s true of any bureaucracy we run into. We don’t have much bureaucracy at Berkshire done.

I think that there’s no question that our “no retirement policy” means that somebody who’s just itching to be the CEO of a business, and they see that the CEO is 65, and then 70, and then 75, above them at some of our companies, is probably not going to stick around.

I mean we don’t develop, naturally, lots of number twos because we can’t promise them that number one is going to go out the door. But as long as number one doesn’t go out the door, from our standpoint, that’s just fine.

And we occasionally have to replace managements, but it’s very occasional. I mean if — on an expectancy basis, you know, even with all the subsidiaries we have, you know, we may face one management succession problem, perhaps, every 18 months or something of the sort. And we’ve got all kinds of other businesses. So it’s not a big deal at Berkshire.

CHARLIE MUNGER: Yeah. And on EVA, there are ideas implicit in that that we use. For instance, hurdle rates by — based on opportunity costs. Perfectly reasonable concept.

But to us, that system, with all its labels and lingo, has a lot of baggage that we don’t need. We just use the implicit, simple stuff that’s buried in EVA.

WARREN BUFFETT: Yeah. We could spend a million bucks a year on consultants to get an answer we can get in five minutes, frankly. I mean it is — it just isn’t that complicated.

But can you imagine a consultant coming around and saying, “I’ve got a one-paragraph compensation arrangement for you?”

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

And we get good results out of our managers.

The main reason we get good results out of our managers is that, you know, they like hitting .400. They like hitting .400 and being fairly paid, but they — the fact that they batted .400 is the biggest thing to them, in life.

And it's, you know, it's sort of the way we feel. If we get a good batting average in our business performance, the pay is incidental.

Now, it shouldn't be incidental to our managers. It's got to be fair or they're going to — nobody wants to work in an environment where they feel they're being treated unfairly, but —

That is not a complicated procedure. And we do make them very specific to the enterprise that's under their control. We do not pay the people of See's Candy based on how The Buffalo News does or vice versa.

And I can show you a lot of crazy compensation systems in corporate America where that really is the ultimate effect of what's happening.

28. Buffett OK with large brokerages holding his stocks

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good afternoon. This is — I'm Paul Butterfield from Clarksville, Maryland.

You wrote in the annual report about the dangers — the systemic dangers — of derivatives and the growth in derivatives.

An example would be a six-sigma event that would cause domino effect and dangers to the solvency and operations of, maybe, financial institutions and other firms, possibly including brokerage firms.

Would this — do you think this recommends to an individual investor that we might consider not holding stocks in street name?

WARREN BUFFETT: Charlie, how do you — they addressed that, somewhat.

There were some domino effects in the very early '70s in Wall Street. I think, certainly, the failures of some brokerage firms, in part, led to failures of others.

It wasn't a classic domino situation, and of course we had domino effects in banks if you go back a hundred years in this country.

Anytime you have financial institutions that interrelate in many ways, and have big receivables and payables, balances with everything, you've always got the danger of domino effects.

And that's a factor in the insurance business. It's a factor in banking business. I think it'd be less in the brokerage business.

I would think, if you owned securities in a cash account with any large stock exchange firm, you know, it wouldn't worry me.

We've got lots of — I've got lots of personal securities, you know, sitting with a very large stock exchange firm, and that does not bother me. But I mean, obviously, there have been little firms that have been fly-by-night types.

And I don't even know all the rules on margin accounts. But if somebody has got the right to repledge your securities and they get in trouble themselves, I don't know any more what the SIPC — there's a SIPC protection, but I'm —

CHARLIE MUNGER: It's not unlimited. You're liable.

WARREN BUFFETT: Yeah, I think that's true.

And no, I would think twice between having all my securities rehypothecated by somebody else.

A cash account. I think the cash accounts are segregated, aren't they, Charlie?

CHARLIE MUNGER: Yes.

WARREN BUFFETT: Yeah.

29. States shouldn't buy stocks with taxpayer money

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is John Norwood and I hail from Des Moines. Thank you for providing this opportunity to speak today.

I have two questions, one as an individual investor and one as a state resident.

The first has to do with intrinsic value. Can you provide some additional Cliff Notes for working with the Berkshire Hathaway annual report and calculating an intrinsic value for the stock? I'm a little bit hazy.

And the second question has to do with public sector investing. As an example, the state of Iowa is considering the creation of a $1 billion Values Fund.

What sorts of guidelines, strategies, and advice would you employ if you were responsible for investing this money on behalf of the general public?

Are there any significant differences when representing shareholders versus the general public? Thank you.

WARREN BUFFETT: Yeah, elaborate if you will just a second, because I am not familiar with that billion dollar — is the state of Iowa literally creating a billion dollar fund to invest in equities on behalf of the people?

AUDIENCE MEMBER: That's what's being proposed.

WARREN BUFFETT: Is that right? Oh.

Charlie, what do you think about that? That's a new one to me.

CHARLIE MUNGER: I think it's a pretty dumb idea. (Laughter and applause)

WARREN BUFFETT: Yeah. He lives in California. That's why I had him answer. I live right on the border here, so I — (Laughs)

Yeah, I would — I mean, I guess Iowa doesn't have any bonded debt, so I'm not sure what — they probably wouldn't be creating a margin account.

But I would think that most states or municipalities would want to let the citizenry invest on its own and would not want to be taxing people in order to set up an equity fund. So that strikes me as a pretty novel idea. Charlie —

CHARLIE MUNGER: In California, certainly the — of the investment management partnerships — use all kinds of political contributions to finagle their way into managing state pension funds, et cetera, et cetera. It's not a pretty scene.

To the extent that Iowa can dampen it down, why, I think they're better off.

30. Intrinsic value: "fuzzy," but essential

WARREN BUFFETT: The question on intrinsic value — you know, we've written about it in reports. I don't think there's much additional to say.

I mean, the intrinsic value of any financial asset, you know, is the stream of cash that it'll produce between now and Judgment Day, discounted by an interest rate that equates between all the different possible assets.

That's true of an oil royalty, a farm, an apartment house, an equity, a business operation, you know, a lemonade stand. And that — you have to decide what sort of businesses that you think you can understand well enough to make a — some kind of reasonable calculation.

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

And at Berkshire, you've got two questions. You've got the question of what the businesses we own now are worth. And then, since we redeploy all the capital they generate, you have to figure out what you're willing to assume about what we do with the capital.

And you can look back and say that, 35 years ago or so, that people perhaps underestimated what would be done with the capital that was generated, so that it looks very cheap if you look back on it now. But we're in a whole different game now with huge amounts of capital.

And you have to make a decision as to whether the billions and billions and billions of dollars we generate will be deployed in a way that creates lots more cash later on. And it's what Charlie and I think about, but we can't give any prediction on it.

Charlie?

CHARLIE MUNGER: Yeah, I think our reporting, considering the complexity of the enterprise as now constituted, is better than that of any similar enterprise I know, in terms of enabling a shareholder to calculate intrinsic value.

So, I think we've done better than anybody else, and we do it conscientiously. And if you ask, "Will we improve from here?" I don't think so.

WARREN BUFFETT: We've worked hard at doing what you're talking about, and it — but even working hard at it, I mean, we've given you the data we would want ourselves. We don't know the answer, but we do know it's what you have to think about.

And we do it when we buy McLane's, when we buy Clayton Homes. When we buy anything, we are attempting to look out into the economic future and say, "What kind of cash can this business generate over time? How sure do we feel about it? And how does the purchase price compare with that?"

And if we feel we're getting a — we have to feel fairly good about our projections. Won't feel perfect, because we — no one knows the answer precisely. We have to feel pretty good about our projections, and then we have to have a purchase price that's rational in relation to those.

And we get some surprises in both directions. Actually, if you go way back, we've had more pleasant surprises than we would have expected. But we won't get them from this point, mostly because of size, and also because the world's a little more competitive.

Charlie?

CHARLIE MUNGER: Nothing more.

31. Munger: Tort lawsuit system is "crazy"

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: My name is Vic Cunningham. I'm a shareholder from Wilton, Connecticut.

I heard your comments earlier about popping off. But actually, I find it admirable the way you guys, the two of you, have leveraged your clout as investors to be advocates for change.

You know, your outspoken comments on expensing stock options promoted, you know, productive discussions, in not only corporate boardrooms throughout this country, but more importantly on Capitol Hill.

Currently, tort spending in this country continues to rise as a percentage of GDP, and I would argue a lot of that's unproductive spending.

Is there a point — and it seems like right now that, you know, they're trying to stretch their tentacles, not only from, you know, tobacco companies but to consumer product companies like McDonald's and possibly even Coca-Cola.

Is there a point where you would use your considerable clout to try to guilt Congress into moving towards some kind of comprehensive tort reform for this country?

WARREN BUFFETT: Well, I'm sympathetic to the — what you're saying. I would say that our considerable clout is nothing compared to the clout of the plaintiffs' lawyers.

There's no question that — in a certain way, it's appalling when you look at the frictional costs to society of the tort system we have.

But Charlie is a lawyer. He can probably speak much more intelligently than I can as to how you could modify this, because there are plenty of things wrong, too.

I've — I mean it's sort of infuriating to see specious shareholder suits raised on, you know, any kind of a deal, just because there's a lot of DO — D&O insurance — and they know people will pay off rather than go through the nuisance of a suit.

And we never — we don't pay off — but corporate America does. And so, it's a game.

And the people that pursue that activity, you know, are not pursuing it, I think in many cases, because of a great pursuit of justice, but because it's a damn profitable sort of game.

And, you know, the people that are paying. It usually doesn't come out of their own pocket, so it gets back to that — the lack of parity in the interest of the people on both sides.

But then, when I look at some of the things that have happened in corporate America, I certainly don't want to get rid of the plaintiffs' lawyers either — entirely — because I think some terrible things have happened and I think people should pay.

I just wish the people paid rather than the D&O carriers, because when a D&O carrier pays, or when a company pays, it — the costs get socialized, and the people that did the wrong things seldom pay out of their own pockets.

I — Charlie, what — tell me, how do we improve the tort system?

CHARLIE MUNGER: Well, if you define the tort system to include the workmen's compensation system, which I would, you get terrible abuses.

In California, Costco has about one-third of its employees and two-thirds of its workmen's compensation expense.

California is an institutionalized fraud. Fraudulent chiropractors, fraudulent lawyers, fraudulent what have you. And they put this enormous burden on business. And of course, eventually the jobs will leave.

I had a friend who took a plant away from Texas where he had workmen's compensation expense of 30-odd percent, and took it to Ogden, Utah, where it went to 2 percent.

So fraud, allowed to run, builds on itself. And then you've got all these lawyers and lobbyists who like the fraud. And chiropractors and God knows what.

And so, it's a major problem. And in California, it's gotten so bad that my guess is there will be some reform, even with the two-thirds Democratic legislature.

WARREN BUFFETT: What would you change, in terms of the shareholder situation?

CHARLIE MUNGER: Well, that's harder, because if you take the worst of the plaintiffs' lawyers, half the time they're suing somebody that's behaved terribly.

Now, they're suing in a process where a lot of money is paid out, as you say, on a socialized basis, and doesn't really go to the people that were hurt. So, they're like a public scold that gets paid an enormous sum out of the public.

But certainly, a lot of the defendants in these cases that are screaming about the plaintiffs' bar have done some very regrettable things. So, I think that gets very hard to figure out what should be done.

The present system is crazy, and I don't know how I'd improve it. You could easily improve it if you could count on government being rational and fair, but how do you do that?

WARREN BUFFETT: Would you do anything toward making the people who are defendants in D&O situations pay any portion of it themselves or not?

CHARLIE MUNGER: I think there would be a great improvement, net, in Omaha — in America — if there were no D&O insurance. Zero. I think people — (applause) — would behave a lot better.

The counterargument is you'd never get anybody with any money who was willing to serve on a board. But my guess is that, net, even after taking into account that little problem, the system would work better than the present one.

32. "It's tough to buy things out of bankruptcy"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: John Goss (PH), Key West, Florida.

You mentioned last year your frustration with buying companies out of bankruptcy. Were you surprised, from your past experience, that the court would not allow a breakup fee regarding your Burlington bid?

WARREN BUFFETT: That's a good question. We submitted a bid to the court. The management agreed to our offer and we submitted a bid in the bankruptcy of Burlington Industries. And our bid was 500-and-some million dollars.

And we provided a — what's called a breakup fee. I'll get to that in a second, but I think it was $14 million.

Now really, when we submit that bid of 500-and-some-odd million, our bid has to remain outstanding for a good many months. So in effect, by making that bid, I get back to the earlier statements I made about option value.

For $14 million, we were telling the creditors of Burlington that, for a period of maybe four months or five months, that they could sell us that business for our number or, for a considerable period, they could get more money for it.

Now that is a very low price, in my view, for a put. In fact, it's an inadequate price, but it's become sort of a customary percentage in terms of bankruptcy proceedings.

The court said that that was too much to charge as a breakup fee, or what I would call a put fee, and so they have set up a new procedure, which will result in Burlington getting sold some months from now to people who follow this new procedure.

I think that — I frankly think 14 million is inadequate, but it's roughly in the range of what has been allowed in many cases.

But we would never agree to that sort of a sum for that sort of exposure, outside of bankruptcy. It just doesn't make any sense. The world changes too much.

If you look at the value of businesses, as measured on the New York Stock Exchange, you'll see fluctuations of a hundred percent in a year. And for 2 or 3 percent, to commit 500-and-some million dollars at a fixed price for a business in a tough industry, I mean that's — that does not make a lot of sense.

I did it, so — but it got rejected. We would not — we will not participate in a procedure where we're going to bid hundreds of millions of dollars and where our bid has to remain outstanding.

And if the — you know, if there's a twin — if there's a World Trade Center disaster, or there's an earthquake in California, or there's a suspension of trading on the stock exchange, or all kinds of things, that our bid sits out there and we've gotten paid $5 million or something for it.

It just doesn't make any sense to me.

So, it's tough to buy things out of bankruptcy, although we've done it twice now. And both situations have worked out well.

But then we tried it a third time with Burlington, and we spent a considerable amount of time and money generating that bid. Weeks and weeks and a good many dollars, and it wasn't accepted.

So, you know, when I look at these experiences, I say to myself it's a lot easier to make a deal with Walmart, where I talk with them for an hour and we shake hands and we got a deal.

Or the other deals we've made in the last year where we buy Northern Natural in a day or two, or where we buy Kern River Pipeline in a few days, or the various businesses we've bought.

And bankruptcy, I think it's probably a necessary part of the procedure. I mean you have to comply with bankruptcy laws. But I would say it's a very awkward way to buy a business.

And if we have to submit bids that will remain outstanding for many months when people can top us, and only have a 1 percent fee for giving that sort of a put, we will not be making many bids.

Charlie?

CHARLIE MUNGER: Well, we know it was unreasonable, from our point of view, to have a transaction that didn't have that modest 2 percent commitment fee in it. The court had a different view, and he thought that the figure should have been different. And who knows. We'll see how it all works out.

33. "We like to go in heavy" when buying a stock

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Gentlemen, Wayne Peters from Sydney, Australia.

My question goes to stock reweightings. Could you describe your thought process in, firstly, determining your commitment weighting level in a new investment? Now, marketable securities is what I'm referring to.

And secondly, your thoughts on potential reweighting. Your record, and clearly in the earlier days as opposed to now, would indicate that on average, you're either in a stock or out of it, though on occasion you've topped up and lightened up.

WARREN BUFFETT: Charlie? I'll let you have one. (Laughs)

CHARLIE MUNGER: I didn't fully understand that question.

AUDIENCE MEMBER: Charlie, I was just referring to how you make an initial commitment to a marketable security investment, in regards to making it maybe a 5, 10, 15 percent commitment. How heavy you decide to go into a position, initially.

CHARLIE MUNGER: Well, we ordinarily don't like small positions.

WARREN BUFFETT: Yeah, we like to go in heavy. I mean, if we want to invest in a business through the stock market, we want to put a lot of money in. You know, we do not believe in a little of this and a little of that.

So, at our present size, we're limited primarily by the availability of the quantity we want, rather than restricting ourselves based on some percentage of a total portfolio.

I can't — it's very hard for me to think of a stock we quit on, in terms of buying, except because we were going to run into some 10 percent limit where we would get liable for short-swing profits or become insiders or that sort of thing. But we almost never want to quit. Isn't that right, Charlie?

CHARLIE MUNGER: Well, not unless the price goes up.

WARREN BUFFETT: Yeah. And of course that's where we made our big mistakes. I mean we have — or I've made the big mistakes, actually. I —

There have been a couple of things that we knew enough to buy, that were in our circle of competence, where we could have bought lots of stock, except it went up a little bit and then we faded because of price.

We didn't fade because we didn't want to put more than X dollars in. If we find an idea that we want to put $500 million in, we probably would be even happier if we could put 3 or 4 billion in.

Good ideas are too scarce to be parsimonious with once you find them.

CHARLIE MUNGER: Yeah, having narrowly averted the mistake of being unwilling to pay up at See's Capital [Candies], we've gone on and made the same damn mistake several times, with respect to marketable securities. We evidently learn very slowly. (Laughter)

WARREN BUFFETT: It's cost us many, many, many billions of dollars, too.

CHARLIE MUNGER: Those are opportunity cost billions. They don't show up on the financial statements, but the amount of money that's been blown by dumb decisions at headquarters at Berkshire Hathaway is awesome. (Laughter)

WARREN BUFFETT: Well said.

CHARLIE MUNGER: Yeah. (Laughter)

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

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Hi, I'm Steve Casbell (PH) from Atlanta. My question involves interest rates.

When you calculate the intrinsic value of a business in a period of low interest rates, like we have currently, do you use a higher discount rate to factor in higher rates in the future?

And also, when — do you ever look at a company's free cash flow yield relative to current rates?

And if I could also get your thoughts on the dividend tax cut. If, by some miracle, the politicians think logically and get rid of the dividend taxes, would Berkshire ever pay a dividend?

WARREN BUFFETT: The question on discount rates, we use the same discount — I mean in theory — we would use the same discount rate across all securities, because if you really knew the cash they were going to produce, you know, that would take care of it.

We may be more conservative in estimating the returns of cash from some, but the discount rate we would use is a constant.

Now, in terms of where we commit, you know, we don't want to use the fact that short-term rates are 1 1/4 percent to think that something that yields us 3 percent or 4 percent is a good deal.

So we sort of have a minimum threshold in our mind about which we're — below which — we're unwilling to commit money. And we're unwilling to commit it whether interest rates are 6 or 7 percent, or whether they're 3 or 4 percent, or whether they're, on a short-term basis, 1 percent.

We just — we don't want to get hooked into long-term investments at low rates just because they're a little bit better than short rates would be or low Government rates would be. So, we have minimum thresholds in our mind.

I can't tell you precisely what they are, but they're a whole lot higher than present Government rates would be.

And at other times, we'd be very happy owning Governments, just because we feel that they offer attractive enough rates.

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

35. Dividends should be taxed

WARREN BUFFETT: The tax on dividends — you know, I've used this illustration before, but I'm paying about the same percentage of my income to the federal government as my secretary does.

Now, I pay more in income tax rates than she does. I pay a higher marginal tax rate, by some margin, than she does.

But she pays way more in Social Security taxes than I do, because I only pay on the first whatever it is, 70,000 or 80,000 of income. And so, she is paying, between what we pay at the company for her and what she pays, we're paying 12 percent or 13 percent or whatever it is of that.

So, we both end up paying fairly similar percentages of our income to the federal government every year.

If Berkshire were to declare a billion-dollar dividend, and my share of it was 330 million, and it were tax-free as the Bush people originally suggested — and it would be tax-free. I mean, we have lots of taxable earnings at Berkshire.

You know, I might be paying 1/10th of the rate to the federal government of my income that she would be.

Now, I can make the argument about the fact that structure shouldn't govern tax rates. That Subchapter S, and Subchapter C, and partnerships, and all of these things, that the tax codes should be neutral between them. And I've made those kind of arguments in the past.

But I can make no argument in my mind that says that I, with everything that — you know, all the luck I've had in life, you know, I was wired a certain way at birth that enabled me to make a lot of money.

And, frankly, it was better to be born a boy than a girl, in terms of money-making possibilities, in 1930. And probably still is, but not to the same degree.

I mean the fact that I would send 1/10th the portion of my income in a year to the federal government that my secretary would, I — it just — it screams at injustice to me, in terms of what the society gives back to me. (Applause)

So I am not for the Bush plan. Charlie?

CHARLIE MUNGER: Well, I agree with you. Even if you assume that the whole economy would work better if we'd never gotten into this double-taxation system on corporate earnings, which I don't think is a clear thing anyway.

But even if you assume that, I think when you live in a democracy where there's lots of envy and resentment and what have you, to have the absolutely most fortunate people paying practically no income taxes, I just think it's unacceptable.

I think there has to be some fairness in some of these arrangements, even if there's some theoretical argument that the economy might work a little better some other way.

WARREN BUFFETT: Yeah, there are IRAs now, obviously, that work very well for people with modest amounts of dividends. That they — they're getting tax deferred for a very long period of time, which has huge benefits.

The big benefits of exempting dividends would go to fellows like me and Charlie, you know. And that's not going to stimulate the economy. It's going to stimulate us, but — (Laughter)

And it's going to result in us sending a very small percentage of the income — of our income — to Washington compared to what the people, you know, working in our shoe factories send.

And that — you know, when somebody says, you know, "What did you do during the war, Grandpa?" I'm not sure that's what I want to explain to them.

36. Why Berkshire wants at least a 10 percent return

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Good afternoon. I'm Patrick Wolff from Arlington, Virginia.

Charlie, I can't resist telling you that I'm actually the fellow who plays the chess games blindfolded.

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: So, I look forward to not seeing you there tomorrow. (Laughter)

CHARLIE MUNGER: Right.

AUDIENCE MEMBER: I actually have a two-part question. I'd like to ask you to elaborate a bit how you think about opportunity costs. And I'm — I think I'm going to be elaborating very much on the very last question that was asked.

First of all, in the annual report you say explicitly that you look for a 10 percent pretax return on equity, in looking at common stocks. And I think you talked earlier about how you built up from that for 5 to 6 percent after-tax return, and then you layer on inflation, and then layer on taxes.

My first question would be, how do you adjust that required rate of return across periods of time? So, for example, when interest rates are higher. And do you look for a different equity premium return over different periods of time?

My second question would be, Warren, you just said that you actually would apply the same discount rate across the stocks.

And I'm sure you know that modern finance actually suggests that you should not do that — that you should be thinking about the timing of cash flows and, in particular, the covariance with the general market.

Now, you've made a point of emphasizing that when you think of risk, you think of risk primarily in terms of, will you get the cash flows that you predict you will get over time?

Sort of numerator risk, if you think in terms of discounted cash flow, which I think everyone here will have to acknowledge — your results speak for themselves — has probably been a very effective way of thinking about risk.

But there is a true economic cost to think about the timing of cash flows as well. And it may be a much smaller cost, but it is still a real cost.

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

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

That's the essential logic behind the idea that you look at the covariance of when cash flows come in with the overall market.

It's a real cost, even though it is difficult to measure, and even if it is a smaller risk than numerator risk, the risk of getting the actual cash flows, since it's a real cost, I imagine you must think about it.

And so, my second question to you would be how do you think about it? And if you decide not to, why?

WARREN BUFFETT: Now, first of all, I would like to say, Patrick, we appreciate you coming out, because Patrick — now, I don't know how many years it's been, but it's been a number, has volunteered on Sunday to play.

Now, I think he's playing six people or so, blindfolded, simultaneously, and after hearing that question you can understand how he does it. (Laughter)

But Patrick, as well as [champion bridge player] Bob Hamman, and then this year, [champion Scrabble player] Peter Morris and [champion backgammon player] Bill Robertie, all come out. And on Sunday they — we've got these extraordinary talents out there. And for people who like the various games they play, they devote an afternoon for it and ask nothing in return.

So, I — we really appreciate it, Patrick, and I'll look forward to seeing if you're peeking out of your blindfold tomorrow. (Laughter)

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

Now, that's true whether short rates are 6 percent or whether short rates are 1 percent. We just feel that it would get very sloppy to start dipping below that.

And we would add, we feel also, obviously, that we will get opportunities that are at least at that level, and perhaps substantially above.

So, there's just a point at which we drop out of the game. And it's arbitrary. There's no — we have no scientific studies or anything.

But I will bet you that a lot of years in the future we, or you, will be able to find equities that you understand, or we understand, and that have the probability of returns at 10 percent or greater.

Now, once you find a group of equities in that range, and leaving aside the problem of huge sums of money, which we have, then we just buy the most attractive. That usually means the ones we feel the surest about, I mean, as a practical matter.

There's just some businesses that possess economic characteristics that make their future prospects, far out, far more predictable than others. There's all kinds of businesses that you just can't remotely predict what they'll earn, and you just have to forget about them.

But when we get — so, we have, over time, gotten very partial to the businesses where we think the predictability is high. But we still want a threshold return of 10 percent, which is not that great after-tax, anyway.

Charlie, do you want to comment on that portion of that question first?

CHARLIE MUNGER: Yeah. The — I think in the last analysis, everything we do comes back to opportunity cost. But it, to some extent — in fact, to some considerable extent — we are guessing at our future opportunity cost.

Warren is basically saying that he's guessing that he'll have opportunities in due course to put out money at pretty attractive rates of return, and therefore, he's not going to waste a lot of firepower now at lower returns. But that's an opportunity cost calculation.

And if interest rates were to more or less permanently settle at 1 percent or something like that, and Warren were to reappraise his notions of future opportunity cost, he would change the numbers.

It's like [economist John Maynard] Keynes said, "What do you do when you change your view of the facts? Well, you change your conduct." But so far at least, we have hurdles in our mind which are basically — well, they involve, implicitly, future opportunity cost.

WARREN BUFFETT: Right now, with our 16 billion that's getting 1 1/4 percent pretax, that's $200 million a year. We could very easily buy Governments due in 20 years and get roughly 5 percent. So, we could change that 200 million a year to 800 million a year of income.

And we're making a decision, as Charlie says, that it's better to take 200 million for a while, on the theory that we'll find something that gives us 10 percent or better, than to commit to the 800 million a year and then find that, in a year or thereabouts, when the better opportunities came along, that what we had committed to had a big principal loss in it.

But that's — you know that's not — it's not terribly scientific. But it — all I can tell you is, in practice, it seems to work pretty well. People —

CHARLIE MUNGER: Years ago, when Warren ran a partnership, and to some extent the partnership that I ran was the — operated in the same way — we implicitly did what you're suggesting, in that part of the partnership funds were in so-called event arbitrage investments.

And those tended to generate returns, occasionally, when the market, generally, was in the tank. And alternative investments would more mimic the general market. So, we were doing what this academic theory prescribes, you know, 40 years ago. And — but we didn't use the modern lingo.

WARREN BUFFETT: Yeah, we've got some preferences for having a lot of money coming in all the time.

But we do go into insurance transactions with huge volatility, which could mean that a big chunk of money could go out at one time, or in a very short period of time.

And we won't give up a lot in expectable return for smoothness, but if you give us a choice of having money come in every week and the same present value of money coming in in very lumpy ways that we wouldn't know about, we would choose the smooth.

But if you give us a choice of a higher present value for the lumpiness, we will take the lumpiness. And that's usually the choice that's — I mean that's usually — we get offered that choice. And other people value smoothness so highly that we do get a spread, in our view, for lumpy returns.

37. Berkshire insures $1B Pepsi contest

WARREN BUFFETT: We are writing — and then we're going to close this up — but you will read a lot, or you may hear a lot, maybe you've heard it already, Pepsi-Cola's having a contest. They're going to have a drawing in September.

The contest goes through a lot of little phases, but in the end, there's going to be one person who's going to have one chance in a thousand of winning a billion dollars. That billion dollars will have a present value of maybe 250 million.

If whoever gets to that position hits the number, we will pay it. And we don't mind paying out $250 million as long as we get paid appropriately for us. And that would create bad cash flow that particular week. We're willing to — maybe even for two weeks. (Laughter)

We're willing to assume that for a payment, and very, very few people in the world are. Even those that can afford it. We would even assume it for 2 1/2 billion, present value.

We'd want more proportionally to assume it for that, but Charlie and I, I think, would agree that we would take that on if we got paid well enough for it.

We wouldn't do it for 25 billion, but we will do things, and therefore, you know, we get the calls on that sort of thing. And that is more profitable business, over time, than bread and butter business.

It also can, you know — it can lead you having an intense interest in watching the television show when the drawing takes place — (laughter) — making sure who draws the number, too.

Charlie, you have anything to add? Then we'll —

CHARLIE MUNGER: Yeah, once you're talking about opportunity cost that's personal to yourself and your own situation and your own abilities, you've departed from modern finance, totally. And that's what we've done.

We're intelligently making these guesses, as best we can, based on our own circumstances and our own abilities. I think it's crazy to do it based on somebody else's circumstances and somebody else's abilities.

Morning Session - 2004 Meeting

1. Welcome

WARREN BUFFETT: (Applause) Thank you.

Good morning. Some of you may have noticed a stunt man was used in that [video shown before the meeting]. (Laughter)

Arnold [Schwarzenegger] just couldn't handle some of those scenes. (Laughter)

Before we get started, I'd especially like to thank Andy Heyward, who's here today and if we can — I don't know whether we can find him out in the crowd, it's a little hard to see from up here.

But Andy runs DiC Productions. He does that cartoon for us and let's give him a big hand. (Applause)

Andy has produced a really extraordinary series telling the story of the beginning of this country called "Liberty's Kids." It's been on public broadcasting the last couple of years. It's great for kids but it's great for adults, too. I've watched a number of sessions myself.

And this summer, in July, it will go on sale at Walmart, a very special celebration. And for those of you who want to pick out something good for your children or your grandchildren, I can't think of a better series to have them watching. And thanks again Andy.

And thanks also to Kelly Muchemore who puts this whole production on. (Applause)

This is Kelly's show.

She, along with that dog Dudley, who you saw in the movie — Dudley is a regular at Berkshire Hathaway. We don't count him in the 15.8 [employees at headquarters], but she, along with Dudley, handle everything. I don't even give a thought to what's going to happen here, as might become evident during the meeting. (Laughter)

She is responsible for putting up that whole exhibition arrangement and really the whole thing. So, Kelly, I don't know where you are exactly, but in any event, thank you very much. (Applause)

2. Formal business meeting begins

WARREN BUFFETT: Now, we'll go through the business part of the meeting. And it may take a little longer than usual, but please be patient.

And I'd like to start out by calling the meeting to order. I'm Warren Buffett, chairman of the board of Berkshire Hathaway, and I welcome you to this meeting.

This hyperkinetic fellow next to me is Charlie Munger — (laughter) — the vice chairman. And we will have a good time, and I hope you do, too.

We work together because he can hear and I can see. I mean, it's — (laughter) — there are times where we can't remember each other's name, but we have a lot of fun together.

Now, any shareholder who wishes to speak regarding the shareholder proposal expected to be presented by Human Life International, or any other matters germane to the shareholder's meeting, should now go to microphone zone 1, which is in section 121 over on my right.

Or section 2, which is at section 221, I believe that's higher up on my right. And — let me see if I have that right. Yeah, or go to section 7, which is — or section 105 — which is microphone 7 on my left. Or to section 205, which is microphone 8.

If you'll go to — if you're going to want to talk about anything concerning the business of the meeting, not the questions afterwards, but just that relates to the matters germane to the meeting, please go there now, because I'm not going to be able to spot people in a crowd this size.

And when it comes time to do the business, we're going to ask anybody that cares to speak up on the business to be at those microphones. And that will be in just a couple of minutes.

Now after adjournment of the business meeting, I'll respond to questions that you may have that relate to the businesses of Berkshire but that don't call for any action at the meeting.

We had some complaints after last year that some people were asking six or seven-part questions. At least, that's the reason I'm giving that we're eliminating those.

The bigger reason is Charlie and I can't remember the first part by the time you get to the fifth part. (Laughter)

So, we are asking you to ask only one question. And don't try to get too clever about working three or four into a single question. And that will give more people a chance to get their questions asked. Only one question at a time and we will go around from microphone to microphone and get as many in as we can.

Now, we're going to do this until noon and then we'll take a break for lunch and we'll come back about one and we'll continue until 3:30. And anything goes on the questions. We'll answer almost anything, except questions about what we may be buying or selling.

You're free, of course, to wander around, go over and buy things. You know, we have a lot of things for sale over there.

It's — as I've pointed out in the past, it's better form to leave while Charlie is speaking than when I'm speaking, but you can — (laughter) — use your own judgment on that.

Now, I do want to remind you that any audio or video recording of this meeting is prohibited. That if anybody's seen recording the proceedings, we will have to ask you to leave. So, if you see anybody doing that, we would appreciate it if you would just inform one of the staff personnel around.

Because there's certain copyrighted material that we use and people, like Judge Judy, give us permission to use a segment like that. But it's not intended to be used in any commercial way. So, we do ask that no recording take place.

3. Directors introduced

WARREN BUFFETT: Now, I'll first introduce the Berkshire Hathaway directors that are present, in addition to myself and Charlie. Now, I'll ask the directors to stand as their names are read and ask that you withhold applause, if any — (laughter) — until all are introduced.

We have — I don't know whether we have anybody here from CalPERS, but they can register their own views as we go along. (Laughter)

And it is difficult to see from here, so if you'll just stand as I mention your name and remain standing until the end, when we will see whether you get any applause.

Susan T. Buffett. Howard G. Buffett. Malcolm G. Chace. David S. Gottesman — Sandy had a conflict today. There's a bat mitzvah, I believe, for a granddaughter, so he's coming in tomorrow for our director's meeting on Monday.

Charlotte Guyman. Donald R. Keough. Thomas S. Murphy. Ronald L. Olson, and Walter Scott Jr. And now you can go crazy. (Applause)

4. Four questions for the auditors

WARREN BUFFETT: Also with us today are partners in the firm of Deloitte & Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

In that regard, I wish to report that at Berkshire's audit committee meeting held on March 2nd, 2004, Deloitte & Touche responded to the four questions I suggested be asked to the independent accountants by all audit committees. And we're going to put these up in just a second.

With respect to Berkshire, the questions and the auditors' responses will be shown on the following slides.

And I might mention that I really do think these questions should be asked of all auditors, at least annually, perhaps even quarterly.

And I really think that, if such a procedure had been followed over the years — don't eat them all Charlie. (Laughter)

If such procedures had been followed over the years, there would have been a lot less trouble in corporate America.

I mean, for many years, particularly in the '90s, I think there was a weakening, frankly, in auditor vigilance. And the trick, as I've said, is really to have the auditors more worried about the audit committee than they are worried about the management.

And it's quite natural when they're, essentially, hired by the management and when they see the management regularly and they only see the audit committee infrequently, that it's tempting to listen a little bit more to management than the audit committee.

But these questions, if asked, in my view — and if the answers are put on the record — I think it would have a very helpful effect on behavior. Because once on the record, it means the auditors — it means they're on the line.

And I've been on a lot of boards of directors and I've seen, in retrospect, things go by that I wish had been called to my attention by the auditors.

So we have these four questions. And if we'll put up the first one — and I'd like to explain one item. Do we have those up? Yeah.

You can read the question and these are the responses, as we go along, that the auditors have given to these questions.

Now you'll notice on the first one that there is one item that — and incidentally, we owe a shareholder, who I think is going to speak later — it was his suggestion that we actually present these at the meeting. And I think it's a good suggestion. And I think if more companies did it, it would be a good idea. So I thank him for the suggestion.

The major item, which is not material, as auditors define it, but the major item in which we disagree and use a method which I will explain further — actually, it's been changed — but concerns the purchase of life insurance policies, or the reinsurance of people who are purchasing life insurance policies, their so-called viatical settlements.

And we have had a business, of sorts, in that. And it's likely to even be a larger business in the future.

And what takes place there is that somebody, usually elderly, has a life insurance policy and they'd rather have the money themselves than have their heirs get it later on. So, they want to cash out early.

And as you know, a life insurance policy typically has a cash surrender value. And sometimes those cash surrender values are quite low in relation to the actuarial value of the policy. So sometimes those people wish to sell a policy.

We had a case the other day where a 79-year-old woman had an insurance policy amounting to some $75 million. I've never met her, but she must be quite a woman, but — (Laughter)

The cash surrender value of that policy was $2 million. Clearly, for even a 79-year-old in the best of health, that was an inadequate sum for her to receive. But yet she wished to have the cash herself rather than eventually die and leave it to her heirs.

So, we paid — or we actually reinsured a transaction where somebody else did it, and we took only 50 percent of it, but I'm going to use a hundred percent figures.

We reinsured — we bought that policy for $10 million. And under accounting rules — GAAP accounting — we — it is recommended that we write that policy down immediately to the cash surrender value of 2 million. Well obviously, we think it's worth 10 million or we wouldn't have paid 10 million for it today.

But the rules, as they become more clear, say write it down immediately. I happen to think that rule is wrong. But last year, at the end of the year, there had been a total of $73 million applicable to such policies that reflected our purchase price as opposed to the cash surrender value.

In the first quarter of 2004, our activity has stepped up in this field some — the people we reinsure have stepped up their activities, so we get our 50 percent. And that amounts to — it's going to amount in the first quarter to about 30 million.

So, we have adopted — even though we think it's in incorrect — we have adopted the GAAP accounting. And you will see in the first quarter report of Berkshire the charge for the 73 million of last year plus the 30 million in the first quarter this year.

And that gets charged, believe it or not, to realized capital gains. And so, by buying these policies for X on one day and immediately writing them down substantially, that becomes a realized capital loss on our book. Now later on, we expect to get a perfectly satisfactory return from these policies. But that is the main item that is referred to in the auditor's answer on question one.

Now, if we'll go to number 2. You have time to read that.

I like the idea of this question being asked. I've read many reports where the footnotes are such that even if I reread them several times, I still don't know what's happened. And we try to write everything in plain English at Berkshire, and we try to explain things within the body of the letter that might give people the wrong impression if they simply looked at the figures, or that they might not be able to discern.

Because Berkshire's gotten so large that we — there are all kinds of things that are lumped together in the consolidated statements, that I think it's more helpful if we look at separately.

We're going to work at — annually — at trying to disaggregate numbers and information in a way that makes it most useful without turning out something as long as the World Book.

Third item is very simple.

And the fourth item relates to something that became very prevalent in corporate America in the 1990s, which was moving around numbers from one quarter to another or moving them for one year to another.

And I have seen a lot of that. It's deceptive. I like the statement that the two fellows at Google made the other day where they essentially said that if numbers are lumpy or peculiar when they get to them, they're going to be lumpy or peculiar when they get to the public.

And if there's some reason that requires explanation as to why they're lumpy, that the management should explain them. But the one thing they shouldn't do is start playing games from quarter to quarter or year to year in terms of moving numbers around.

And that became very fashionable. I hope it's on the way to being moderated and we will continue to — each year, we will give you these questions at the meeting and we will report on the auditor's answers.

5. Election of directors

WARREN BUFFETT: Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings. Miss Becki Amick has been appointed inspector of elections at the meeting. She will certify to the count of votes cast in the election for directors. The named proxy holders for this meeting are Walter Scott Jr. and Marc D. Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 3rd, 2004, being the record date for this meeting, there were 1,278,436 shares of Class A Berkshire Hathaway common stock outstanding with each share entitled to one vote on motions considered at the meeting, and 7,766,293 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,121,231 Class A shares and 6,473,904 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 29th.

WARREN BUFFETT: Thank you. That number represents a quorum and we will therefore directly proceed with the meeting.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: Seconded.

WARREN BUFFETTT: Motion has been moved and seconded. Are there any comments or questions?

We will vote on this motion by voice vote. All those in favor say “aye.”

VOICES: Aye.

WARREN BUFFETT: Opposed? Motion’s carried.

First item of business at this meeting is to elect directors. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he and she may do so. Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you.

Would those persons desiring ballots please identify themselves so that we may distribute them? And I now recognize Mr. Walter Scott to place a motion before the meeting with a respect to election of directions.

WALTER SCOTT: I move that Warren E. Buffett, Charles T. Munger, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, David S. Gottesman, Charlotte Guyman, Donald R. Keough, Thomas S. Murphy, Ronald L. Olson, and Walter Scott Jr. be elected directors.

WARREN BUFFETT: Is there a second?

It's been moved and seconded that Warren E. Buffett, Charles T. Munger, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chace, David S. Gottesman, Charlotte Guyman, Donald R. Keough, Thomas S. Murphy, Ronald L. Olson, and Walter Scott Jr. be elected as directors.

Are there any other nominations? Is there any discussion? Is there anybody that is at the microphones that would —

AUDIENCE MEMBER: Yes. Paul Tomasik, Thornton in Illinois.

I like the idea of inside directors. I think they're necessary. However, I think we should have the best available. In particular, I'd like you to consider the CEOs of the Berkshire subsidiaries.

If you compare their qualifications to Susan Buffett's and Howard Buffett's, I think you'll find that the CEOs have superior qualifications, particularly, business savvy and the ability to stand up to a forceful CEO.

I'd like to point out that we'll hear how many of these CEOs are independently wealthy and could easily say, "Take this job and shove it." So this is why I am withholding my votes for the directors. Thank you.

WARREN BUFFETT: Thank you. Charlie, do you have any thoughts on that?

CHARLIE MUNGER: I think we should go on to the next item. (Laughter and applause).

WARREN BUFFETT: The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of election.

Would the proxy holders please also submit to the inspectors of elections a ballot on the election of directors voting the proxies in accordance with the instructions they have received.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders, in response to proxies that were received through last Thursday evening, cast not less than 1,123,189 votes for each nominee. That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by the Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to the proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. Warren E. Buffett, Susan T. Buffett, Howard G. Buffett, Malcolm G. Chase, David S. Gottesman, Charlotte Guyman, Donald R. Keough, Thomas S. Murphy, Charles T. Munger, Ronald L. Olson, and Walter Scott, Jr. have been elected as directors.

6. Proposal to publish political contributions

WARREN BUFFETT: The next item is business is a proposal put forth by Berkshire shareholder Human Life International, the owner of one Class B share.

Human Life International's motion is set forth in the proxy statement and provides that the company be required to publish annually a detailed statement of each contribution made by the company and its subsidiaries in various political causes.

The directors have recommended the shareholders vote against the proposal. We will now open the floor to recognize the appointed representative of Human Life International to present their proposal. Is someone here to present that?

TOM STROBHAR: Yes, Mr. Buffett. My name is Tom Strobhar and I do represent Human Life International. And I'm here to present the shareholder resolution regarding political contributions.

But before I do, I'd like to give you a little background. Some of you may remember, two years ago, there was a resolution asking the company to end its charitable giving program.

The resolution said corporate charitable contributions should help, not hinder, the company and suggested certain contributions, especially those related to abortion and population control, were doing just that.

This proposal was soundly defeated by the shareholders, receiving less than 3 percent of the vote. Oddly enough, a little over one year later, Mr. Buffett, in his wisdom, did terminate this program citing the adverse impact his philanthropic interests were having on the livelihoods of some employees at the Pampered Chefs division.

At the time of the resolution, we first learned that Mr. Buffett and Mr. Munger were directing their money to their personal foundations rather than more recognized public charities.

While previous chairman's letters extolled the high participation levels among eligible shareholders, no mention was made that Mr. Buffett, who accounted for 31 percent of the equity of the company, was giving away almost 55 percent of the charitable gifts.

Why all of you B shareholders, who probably comprise a majority of the people in this audience, were excluded from giving, and whose vote on this proposal was dramatically diluted down to 1/200th of the value of an A share — which obviously is not quite democratic.

I refer you to the 1983 Chairman's Letter. In addressing why he wouldn't split the stock, Mr. Buffett describes something he calls "shareholder eugenics."

Mr. Buffett laments how it's impossible to screen entering members of the shareholder "club" for quotes, "intellectual capacity, emotional stability, moral sensibility, or acceptable dress."

Splitting the stock and lowering the price of admission to the club — Class B shareholders take note — "would attract an entering class of buyers inferior to the existing class" and "downgrade the quality of our present shareholder group," end quote.

All told, Mr. Buffett gave to his private foundation almost $100 million, much of it other shareholders' money. This money, in turn, was devoted almost exclusively to population control seeking to lessen the number of people at a time when Western nations, especially those in Europe and Japan, face economic calamity from a baby bust.

How do charitable contributions relate to political contributions? It wasn't until there was a resolution on charitable contributions that we received some disclosure. So too, with the resolution I'm about to present, did we find out the company gave a very modest $200,000 to various political candidates or causes.

While the charitable contributions may have been too much, the political contributions may be too little. Not necessarily from the company, but from other shareholders. If there are politicians or causes in which there is legitimate business interest in supporting, why not give the shareholders the opportunity to help them also?

By publishing the list, the word goes out to our thousands of shareholders who may wish to do the same with their own money. It costs little to publish, provides for transparency, checks any personal abuse, and sets an example to the rest of corporate America.

It also provides an opportunity for all the members of our shareholder club, even B shareholders, to get involved and help this company and help their investment.

And with that, I'd like to read the actual resolution, which I'm required to do.

"Within one month, after approval by the shareholders of this proposal, management shall publish in The Buffalo News a detailed statement of each contribution made by the company or of any of its subsidiaries, either directly or indirectly, within preceding fiscal year, in the respect of any political campaign, political party, referendum or citizen's imitative, or attempts to influence legislation, specifying the date and amount of each contribution and the person or organization to whom the contribution was made.

"Subsequent to this initial disclosure, management shall cause like data to be included in each succeeding report to the shareholders. If no such disbursements were made, to have the facts so noted in the annual report."

This proposal, if adopted, will require the management to advise its shareholders how many corporate dollars are being spent for political purposes, and to specify what politicians or political causes the management seeks to promote with these funds.

Political contributions are made with the dollars that belong to the shareholders of the group and they are entitled to know where their dollars are being spent. A vote for this proposal is a vote for full disclosure. Thank you.

WARREN BUFFETT: Is there anyone else that would care to speak on the motion?

Charlie, do you have any comment?

CHARLIE MUNGER: Well, I preferred our old charitable giving program to the way most corporations do it in America — (applause) — where the controlling officers decide. However, it's a dead horse. It's gone and there's no point beating on the corpse. (Laughter)

WARREN BUFFETT: The dead horse will now speak. (Laughter)

I just want to add one point, because it a little different than occurs at many other corporations. To my knowledge or memory, I don't believe Charlie and I have ever asked any employee or any vendor to Berkshire — any employee of Berkshire or a vendor to Berkshire — for either political contributions or charitable contributions.

There's been no — there's been no use of our positions to, in effect, extract money for our own personal causes, either in the charitable area or the political area. Is that correct, Charlie?

CHARLIE MUNGER: Yeah, but we don't deserve too much credit for not asking other people for charitable contributions. (Buffett laughs)

Think what the reciprocity implications would be.

WARREN BUFFETT: Yeah. (Laughter)

But it's a fairly common activity.

So here we are. We'll — if any shareholder's voting in person, they should now mark their ballots in the — on the motion and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the proposal, voting of proxies in accordance with the instructions they have received? Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballet of the proxy holders, in response to proxies that were received through last Thursday evening, cast 27,287.605 votes for the motion and 936,045.815 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes related to all Class A and Class B shares outstanding, the motion has failed. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The proposal fails.

7. Shareholder proposal to "tell us the rules" on motions

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn? If so —

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: —they should approach microphone 1 to be recognized. I believe we have someone.

AUDIENCE MEMBER: Yes. Paul Tomasik, Thornton in Illinois.

I have a proposal to put written rules for this meeting, the formal part, on the web, in order that this meeting can be conducted fairly and with good faith.

Would you like a little more comment?

WARREN BUFFETT: No.

CHARLIE MUNGER: No.

WARREN BUFFETT: The faster you can make it, the better. But go to it. (Applause)

AUDIENCE MEMBER: Well, that's it —

WARREN BUFFETT: That's it.

AUDIENCE MEMBER: — on that one.

WARREN BUFFETT: OK.

(To person sitting next to him) Is that a motion?

WARREN BUFFETT: Well, do you want to — would you place all — if you have more motions, would you place them, or is that it?

AUDIENCE MEMBER: No, certainly. The other three motions are to put the bylaws and the articles of incorporation up on the website, to write it into the bylaws how shareholders should present motions, and the fourth, to write it into the bylaws how shareholders can make director nominations.

To sum up, what these motions ask for is just tell us the rules. We'll follow them. That's it. Thank you.

WARREN BUFFETT: OK, thank you.

I actually think you came up with a very good suggestion on the audit committee report, which we've incorporated. I don't really think this would add much, but if there are any shareholders voting in person, they should now mark their ballots in the motion — on the motion — and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the proposal, voting the proxies in accordance with the instructions they've received.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders cast 1,153,600.52 votes against the motion. As the number of votes against the motion exceeds a majority of the number of votes related to all Class A and Class B shares outstanding, the motion has failed. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank, Miss Amick. The proposal fails.

I now recognize Mr. Walter Scott to place a motion before the meeting.

WALTER SCOTT: I move the meeting be adjourned.

WARREN BUFFETT: Is there a second?

VOICE: I second.

WARREN BUFFETT: A motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say "aye."

VOICES: Aye.

WARREN BUFFETT: All opposed say "no." The meeting's adjourned. OK, now we're — (Applause)

8. Rebuttal of calls for Buffett to leave Coca-Cola's board

WARREN BUFFETT: Now we're going to move into the questions and answers, at least questions. And just ask one as we spelled out before. And we will start with microphone 1, which is in section, what, 121 on my right. And we'll keep moving 1 through 12 until we get till noon. Microphone 1.

AUDIENCE MEMBER: Jonathan Mills (PH) from London, England.

I wondered if you could comment on the views of those people who have stated that, because of so-called conflicts of interest, you should leave the board of Coca-Cola and whether you had any intention of doing so.

WARREN BUFFETT: That we should do what with the board?

AUDIENCE MEMBER: Leave the board. That you personally should leave the board of Coke.

WARREN BUFFETT: I would say that whoever suggested that should do 500 sit-ups. (Laughter)

Actually, Charlie and I — certainly I have — well, I'll Charlie speak for himself — we like the idea and we've encouraged the idea of shareholders behaving like owners. I mean, shareholders have too often behaved like sheep in this country and they got shorn, in many cases.

And big institutional shareholders have sat on the sidelines while some things that might possibly have been corrected, had they gotten active, took place. So we have — we actually applaud the idea of shareholders behaving like owners.

The question is whether they, you know, can behave like intelligent owners. And I think that in the last year or two, as they've sort of woken up, they've searched for checklists of one sort or another to determine whether directors are appropriate in a given company or not.

And frankly, checklists are no substitute for thinking. The real job of the directors is to come up with the right CEO for a company and prevent him or her for overreaching. If they do that job well, the rest takes care of itself.

And you have to think some to determine whether that's taking place. You can't solve it by just running down a little checklist.

I think it was Bertrand Russell who said, "Most men would rather die than think. Many do." (Laughter)

And I think we've seen a little bit of what he was thinking about in some of the voting. I think it's absolutely silly, frankly, if Berkshire Hathaway owns 200 million shares of Coca-Cola, $10 billion worth, to not be able — it's a little silly not to think that the interest that Berkshire Hathaway has in selling some hours of training at FlightSafety would cause me to do something counter to the interests of the shareholders, when we have $10 billion riding on that side of the table. I mean, it's almost absurd, and somebody doesn't understand proportionality at all when they come to that sort of conclusion.

I also think it's absolutely foolish if — just to use Coca-Cola as an example. I think the directors of Coca-Cola haven't even looked, but I think we probably received something like $100,000 a year.

And if we were to go out into the welfare line and pick somebody out who has no income and say, "We'd like you to become a director," and that person would get $100,000 a year, which would be their entire income, and to say that person would be independent — you know, while they would be 100 percent dependent on their income — that person would be independent. Whereas Berkshire Hathaway, or myself representing Berkshire Hathaway with 10 billion of stock — and receiving the same $100,000 a year — is not regarded as independent.

So I encourage — I encourage institutional shareholders to — and large owners — to behave like owners. But I also encourage them to really think logically, as owners should think, in determining what causes they take on and how they vote.

Charlie? (Applause)

CHARLIE MUNGER: Yeah, I think that they, corporate America, needs a fair amount of reform. But the cause of reform is hurt, not helped, when an activist makes an idiotic suggestion — (laughter) — like the one that — (applause) — having Warren Buffett on the board of the Coca-Cola Company is contrary to the interest of the Coca-Cola Company. Nutty activities do not help the cause for which the person speaks.

WARREN BUFFETT: It's a little bit like having a slicing machine in an orchard where you're gathering together apples but you're also picking up a lot of rocks in the process and sticks and stones. So you have a slicing machine with a conveyer belt. And the slicing machine is programmed so that every time something is red and round comes down the line, it slices and comes down, but it doesn't come down on the rocks and everything and ruin the blades.

And, of course, that's fine until a red balloon comes down the line and then you get a big pop and the machine has followed its little guidelines but it's not slicing apples anymore.

And I think — I just — actually, institutions are coming new to really thinking about how they behave as owners. And you would hope that, in the evolutionary nature of learning — that not too many years distance — distant — they would actually think about what's good for the shareholders of the company.

9. Surviving inflation

WARREN BUFFETT: Let's go to microphone number 2, please.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, good morning. My name is Zachys Sarris (PH) and I am from Athens, Greece.

There is a widespread perception that we're heading towards an inflationary environment. What advice would you give to investors who need to preserve their capital and their purchasing power in such an environment?

WARREN BUFFETT: The best thing is to have a lot of earning power of your own. If you're the best brain surgeon in town, or even the best lawyer in town, you will retain purchasing power, in terms of your income, no matter what happens, you know, whether people are using seashells for money, or whatever as time goes by.

In the investment world, it's tougher. But Charlie and I think the best answer is to own fine businesses that will be able to price in inflationary terms and will not have huge capital investment that is required to handle the larger dollar volume of sales.

Some years ago, I used See's Candy in our — in the annual report — as an example of the kind of business that, more or less, can handle an inflationary world and maintain investment and value, no matter what happens to the currency.

Unfortunately, most businesses will not come out well in real terms during inflation. Their earnings may go up a fair amount over time, but they're compelled to put more and more dollars into the business just to stay in the same place.

You know, the worst kind of a business is one that's — makes you put more money on the table all the time and doesn't give you greater earnings. So you really want a business that can have pricing that reflects inflation and does not have very much capital investment that reflects inflation. But inflation is the enemy of the investor, in terms of real returns.

As you know, there are, in this country as well as a half a dozen other countries, there are what they call "inflation protected bonds" — we call them TIPS in the United States — where the income is adjusted — or, the principle amount is adjusted — to inflation. And that's not a bad investment for people that have worries about inflation heating up. And I think, incidentally, we're starting to see it heat up in this country.

Charlie?

CHARLIE MUNGER: Yeah, most people are going to get a very small real return from investment after considering inflation and taxes. I think that's an iron law of the world and if, for a brief period, some of us do better than that, we ought to be very thankful.

One of the great defenses to being worried about inflation is not having a lot of silly needs in your life. In other words, if you haven't created a lot of artificial demand to drown in consumer goods, why, you have a considerable defense against the vicissitudes of life.

WARREN BUFFETT: Charlie, we're selling consumer goods in the other room. (Laughter)

It's OK to talk that way at home, but — (Laughter)

CHARLIE MUNGER: It doesn't do any good there. (Laughter)

WARREN BUFFETT: I know the feeling. (Laughter)

10. Reluctance to hold special meetings for analysts

WARREN BUFFETT: Let's go to microphone 3.

AUDIENCE MEMBER: Good morning, gentleman. My name is Larry Coats, from Durham, North Carolina.

Mr. Buffett, after last year's meeting, my longtime friend and business partner George Brumley [III] sent you a letter addressing several issues. Having participated in the preparation of that letter and on his behalf, I thank you for your response.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: In such, you suggested that many of those issues would be appropriately addressed in this forum. In his honor, I'd ask you to address just one of those, and that is the ultimate generational transfer of Berkshire away from its current base of long-term, self-selected, and well-informed shareholders, and the potential of instituting a series of analyst meetings to address the relative lack of interest in, and ownership, and understanding of, Berkshire by institutional shareholders and investors. Thank you and good morning.

WARREN BUFFETT: Well, thank you. I mean, George was a wonderful man. A great analyst and a friend.

I have some problem with having meetings with subgroups of investors, such as institutional investors. If we had something like that, I think we would want it to be open to everybody. And, you know, that gets to be quite a production.

But I can understand, you know, why A) you'd like to see our managers and hear what they have to say about their businesses. We try to convey a lot about the businesses in the report, but —

Charlie, do you have any thoughts on that?

CHARLIE MUNGER: I don't think it fits our temperament at all well. Many corporations have a huge amount of effort spent in talking to groups of analysts. One of Berkshire's strengths has been that we don't spend time in that way.

That's a very time-consuming process. And it does give some shareholders some advantage over others. We try and be more egalitarian in events like this and the way we write the annual report, et cetera.

WARREN BUFFETT: Yeah, we really like the group of shareholders we have. I mean, we're not about enticing new people into it. But I know your point also is that the present shareholders could better understand Berkshire if they would listen to Bob Shaw talk about Shaw Carpet or Rich Santulli talk about NetJets. And the truth is, it is fun to listen to those people.

But one of the things we promise managers when they join up with us, too, is they that they don't have to listen to bankers, they don't have listen to investment analysts. They just get to run their businesses. They can devote a hundred percent of their time to it. And people like that, and they're more productive because of it.

I mean, we really place no impediments in the way of our managers doing what they do best and what they like to do best, which is run their businesses.

And frankly, a number of them have expressed to me that they're very happy because they existed in a different mode before. And in that mode, they would spend maybe 25 percent of their time on activities that they didn't enjoy and they didn't feel were very productive.

So we want to get across the information about our businesses to you. And believe me, when I write the report and Charlie looks at it, we say to ourselves, "Are we telling you what we would want to know about if our positions were reversed, if we were on the receiving end?" And we really try to put in the report everything that's germane to evaluation.

Now, if you have a market cap of 130 billion, you know, it's really not too important to get keen insights into some business that's making a relative small amount of money. But anything that counts — and really, you have to look at them in aggregates — we want to get across to you.

So, you know, it's — I'm very respectful of your suggestion. It's conceivable to do it.

The Washington Post has a shareholder day, because their annual meeting is turned into a farce often because it's largely dominated by people who are complaining about this story or that story. But the shareholder day is very useful and they do have their managers there and talk about it.

But I really think if we spend six hours here answering your questions about the business and we do a half-way decent job of writing the annual report, we should get across the essential information.

And we're really not trying to get across — we're not trying to talk to an audience that is trying to get some special insight into what next quarter or next year is going to look like.

We're really looking for owners who join us in what we regard as kind of a lifelong investment. And I would say that certainly analysts, like your group, have exactly the same objective we do and want to understand the business that way.

But my experience, you know, in talking to hundreds of them, is that there are relatively few that are actually thinking about, "What do we buy and put away forever?" Like, we'd buy a farm or an apartment house or something. So we'll consider it, but I don't want to make any promises.

11. Compensation plans: specific to the business, simple, and generous

WARREN BUFFETT: Go to number 4, please.

AUDIENCE MEMBER: Good morning, gentleman. My name is Matt Sauer and I'm from Durham, North Carolina.

Regarding compensation, you have commented along the lines of people willing to bet big on their (inaudible) usually have a lot of bet on.

A MidAmerican regulatory filing indicated some attractive prospective compensation possibilities for its senior executive team, subject, of course, to meeting profitability milestones.

Perhaps you might provide some details on the thought process that went into crafting that compensation structure, and in doing so, use this specific example as a reminder about Berkshire's compensation philosophy, related to pay for performance versus the more popular approaches.

If it's easier to figure out and administer, better for owners, and can still attract talented people, why don't more companies adopt such practices?

WARREN BUFFETT: Yeah, we — you could make a lot of money working for Berkshire. Not if you're chairman or vice chairman, but there's a chance to make a lot of money. But it will relate to performance. No one is going to make lots of money at Berkshire for average performance.

And you mentioned the MidAmerican situation. We've got some extraordinary management at MidAmerican. And it's — in terms of how that compensation arrangement was worked out, I was thinking one day about what would be appropriate for the two individuals who are key to the success of MidAmerican. And I took a yellow pad and I spent about three minutes sketching out a proposal.

And I went to Walter Scott, who is our partner in the business and now actually heads the comp committee. And I said, "Walter this is an idea I have, what do you think of it?" And he looked at it and he said, "It looks fine to me."

And we talked to the two managers about it and actually, as we presented it, we had it so that something over 50 percent went to the CEO, Dave Sokol and something under 50 percent went to the number two man, Greg Abel, who's enormously well named.

And when we gave it to David, he said, "Let's just" — he said, "I like it fine, but let's make it 50/50." That's the extent of it.

As you have commented, that's wildly different than the approach at companies. I mean, most companies go through very elaborate procedures in working out executive compensation. I don't think that Charlie and I have spent ever, maybe five minutes, on thinking about any.

We have an arrangement at See's Candy with Chuck Huggins. We worked it out in 1972. It's still in force now.

John Holland took over Fruit of the Loom a couple of years ago. I met with him for a couple of minutes, suggested something, takes up a paragraph or two. And that's what we'll have with John the rest of his life.

It's not highly complex. You have to understand the businesses. There is no one formula we could use at Berkshire that would fit across our businesses, that's asinine.

You don't want them complicated. We don't have anything that goes on for pages and pages. It's not needed. It establishes a relationship between us and the manager that's not good.

So all of our stuff is very, very simple.

At GEICO we have two variables and they're what count, you know. So we make — from Tony Nicely on down, we have everybody participating based on that. We worked that out whenever we took over at GEICO and it's worked fine since and it'll keep working.

But we do not bring in compensation consultants. We don't have a human relations department. We don't have — at the headquarters, as you could see, we don't have any human relations department. We don't have a legal department. We don't have a public relations department. We don't have an investor relations department.

We don't have those things because they make life way more complicated and everybody gets a vested interest in going to conferences and calling on other consultants and it takes on a life of its own.

In the typical large corporation, there's a comp committee. And, as I pointed out in the past, they don't put Dobermans on the comp committees, usually. They — they look for Chihuahuas that have been sedated and — (Laughter)

I've been on 19 boards. They put me on one committee once, and I was chairman and I got outvoted. Do you remember that, Charlie? (Laughs)

CHARLIE MUNGER: I certainly do.

WARREN BUFFETT: Yeah. The —

CHARLIE MUNGER: By two very fine guys.

WARREN BUFFETT: Yeah, terrific guys, actually. And they — you know, the nature of it is that now, particularly with Sarbanes-Oxley, there's lot of committee meetings. The directors meetings are filled up with process.

And you have on one side of the table, some people that usually are spending an hour or two and getting presented with a bunch of material by the human relations department and some outside consultants.

And I've never seen the head of a human relations department or a consultant come in and say, "This bozo you've got is only worth about half what you've been paying him." This just isn't going to happen.

So it's, you know — it's a situation where the intensity of interest on both sides is seldom equal. The directors are often dealing with something my friend Tom Murphy in the past has called, "play money," and the CEO is dealing with something very dear to his heart.

So you've got to expect a situation like that to get gamed over time. Not over time, promptly, actually.

And there is some change in that that's taking place. But it's not being — in large part, it's not being led by CEOs and it's difficult for directors to do — to get a lot done.

They get handed a sheet of paper that shows them comparables elsewhere, and everybody thinks their CEO is in the top 25 percent or something. And so there's a ratcheting effect that takes place.

And now stock options are coming out of favor, so restricted stock comes in. But the idea is to keep the pie very large for CEOs. And if I needed the money, I'd probably be doing the same thing.

Charlie?

CHARLIE MUNGER: Well, I would rather throw a viper down my shirtfront than hire a compensation consultant. (Laughter and applause)

WARREN BUFFETT: Tell me which kind of consultants you actually like, Charlie? (Laughter)

He's not going to answer that.

12. We don't think about investing "categories"

WARREN BUFFETT: We'll go to number 5. (Laughter)

AUDIENCE MEMBER: Warren and Charlie, good morning. My name is Mo Spence from Waterloo, Nebraska.

Years ago, you listed the four or five investment vehicles you considered appropriate for Berkshire, including, I believe, common stocks, long-term debt, and arbitrage opportunities.

In light of your comments in this year's annual report, I was wondering if you could review that list, in order of preference, and specifically comment on them, including the current environment for arbitrage.

WARREN BUFFETT: Yeah. Well, the items you name — and you could break that down by high-grade bonds, you know, versus junk bonds.

The items you mention are all alternatives. You know, Charlie and I sit around and think about what's the best thing to do with Berkshire's money. It's a fairly simple proposition.

And we have a number of things that we feel competent to make judgments on, and we have a number of things that we're not competent to make judgments on. So we narrow — we hope to narrow the field to investments that we think we can understand. And there are a reasonable number of those, although there are a lot that we can't understand.

Anything I would say today, you know, can change tomorrow. We don't think about the categories by themselves.

Now, in a period like summer to mid-fall of 2002, when junk bonds became very attractive, we bought a lot of them. But we didn't make some great decision to buy junk bonds, we just started seeing things, individual items, that started screaming at us, you know, "buy, buy, buy." And then that came to an end.

And so we don't go to the office in the morning thinking what category — how do we prioritize our categories. You know, we have an open mind and whatever we see that day that overcomes, or that crosses the threshold to where we take money out of short-term cash and move into it.

It could be arbitrage — it's unlikely to be arbitrage now, because that's a game that, to play on a scale that would have a meaningful effect at Berkshire, is hard to do.

I mean, take very big deals, and it's something we've done successfully in the past. We've made a lot of money over the years in arbitrage and quite consistently sometimes in the past.

But we don't — Charlie and I do not have a checklist that we talk about every day, or every month, or every year, in terms of prioritizing categories.

We just hope — I hope he gets a good idea, he hopes I get a good idea. And when we get one, we move in a big way.

They have to be big now and that's a limiting factor in terms of what's available for us.

As you know, if you read the annual report, you know, we took a significant position in currencies. We're buying viatical settlements, in terms of the transaction I mentioned a little earlier.

We're open to anything we can understand. Charlie?

CHARLIE MUNGER: Yeah, you really asked us to determine an order of precedency among two or three activities we don't have much interest in at the moment. And that's not something we spend a lot of time at.

In other words, we have all this cash because we don't much like any of those fields at the moment. And spending all the time thinking about orders of precedency among things you clearly are not going to do is pretty fruitless for us.

WARREN BUFFETT: Yeah, I thought I had a slide here but I don't. But it — when we were buying junk bonds in the summer to fall of 2002, we were literally buying securities — and we limited it to the kind of junk bonds we can understand, which is far from the whole universe — but we were literally buying things on a 30, 35, 40 percent yield to maturity basis.

Now, we buy those with a mental attitude of buying common stocks.

Interestingly enough, within 12 months, some of those same securities that were yielding 30 or 35 percent went to prices where they yielded only 6 percent. I mean, that is truly remarkable when you think about that happening in a country that was not in the throes of depression or anything.

I mean, prices do amazing things in securities markets. And when they do something that strikes us as amazing in our direction, you know, we will act.

But we do not know today what we're going to be doing tomorrow. We have — you know, we have some things — a few things we may be doing. They're likely — It's likely we're doing them tomorrow, but there's — we don't hold any committee meetings on this.

And there's, you know, this business where somebody says, "You should have 50 percent of your money in bonds and 35 percent, you know, in equities, and 15 —." We don't go through anything like that. I mean, we regard that as nonsense.

Any further thoughts, Charlie?

No further thoughts, evidently. (Laughter)

13. "Very dangerous to project out high growth rates"

WARREN BUFFETT: Microphone 6.

AUDIENCE MEMBER: Good morning, gentleman. My name is Tony Ado (PH) and I come from New Jersey.

Mr. Buffett, my question is on business valuation and growth. In one of your letters, you mentioned the discounting formula on earnings divided by the difference between the discount and the growth rate.

But if the growth rate is larger than the discount rate and if we use this formula, then we get a negative number. And one way around this — let's call it method A — is to have two growth stages, one with a high growth and the second stage with a low growth.

And the second way, method B, would be to estimate how much the earnings is on the third year for the company and then multiply this by the average price-to-earning ratio to get the price in the tenth year.

I don't know if you use the method A or method B, but if not, I would like to ask, Mr. Buffett, how do you estimate how much a company is worth if the growth rate is larger than the discount rate?

WARREN BUFFETT: Well, you put your finger on an interesting mathematical relationship. Because if you're using a present value discount formula and you put in a growth rate that is higher than the discount rate, as you have postulated, the answer, of course, will be infinity.

And there are a lot of managements around who like to think their stocks are worth infinity, but we — (laughs) — haven't found one yet.

That precise subject was covered in a paper called "The St. Petersburg Paradox" by a fellow named [David] Durand probably 30 years ago. And somewhere, we probably have a copy at our office. My guess, if you go to Google and you put in the name Durand and you put in St. Petersburg, you may be able to call up that article, although they aren't necessarily terrific on old articles.

So if you'd like it, we would — if you'll let somebody know in our office, we'll look around a little and see if we can find that.

It gets very dangerous to project out high growth rates because you get into this paradox. If you say the growth rate of a company is going to be 9 percent between now and judgment day and you use a 7 percent discount rate, it goes off, you know, you get into infinity. And that's where people get in a lot of trouble.

The idea of projecting out extremely high growth rates for very long periods of time has caused investors to lose, you know, very, very large sums of money.

There aren't many companies — just take a look at the Fortune 500, go back 50 years — they're commemorating that — and look at the companies that were there and how many have really maintained rates much above 10 percent. It's not an easy hurdle. And when you get up to 15, you know, you're in the atmosphere and rarified atmosphere.

So that's — there's a real danger in projecting out high growth rates. And Charlie and I will very seldom — virtually never — get up into high digits. You can lose a lot of money doing that.

You may miss an opportunity some time, but I haven't seen people who have been consistently successful doing that. And you do run into this paradox you mentioned.

Charlie?

CHARLIE MUNGER: Well, you're obviously right, when you get a mathematical result that is infinity, to back off and realize that can't happen. And, of course, what people do is they project that the growth rate will reduce and, indeed, eventually stop. And then you get more realistic numbers. What else could anyone do?

14. NYSE specialist system has "worked pretty well"

WARREN BUFFETT: OK, we'll go to microphone 7. I believe that's over here.

AUDIENCE MEMBER: Yes, My name is Jack Oneil (PH). I'm from New Brighton, Minnesota. Thank you for the opportunity to ask questions here and for the opportunity to learn from you and Charlie.

I had a two-part question and I'm striking the first part, which dealt with my concern over how long the country can continue with this ballooning national debt.

My second — my question then is, what is your opinion of the need for specialists on the New York Stock Exchange? Thank you.

WARREN BUFFETT: Charlie, you want to tackle that one? (Laughs)

CHARLIE MUNGER: Well, thank you, Warren. (Laughter)

Generally speaking, I think the specialist system has worked pretty well over the years. There may have been a few troubles lately, but averaged out, it's worked pretty well for a long time. And I'm not all that horrified that some people who stand there all day make a fair amount of money.

WARREN BUFFETT: Charlie actually had a specialist firm, you should know that. That's why I turned the question over to him, despite his snide remark. (Laughter)

How long were you and Jack [Wheeler] the specialists in General Motors on the Pacific Coast Stock Exchange?

CHARLIE MUNGER: About 13 years.

WARREN BUFFETT: Yeah —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: You're looking at an experienced specialist.

15. Buffett predicts "big problems" from derivatives

WARREN BUFFETT: Let's go to number 8.

AUDIENCE MEMBER: Good morning, gentleman. I'm Neil Steinhoff from Phoenix, Arizona.

Thanks for the tips on TIPS. Also thanks for the information in the newsletter — your annual letter — about the books. I particularly enjoyed "Bull!" by Maggie Mahar, I think it was.

I'm concerned about the future for a number of different reasons, in America. The debt, both accumulated by the government and personally, the stock buybacks, which are benefiting the top five executives, continues. The insanity of derivatives and the overpriced market with a P/E, which is also insane. Any comments?

WARREN BUFFETT: Well, which one do you want us to comment on? You only get one question. (Laughter)

AUDIENCE MEMBER: Derivatives.

WARREN BUFFETT: Derivatives.

Well, Charlie and I have expressed ourselves on derivatives. You know, we don't think the probability, in any given year, is necessarily very high, that derivatives will either lead to or greatly accentuate some financial trauma. But we think it's there.

And I think it's fascinating to look at something like Freddie Mac, where you had an institution that perhaps even hundreds of financial analysts were looking at — certainly many, many dozens of financial analysts were looking at. You had an oversight office. You had a creature that was created by Congress, presumably with committees that would be interested in their activities.

You had on the board two of the smartest and highest-grade people that you could have, in terms of fixed income markets, in Marty Leibowitz and Henry Kaufman, and you had a bunch of other very good directors, too.

And, with an auditor present, they managed to misstate earnings by some $6 billion in a fairly short period of time.

Now, all of that wasn't accounted for by derivatives, but a very large portion of it — 6 billion, that, you know, that is real money even — well, in any place. A large part of that was facilitated by activities and derivative instruments.

Now you can look at the Freddie Mac annual report for 2000, whatever it is, '2 or 2001. And you can read the footnotes and you can read the auditor's certificate. And you can look at bunch of high-class, very smart directors.

And you can be comforted by the fact that dozens of people in Wall Street, who are paid just to follow relatively few stocks, were studying this, and that they had conference calls all of the time.

And in the end, what happened? It was 6 billion. It probably could have been 12 billion if they'd wanted.

A lot of mischief can happen with derivatives. And as we've pointed out, Charlie and I have seen it happen.

When there's a derivative transaction, particularly a complicated one — the plain vanilla ones, probably people will not get in big trouble on — but when you have a complicated derivative transaction, and the trader at investment house A is on one side and a trader on investment house B is on the other side, and they record a transaction — which has to be a zero-sum game between the two of them — and both put on the books a profit that day — I've never seen one where they both put on a loss that day — it lends itself to mischief. And the scale is absolutely huge and getting larger all the time.

And I will tell you that I know the managements of some of the companies that have big derivative activities, and they do not have their minds around what is happening.

We didn't have our mind around what was happening at Gen Re Securities. We couldn't. We tried to get our mind around it. We couldn't do it. And that was far from, you know, the most extensive or complicated derivative operation around.

We had the same experience at Salomon. But whatever the figures were at Salomon, they would be a great multiple today. And there was a Sunday in 1991 when we were preparing — or we had the lawyers preparing — bankruptcy papers at Salomon.

And if the Treasury hadn't reversed itself, we would have found a judge some place in Manhattan. He probably would have been watching baseball, eating popcorn. And we would've walked up to his door and said, "You know, here is a situation with Salomon. There's these 1.2 trillion of derivative contracts that the guy on the other side thinks is good and they're not going to be any good," and a lot of other things, and, you know, "It's your baby."

A lot of things correlate in the securities world that people don't expect to correlate. And there are people following similar strategies all over the world, as happened when Long-Term Capital had its problems.

And the world — the financial world — operates on a hair trigger, to some extent. People want to jump the gun and move just ahead of the other fellow.

And when you get huge amounts of transactions, which many people only vaguely understand, you are creating a potential huge problem that may come about because of some other exogenous event that triggers defaults on a huge scale. And that can be very disruptive to financial markets.

So we think they're dangerous as used in society. We use them ourselves, incidentally. You know, we get them collaterized. We've made money off of them.

But I would predict that sometime, in the next 10 years, that you will have some very big problems that will either be caused by, or accentuated in a big way, by people's activities in derivatives.

Charlie?

CHARLIE MUNGER: Yeah, I think part of the trouble in — you were talking about — came because people didn't think enough about the consequences of the consequences.

That's a common error. You start trying to hedge against interest rate changes, which is a very complicated thing to do when you've got a mortgage portfolio where people have options to pay the mortgages off early.

And then, under the accounting conventions, the hedges started making the quarterly results lumpy instead of nice and regular, the way all the institutional analysts like them. So then they gave us another bunch of derivatives to smooth out the returns. Well, now you've morphed into lying.

Well, it's complicated enough to start with. But when you add lying to the process, it's a Mad Hatter's Tea-Party.

And yet, this happens with eminent directors of vast financial sophistication sitting on the board. It shows that the sophistication won't save you. Somebody has to have the common sense to say, "We're just not going there." It's too tough.

WARREN BUFFETT: Charlie was on the audit committee at Salomon and changed it into, you know, six and seven hours meetings. I think you found mismarks that were in the tens of millions of dollars on a single contract with a place with many — you know, tens of thousands of contracts. Isn't that correct?

CHARLIE MUNGER: I think it's fair to say that it was bonkers and that the accountants sold out.

WARREN BUFFETT: Uh-huh. (Laughter)

It's interesting stuff. You might — if you feel in kind of a nasty mood, you might go to a shareholders meeting of some company that has very large positions in derivatives and grill the CEO a little bit about some of the more esoteric transactions.

They get very, very complicated. They get mind-boggling, in terms of trying to figure out the consequences.

And the one thing you can be sure of is that the trader that puts them on will certainly want to mark them at a profit, either immediately or within a year or two, because he gets his bonus too often based on the figures for that year, and will be done in 20 years, because some of these are very long-dated. Will be gone — when the consequences fall to the firm.

Anytime you have incentives, with people who are quite smart, to mismark things, you're going to get mismarks, or temptations to take on risk in an inappropriate manner.

Originally with derivatives, the argument was made that it would disperse risk. That, you know, the Coca-Cola Company faced foreign exchange risk, or some bank faced, you know, interest rate risk.

And the theory was that you would use these derivatives to spread risk around the system. And indeed, there are many people that make that argument now.

I would say that that may work in that manner a great percentage of the time. But the time that counts is when the system has intensified risk and placed enormous credit risk on very, very few institutions.

Believe me, the Coca-Cola Company is in a better position to accept foreign exchange or interest rate risk in a year than some derivatives dealer who has tons of positions on.

And I think, actually, there is much more risk in the system because of derivatives than the proponents of derivatives would say has been dispersed because of the activities.

16. Bill Gates as next Berkshire chairman?

WARREN BUFFETT: Microphone 9, please?

AUDIENCE MEMBER: Good morning. Robert Piton (PH) from Chicago, Illinois. Thank you very much for your countless insights about investing, and life, for that matter.

My question has to do with Bill Gates. You've gone on record stating that Bill Gates is the smartest person you've probably met in your life. Charlie, sorry to break it to you.

WARREN BUFFETT: No, and I haven't said that quite — but you're close. (Laughs)

AUDIENCE MEMBER: I'm close. And you've also mentioned that he can do your job, but you probably could not do his.

WARREN BUFFETT: That's entirely correct.

AUDIENCE MEMBER: OK. So that being the case, given his aptitude, his accomplishments, his ability to keep great people together within Microsoft, would you consider having him become the future chairman of Berkshire in one of two ways.

Either a merger — and if a merger doesn't make sense because it's a technology company and you don't understand it, so you don't want anything to do with Microsoft.

With the second being he resign his post as chairman of Microsoft in order to keep the masterpiece that you've assembled together, as well as keep these very talented managers of all the Berkshire Hathaway companies together, with a leader that you so respect because of his accomplishments and aptitude.

WARREN BUFFETT: Did Bill put you up to this? (Laughter)

AUDIENCE MEMBER: He did not.

WARREN BUFFETT: No, I know that.

You know, it's not a crazy suggestion, but we've got a better answer.

Bill could do my job very well. And I could not do his job. But we also have at least four people within the Berkshire organization that, in many respects, could do my job better than I do. And probably in one or two respects, they might not be as good at certain parts of it. But they would be terrific successors.

We're more blessed in that situation than we've ever been in the history of Berkshire. If you go back 15 years, we did not have four.

And as we add businesses, it's not inconceivable that more potential future leaders come with those businesses. So we're well-equipped.

And we would — we will — barring something terribly unusual — we will have a leader that succeeds me that comes from within Berkshire and has been around for a long time.

One advantage of that — and this would not be necessarily a disadvantage if it were Bill — but one advantage to that is that we really like the culture at Berkshire. And having someone that has operated in that culture for a number of years, I think, is a plus.

Plus, you know, we've seen how they work and we know their pluses and minuses. We are very well-equipped now.

And Bill, I think — to the extent that he spends less time at Microsoft and he will probably be — you know, the Gates foundation will take up, perhaps, more of his time — I don't really think he is looking for my job, although he may salivate at the pay level that's available. (Laughter)

Charlie?

CHARLIE MUNGER: I've got nothing to add.

17. Reading list for improving investment knowledge

WARREN BUFFETT: OK, we'll go to number 10.

AUDIENCE MEMBER: My name is Oliver Graussa (PH) and I'm Vienna, Austria.

I have studied economics and I've read about 40 books about investing and want to be such a successful investor as you have been.

Mr. Buffett and Mr. Munger, when both of you were younger and had much less capital for investing, how many — which publications were the best to get a few excellent investment ideas to be so successful? And how many hours per week, on average, did you spend with reading about companies? Thank you.

WARREN BUFFETT: Well, when we were younger, we spent — probably Charlie, compared to now, spent a lot more time — I spent a fair amount more time — looking at companies.

But we would — if we were doing it over again, we would do it over again pretty much the same way.

We would look at everything in sight that we thought we could understand. And it — the world hasn't changed in that respect. There may be some more people doing it, but there are a lot more companies to look at now.

And we would — we would read everything in sight about the businesses and the industries we thought we could understand.

We would look for things that jumped out at us as being very cheap in relation to the value. And we would have one enormous advantage because we would be working with far less capital, which means the universe of potential ideas would be far greater.

But there's no — there's nothing different, in my view, about analyzing securities now than there was 50 years ago.

Charlie?

CHARLIE MUNGER: Yeah, we read a lot and we thought a lot. I don't know anybody who is wise who doesn't read a lot.

On the other hand, that alone won't do it. You have to have a temperament, really, which grabs the correct ideas and does something with those ideas. And I think most people who read a lot don't have the necessary temperament, and they grab the ideas or they're simply confused by the mass of material. And, of course, that won't work.

WARREN BUFFETT: Yeah, there's probably something — Phil Carret used to talk about having a "money mind," and I would call it a "business mind." And, you know, there are people that are better with, you know, identical IQs, that are better adapted for one than the other. And the temperament is all important.

I mean, if you can't control yourself, no matter what the intellect you bring to the process, you know, you're going to have disasters. And Charlie and have seen one after another that —

It's not a business that requires extraordinary intellect. It does require extraordinary discipline.

That shouldn't be so difficult. But as I look around the world sometimes, apparently it is quite difficult. I mean, the whole world went a little mad a few years back in terms of investments.

And you say to yourself, "How could that happen? Don't they learn anything for the earlier ones?" But, you know, what we learn from history is that people don't learn from history. And you certainly see that in financial markets all the time.

Incidentally, you mentioned books. Charlie, you didn't recommend any books this year?

CHARLIE MUNGER: Well, one book I really like I couldn't buy because it's published only in England. But it'll get here in due course. And that's called "Deep Simplicity" by John Gribbin. It's a perfectly marvelous book. And of course, that's a great title: "Deep Simplicity." That's what we're all looking for.

WARREN BUFFETT: I've been reading "A Short History of Nearly Everything." It's very impressive to — you know, to read about people pondering how to figure out the weight of the Earth or something in the 18th century.

And you would think that minds that would do that would do very well in financial matters. But, you know, if you remember, Isaac Newton spent a significant part of his life trying to turn lead into gold. And he might have made a good stockbroker. (Laughter)

But it didn't do much for him financially. Charlie knows more about Isaac than I do, so —

CHARLIE MUNGER: Well, and he lost an enormous —

WARREN BUFFETT: Yeah, in the bubble —

CHARLIE MUNGER: —chunk of his net worth in the South Sea Bubble. So he invested in an absolute crooked mania. And here was the smartest man in the world. So just IQ points alone won't do it.

18. Admiration for Treasury's crack down on tax shelters

WARREN BUFFETT: Microphone 11, please.

AUDIENCE MEMBER: My name is Martin Wiegand from Bethesda, Maryland. Thank you for hosting this wonderful, educational, and fun weekend. We —

WARREN BUFFETT: Well, thanks for coming —

AUDIENCE MEMBER: —appreciate it.

WARREN BUFFETT: —Martin, yeah. (Applause)

AUDIENCE MEMBER: In this year's annual report, you defended Berkshire's tax payment record against criticism from certain newspaper columnists and Assistant Secretary [for Tax Policy at the U.S. Treasury] Pamela Olson.

Compared to other large corporations, particularly insurance companies, does Berkshire pay its fair share so we can our Berkshire Activewear with the American flag on it with pride?

WARREN BUFFETT: Incidentally, Pamela Olson is here today. I don't know whether she can stand up. But I owe her an apology.

She's done a great job as a public servant and I teased her a little bit in the annual report. But she actually has worked actively at the Treasury in cracking down on tax shelters and some things that Charlie and I think shouldn't exist. So Pamela has my admiration. And, like I say, if she's here and can stand up, we'll give her hand. (Applause).

Some of the tax shelter proposals — I met with her yesterday — and she told me of some things that I've sort of seen myself. But some of the things that have been done and, in some cases, sponsored by the most prominent auditing firms, you know, are absolutely disgusting, and are the reason why, in my view at least, the middle class probably pays a lot more than they should be in terms of raising the total funds that are needed to sustain the government.

Berkshire, as we noted in the report, is a heavy contributor to the Treasury. As I mentioned, if only 540 entities in the country paid what we pay in income tax, no one else would have to pay anything, no Social Security, no nothing.

We have not — I mean, we may own tax-exempt bonds. We own dividends, which receive a dividend receive credit. But we pay on a very, very high percentage of our income — including capital gains — we pay at the full 34 percent corporate rate.

So go out and buy the Fruit of the Loom underwear with the flag on it, you're entitled to wear it. (Laughs)

Charlie?

CHARLIE MUNGER: I've got nothing to add. But you understate the evil that crept into our leading accounts — accounting firms — when they started selling these fraudulent tax shelters in exchange for contingent fees.

One of them actually explained to me that they were an ethical seller of fraudulent tax shelters. (Laughter)

He said, "The other firms just sold these to anybody. And we just sold them to our 20 most important clients so they were more likely to stay secret."

WARREN BUFFETT: Yeah. And of course, the lawyers would write the opinions so that, if they did get caught with these things that they hoped that no one even picked up because they were so obscure, convoluted, the lawyers wrote the opinions so that the — they could walk — you know, when the IRS came around, they could wave that letter and say, "Well, gee, we're sorry we made a mistake, but we did it on the advice of counsel and therefore you shouldn't assess fraud penalties or anything." I mean, they would — we don't want to leave the lawyers out of this, Charlie. (Laughs)

We had people come to our office. Not the auditing firm that we use, I want to make that clear. But we had people come to our office from the top auditing firms with these propositions which they said we had to sign away a given percentage of the amount we saved. And then they would give us these proprietary methods, you know, which would usually involve about 20 off-shore trusts and partnerships around the world and all kinds of things.

Many of — part of the design being to have so many entities involved so that the numbers that popped up here or there on the return, that no agent could figure out what the totality of the transaction was.

You know, it's — those are — the people who don't pay taxes because of that, increase the taxes of the people in this room. So we — I applaud Pamela for her efforts on that and a lot more are needed.

19. "If you're innumerate, you're going to be a klutz"

WARREN BUFFETT: We will go to number 12, please.

AUDIENCE MEMBER: Good morning. My name is Johann Freudenberg (PH) from Germany.

Mr. Munger, you said in a speech that scientific reality is often only revealed by math, as if math, it's a language of God. Could you elaborate on that, and especially tell us the reason why math often reflects reality? Thank you.

CHARLIE MUNGER: It's just the way it is. (Laughter)

If you — it's as though God made the world so that only people fluent in math could understand it.

I think you can handle an ordinary human activity pretty well. But if you want to understand, say, science, you can't do it without math. That's just the way it is. And in business, if you're innumerate, you're going to be a klutz.

WARREN BUFFETT: Keep talking, I'm chewing. (Laughter) We'll go back — go ahead.

CHARLIE MUNGER: The good thing about business is you don't have to know any high math.

WARREN BUFFETT: It may be a disadvantage to know high math, Charlie.

CHARLIE MUNGER: Yes, I think it is. Because you look for opportunities to use this marvelous, complicated tool. And by and large, that doesn't work nearly as well as just using the simple math.

WARREN BUFFETT: Yeah. When my mother sang me songs about compound interest, there really wasn't any need to go further. (Laughter)

20. Buffett's $10 billion Walmart mistake

WARREN BUFFETT: Let's go back to number 1.

AUDIENCE MEMBER: My name is David Farlow (PH) from Minnesota, Minneapolis. Thank you, Warren and Charlie.

A few minutes ago you mentioned the importance of learning from history. What have you learned from the investments you did not make over the last few years that you now regret refraining from?

WARREN BUFFETT: Well, the mistakes we made, and we made them — some of them big time — are of two kinds. One is when we didn't invest at all in something that we understood that was cheap, maybe because we weren't even working hard enough at looking at the whole list, or because, for one reason or another, we just didn't — we didn't take action.

And the second was starting in on something that could have been a very large investment and not maximizing it.

Charlie is a huge believer in the idea that you don't sit around sucking your thumb when you can — when something comes along that should be done that you pour into it.

And that's generally what we've tried to do. But there have been times — and it's usually happened when I've started buying something at X and it went up to X plus an eighth or some intolerable amount like that — and I quit or waited for it to come back. And we've missed, in some cases, billions of dollars of profit because of the fact that I'd gotten anchored, in effect, to some initial price when I could have paid more subsequently and it really was inconsequential.

CHARLIE MUNGER: Do you have anything worse to confess than Walmart?

WARREN BUFFETT: No, Walmart — I cost us about — it's up to 10 billion now. (Laughter)

I cost us about 10 billion. I set out to buy 100 million shares of Walmart, pre-split, at about 23. And Charlie said it didn't sound like the worst idea ever came up with, which is — from him, I mean, it was just ungodly praise. (Laughter)

And then, you know, we bought a little and then it moved up a little bit. And I thought, "Well, you know, maybe it will come back" or what —

Who knows what I thought? I mean, you know, only my psychiatrist can tell me. And that thumb sucking, reluctance to pay a little more — the current cost is in the area of 10 billion.

And there have been other examples, too. And there will probably be more examples in the future, unfortunately.

But that is — that's — on the other hand, it doesn't bother us. I mean, you know, it's maybe instructional to talk about it just a little and I'm glad to respond to the question.

But in the end, we're going to make a lot of mistakes at Berkshire. And we've made them in the past, we'll make them in the future.

You know, if every shot you hit in golf was a hole-in-one, it wouldn't be — you know, the game would soon lose interest. So you have to hit a few in the woods occasionally just to make it a little more interesting.

We'll try not to do that too often. But those will be the kind of mistakes we make. We probably won't make the kind of mistakes — although we have — we made one with Dexter Shoe — but we probably won't make the kind that cost us a ton of money. They'll be much more of omission than commission, I think, you'll find in the future.

Charlie, you want to add any more?

CHARLIE MUNGER: Yeah. At least we are constantly thinking about the past occasions when we blew opportunities. Since those don't hit financial reports, the opportunities you had but didn't accept, most people don't bother thinking about them very much. At least that is a mistake we don't make. We rub our own noses in our mistakes in blowing opportunities, as we just did.

21. Very hard to find a good, honest stock advisor

WARREN BUFFETT: OK, number 2.

AUDIENCE MEMBER: Warren and Charlie, my name is Peter Brotchie from Beverly, Massachusetts. And I would like to thank you both for helping me become a better businessman and a better investor. Perhaps more importantly, you have created, by example, a kind of true north on the moral compass for me to steer by.

While the education has been fantastic, I have found that the demands of owning a successful business and having a large family do not leave time to apply the research stance I have become so wonderfully accustomed to by being a member of this cult.

Please imagine, for a moment, that you are 30 years younger, and have only —

WARREN BUFFETT: I like him.

AUDIENCE MEMBER: — a few holes left in your investment punch card. If you were in my situation, to the extent that you would diversify your holdings beyond Berkshire Hathaway, given this environment, how would you choose the investment managers? Or as Charlie has just discussed when addressing foundations, would you hunt for two more great companies to invest in via common stocks?

WARREN BUFFETT: Charlie, why don't you take a swing at that?

CHARLIE MUNGER: Well, of course you're hunting, that's part of the fun of life. And — but I would say that the chief lesson would be that you're unlikely to find very many in a whole lifetime. And when you find one in which you really have thought it out and have confidence, for God's sakes, don't do it in a niggardly fashion.

The idea that very smart people with investment skills should have hugely diversified portfolios is madness. It's a very conventional madness. And it's taught in all the business schools. But they're wrong. (Applause)

WARREN BUFFETT: The question of finding other advisers is a tough one. I mean, when I wound up my partnership in 19 — at the end of 1969 — and I had all these partners that had counted on me and I was going to mail them back a lot of money, you know, I felt an obligation to at least suggest some alternatives for them.

And I recommended two people who I knew were exceptionally good and exceptionally honest. We put one of them on the board not long ago and reaffirmed it today — Sandy Gottesman. The other one was Bill Ruane.

Now, I'd been around the investment world for a long time at that point, and those were the two I knew, but they were more or less contemporaries of mine. And I'd gotten to know them over the years and I'd seen them for a long time.

So I not only knew their results, but I knew how they'd accomplished their results, which is terribly important. I don't know that generation of managers now. But the fact that, with the number of people I knew, that I could only come up with two, at a time when I was very active, says something about the difficulties of finding managers.

The one thing I can almost guarantee to you is that the promotional types going around to solicit the institutional investors are very unlikely to meet any long-term tests of ability, and sometimes, integrity.

It's not an easy job spotting an investor. I think it's probably easier, depending on the amount of time — you know, you mention having children and a business and the amount of time you can spend on. Every now and then you do — if you're conscious of the investment world and you have some kind of sort of grounding knowledge about what's going on, and you can see something, you know, as we did in junk bonds a couple of years ago, or as we did with all kinds of things, some years back, when stocks were cheaper.

You will occasionally see something that you should load up on. And, as Charlie says, that's what you really have to do. I mean, some of the people in this room loaded up on Berkshire many years ago. And the truth was, they didn't need diversification, you know. I loaded up on it. Charlie did. And you'll see opportunities occasionally but you're not going to see them every day or every week.

If you think you're going to see an opportunity every week, you're going to lose a lot of money because people will come around and tell you that they've got them, and they may not be quite as flagrant as that fellow we had in the movie — (laughs) — but they're a version of them.

Charlie?

CHARLIE MUNGER: The business of selecting investment managers was recently shown to be even harder than I had previously thought it was. A significant fraction of the institutional investment managers who run the nation's mutual funds actually accepted propositions to take bribes for betraying their own shareholders.

It was as if a man came to you and said, "I have a wonderful proposition. Why don't I kill your mother and we'll split the insurance money?" And it was that ridiculous. And yet, a significant number of the people said, "Gee, I would like some insurance money." And they just went right ahead.

WARREN BUFFETT: And they were already rich beforehand.

CHARLIE MUNGER: Yes. And they've destroyed themselves, many of them, by making this insane decision. And I think many of them will probably think the outcome is unjust.

WARREN BUFFETT: And the —

CHARLIE MUNGER: I mean the downfall they've had.

WARREN BUFFETT: And the interesting thing about it, of course, is that here is a huge industry that — where the people who weren't doing it have a great interest in having that reputation of the industry not get stained. And a number of them had to know what was going on.

I mean, this was — I don't — it's hard for me to imagine that people at most large mutual funds, even the ones that didn't — that are mutual fund management companies — even the ones that weren't engaging in the activities mentioned weren't aware of it. I mean, you just — if you're in an industry like that, you're going to hear what's going on.

And the Investment Company Institute was busy patting itself on the back, you know, at one meeting after another and becoming very cozy with legislators.

And there wasn't one thing done until a whistleblower when to [New York State Attorney General] Eliot Spitzer and he got active in a very strong way with a very limited staff.

And he uncovered, and put on the front pages, what was taking place. But the industry itself, with hundreds and hundreds and hundreds of people that most have known what was going on — and it went on for a long time. Never said a word. It's — you know, it makes you wonder a little bit.

22. Asset allocation models are "pure nonsense"

WARREN BUFFETT: Number 3?

AUDIENCE MEMBER: Hi, I'm Bob Klein (PH) from Los Angeles.

You've touched on the issue of asset allocation — capital allocation — in response to previous questions. But I wonder if you could elaborate from a risk management perspective. Wall Street and financial planning firms charge a lot of money for their asset allocation models, say, 50 percent stocks, 40 percent bonds, et cetera.

I know you take a more opportunistic approach to building your portfolio and managing risk, as you mentioned by — as you illustrated — by your junk bond example.

And so I just want you to hammer out how you use price and value as a tool of risk management and asset allocation as opposed to coming at it with a pre-conceived idea of how much should be allocated to each asset class.

WARREN BUFFETT: Yeah, we think the best way to minimize risk is to think. (Laughter)

And the idea that you have — you know, you say, "I've got 60 percent in stocks and 40 percent in bonds," and then have a big announcement, now we're moving it to 65/35, as some strategists or whatever they call them in Wall Street do.

I mean, that has to be pure nonsense. I mean, 60/40 or 65/30 — it just doesn't make any sense.

What you ought to do is have — your default position is always short-term instruments. And whenever you see anything intelligent to do, you should do it. And you shouldn't be trying to match up with some goal like that.

I found it entertaining — I was just reading yesterday in an article, I think it was, about the two fellows at Google and all of the problems they're going to have because they're each going to get a few billion dollars. I mean, it was — I want to send a sympathy card. I almost went down to Hallmark store because this article went on — they've got this terrible problem and that terrible problem and they're going to need lawyers, and they're going to need financial — they don't need anybody.

Those guys are smarter than the people that are coming to them. And they do not have a big problem, and they are very capable of thinking it through themselves.

The people that have the problem are the people who want to sell their services to them and are going to have to convince them that they have a problem.

But so much of what you see when you talk about asset allocation — it's just merchandising. It's a way to make you think that if you don't know how to determine whether it should be 60/40 or 65/35, that you need these people. And you don't need them at all in investing.

Most of the professionals that tell you that you're going to get in great trouble unless you listen to them and sign up for their services, you know, they're good at selling, but —

It's what my brother-in-law — former brother-in-law — that worked at the stockyards used to say was that people would bring in cattle or something. And I'd say to him, you know, "How do get the farmer to employ you to sell to Swift or Armour or Cudahy instead of the guy right next to you. I mean, you know, a cow is a cow and Armour's going to buy it the same way."

And he gave me this disgusted look and he said, "Warren, it's not how you sell them, it's how you tell them." Well, there's a lot of that in Wall Street.

Charlie?

CHARLIE MUNGER: Yeah, people have always had this craving to know the future. You know, the king used to hire the magician or the forecaster and he'd look in sheep guts or something for an answer as to how to handle the next war. And so there's always been a market for people who purported to know the future based on their expertise.

And there's a lot of that still going on. It's just as crazy as when the king was hiring the forecaster who looked at the sheep guts.

And people have an economic incentive to sell some nostrum. It can be sold over and over and over again.

The really interesting figures are when you combine the underperformance of the market, say, by the mutual fund industry, which is probably a couple of points per annum. And that understates it.

Now, if you take all of the investors in the mutual funds who are constantly whipsawing from one fund to another by a bunch of brokers who want commissions, now you take a sub-normal performance and it goes on another three or four percentages points due to the shuffling of the mutual fund investments.

So the poor guy in the general public is getting a terrible result from contacting the experts. And these guys are hitting the Scout troop and the Community Chest drive and are locally reputable people.

I think it's disgusting. It's much better to make a living by being part of system that delivers value to the people who are buying the product. But nobody refrains from creating gambling casinos or something, on my theory.

If it'll work to make money, why, we tend to do it in this country.

23. Workers' compensation insurance fraud

WARREN BUFFETT: Microphone 4.

AUDIENCE MEMBER: Good morning Mr. Buffett and Mr. Munger. My name is Steven West and I am a framed art manufacturer in Morganton, North Carolina.

I feel especially tied to Berkshire Hathaway as I am both a vendor to Nebraska Furniture Mart, Star Furniture, and RC Willey, and also a customer of Larson Jewel.

My question relates to workers' compensation fraud being committed by workers' compensation carriers on manufacturers such as myself, a scandal which I believe is far greater than the scandals that have been mentioned heretofore at this meeting.

As an example, in 1998, when I was trying to figure out why my experience mods were going way out of whack, I received a loss run and I believe, mistakenly, also a check run from my insurance carrier.

It was shocking. Four losses for $152,000 they claimed to the state of North Carolina actually amounted to less than $6,000. And one claim, which they claim they spent $70,072 on, they actually only spent $86.88.

Now naturally, this threw my company into the high-risk pool. It's cost me hundreds of thousands of dollars.

And my question is, are they trying to pull the same stunt on Berkshire Hathaway companies, especially in labor intensive operations, such as Dairy Queen. Because I have not, in the intervening years, been able to get one single copy of a negotiated check out of these insurance company. They will not give it up, even under subpoena, and their behavior is entirely consistent with criminal fraud.

Now, my question relating to the Berkshire Hathaway problems — or companies — is, are your managers attuned to this and are they receiving the actual copies of the negotiated checks that the insurance companies claim that they're spending to settle workers' compensation injury cases? Thank you.

WARREN BUFFETT: Yup. Well, I would say that there's plenty of fraud in various aspects of insurance.

In auto insurance, for example, I mean, obviously, we have fraud units, but I know you're directing your question more to the insurance carriers than actually what takes place with policy holders and doctors and lawyers and various other parties.

But we find that for every dollar we spend on fraud prevention or detection, I think we get back well over $10.

In the comp field, workers comp, you know — we have lost more money in workers' compensation insurance, I would guess — I may be wrong on this, but I would guess than just about any line.

Not necessarily as a percentage of premiums, but in terms of aggregate dollars. It's been a very tough period.

So from the standpoint of — we have one small workers' compensation direct operation in California called Cypress. And then Gen Re had — has written a lot of workers' comp reinsurance and it's been a bit of a blood bath. The rates have not covered the losses.

And I would say that there is a fair amount of fraud that enters into the losses we've experienced, or at least the industry's experienced, particularly at the direct level.

But I — in terms of your dispute with an insurance company, I don't know what company that would be, but I would say that most — many companies that have been in the workers' compensation business, particularly in California in recent years, wish they hadn't been in the business. I mean, they have not been making a lot of money off of defrauding policy holders that I know about.

But Charlie, do you have anything to say on that?

CHARLIE MUNGER: Well, the experience may be related. If a company gets into a lot of trouble from fraud practiced on it by lawyers, doctors, and claimants, and its own affairs are disrupted by fear and agony, that company is likely to start behaving badly with its own policy holders in order to lay the troubles off on somebody. I think that's just human nature.

But I don't think the main fraud in workman's comp is by the carriers against the small businessmen. It's by the claimants, the attorneys, and the doctors, against the whole system. (Applause)

WARREN BUFFETT: That really would be our experience.

As a sidelight, I noticed you were from Morganton, North Carolina. We have a business there, Carolina Shoe. We make work boots. And I give a talk at University of North Carolina some time ago. In fact, I think they have a tape of it still.

And afterwards — I had mentioned in the talk that we had this business in Morganton. And one of students came up to me afterwards. And there were a number of them, and I shook his hand and, making idle conversation, I said, "Where are you from?" And he said, "I'm from Morganton."

And I said, "Oh," I said, "Do you know Carolina Shoe?" And he thought a second, he said, "I don't know her, but I think I know her family." (Laughter)

Never forgotten that fellow.

24. Utility law repeal would help MidAmerican, but no bonanza

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Good morning. Andrew Sole from New York City.

I just want to preface my question by saying that I have a deep admiration and affection for both of you men. And in that spirit, I had got a Golden Retriever puppy a few months ago, and he's been proudly named "Munger."

WARREN BUFFETT: Is he housebroken? (Laughter)

AUDIENCE MEMBER: And Charlie, you'd be very proud. He's just like you. I bring him to Central Park and hundreds of women flock over to pet him.

CHARLIE MUNGER: Really?

WARREN BUFFETT: He's well-named. He's well named. (Laughter)

AUDIENCE MEMBER: That's serious, but this is also serious.

My question has to do with the Public Utility Holdings Company Act, which obviously affects MidAmerica's businesses.

You've spoken that, if it were repealed, you'd be able to commit billions of dollars into the energy infrastructure for the country.

And despite the fact that there was a massive blackout in this country over the last summer, the act has not been repealed. And I'm curious as to what effect it might have if PUHCA wasn't repealed for MidAmerica.

WARREN BUFFETT: Yeah. The Public Utility Holding Company Act was passed in 1935. It was a reaction, and a justified reaction, to some real wild antics that had taken place in the '20s in the public utility field that were most dramatic in the case of Sam Insull, but occurred with a lot of other companies, Associated Gas and Electric and various other companies.

And there was pyramiding of the utility capital structure. And there were a lot of things that were wrong that were addressed in that act. And in our view, that act is long outmoded. And I think that — I mean, the SEC, which has responsibility for administering it, I think there's a lot of feeling there that it's long been unneeded.

And I think that there've been various energy bills that have included the repeal of it. But there was no energy bill passed in the last year. So we live with the Public Utility Holding Company Act. And it does restrict what we do.

It's an interesting question, though, if it were repealed, whether that necessarily would open up lots of opportunities. Because if it were repealed, it's quite conceivable that a number of other companies would also be competing with us, in terms of possibly buying utilities that might have been difficult for us to acquire, or for them to acquire, back when the law was in existence.

So I don't want you to think that, if it gets repealed, that Berkshire Hathaway is necessarily worth a lot more money.

But I do think it should be — I mean, I think it's logical. It's — there are lots of — there's plenty of appropriate regulation in the public utility field and there are advantages to having strong companies like Berkshire Hathaway pouring money — energy requires enormous sums of money. And to the extent we can use capital advantageously in that business, we're ready to do it. And it should not be impeded by the act.

If I had to bet, that act will probably go off the books at some time. But it doesn't seem to be, you know, in the immediate future. It will not necessarily mean we get a lot richer.

Charlie?

CHARLIE MUNGER: Yeah, but if we had a wonderful opportunity in the field now, we would find a way to do it. Probably through MidAmerican, right?

WARREN BUFFETT: Well, we'd find a way to do it. Yeah.

There's been nothing that's been presented to us that we couldn't get done so far. Now it might involve a more awkward structure, but we have not — you know, there's been nothing that we wish we could have done and when we got to the finish line, or a yard from the finish line, we said, "Well, we can't do this because of the Public Utility Holding Company Act."

Now, there might have been other things presented if that act hadn't been on the books.

But it will be no bonanza for us at all if it goes away. It may make life simpler on some very large transaction.

25. Berkshire real estate business will grow

WARREN BUFFETT: Number 7? I'm sorry, number 6. I skipped 6. Number 6.

AUDIENCE MEMBER: Good morning. My name is Andy Lewis Charles from Miami. I think I speak for everyone when I wish both of you gentleman continued health. I would wish you continued wealth, but I think you have that covered.

WARREN BUFFETT: We could use more. (Laughter)

Of each.

AUDIENCE MEMBER: Speaking of MidAmerican Energy, a unit company underneath it, HomeServices, I see as a great opportunity. I would love to see and hear your thoughts about the future growth potential for it, especially against large consolidators like Cendant Corporation. Thank you.

WARREN BUFFETT: Yeah, HomeServices will grow. HomeServices, as you know, owns a number — I can't recall how many, but probably in the area of 15 or 16 maybe — controls a number of local real estate firms. And they retain all of their local identity.

In that way, it's somewhat akin to the whole Berkshire Hathaway model, where we leave our subsidiary companies quite autonomous and they operate as if they were — the managers operate as if they own them themselves.

Well, HomeServices is somewhat along the same line in that we have no national identity, where Cendant works under a couple of big names.

We've acquired one company in North Carolina here in the last month or 6 weeks, Prudential of North Carolina. And we will end up — unquestionably, in my view — we'll end up buying either a few or a whole lot of additional companies over the next 10 years.

We will — we've got great management. We like the business. We hear about opportunities from time to time.

Last year, you know, we participated in roughly $50 billion of transactions. And I think — I'm really vague on this one, but — I better not give you a percentage of the national total that is, but it's a very small percentage. It's a lot of transactions, a couple hundred-thousand transactions.

We're very big in Southern California, for example. We're very big in Minnesota. We're very big in Iowa. Very big right here in Omaha and in Lincoln. But there's an awful lot of places where we aren't at all.

We like to buy leading firms as we go around. And we sometimes like to buy more than one in a community.

It's a good business. It's a very cyclical business. Right now, it's very good. We will go through periods in the next five years. I'm sure we'll go through a period where it's very slow. But we'll keep buying. We'll buy when business is slow, we'll buy when business is good, depending on the price of the institution and the kind of business we're buying.

I don't know how big it can become. It will become bigger than it is now. Relative to Berkshire's total market value, it may not be that — a huge factor. But it's conceivable as we buy more operations, we'll find other things to do with them, too.

I mean, the purchase of a home is a big deal to people. You know, often they're buying furniture at the same time and maybe we can make a suggestion or two.

Charlie?

CHARLIE MUNGER: I've got nothing to add about that business.

26. Charity program reluctantly dropped after anti-abortion boycott

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good morning. I'm Jim Hayes (PH) from Alexandria, Virginia.

I hate to beat a dead horse, but I really like the charitable plan. Suppose you brought it back and then personally opted out and then we floated you a bonus equal to what you might otherwise be entitled. Would you consider that?

WARREN BUFFETT: Are you talking about renewing the shareholder-designated contribution program?

CHARLIE MUNGER: Yeah.

AUDIENCE MEMBER: Yes. And then personally opting out, and then we could have a shareholders' vote to grant you an option bonus or some kind of tax-advantaged bonus.

WARREN BUFFETT: Yeah, I think that might get a little complicated.

Additionally, I wasn't the only one giving money at all, nor was Charlie, to organizations, primarily pro-choice organizations, in fact over — I don't know of any other than pro-choice organizations — that the people that were causing harm to the Pampered Chef representatives. We had dozens and dozens, maybe even hundreds, giving money on both sides of the issue.

I mean, if you looked at one class — well, the largest classification of gifts went to churches. Probably the largest classification in that, I'm (inaudible) positive, were Catholic churches.

And we had people giving money to everything in the world, which is exactly the way we wanted it. I mean, whatever — it's the shareholders' money.

So even if you had the two of us opt out, we would have organizations that would get violent about the fact that some money was going to pro-choice organizations. And rather than take it out on us, whom they can't hurt, they've taken it out on some very innocent people.

And neither Charlie nor I like the idea of somebody — you know, some woman that's developed a living, you know, in Dubuque, Iowa or in Casper, Wyoming, having her livelihood destroyed because of what we're doing.

So reluctantly, we gave up the practice. I mean, we — actually, I received a letter one time from somebody — some organization was monitoring — said they didn't give — they didn't care if we were giving $10 million to pro-life organizations and $1 to pro-choice organizations, they were still going to boycott our people.

Well, boycotts don't bother me. We had some of that right along, always on a small scale. But — because they can't — they basically can't hurt us in any significant way.

But they can hurt individuals very badly and we're not going to have something around Berkshire that's hurting a bunch of people that have devoted their lives to working with us. So we reluctantly gave it up.

Charlie?

CHARLIE MUNGER: Well, as I said, it's a dead horse and I miss it, too.

27. Buffett family and Berkshire managers will protect the company

WARREN BUFFETT: Number 8, please.

AUDIENCE MEMBER: Good morning. I'm Jay Leiber (PH) from Houston, Texas.

Mr. Buffett, since I'm older than you and maybe even as old, or older, than Charlie, I feel like I can ask this question. And I'll ask it as delicately as possible.

When the time comes that you, I, and Charlie have gone to that big stock market in the sky, I understand that you planned — or at least, I have read — that you plan to give the bulk of your Berkshire Hathaway stock to your charitable foundation, along with your 30 percent of the votes of the company.

If this is correct — and if it's not correct, this question is moot — but if so, what assurance do the Berkshire Hathaway shareholders have that the company will continue to be run as honestly and straightforward as it is now, such as only 15.8 employees or so at headquarters and no —

WARREN BUFFETT: Yeah, the —

AUDIENCE MEMBER: — huge salaries or other ridiculous giveaways to dilute and weaken the equity of the shareholders at that time.

WARREN BUFFETT: Well, for a short while there'll only be 14.8, actually. (Laughter)

But it's a good question — a very good question. Since you're older than I, apparently, I hope we don't go at the same time. The —

There's one slight twist to the estate plans we have. If I die first, all of my Berkshire goes to my wife. And if we died simultaneously, it would all go to the foundation.

But all of the stock will end up in the foundation. In fact, if I died first, she might put my stock in the foundation before her death, but that would be up to her. But it will end up in the foundation — all of the stock.

As you mention, it has 30-odd percent of the votes, although under the tax law, once it's in the foundation, within five years, it would have to either convert to be some of it — it would have to get down to 20 percent of the vote. That's required under foundation law.

In terms of how it would be run in the future, I think it has a far better chance than any company — any major company I know in the country — of maintaining the culture, because it has — it will have people running it who have grown up in the culture.

Earlier, it was — the criticism was made about my wife and my son being on the board, but they are guardians of the culture. They are not there to profit themselves, they are there to profit as the shareholders profit, but also to keep the company in the same way as previously.

One great example of that, of course, has been at Walmart where, when Sam Walton died, a not too dissimilar amount of stock was left among the family. And essentially the Walton family has, in my opinion, done a magnificent job, not only of selecting successors to run the place, but having successors who, if anything, reinforced the culture of Walmart. And it's been an enormously successful arrangement.

The Waltons are there, in case anything goes wrong, to make a change if needed, but they're not there to run the business. And that's exactly the pattern that we hope to have at Berkshire. And I think we have it.

I think I — you know, I can't give you a hundred percent guarantee, but I would far rather bet on the integrity of the family that succeeds me, plus the managers that succeed me, at Berkshire remaining true than I would any other company in — for a long, long time — any other company I can think of.

Charlie?

CHARLIE MUNGER: Well, I would have a reason to fret about this subject, just as you would. And I, of course, have known the members of the Buffett family that would be here after Warren is gone for decades. Don't worry about it. You should be so lucky. (Laughter and applause)

WARREN BUFFETT: It's a question we don't wish to have an instant answer for, though, however. (Laughter)

28. Profits as GDP percentage won't be moved by technology

WARREN BUFFETT: Number 9, please.

AUDIENCE MEMBER: Good morning. James Easterlin (PH) from Durham, North Carolina.

My question — statement is, you have often written in reference to average corporate profitability remaining fairly consistent in the long run, such that return on equities are in the 12 percent range for U.S. companies, and after-tax profits as a percentage of GDP is sticky in the 4 to 6 1/2 percent range.

And the question is, given the advances in technology that brought the inventory-to-sales ratios down to historic lows, given the widespread adoption of the EVA principles by companies, might you think that might change over time?

WARREN BUFFETT: Yeah, I don't think any of the factors that you mentioned will act to move corporate profitability out of the range that has historically existed.

It's going to bob around, obviously, some, but I certainly don't think EVA will do a thing for American corporations in terms of making them receive a greater share of GDP in profits.

Technology, that's just as likely to reduce profits as to increase profits. I mean, as the economic machine of the United States works better and better over time, the main beneficiaries are going to be consumers.

If you took whoever you think is the best business manager in the United States and you put a clone of that person in charge of each one of the Fortune 500, the profits of the Fortune 500 would not necessarily go up, because there's this competitive nature to capitalism where the improvement you get one day, your competitor gets the next day.

And it very much tends to work to the benefit of consumers but not to increase overall profitability.

We see that in the industries we're in. Every — we were in the textile business for a long time and various new products — various new machinery — would come along and it would promise to deliver a 40 percent internal rate of return and get rid of 43 employees or something like that.

And, you know, we just did one after another of those, and when we got all through we didn't make any money, because the other guy was doing the same thing.

And I liken it to everybody at a parade — you know, a huge crowd watching it and somebody stands up on tiptoes and, you know, 10 seconds later, everybody in the crowd is up on tiptoes and they're not seeing any better and their legs hurt. Well, that was the textile business.

And there's an awful lot of self-neutralizing things in capitalism. So I don't really expect any of the factors you named, or any other factors that I can think of, that will move profits up as a percentage of GDP.

And indeed, I think that if you're looking at GDP as being the national pie and profits being what investors get out of it, and the rest belonging to people who are out there working for a living every day, I don't think the relative — the proportions — are inappropriate.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that.

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

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Good morning. I'm Marc Rabinov from Melbourne, Australia.

Mr. Buffett and Mr. Munger, I'd like to ask you, when you assess a business and derive its intrinsic value, how do you estimate the future growth of the business, and how do you decide what margin of safety to use? Thank you.

WARREN BUFFETT: It was the future growth and what, Charlie?

CHARLIE MUNGER: Well — I have difficulty understanding that question fully. He's talking about how do we combine our estimates of future growth with our passion for having a margin of safety. Surely, you can handle that. (Laughter)

WARREN BUFFETT: Well, I can certainly handle it as well as you can. (Laughter)

Every time he laterals them off to me, you know, he calls those audibles. (Laughter)

You calculate — I think you take all of the variables and calculate them reasonably conservatively. But you don't try and put too much windage in at every level.

And then when you get all through, you apply the margin of safety. So I would say, don't focus too much on taking it on each variable in terms of the discount rate and the growth rate and so on. But try to be as realistic as you can on those numbers, but with any errors being on the conservative side. And then when you get all through, you apply the margin of safety.

Ben Graham had a very simple formula he used for just the most obvious situations, which was to take working capital — net working capital — and try and buy it at a third off working capital. And overall, that worked for him. But that method sort of ran out of steam when the sub-working capital stocks disappeared.

But it's the same thing we do in insurance. I mean, if we're trying to figure out what we should charge for, we'll just say, the chances of a 6.0 earthquake in California, well, we know that in the last century, I think that there have been 26 or so 6.0 or greater quakes in California.

And let's forget about whether they occur in remote areas, let's just say we were writing a policy that paid off on a 6.0 or greater quake in California, regardless of whether it occurred in a desert and did no damage or anything.

Well, we would look at the history and we'd say, "Well, there've been 26 in the last century." And we would probably assume a little higher number in the next century, that'd just be our nature. But we wouldn't assume 50. If we did, we wouldn't write any business.

So we would — we might assume a little higher. I would, if I was pricing it myself, I'd probably say, "Well, I'll assume there are going to be 30, or maybe 32, or something like that."

Then when I get all through, I'll want to price the — I'll want to put a premium on it that now puts in a margin of safety. In other words, if I figured the proper rate for 32 is a million dollars, I would probably want to charge something more than a million dollars to build in that margin of safety.

But I don't want to hit it at — I want to be conservative at all the levels and then I want to have that significant margin of safety at the end.

And I guess that, as I understand the question, that'd be my answer. And Charlie, do you want to add to that?

CHARLIE MUNGER: Yeah, that book, "Deep Simplicity," that I recommended to you says that you can predict out of those 26 earthquakes how the size will be likely to be allocated.

In other words, there's a standard power law that will tell you the likelihood of earthquakes of varying sizes. And of course the big earthquakes are way less likely than the small ones.

So you count the math and you know the applicable power law and you guess as to how much damage is going to — it's not that difficult.

WARREN BUFFETT: It becomes more difficult if somebody said they really want protect against a 9.0 or something like that. You know, is it one in 300 years? Is it one in a thousand years? You know, when you get really off the data points.

But that is not what you're looking at in investments. You don't want to look at the things that are that — you don't want to come up with the companies where you make the assumptions that get that extreme.

And you don't have to, that's the beauty about investments. You only have to look at the ones that you feel capable of evaluating and you skip all rest.

30. No single formula for regulatory impact on businesses

WARREN BUFFETT: Number 11?

AUDIENCE MEMBER: Good afternoon. It's James Tarkenton of Durham, North Carolina.

Current examples, including discussion of media ownership rules, FCC regulation of the telecom industry, and proposed oversight changes for mortgage giants Fannie Mae and Freddie Mac are all examples of the legislative, regulatory, and lobbying process as an influence in shaping and reshaping economic moats.

We would be interested in your comments on these and other examples of how competitive advantages are shaped by government.

In general, how do you incorporate the impact of regulation on the size and ferocity of economic moats for various businesses?

WARREN BUFFETT: Well, that varies enormously by the business. I mean, there're some businesses that we think that it's not a very big factor, and there's other businesses we're in — the energy business, the insurance business — where regulatory change could have a huge impact.

You know, we don't have any one-size-fits-all type arrangement. We just try to think intelligently about any business we're in. And if it's — when we bought GEICO in 1995, or bought that last half of it or whichever year it was, the question, you know, whether the regulatory climate would change in some major way, you nationalize auto-insurance — well, all of those things go through our mind and we evaluate them.

But there is no — there's no formula. You know, if we're — if we're in furniture retailing, you know, that is not something we're going to worry about. We're going to worry about plenty of things, in terms of competition, but there are different variables that apply with different intensity to each business we're in. And it's up to Charlie and me to try and think about any of the variables that might hit those businesses, and to weigh them appropriately, and to crank that into our evaluation.

Charlie?

CHARLIE MUNGER: I think it would be fair to say that in our early days, we tended to overestimate the difficulties from regulation. We refrained from buying television station stocks for a long, long time because it seemed like such a peculiar asset when anybody could just ask to have your license jerked away from you each year and they could ask a government agency to do it. And — but it turned out, the way the system evolved, that almost never happened.

WARREN BUFFETT: Yeah, Tom Murphy figured that one out before we did. (Laughs)

CHARLIE MUNGER: Yeah, and we had it — we were slow on the learning curve. Murphy was way better at it than we were.

31. Buy Berkshire or low-cost index fund?

WARREN BUFFETT: Microphone 12, please.

AUDIENCE MEMBER: Hello, gentleman. My name is Vivian Pine and I'm from Tarzana, California.

And my question is, for a new investor buying stocks today, would you recommend that they buy a low-cost S&P index fund or Berkshire Hathaway, and why?

WARREN BUFFETT: Well, we never recommend buying or selling Berkshire. But I would say that, among the various propositions offered you, a very low-cost index fund where you don't put all your money in at one time.

I mean, if you accumulate a low-cost index fund over 10 years with fairly regular sums, I think you will probably do better than 90 percent of the people around you that take up investing at a similar time.

Charlie?

CHARLIE MUNGER: I would agree with that, totally. It's awkward for us sitting here at these annual meetings where we have a sampling of some of the most honorable and skillful stockbrokers around who've done a wonderful job for their own clients and families. But the stockbroking fraternity, in toto, can be guaranteed to do so poorly that the index fund is a better option.

32. Leverage can prevent you from playing out a winning hand

WARREN BUFFETT: We'll go to number 1 again.

AUDIENCE MEMBER: John Bailey from Boston.

As of last week, my house is almost totally covered with Benjamin Moore now. (Laughter)

But more seriously, you spent a fair amount of time talking about the low-probability transformative events. I recall a discussion on the probability of a nuclear event not occurring in any given year for, say, 50 years, at which point it begins to look like, over the time period, it's pretty darn likely and therefore the expected value is a pretty big negative.

There are some other things that could be happening that somebody might expect. For instance, perhaps there is, in fact, a ceiling on consumer debt coverage ratios. If they quit falling, there — that could be a big change.

If you even listen to the United States Geological Survey, they're now saying that sometime in the next 50 years, there could be a fall in the production of oil.

And so, I'd like you to address how you conceive of the portfolio of businesses in the context of these possible transformative events, especially given that over this same time period of maybe the next 50 years, at some point, you're not going to be able to personally revise the portfolio.

WARREN BUFFETT: Yeah, I think it's a fair statement that over the next 50 years at some point, Charlie and I will not personally be able to — (laughs) — participate in portfolio revisions. The —

Well, you're quite correct that people tend to underestimate low-probability events when they haven't happened recently and overestimate them when they have happened recently.

That is the nature of the human animal. You know, Noah ran into that some years back. But he looked pretty good after 40 days. The —

What you mention on the nuclear question, it's a matter — you can do the math easily. What you don't know is whether you're using the right assumptions. But it —

For example, if there is a 10 percent chance in any given year of a major nuclear event, the chance that you'll get through 50 years without it happening, if the 10 percent is correct, is a half of 1 percent.

I mean, 99 1/2 percent of the time a 10 percent event per year will catch up with you in 50 years. If you can reduce that to 1 percent, there's a 60 percent chance you get through the next 50 years without it happening.

That's a good argument for trying to reduce the chances of it happening.

In terms of our businesses, I think Charlie and I are — I mean, we think about low-probability events. In fact, in insurance, we probably think about low-probability events more than most people who have been insurance executives throughout their years. It's just our nature to think about that sort of thing.

But I would say, if you talk about transforming events, or really talk about major events that could have huge consequences that are low probability, they're more likely to be in the financial arena than in the natural phenomena arena. But we'll think about them in both cases.

But we do spend a lot of time thinking about things that can go wrong in a very big and very unexpected way.

And financial markets are — they have vulnerabilities to that, you know, we try to think of and we try to build in ways to protect us against it and perhaps even build in some capabilities where we think we might profit in a huge way from it.

Charlie?

CHARLIE MUNGER: Yeah, that temporary collapse in the junk bonds, where they got down, many of them, to 35 and 40 percent yields, that's a strange thing. And to have all those things pop back — you know, quadrupling in a short time. There was absolute chaos at the bottom tick of that.

And that isn't as much chaos as you could have. And of course, it can happen in common stocks instead of junk bonds.

So I think if you're talking about the next 50 years, we all have to conduct ourselves so that we — it won't be all that awful if a real financial crunch of some kind could come along. Either inflationary or a typical deflationary crunch of the time [kind] that people used to have a great many decades ago.

WARREN BUFFETT: Probably the most dramatic way in which we are — give evidence of our — of your worries, is we just don't believe in a lot of leverage. I mean, you could have thought junk bonds were wonderful at 15 percent because they eventually did go to 6 percent, you would have made a lot of money.

But if you owed a lot of money against them in between, you know, you wouldn't have been around for the party at the end.

So we believe almost anything can happen in financial markets. And the only way smart people can get clobbered, really, is through leverage. If you can hold them, you have no real problems.

So we have a great aversion to leverage and we would predict that a very high percentage of the smart people operating in Wall Street, at one time or another, are likely to get clobbered through the use of leverage.

It's the one thing that forces you — it's the one thing that ends — or can prevent you from playing out your hand. And all of the hands we enter into look pretty good to us. But you do have to be able to play them out.

And the fascinating thing to me is that — just take the junk bond situation. In 2002, you had people with terrific IQ — tens of thousands of them operating in Wall Street. You had the — money was available. They all had a desire to make money.

And then you see these extraordinary things happen in markets and you say to yourself, you know, can these be the same individuals that two years later or two years earlier were buying these things at prices that were double or triple or quadruple what they sunk to in between? And did they all go on vacation? You know, did they lose their ability to raise money?

No, the money was — you know, Wall Street was awash in money, and it was awash in talent, and yet you get these absolutely extraordinary swings.

I mean, it doesn’t happen with apartment houses in Omaha or, you know, with McDonald’s franchises or farms or something. But it’s just astounding what can happen in the marketable securities department.

And the big thing you want to do is, at a minimum, you want to protect yourself against that sort of insanity wiping you out.

And better yet, you want to be prepared to take advantage of it when I happens.

Now it’s about noon, so we will come back and begin at microphone 2 about, say, a quarter of one.

Afternoon Session - 2004 Meeting

1. Difficulties of judging whether a company has ethics

(Note: Video recording begins with meeting already in progress.)

AUDIENCE MEMBER: After reading this story on Enron, I would like to ask you the following question.

How does an entry-level employee in a large company find out if her employer operates with a long-term perspective, and with honesty and integrity?

WARREN BUFFETT: Well, that's a very good question. I'm not sure I'm going to have an equally good answer. It —

You know, you pick up signals — or frequently, you can pick up some signals — about what is going on at the top of a business if you're at a lower level. But I would say it would be very easy to be fooled on that subject.

Charlie and I would tend to be looking at things that they do in public in relation to their investors and the promises they make, and all of that sort of thing. But I think that might be tough for people, and it wouldn't always give you a great guide.

I've — we've been suspicious of companies, for example, that place a whole lot of emphasis on the price of their stock.

I mean, when we see the price of a stock posted in the lobby of the headquarters or something, you know, things like that make us nervous. But I'm not so sure that's, you know, that that would be enormously helpful.

So I guess you just have to sort of pick up from coworkers, publications, pronouncements of the leaders, the sort of culture that was being presented to them and the world, and, you know, you might get suspicious about it.

But I don't think I have a really good answer for that, do you Charlie?

CHARLIE MUNGER: No, it's obviously easy when you've got a caricature of a person like Bernie Ebbers or Kenny Lay. I think it's easy to say that you've got almost a psychopath — (laughter) — in charge.

But what fools you is a place like Royal Dutch. If I'd been asked to guess —

WARREN BUFFETT: Ah!

CHARLIE MUNGER: — major companies with sound, long-term cultures, and a good engineering values, and so forth, Royal Dutch would have been near the top of my list.

And to have the oil reserves phonied for years, and internal reports of people who were tired of lying.

If it can happen at Royal Dutch, believe me, it can happen a lot of other places.

WARREN BUFFETT: Yeah, Charlie and I would not have spotted it at Royal Dutch by any of the means that we normally use.

In fact, we — as Charlie said, we might have used that as an example of some place that was almost certainly above reproach. And then you do read the emails and all that.

CHARLIE MUNGER: But we don't learn, because I would still expect that Exxon's figures were fair.

WARREN BUFFETT: Yeah.

I think you — what was — what transpired in the 1990s, you know, was this gradual — and later on, not so gradual — embracing at the top of the feeling that anything goes.

You know, I don't — I'm not going to speculate as to the motives at the top of Shell.

But there was so much going on where people saw the fellows — in most cases fellows, unfortunately — that were at their clubs, that they saw at other corporate meetings, were respected business leaders, they saw just one after another that were really cutting corners in one way or another.

And, you know, situational ethics can take over in that. People do, I think, they sink faster to a lower prevailing morality than they rise to a higher prevailing morality.

But they do move in the direction of what they perceive to be the prevailing morality of those around them, in many cases. And certainly the corporate world in the late 1990s, particularly, it was extreme on that.

2. Congress shouldn't make (immoral) accounting rules

And that leads me into — I ran into a friend at the lunch break who's involved in these matters. And he suggested, and I'm delighted to put in a plug to encourage all of you to write your congressman and senators to give your views on whether stock options should be expensed, or whether indeed, whether Congress has got any business legislating on the question of what proper accounting is.

It was a disgrace some 10 years ago when the United States Senate essentially threatened the accounting standards board with extinction and bludgeoned Arthur Levitt, then running the SEC, at the behest of a lot of rich contributors, to declare that — to override the accounting standards board's pronouncement that options should be treated as expense.

And it was — and I think in a very significant way, it accelerated the "anything goes" mentality of 1990s.

At that point, when Congress says it's more important to have stock prices go up than it is to tell the truth, and they voted 88 to 9 in order to do it, as I remember, I think there was a shift in morality among many corporate executives.

You may remember that the FASB then backed off, but still said that expensing was preferable. And having said it was preferable, 498 out of the 500 companies in the S&P took the less preferable method.

All of the big auditing firms at that time endorsed their big clients' views, in order to report higher earnings. Now, all four accounting firms say you should count them as expenses.

Well, they're right, now, but it just shows what was going on in that period when, on a question of accounting principles, and when really nothing has changed, when what were then five — the Big Five —have shifted 100 percent to where the Big Four are now, and, now, they say options should be expensed.

So, if you are inclined to write your congressman or senator, tell him you really think the FASB knows more about accounting than they do. And I think you'll be right.

If you want to have some fun, go to Google and type in two words. Type in the word "Indiana," and type in the word "pi," that's the mathematical symbol pi. And when you do that, you'll see a number of stories come up.

And they relayed how in 1897, at the instigation of one legislator who was responding to a constituent, the House in Indiana voted almost unanimously, it may have even been unanimously, it says what it was on Google, to change the value of pi. (Laughter)

I'm, you know, I'm not making this up. It's checkable.

And it seems that there was a fellow that thought he'd discovered some new relationship between circumference and diameter, and area, and a few things. And it came out to 3.20 if you worked through his formula.

And he offered to give this royalty-free, as he put it, to the State of Indiana to teach its children so that they would have not only the truth, but they'd have an easier number to work with than the long decimal that heretofore had been thought of as pi.

Well, that passed the Indiana legislature. And it passed the House. By the time it got to the Senate, there were a few people that were still clinging to the old values who managed to shoot it down.

But I would submit that in the — in 1993, that the U.S. Senate cleansed the record of the Indiana legislature by outdoing them in attempting to change the rules on something, on a subject, they knew nothing about.

And I think some of the excesses of the 1990s that followed came about through the fact that they knew 88 senators were willing to declare the world was flat if constituents who had contributed enough money to them wanted it thus.

Let's — we pause now, go back to our schedule here.

Number 3. Oh, Charlie, do you have anything to say about the Indiana legislature?

CHARLIE MUNGER: Well, I — the current members of Congress that want to retain the former abusive accounting, which are probably a majority of the House of Representatives, are way worse than the people who wanted to round pi to an even number.

Those people were stupid. (Laughter)

These people are mostly not stupid, but dishonorable. I mean, they know it's wrong, and they want to do it anyway. (Applause)

3. "Too many conflicts" for a Berkshire fund management company

WARREN BUFFETT: Let's go to number 3.

AUDIENCE MEMBER: Hi, my name is Nate Anthony (PH), from Hinsdale, Illinois.

First, I would like to venture a response to an earlier question about the future of Berkshire.

I believe it is our responsibility as shareholders to think for ourselves and ensure that Berkshire is run as respectably in the future it has been until now.

You both have had a lot to say, both today and in the past, about how mutual funds should be run. But to my knowledge, we do not directly have a fund management business.

What do you think about putting your words in action, and offering to have a Berkshire company manage the assets of funds where the directors are dissatisfied with present management?

WARREN BUFFETT: Yeah, the problem would be, there would be too many conflicts.

You know, we're managing so much of our own money at Berkshire that to take on the responsibility for managing another group of people to whom we would owe our best efforts, and handling that situation of wearing two hats ethically, I wouldn't know how to do it.

I certainly wouldn't want to start a fund management company and be prorating all purchases between Berkshire and that fund management company, or the funds that it managed.

I — we've thought about it plenty. I mean, we've had all kinds of propositions put to us.

And obviously, we could sell it big time. But when we got through selling it, then we'd have the problem of administering it fairly. And I don't know how we would do it. Charlie, do you?

CHARLIE MUNGER: No, that's why we don't do it. But — (laughter) — I must say it's an attitude that doesn't seem to bother many other people. (Laughter)

4. New Omaha convention center allows more people to attend

WARREN BUFFETT: Microphone 4, please.

AUDIENCE MEMBER: Norman Rentrop from Bonn, Germany.

Two thanks and one question. My thanks go to both of you for allowing us investors to participate on equal terms with you.

No management fees, no performance fees, no transaction fees. (Applause)

My thanks also go to the people of Omaha for building this very fine new convention center. (Applause)

WARREN BUFFETT: Our thanks, too.

I'll interrupt you for just one second. We wouldn't be able to hold this meeting if we'd been limited to the facilities we had last year.

Last year we had the biggest facility in town. And I was told that we have at least 19,500 people here. And that would have been many, many thousands beyond what we could have had last year. And this is, — (applause) — this facility really does the job.

Incidentally it's known as the Qwest Center. If you read about it in the paper, they have a — they seem to have some unwritten rule — or maybe it's a written rule — that they can't use the name. So you will not see that name in the paper for reasons that absolutely baffle me.

But this is the Qwest Center, and they've done a wonderful job with it. And Omaha has 19,500 people here today that otherwise might have to go to Kansas City. So, thank you for thanking them, and now, your question, please. (Applause)

5. "I'm the only one that can double-cross you"

AUDIENCE MEMBER: My question is your outlook on buying companies. You have taught us when stocks are priced high, and companies are priced low, then buy companies.

In the 1960s and '70s, we did see the rise of the conglomerates. Then came in the pure industry plays. Now, we see a huge amount of money in private equity. And somehow private equity is competing for buying companies.

So my question is, what is your outlook on the future of the buyout and the buying company industry?

WARREN BUFFETT: Yeah, you're absolutely correct that the private equity funds are a form of competition with Berkshire in buying businesses.

We don't really seek to buy businesses cheap, because you're not going to get the chance to do that. We haven't been able to do that.

We do get occasional chances to buy them at what we would regard as fair value. You'll never buy companies as cheap as stocks sometimes get. I mean, sometimes stocks sell for very low valuations compared to intrinsic value.

Businesses just don't do it. I mean, the reason is the prices of stocks, like those junk bonds we talked about earlier, are set in an auction market, and that market can do extreme things. But businesses are sold in a negotiated transaction, and that doesn't get as extreme.

Nevertheless, our preference — our strong preference — is that we would rather buy businesses at fair prices than stocks even a little cheaper. And the private equity funds are our competition.

On the other hand, we have bought a reasonable number of businesses in recent years, and we'll buy more in the future.

If somebody wants what we are offering, you know, we are somewhat one of a kind, in that we can — we will buy a business, and the people that sold it to us, if they built that business, are really able to run it as if it's their own indefinitely in the future. So they —

If they have a tax reason, if they have a family situation, or whatever, where they want to sell some business they love, and they don't want to auction it off like a piece of meat, and they don't want some guy buying it and then leveraging it up, and then reselling a couple years after changing the accounting or something of the sort, they come to us.

And they know they'll get the result they want. And that happens periodically.

It doesn't enable us to buy super bargains or anything like that. It just doesn't work that way. But it does let us put the money to work at a sensible rate.

There will be more people like that. Unfortunately, we need big businesses, and, you know, they don't come along every day. But as I've said, when they — if you find that kind of owner —

If I owned a business that was big, and maybe my father had started, my grandfather had started, and I worked a long time for it but for one reason or another I had to monetize it, you know, I would sell to Berkshire.

It's very simple, because I wouldn't regard the carving up of it to get perhaps the highest — a higher price — which might or not — might not be higher — but I wouldn't regard that as the ultimate goal in life.

I think it's kind of crazy, you know, to spend — I think it'd be kind of silly to auction off your daughter to whatever, you know, whatever man is willing to pay the most for her. And I feel the same way about a business you've created lovingly over decades, and decades, and decades.

And we will buy some more. It's a matter of luck whether it happens in any given quarter, or even any given year.

But there's really no one else can quite make the promises that we can make. I mean, the degree of ownership that I have in Berkshire, and the way I've got it set up for the future, where none has to be sold, you know, my promises will probably be about as good as you can get in that arena.

Most big companies simply can't do that. If their board of directors, you know, decides they wanted to have a pure play, as you put it, in something. You know, what can be done about it?

I tell perspective sellers basically, "I'm the only one that can double-cross you." I mean — and I can double-cross them. I mean, if I, the next day, want to pull something on them, I — it's not contractual, what I've said to them, in all probability.

But nobody else can. We're not going to get some management consultants in, and they say you ought to rearrange the business, or we're not going to get Wall Street dictating to us.

And that's, I think, a significant advantage over time. I think it'll enable us to buy businesses, but we do have a lot of competition, as you point out.

Charlie?

CHARLIE MUNGER: Yeah, it's been interesting, though, that we've had this private equity competition for a long time, and one way or another we've managed to buy a few things. (Laughter)

6. David Sokol defends MidAmerican's environmental record

WARREN BUFFETT: OK, we'll go to number 5.

AUDIENCE MEMBER: Hello, my name is Dan Cunningham, and I'm from Boston, Massachusetts, home of the 2004 world champion Boston Red Sox. (Applause and laughter)

Thank you, Warren and Charlie, for providing this forum, and teaching over the years. It's much appreciated.

In a recent New York Times magazine cover story titled, "Up in Smoke," David Sokol, who runs Berkshire's MidAmerican Energy business was cited as a prominent CEO actively working to roll back the United States Clean Air Act, which 80 percent of Americans view as crucial to our public health.

MidAmerican, itself, was cited as a major mercury polluter, among other things.

With this in mind, could you see a role for a type of independent oversight committee charged with the purpose of auditing for shareholders the social responsibility of Berkshire's businesses?

This committee would monitor costs that Berkshire's businesses incur for our society, but do not show up anywhere in an income statement. Maybe in Berkshire's case, this would be a fraction of a person instead of a committee. Thank you.

WARREN BUFFETT: Yeah. Is Dave here? I can't, it's hard for me to see here. Do you see Dave? Marc [Hamburg], is David here?

We'll go to a — yeah, he might —

I'd like to have David respond to that, because, you know, I have seen MidAmerican actually lauded in many — a great many respects.

I did not see that particular article, but I know that if there were anything being done, that had been judged wrong, I would have heard about it. So maybe David can address that, if he will.

Well, he can — there's a mic. Either come up here, or go to the microphone that's nearest.

DAVID SOKOL: Yeah, Warren, this is David.

WARREN BUFFETT: Yeah, OK, uh-huh.

DAVID SOKOL: The article actually does not criticize MidAmerican for any air emissions. It criticized me for two years ago being a "Ranger" in President [George W.] Bush's election.

For what it's worth, I'm no longer a Ranger, but that was the — the focus of the article was energy CEOs trying to influence legislation.

That's not why I was a Ranger, and frankly, MidAmerican's environmental policies, I think, rank among the best in the industry.

WARREN BUFFETT: Thanks, David. Yeah, I've never seen any criticism of MidAmerican. And matter of fact — (applause) — David, could you tell them what happened with that J.D. Edwards study just recently?

DAVID SOKOL: Yeah, we were ranked nationally number two in the country for environmental reliability, availability, and customer satisfaction — number one in the Midwest out of 55 utility companies.

WARREN BUFFETT: Thanks, Dave. (Applause)

7. U.S. has "certainly benefited enormously" by immigration

WARREN BUFFETT: Number 6, please.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Van Argyrakis. I'm from Omaha.

Many U.S. multi-national corporations depend on the importation of foreign workers.

What is your opinion on the current state of U.S. immigration law as it applies to the employment of highly-skilled permanent workers?

WARREN BUFFETT: Charlie, you want to comment on that?

CHARLIE MUNGER: Well, of course, that's a subject on which reasonable minds disagree.

My personal view is that I'm almost always glad to have very talented people come into the United States, and I'm almost never pleased when the very bottom of the mental barrel comes in. (Laughter)

WARREN BUFFETT: Yeah. We may differ just a bit on that one. (Laughter)

The — this country has certainly benefited enormously over the decades, you know, by immigration.

We started out with 4 million people in 1790. China had 290 million at that time, just about what we have now. Europe had well over 75 million.

So you had 70 times as many people in China. You had, probably, 20 times as many people in Europe. We had the same degree of intelligence in China, or in Europe, as we had here. We had similar natural resources. And now this country has well over 30 percent of the GDP of the world.

So it's a pretty remarkable story. And how to attribute — or how to quantify the various components that entered into that is very difficult, but we've certainly been a country characterized by lots of immigration.

And whether that is responsible in any way for the incredible record of this country, I don't know. But I suspect that it was. And I think what Charlie would like to do is perhaps be the admitting officer. And — (laughs) — it would work —

CHARLIE MUNGER: You're right.

WARREN BUFFETT: It would work pretty well if Charlie was, but in the absence of that I think — I don't think, net, this country has been hurt by immigration over time.

8. Why we don't split Berkshire's stock

WARREN BUFFETT: Number 7?

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I would like to thank you for being here.

Well, my question pertains to price discovery and liquidity. It is a common perception that, unless there is adequate liquidity, price discovery is hurt.

Now if liquidity helps price discovery, then does it make sense to split the stock of a company which has a low liquidity problem? As a corollary, why do you consider stock splits and bonus issues to be bad for shareholders in the long run? Thank you.

WARREN BUFFETT: Stock splits, and what else Charlie?

CHARLIE MUNGER: Bonus issues.

WARREN BUFFETT: And what's the relation, I don't get it.

CHARLIE MUNGER: He didn't indicate a relation —

WARREN BUFFETT: Oh.

CHARLIE MUNGER: He just asked you to describe —

WARREN BUFFETT: It's just two —

CHARLIE MUNGER: — what's wrong with both.

WARREN BUFFETT: It's two questions, then. (Laughter)

Yeah, well, our — we have explained how we think about stock splits. There's no religious view against them. We don't think companies that do them are evil or anything of the sort.

We do think we've got the best group of shareholders in the world, and I think that a meeting like this, to some extent, is evidence of it.

We've got people that are more in sync, I think, with the policies of the company. We certainly have people who are more long-term in their view of Berkshire — or their intentions — regarding Berkshire.

I think we have people that understand their investment in Berkshire better than — well, really better than other large American corporation. We've got the lowest turnover of any large American corporation. Now, why is that?

Well, people can buy stock in any company they want to. I mean, you could have bought stock in Berkshire, or something else. But there's this self-selection process of who comes in, and there's a self-selection process of the people that just say, you know, that company doesn't interest me.

And I would say that people who say they aren't interested in a stock that sells in the thousands of dollars a share simply because it sells in the thousands of dollars a share, are not — would not as a group be as intelligent, and informed, and long-term in their outlook, and as in sync with the policies of management, as this group.

It's not a killer of a thing, obviously. But it's a sign — it's a symptom — of people with a somewhat different attitude toward the stocks they own. Now, somebody is going to —

If we have a million and a half Class A equivalent shares — we have a little more than that — outstanding, somebody's going to own them all. So it's just a question of who is attracted and who is repelled to your — from your shares.

And I think not splitting, and some other things we do at Berkshire — a number of other things we do at Berkshire — has attracted a group of shareholders that really come the closest to an investment-oriented group, as is almost possible in a widely traded, widely available company.

And we like the group we've got. We're not looking for the people who think it would be a more attractive stock if, instead of selling at 90,000 a share, it sold at $9 a share. Nothing wrong with those people, but they are —

If we were choosing partners, we would choose the group we have over the people who think a $9 stock is a wonderful thing.

Charlie?

9. Munger: liquidity is not a "great contributor to capitalism"

CHARLIE MUNGER: Yeah, and on the second part of that question, I think the notion, which is taught in so much of modern academia, that liquidity is this — of tradable common stock — is a great contributor to capitalism — I think that is mostly twaddle.

The GNP of the United States grew at very good rates long before we had highly-liquid markets for common stock.

I don't know where people got that silly notion. I think the liquidity gives us these crazy booms, which have many problems as well as virtues.

And in England, if you'll remember, after the South Sea Bubble, England banned tradable common stocks for decades. It was absolutely illegal to have a company so widely held you got a liquid market in the shares, and England did fine during that period when you didn't have a stock market.

So, if you think that liquidity is a great contributor to civilization, why then you probably believe that all the real estate in America, which is relatively illiquid, hasn't been developed properly.

WARREN BUFFETT: The kings actually commented on the perversions brought about by liquidity. But of course, the truth is that Berkshire trades on average $50 million or so of stock a day. So there's very few people that are going to have any problem with Berkshire, the liquidity in the stock.

CHARLIE MUNGER: But we're trying to create more of them.

WARREN BUFFETT: Uh-huh.

CHARLIE MUNGER: More people who have this big liquidity problem, because they own so much stock.

10. Buffett's moral distinction between owning a company or a stock

WARREN BUFFETT: Let's go on to number 8, please.

AUDIENCE MEMBER: Hello, there. This is Michael Angelo (PH) from San Francisco.

My general question is about how ethical concerns enter into your asset allocation decisions.

So, for example, I think there's some strong arguments that can be made that, say, Classic Coke should never be part of anyone's diet.

If such an argument could be made, and you were convinced of it, would that change the way that you viewed Coca-Cola Company as part of your portfolio?

WARREN BUFFETT: Well, I think that's a hypothetical that simply wouldn't happen. I mean, I've been drinking five of them a day, you know, and maybe it's the combination of that and peanut brittle, you know, that does the job. But I just feel terrific. The — (Laughter and applause)

We passed one time on the chance to buy an extraordinarily profitable company, because Charlie and I met the people that ran it. And they were perfectly decent people, too.

And we went down in the lobby of the hotel that we met them in, and we just decided that in the end we didn't want to be involved in that.

On the other hand, I would have bought stock, as a publicly traded stock, in the same company. Charlie will give you his view on that later.

So, I do not have a problem buying stock in companies — marketable securities — the bonds of companies in the market — that engage in activities that I wouldn't probably endorse myself.

I would have trouble owning outright, and actually directing the activities, of some of those companies.

But, you know, the — any major retailer in this country is — virtually — is going to be selling cigarettes, for example. And if they're not declared illegal, it does not bother me to own — it would not bother me to own those retailers outright — or it does not bother me to own the stock.

CHARLIE MUNGER: Yeah, but you wouldn't buy a company that made the tobacco and concocted the advertisements.

WARREN BUFFETT: No, we — and, you know, I can't tell you perfectly why that, I mean, I can't tell you that's the perfect line, or I can't tell you precisely why that's where I draw it. But I will tell you that is where I draw it.

We would not be in the manufacture of it, but I — we owned stock at one time in R.J. Reynolds. Before it had the LBO, we owned bonds in it. And, you know, I would still be doing it if I liked either the bonds or the stock.

We would not buy the manufacturer. And like I say, we walked on one that — and we went down to the hotel to talk about it though, too. (Laughs)

So we'd have to say that we were thinking about it, but we decided not to do it.

Charlie?

CHARLIE MUNGER: We didn't think very long. The — (Laughter)

We don't claim to have some kind of perfect morals. You can draw these lines where you wish. But at least we've got a huge area of things which is perfectly legal to do, that we think beneath us. So we won't do them.

And we see more and more in America, a culture where just anything that's unlikely to send you to prison, which looks like it'll make money, is OK. And that is a very bad development.

WARREN BUFFETT: Yeah, but I think it's a little crazy myself — (applause) — to say that it's terrible if people eat hamburgers, or eat — or drink Coca-Cola, or eat candy, or anything like that, because they're likely to gain weight. That is a perfectly optional decision.

And who knows whether somebody has lived a happier life, that lives to 75, and they're overweight condition causes them to die a little sooner than if they lived to 85 and lived on carrots and broccoli, you know, has lived a better life. I know which one I prefer. (Laughter)

11. Give Buffett a salary bump for his retirement

WARREN BUFFETT: OK, number 9, please.

AUDIENCE MEMBER: Hi, Mr. Buffett. I'm Allan Maxwell. My wife and I are shareholders from Omaha. I'm going to keep things simple so you can understand them.

WARREN BUFFETT: Good. (Laughter)

Allan's a friend of mine, so he can get away with that.

AUDIENCE MEMBER: Thank you, Colonel.

Excluding the Buffett's stake, I'm going to combine A and B shares. And there are approximately 1 million A shares outstanding, correct?

WARREN BUFFETT: That'd be about right, uh-huh .

AUDIENCE MEMBER: OK, about. Your salary is approximately — or is — $100,000 a year.

WARREN BUFFETT: It's been stuck there for a while. We'll talk about the board. (Laughter)

AUDIENCE MEMBER: Well, you'll be happy with my question.

WARREN BUFFETT: You can make it a motion —

AUDIENCE MEMBER: In other words —

WARREN BUFFETT: — if you're heading where I think you are. (Laughter)

AUDIENCE MEMBER: In other words, we're paying you 10 cents a share to manage a $90,000 investment. That's remarkable in today's corporate culture. Thank you, Mr. Buffett, thank you. (Applause)

WARREN BUFFETT: Yeah, thanks. Allan, thank you. But I have to tell you, as I did last year, I would pay to have this job. I mean, it doesn't get any better than this.

AUDIENCE MEMBER: Well, rather than you doing something for us, I would like to suggest that we, the shareholders, do something for you. As a shareholder, I would be willing to pay you 25 cents an A share. (Laughter)

That way you could save a little extra money for your retirement. (Laughter)

Would you support such an idea?

WARREN BUFFETT: Allan, I'm getting Social Security now. (Laughter)

And that really pretty well takes care of things. My family would go crazy if I made any more money. (Laughter)

AUDIENCE MEMBER: This would help you —

WARREN BUFFETT: But I appreciate the offer, however.

AUDIENCE MEMBER: My heart's with you, thank you.

WARREN BUFFETT: OK, thanks, Allan. (Applause)

12. Why Berkshire's insurance companies never have layoffs

WARREN BUFFETT: Let's go to number 10, and see if we can get 50 cents. (Laughter)

AUDIENCE MEMBER: How about a dollar? (Laughter)

David Winters, Mountain Lakes, New Jersey. Thank you, Warren and Charlie, for a fabulous weekend and for the discussion about governance in the mutual fund industry in the shareholder letter.

Specifically, have you altered the compensation potential for the insurance underwriters to make sure, as Charlie has described, the incentive-caused bias creates an environment that encourages writing new policies that, when the tide goes out again in the property and casualty business, Berkshire Hathaway minimizes losses, maximizes float, while compensating underwriters for not writing business?

WARREN BUFFETT: Well, thank you, that feeds into an interesting set of slides I've got, if I can find them here to tell the projector what to put up, because that's a very important point you raise.

I mean, we are very big in insurance, and having the wrong incentives in place could be very harmful.

So let's put up a couple of slides. Let's put up slide number one, if we would, please.

Slide number one is the situation at Berkshire, and Shirley, I'll give you one of these, but that's the situation at Berkshire shortly before we bought National Indemnity.

There's our balance sheet there. And as you'll notice, we just had a few million dollars extra. We had about $20 million tied up in the textile business.

And then I heard that Jack Ringwalt wanted to sell his company. Some of you here in the audience know him. He — for 15 minutes every year, Jack would feel like selling his company. He would get mad at something or other.

And so my friend Charlie Heider knew Jack pretty well, and I'd said to Charlie, "Charlie, next time Jack is in heat, have him, you know, get him over here." (Laughter)

And so Jack, early in 1967, came by 11:30, 11:45 in the morning, and said he'd had it with insurance, and with the insurance regulators and everything, he'd like to sell. So we bought it.

Now, we bought, that was the — made a major — that's when we really embarked on what has happened subsequently.

As you can see from that slide, the following year the textile business made all of $55,000. So sticking with textiles would not have been a great idea. We spent $8 1/2 million to buy National Indemnity.

Now, on the next slide, slide two, you will see a record like has never been, I don't think there's another insurance company in the world that has a record like this. That's the premium volume of National Indemnity's traditional business.

And you will see a company that went from 79 million in that first year of premiums — if you go all the way back to the time we bought it — it was 16 million, but by 1980 we were up to 79 million.

And you will see that in what was known as the "hard market" of the mid-'80s, we got up to 366 million.

And then we took it down — not intentionally, but just because the business became less attractive — all the way from 366 million down to 55 million. And now the market became more attractive in the last few years, and it soared up to almost $600 million.

I don't think there's a public company in America that would feel they could survive a record of volume going down like that, year after year after year after year.

But that was the culture of National Indemnity. It was the culture started by Jack Ringwalt, and it was the culture all the way through several other managers, Phil Liesche, and Rolly [Roland] Miller, to Don Wurster, who has done a fabulous job. And we don't worry about premium volume.

But if you're not going to worry about premium volume, then you have to take a look at slide three. Because if the silent message had gone out to our employees that unless you write a lot of business, you're going to lose your job, they would have written a lot of business. You could —

National Indemnity can write a billion dollars' worth of business in any month it wanted to, all it has to do is offer silly prices. If you offer a silly price, brokers will find you in the middle of the ocean at four in the morning. I mean, you cannot afford to do that.

So what we have always told people in our insurance businesses generally, specifically at National Indemnity, is that if they write no business, their job is not in jeopardy.

We cannot afford to have our unspoken message to employees, that you write business, or your job, or the guy sitting next to you's, you know, may be lost.

So when we bulged up to 366 million, we — employment went up modestly, and when we went all the way down, you'll see it trickle downward, but that was all by attrition. We never had a layoff during that period. Other people would have, but we didn't.

And now we're going back up some, and we'll go back down again at some time in the future.

Now, if you go to the next slide, you'll see that that created an expense ratio that went up dramatically, up as high as 41 percent in 1999, as volume shrunk back. And when we were writing a lot of business, our expense ratio was as low as 25.9.

Now, some companies would feel that was intolerable, but what we feel is intolerable is writing bad business. And again, we can take an expense ratio that's out of line, but we can't afford to write bad business. For one thing, if you get a culture of writing bad business, it's almost important to get rid of.

So we would rather suffer of having too much overhead, than we would want to teach our employees that to retain their jobs, they needed to write any damn thing that came along, because that's a very hard habit to get rid of once you get hooked on it.

Now, move on to slide number five, you will see what the result has been of that policy. And it's been that we had a few years, bad years, in the early '80s — that's what led to that hard market. But even with a high expense ratio, you'll see that we made money underwriting in virtually every year.

You'll see the year 2001 at 108.4, but that will, in my view, that will come down. I think that will turn out to be quite a good year. These are the — that year is not fully developed yet.

Now, you'll see in 1980 — in '86 — we had this incredible year, when we wrote at 69.3, that's a 30 percent underwriting margin. And the nice thing about it is, we did it with the most volume we ever had to that point, 366 million.

So we coined money when we wrote huge amounts of business, and we made a little money when we wrote small amounts of business.

So it's absolutely imperative in our view, and I think we're almost the only insurance company like this — certainly public — in the world that sends the absolutely unequivocal message to the people that are associated with us, that they will never be laid off because of lack of volume, and therefore, we don't want them to write one bit of bad business.

And we'll make mistakes, and we'll have a high expense ratio when business is slow, but we'll win the game. And that's what National Indemnity has done over a period of time.

National Indemnity was a no-name company 30 years ago operating through a general agency system which everybody said was obsolete.

It had no patents, no real estate, no copyrights, no nothing, that distinguished it, essentially, from other insurance — dozens of other insurance companies could do the same thing. But they have a record almost like no one else's because they had discipline. You know, they really knew what they were about.

And they've stayed with that. In fact they've intensified it over time. And their record has left, you know, other people in the dust.

It wouldn't be a record you would point to Wall Street, you know, if you went to Wall Street with that record alone in 1990 or 1995, they'd say, "What's wrong with you?"

But the answer's nothing's wrong with it. And you put your finger on having the incentives in place to write the right kind of business for the shareholders at Berkshire. And we try to think those things through.

I mean, you can't run a — you can't run an auto company without having layoffs. You know, you can't run a steel company that's this way. But this is the right way to run an insurance company.

And that's why these cookie-cutter approaches to employment practices, or bonuses, and all that are nonsense. You have to think through the situation that faces you in a given industry with its given competitive conditions, and its own economic characteristics.

Charlie, you want to comment on that?

CHARLIE MUNGER: Well, the main thing is that practically nobody else does it. And yet to me it's obvious it's the way to go.

There's a lot in Berkshire that is like that. It's just a little different from the way other people do it, partly the luxury of having a controlling shareholder of strong opinions.

That accounts for this. It would be hard for a committee, including a lot of employees, to come up with these decisions.

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

WARREN BUFFETT: We go to number 11. (Applause)

AUDIENCE MEMBER: Good afternoon, my name is Andy Peake, and I'm from Weston, Connecticut.

As a keen China watcher, I was very interested in your PetroChina investment.

Could you please tell us more about your thought process on investing in a complicated, opaque country like China, and PetroChina?

WARREN BUFFETT: Yeah, PetroChina itself is not a complicated or opaque company. You know, the country, you know, has obviously, different characteristics in many respects than the United States.

But the company is very similar to big oil companies in the world. I — and I — PetroChina may have been the fourth largest — fourth most profitable — oil company in the world last year. I may be wrong on that.

But they produce 80 or 85 percent as much crude daily as Exxon does, as I remember. And it's a big, big company. And it's not complicated.

I mean, you know, obviously, a company with half a million employees, and all of that. But a big integrated oil company, it's fairly easy to get your mind around the economic characteristics that will exist in the business.

And in terms of being opaque, actually their annual report may well tell you more about that business, you know, than you will find from reading the reports of other oil giants.

And they do one thing that I particularly like, which other oil companies don't, at least to my knowledge, is that they tell you they will pay out X percent, I think it's 45 percent of their earnings, absent some change in policy.

But I like the idea of knowing in a big enterprise like that that 45 percent of what they earn is going to come to Berkshire, and the remainder will be plowed back.

It was bought not because it was in China, but it was bought simply because it was very, very cheap in relation to earnings, in relation to reserves, in relation to daily oil production, and relation to refining capacity.

Whatever metric you wanted to use, it was far cheaper than Exxon, or BP, or Shell, or companies like that.

Now, you can say it should be cheaper, because you don't what'll happen with it 90 percent owned by the government in China, and that's obviously a factor that what — you stick in valuation. But I did not think that was a factor that accounted for the huge differential in the price at which it could be bought.

And, you know, so far it looks OK on that basis.

We weren't — we aren't there because it's China, but we're not avoiding it because it's China, either. We just — we stick in a fairly appropriate number.

But if you read the annual report of PetroChina, I think that there's no — you will have as good an understanding of the company as you would if you read the annual report of any of the other big oil majors.

And then you would factor in your own thinking about whether there could be some huge disruption in Chinese-American relationships or something of the sort, where you would lose for reasons other than what happened in terms of world oil prices, and that sort of thing. But we're happy with it.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

If a thing is cheap enough, obviously you can afford a little more country risk, or regulatory risk, or whatever. This is not complicated.

WARREN BUFFETT: Yeah, you can — Yukos, as you know, is a very big Russian oil company. And in evaluating Russia versus China, in terms of country risk, you know, you can make your own judgments.

But in our view, something like PetroChina was both cheaper and had less risk. But other people might see that differently.

14. Dubious asbestos claims are taking compensation from true victims

WARREN BUFFETT: We'll go to number 12.

AUDIENCE MEMBER: Good afternoon, gentlemen. My name is Hugh Stephenson. I'm a shareholder from Atlanta, Georgia. This question is for both of you.

If you would both comment on the subject of tort reform, specifically asbestos tort. And if you could construct an optimal solution, how would you construct it, balancing the interest of legitimate plaintiffs versus the attorneys, versus the opportunists?

WARREN BUFFETT: OK, Charlie's the lawyer, so he's going to get to answer this one.

CHARLIE MUNGER: As a matter of fact, that is an easy question.

What's happened in asbestos is that a given group of people get mesothelioma, that came — which is a terrible form of lung cancer that kills people — really only from asbestos. And those people got it from somebody's asbestos. And that's one group of claimants.

Then there's another group of claimants, and these are people who've smoked two packs a day of cigarettes most of their lives, and they've got one little spot here or there, in an elderly lung.

And God knows what the spot is, but an enterprising lawyer can get an enterprising physician, who just happens to find that every damn spot in any lung must be asbestos-caused.

And once you've got one expert witness whom you can bribe, in effect, to say that, you've got a claim that can be filed.

And so you get millions of claims on behalf of people who have no symptoms, and who say that I'm worried about getting cancer from this spot that my attorney's doctor says was caused as asbestos.

There isn't enough in the companies that made the asbestos to pay off everybody. And what happens is that a huge percentage of the money does not go to the people that got the cancer, or another group of people who got terrible lung impairment that is obvious.

But that's another small group relative to these people who just have one little spot and are — and now say they are worried about getting cancer.

And they can file those cases where they say they're worried in some state, usually a southern state, where they've got a jury pool that just hates all big corporations.

And so you've got an industry — and of course the lawyers who are representing the people that aren't hurt are really stealing money from the people who are hurt.

And the guy who gets mesothelioma doesn't get as much as he should. And all these other people are getting money they're not entitled to.

It's a bonkers system. But with federalism the way it is, there's just no way to stop it.

And the United States courts — United States Supreme Court — refused to enter it, and just grab hold and make a decision. And so it just goes on, and on, and on, and the claims come in.

I think the Manville Trust had more new claims come in last year than in any year in history.

WARREN BUFFETT: That's correct.

CHARLIE MUNGER: And they have mined and sold asbestos for the last time, what 35 years ago, or —?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And it just never stops.

The people who are trying to buy these people off, it's like trying to douse a fire by pouring gasoline on it, because word processing machines can grind out these phony claims, and the doctors can ground up — grind out these phony opinions.

And so, a huge proportion of all the money that's available to pay people who've suffered from asbestos goes to lawyers, experts, doctors, contingent fees to the lawyers, defense lawyers.

I think — is it something like 20, 25 percent of the money is flowing through to people who were injured? So it's a total national disgrace.

The only people who have the power to fix it would either be the Supreme Court of the United States or Congress.

The Supreme Court — some people would say rightly, other people would say in too chicken a fashion — ducked the issue. That means the only party that has the power to fix it is Congress. And Congress so far, given the politics, has not fixed it.

Once you get wrongdoers so rich, they get this enormous political power to prevent change in the laws that are enriching them.

I mean, it means that we should all be more vigilant about stepping on these wrongs when they're small. Because when they get large, they're very hard to stop.

But it would be easy to fix this. The right way to fix it, we just are not going to pay off on these tiny claims.

WARREN BUFFETT: But Johns Manville — we own Johns Manville. They went bankrupt. They were the first, at least big one, that asbestos took into bankruptcy, and probably on the history of things, they somewhat deserved it, I think, Charlie. Isn't that right?

CHARLIE MUNGER: Their behavior was among the worst in the history of American corporations.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: They knew this stuff was causing terrible injury, and they deliberately covered it up, time after time, and year after year, to make more money. There's no doubt about the guilt of the original management at Johns Manville.

WARREN BUFFETT: So they went bankrupt in the early '80s, and out of that bankruptcy was formed something, as Charlie mentioned, called the Manville Personal Injury Trust. We've got — have no connection with that.

I mean, this is a new company that we bought a few years ago, and this company has no connection with that except the historical — history.

The — but the Manville Personal Injury Trust was established, and had over time — had a couple billion dollars in it.

And as Charlie said, last year — it's been around now for almost, I would say, close to 20 years — and last year they had a record number of claims introduced.

They didn't have a record number because of the incidents of asbestos compared to the ones that were prevailing at the time it was established, or something of the sort. It's just that it's become a honey pot.

And as a result, the Mansville Personal Injury Trust is now paying out five percent because their 2 billion will only go so far. They're paying five percent of claims.

So as Charlie says, the guy that's got a — that has really been drastically injured by asbestos gets this tiny fraction, and the tens of thousands of claimants for whom it's a gleam in the eye, or rather a gleam in their lawyer's eye, perhaps, also get their five percent.

And it's, you know, it's not the right way to do it, but it's very hard to correct.

We've observed the asbestos legislation over the — proposed legislation — over the last year. And in the end, what they came up with, we did not support because it didn't get the answer that's needed.

And it was Charlie's and, you know, my view that the Supreme Court, when they ducked it, I mean, they left open a can of worms which will be around for decades, and decades, and decades. And the right people will not get compensated.

CHARLIE MUNGER: And those of you who want to be cynical ought to look into it, and see the perjury.

What's happened, of course, is that all the really horrible people pretty well are broke and gone, and maybe there's some money left in a trust here or there. But by and large, there isn't enough money.

But now, there're, like, three solvent people left. And you've got some little spot, or something or other. And by a strange coincidence, every one of those people can only remember three names of products that —

WARREN BUFFETT: Might've caused it?

CHARLIE MUNGER: — somehow saw, that might've caused it. And it's an amazing coincidence, the three that are left solvent are the only names he can remember.

And so you — it's obvious you have a vast amount of perjury being suborned by practicing lawyers. It's not a pretty picture.

15. Dividends vs stock buybacks

WARREN BUFFETT: OK, let's go to microphone 1.

AUDIENCE MEMBER: Hi, my name's Charlie Rice, and I'm a stockholder in from St. Louis, Missouri.

I'd appreciate hearing your comments on publicly-held companies using their cash for dividends versus stock buybacks?

WARREN BUFFETT: Well, we — the equation is pretty simple, but the practice doesn't necessarily follow logic. The —

It's obviously — as long as you're telling the truth to your shareholders about what's going on so that you aren't manipulating the stock downward or something — when a stock can be bought well below its business value, that probably is the best use of cash.

It's something The Washington Post did on a huge scale back in the 1970s. Teledyne may have bought 90 percent, or something, or close to it, of their stock back.

And that was the reason a very significant percentage of companies bought stock back in the past, because they actually thought it was selling for less than it was worth.

Like I say, that that can be abused if you do various things to bury your stock in one way or another, but that wasn't the usual case.

Stock repurchases were relatively unpopular in those days. They've become quite popular now.

And to the extent that I've been around a good number of them, and been able to pick up on what I thought was the underlying rationale, if not the professed rationale, you know, I think it's often done for people that are hoping that it causes their stock price not to go down, and their — and often done at prices that don't really make a lot of sense for continuing shareholders.

If we wanted to return a bunch of cash to shareholders, we would — if our stock was undervalued — we would go to the shareholders, and say, "We think it's cheap, and we think that this cash can be better used by you than by us.

"And we will, therefore, have — be repurchasing at what we think is a discount intrinsic value." And the people that remain will be better off, and the people that get out will get out at a little bit better price than they would otherwise.

In terms of dividends, you get into an expectational situation. And for most companies that follow a — that pay a cash dividend — it doesn't make sense to bounce around the dividend from year to year, although private companies frequently do that.

And we do it ourselves with our subsidiaries. They — some subsidiary can pay us a lot of money one year, and not so much money the next year.

But with public companies, people do — a lot of people do buy stocks to obtain dividends, and they hope for regularity, and that there's a signally aspect to it and everything.

So I would say that once you establish a dividend policy with a public company, you should think a long time before you change that policy in a material way.

But I think the best use of cash, if you don't have a good use for it in the business, if the stock is underpriced, is to repurchase it. And if it's overpriced, you got no business buying in a single share. But a lot of companies do it.

Charlie?

CHARLIE MUNGER: Yeah, dividends are a very interesting subject. If you count the unnecessary stock trading, and the cost of investment advice, and the cost of making a lot of errors, and the trading costs in and out, I don't think we'd be too extreme to say that now the total amount that's paid out in dividends is roughly equal to the amount that is wasted in all this trading and investment advice.

So that the net dividends that come to the shareholders are approximately zero. This is a very peculiar way to run a republic. And very few people comment about it.

WARREN BUFFETT: Yeah, actually I did in an article, some time ago in Fortune. The frictional costs to American shareholders in sort of changing chairs for all American business as a whole, those frictional costs, are probably not much different than the entire amount paid out by American corporations.

So — but getting to the individual corporation level, a company that expects to regularly earn more than it can profitably employ in its business, should be paying out dividends.

Take a subsidiary of ours like See's Candy. We would love to expand See's Candy to double or triple its present size, but it doesn't work. We've tried it a lot of different ways. So it should be paying out its earnings.

If it was a public company, and it was at one time, you know, you could argue that something approaching a 100 percent payout would make sense there.

But most managements worrying about earnings falling off at some time in the future would rather establish a lower level, and therefore, ensure regularity of dividends by going with a conservative level. I — you know, we —

It's obviously something we think about at Berkshire when we have 30-odd billion dollars around. If we can't figure out a way to employ that over time, you know, it's a mistake to keep it in corporate form.

But we have this expectation, and I think it's a reasonable expectation, that we get the — put it to work.

If we ever came to a different conclusion, if our stock — we thought our stock was significantly undervalued, we'd probably figure in terms of disbursing it through repurchases, particularly where now dividends and capitals gains are neutral for individuals.

And if our stock was not underpriced, and we fell, we would probably do something by a dividend.

It's not going to happen soon, however. (Laughs)

16. GEICO and Dell: the low cost is going to win

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Good afternoon. My name is J.P., as in justice of peace, or Jell-O pudding.

My last name is Tan, as in suntan. I flew in from the suntan city of Orlando, Florida where an elderly man told me, "J.P. Tan stands for just 'perfect tan.'"

Mr. Buffett, allow me to give you a big thank you before I ask my question. Some time ago I sent you my business analysis of your investment in Scott Fetzer Company.

I was not sure if you even bothered to read it. Yet you were very kind to write me that my analysis of Scott Fetzer Company is very much on the money.

You also invited me to my first annual meeting where I had the privilege of meeting Mr. Andrew Kilpatrick, who was kind enough to include my analysis of Scott Fetzer Company in his book, "Of Permanent Value: The Story of Warren Buffett." I want to thank you for making this possible.

Here comes my question. Mr. Buffett, you have said that the nine most important words ever written about investing are these nine words: "Investment is most intelligent when it is most businesslike."

Mary Buffett said that you have built your entire business success upon these nine words. Investment is most intelligent when it is most businesslike.

For this reason, I started businesslike.com, looking up to guide GEICO and Dell as direct marketing models, since they have the lowest cost structure.

Please kindly share with us in elaborate details the direct marketing methods of GEICO and your friend, Michael Dell? (Laughter)

WARREN BUFFETT (to Munger): What?

CHARLIE MUNGER: He wants you to analyze the marketing methods of GEICO — the direct-marketing methods of GEICO — and Dell.

WARREN BUFFETT: Yeah, well, I'm not as familiar with Dell as I am with GEICO.

The idea of direct marketing in auto insurance at GEICO came from Leo Goodwin, who — and his wife Lillian — who had come from USAA.

And USAA was set up some years — and GEICO was set up in 1936 — USAA was set up, I believe, in the early '20s, because military personnel moved around a lot, and they had trouble getting auto insurance. And a great organization was established.

Leo Goodwin took that idea, and decided to broaden it beyond the officer ranks of the military. And first went to government employees generally, and now that's been extended dramatically over the years to the American public as a whole. It's a better system.

You know, if you go back a hundred years, auto insurance when the auto first came in, was sold by the casualty affiliates of the big fire companies. That's where — that — in the 1800s, the major insurance companies were fire companies, and casualty insurance was something that came along later.

And it was sold through a system whereby the agent got large commissions, where there was sort of cartel-like rates established through something called a "bureau." And that system prevailed for several decades.

And then State Farm came along, formed in the early 1920s. A farmer from Merna, Illinois in his 40s. No background in insurance, no capital, but he came in with the idea of having a captive insurance — agency force. And that brought down costs somewhat.

And State Farm, in time, became the largest auto insurer in the country. And Allstate, which followed that system, became the second largest. And that was a better system, a better mouse trap.

And then USAA, followed by Leo Goodwin at GEICO, came along what a direct-marketing operation that bypassed the agent and brought down costs further.

Now, every American family, virtually, wants to have a car. They don't want to have insurance, but they can't drive their car without insurance. So they're a buying a product they really don't like very well. It cost them a significant part of their family budget. And cost, therefore, becomes very important.

It’s not a luxury item, it’s a mandatory item, virtually. And saving significant money makes a real difference in a lot of household budgets. So the low cost is going to win.

And our direct operation — Progressive has a wonderful direct operation competing with us — we’re the two that will be slugging it out over the years — is a better system, and better systems win over time.

Now, I — again, I’m not that familiar with Dell, but I have the impression that Dell is a very low-cost operation, enormously efficient. You know, very low amounts of inventory.

And, you know, I would hate to compete with them. The — if they can — if they turn out a decent competitive product at the best price, you know, that system will win.

You know, Charlie is a director of Costco, and Costco and Walmart figured out ways to do things at lesser costs that people needed — where people spent money in big quantity. And those two companies are winning.

So, we have a terrific marketing operation, and a terrific insurance operation in GEICO. And in my view it will grow very, very substantially.

And we have a very tough competitor in Progressive, because they’ve seen how well our model works, and they, in effect, have shifted over. I mean, they’re not totally shifted over, but they’ve moved towards a direct operation, and away from an agency operation.

It’s always a good idea to go with a low-cost producer over time. I mean, you could mess it up in other ways, but being a low-cost producer of something that’s essential to people, it’s going to be a very good business usually.

Charlie?

CHARLIE MUNGER: Yeah, you’ve chosen a wonderful field. And if you fail in it, it’s your own fault. (Laughter)

WARREN BUFFETT: I should say also that that — those nine words, they came from Ben Graham, they didn’t come from me. But Ben said those, and they are very important words, although they tie in with some others that he said. But they are very important words.

CHARLIE MUNGER: Warren, I want make an apology, too, because last night I said that some of our modern business tycoons — and I remembered particularly Armand Hammer — were the type that, when they were talking, they were lying. And when they were quiet they were stealing. (Laughter)

And some people got the impression that that was my witticism. That was said a great many decades ago about one of the robber barons.

WARREN BUFFETT: Well, if we start confessing here to the number of quotations we've stolen, we'll be here all afternoon. (Laughter)

17. Praise for Google's co-founders and their owner's manual

WARREN BUFFETT: So let's go on to microphone 3.

AUDIENCE MEMBER: Good afternoon. My name is Matt Lynch, and I'm from Palo Alto, California.

Mr. Buffett, a couple of times today you alluded to Google and its co-founders.

I was hoping you could share with us your thoughts and reactions to the owner's manual the co-founders included in Google's S-1 filed last week, especially in light of the similarities and differences between it and that of Berkshire Hathaway?

WARREN BUFFETT: Well, that's a real softball for me. The obviously —

AUDIENCE MEMBER: You're welcome.

WARREN BUFFETT: I'm very pleased that the Google — the fellows at Google decided — and they say they, it was, I think they used the word "inspired" by the Berkshire Owner's Manual.

And, you know, it obviously pleases us enormously that other people think that it's a good idea to talk to their owners — or in their case, their prospective owners — in a very straight-forward manner.

If you buy into Google, having read their owner's manual, you know, you will — I think you'll know the kind of people you're associating with. You'll know what they will do and won't do.

It's the kind of thing that one person would say to another if you were setting up a partnership. And were — you said, you know, "I'd like you to join me in a partnership. I need your money. And here's the way we're going to do business."

And I think more companies — obviously, I think more companies ought to do it.

It's been simple for us at Berkshire. We've had these principles in mind for a long time. And we really want people to understand those principles before they join with us.

And the Google fellows, in a very straightforward manner, you know, I liked their prose. You know, it doesn't mean I agree with every idea they have, but, you know, I do know what ideas they do have. And I hope more companies sign on for that sort of thing.

Charlie?

CHARLIE MUNGER: Well, you know, most of the world does not, in any way, imitate Berkshire Hathaway. This is a quirky few. It may look — there may be 19,500 of you that came — but it's still a quirky few by the standards of the country.

And what's interesting about Google is those two guys who created that are two of the smartest young men in the whole country. And it's much more fun to be copied by people that smart, than — (Laughter)

WARREN BUFFETT: Hey, we even think they are smarter than we thought they were last week. (Laughter)

CHARLIE MUNGER: And we now think they're a lot smarter, yeah. (Laughter)

WARREN BUFFETT: It's going to be a lot of fun to watch that. I — and my guess is that their annual reports are going to make very good reading. They're actually going to alternate the two of them in writing the reports. And I think you'll know a lot about them, and a lot about their business if you read it.

Although they had an interesting — as I remember, they had an interesting sentence of two in there, which I admired also, where they said that, you know, certain of the things that might affect their business prospects really would be better left unsaid, in terms of competition, and so on. And if so, they weren't going to tell you. (Laughter)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: I kind of enjoyed that.

18. Buffett doesn't see big changes for how homes are sold

WARREN BUFFETT: Number 4, please.

AUDIENCE MEMBER: Thanks, Warren, thanks. My question — my name is Chad Bliss (PH), Lincoln, Nebraska.

My question pertains to MidAmerican Energy and the Home Service division. You said earlier that you would continue buying, you know, companies in the real estate industry.

Given the growth in "for sale by owners," discount brokers, also maybe even banks now, do you think the current business model of home services is sustainable, or do you think commissions need to be lowered?

WARREN BUFFETT: Yeah, I really do think it's sustainable. It's a good question. In fact, I forget where I saw the article a few weeks ago, maybe in the Sunday New York Times, about Barry Diller's interest, I think through Lending Tree, on the internet.

And there've been a lot of real estate sales-related operations that have been on the internet. And the internet is a threat to any business, including real estate brokerage.

But, you know, when I think about the process of buying a home, and the degree of personal involvement involved in that, you know, the "for sale by owner." They call them FSBOs in the business.

I remember talking with my friend, Chuck Peterson about that 50 years ago, and FSBOs were with us then, and FSBOs are with us now.

But my guess is that a very significant percentage of home transactions 30 years from now will be done through a pipeline, and through a distribution mechanism, or brokerage mechanism, like exists now.

I do not see it changing dramatically, although there are people that are going to try and change it dramatically. So you've got competitors. But I love the idea of expanding Home Services.

Charlie?

CHARLIE MUNGER: Well, you tried to change it once yourself dramatically, right here in Omaha, and you fell on your ass. (Laughter)

He tried to —

WARREN BUFFETT: His memory's better than mine.

CHARLIE MUNGER: He tried to take away the — a good part of the home advertising business from the World-Herald to, you know, your then-little newspaper —

WARREN BUFFETT: Oh, right, it was very thin, yeah. (Laughs)

CHARLIE MUNGER: Yeah, yeah. And it didn't work worth a damn.

WARREN BUFFETT: Yeah. (Laughter)

And that's the last time I call on him. The — (Laughter)

19. Remembering Phil Fisher

WARREN BUFFETT: Let's go to number 5.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, I'm Tim Medley from Jackson, Mississippi.

Recently Mr. Philip Fisher died.

At this meeting many years ago, you, Mr. Buffett, mentioned your fondness for chapters 8 and 20 of "The Intelligent Investor," the first edition of "Security Analysis," and you said, "Phil Fisher's first two books."

And you Mr. Munger, have also been complimentary of Mr. Fisher's writings and investment approach.

I wonder if the two of you would tell us of your experiences with Mr. Fisher, the circumstances of your meeting, et cetera.

And did his writings, or your discussions with him, start you thinking about the idea of the great business, or the franchise company, or was it simply an affirmation of thoughts which you had already begun to have? And anything else you would like to say about Mr. Fisher.

WARREN BUFFETT: Yeah, Phil Fisher was a great man. He died maybe a month ago, or thereabouts, and well into his 90s.

His first book, and I believe it was "Common Stocks and Uncommon Profits," it was written in 1958. And the second book was written a few years later, those two books were terrific books.

And as with Ben Graham, you could really get it all by reading the books. I met Phil Fisher just once, and it was great. I enjoyed it, I loved it. He was nice to me.

But similarly, actually, to my experiences with Ben Graham, I worked for him, I took his class and everything else — it was in the books.

I mean, they were such good writers, and their thoughts were so clear, that you didn't need to meet them personally. I enjoyed meeting them personally, obviously. But they got it across in words.

And the only time I met Phil was some time after that 1962 book, or whatever it was, '61 or '62. And I was in San Francisco, I think it was in the Russ Building, I may be wrong on that. And I just went there.

I used to do that all the time when I was younger. I'd go to New York, and I'd just drop in on all kinds of people. And I guess they thought because I was from Omaha that, you know, one time and they'd be rid of me. So — (Laughs)

And I would usually get in to see them. And Phil — I did that with Phil. And he was extraordinarily nice to me. But it wasn't that I gained new ideas though, however, by meeting him, because I'd already read it in his books.

And Charlie actually, I met Charlie in 1959, and Charlie was sort of preaching the Fisher doctrine, also, to me. Little different form, but his ideas paralleled those of Phil. So I was sort of getting it from both sides. It made a lot of sense to me. I don't know what Charlie's experiences were with Phil.

CHARLIE MUNGER: Well, I always like it when somebody who's attractive to me, agrees with me. And therefore, I've got very fond memories of Phil Fisher.

The basic idea of that it was hard to find good stocks, and it was hard to find good investments, and that you wanted to be in good investments. And therefore, you just find a few of them that you knew a lot about, and concentrate on those, it seemed to me such an obviously good idea.

And indeed, it's proved to be an obviously good idea. Yet, 98 percent of the investing world doesn't follow it. That's been good for us. It's been good for you.

20. "No single yardstick" for compensation and incentive systems

WARREN BUFFETT: We'll go to number 6, please.

AUDIENCE MEMBER: Good afternoon, my name is Stan Leopard, and I'm from Menlo Park, California. I'm very pleased to be here, Warren and Charlie.

I first heard about you, Warren, in the late '80s, and began reading your writings. Unfortunately I didn't invest until the late '90s.

You have shaped my business thinking, and as I listen to you, and as I continue to read what you write, and the things you recommend to read, it continues to shape my thinking.

My question's about compensation. And I've seen your writing, and I heard the earlier comments today. And they still leave me, as a guy who is a business owner, not quite sure how to act to design compensation for managers.

For most of my career, I've been the senior manager in my businesses, but now I'm in a situation where I'm looking to own a majority interest of businesses that I don't manage every day directly, and I'm very concerned with this compensation issue.

When I think about things, like, return on equity, or growth, or risk, or like that, but if you could speak a little more towards the specific of how you approach the getting it to the right things to measure and incent, I'd appreciate that.

WARREN BUFFETT: Yeah. It's a very good question, and it's — you know, there is no formula that applies across all industries or businesses.

You take something like return on equity. You know, if you pay way too much for the business that you buy, the person who runs it is going to get a lousy return on your equity.

And they may get a good return on the tangible assets employed in the business, but your purchase price may defeat them, in terms of earning good returns.

If you base the — on earnings on tangible equity, you know, there are businesses like a network television station where, you know, if you have an idiot nephew, you can put him in charge, and they'll earn huge returns on equity as long as they manage to stay away from the office. So it's —

And there are other businesses where you have to be a genius to earn 7 or 8 percent returns on equities. So there is no single yardstick.

To have a fair compensation system, both you and the manager have to really understand the economics of the business. In some businesses, the amount of capital employed is all-important. In some businesses, the amount of capital employed doesn't mean anything.

So we have certain businesses where we have charges for capital and all of that, and where we have other businesses where that would just be an exercise to go through, and it wouldn't really change any results, anyway.

We have a great preference for making them simple. I mean, we concentrate on the variables that count to us, and then we try to put that against the backdrop of the competitive nature, or the economic — the true economics — of the business they're in, and really reward where they're adding value, even if that value is from a very low base in a lousy business. And we make it — the base — very high if they're in a very easy business.

And it hasn't been a problem. But I would say it would've been an enormous problem if we'd brought in some compensation consultants, because they would have wanted something that would spread across the whole group, and it would have had all kinds of variables.

And they particularly would've wanted something that would've to come in every year and redo in some way, so that they would have a continuing stream of income.

You know, if I knew what kind of a business you were looking at it, it's easier to talk about what kind of a system to have.

If you had a group of television stations, just to pick an example — let's say they were network television stations, all of a reasonable size.

You know, you would probably figure that a chimpanzee could run the place, and have 35 percent pretax margins. And you might want to pay for performance above some number like that.

But there's — it's silly to have something that starts at 10 percent or 15 percent, when you do that. And a lousy manager will always suggest an arrangement like that.

Charlie and I have seen all kinds of compensation arrangements where, basically, you get paid for showing up. But they try to make it look, by constructing some mathematics around it, like, you really had to achieve something.

But in the end, if you get a great manager, you want to pay him very well.

You know, we've got great managers, for example, at a place like MidAmerican. And somebody mentioned that there's a big carrot out there for them if they achieve the results that we've set out. And that'll be a check I'll be very happy to write.

Charlie?

CHARLIE MUNGER: Yeah, if you want to read one book that will demonstrate really shrewd compensation systems in a whole chain of small businesses, read the autobiography of Les Schwab, who had a bunch of tire shops — has a bunch of tire shops — all over the Northwest.

And he made a huge fortune in one of the world's really difficult businesses by having shrewd systems. And he can tell you a lot better than we can.

WARREN BUFFETT: Yeah, and he worked that out himself. I mean, it's an interesting book, and, you know, selling tires, how do you make any money doing that? And —

CHARLIE MUNGER: Hundreds of millions selling tires.

WARREN BUFFETT: Yeah, yeah. It's a — and people like Sam Walton. I mean, the compensation system, I will guarantee you, at Walmart, or Charlie's involved in Costco, they're going to be rational because you had very rational people running them.

And they wanted to get the best — they wanted to attract good managers, and they wanted to get the best out of them. And they had no use in paying for mediocrity.

But that does require a knowledge of the business. I mean, you don't want to let — if you don't understand a business, you know, you're going to have a problem with both the manager and the consultant in terms of getting film-flamed on how you pay people.

21. Easier to find bargains among stocks than IPOs

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good day. My name is Martin Krawitz. I'm a shareholder from Sydney, Australia. (Applause)

And thank you so much for some of your wonderful hospitality here. We've had a chance to get on some of Omaha's 65 golf courses, and it's just great being in the second-best country in the world. (Laughter)

My question to you, sir, is regarding two IPOs. We had one of the authors about a book on yourself visit us in Sydney last year, and apparently you dislike IPOs.

My question is, there are some really poor businesses that try and get passed off, but there are some good ones. There's some government privatizations, or decentralizations, the demographics of baby boomers, and we have some friends wanted to exit some really good businesses.

Could we as investors, and Berkshire Hathaway, not apply some of your disciplines to look at investing in some of these?

And finally, would your answer be different in its applicability to Berkshire Hathaway as a company, as opposed to us as investors? Thank you, sir.

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Well, the first question, is it entirely possible that you could use our mental models to find good things to buy among IPOs, the answer is sure.

There are a zillion IPOs every year. And buried in those IPOs, I'm sure there are a few cinches that a really intelligent person could find and pounce on. So, welcome. On the —

But the average person buying IPOs is going to get creamed.

So if you're talented enough, why sure, that will work. The second question, I forget.

WARREN BUFFETT: About the government offering (inaudible).

CHARLIE MUNGER: About government spin-offs?

WARREN BUFFETT: Give him the spotlight again. There he is.

CHARLIE MUNGER: What was the second question?

AUDIENCE MEMBER: It was just would the attitude of Berkshire Hathaway be different if it was opposed to investors?

WARREN BUFFETT: Oh.

AUDIENCE MEMBER: Thank you.

CHARLIE MUNGER: Yeah, because the IPOs are normally small enough, so that they won't work for us, or they're high tech, where we couldn't understand them. And so, by and large, if Warren is looking at them, why, I don't know about it. (Laughter)

WARREN BUFFETT: Yeah, I mentioned earlier how you — an auction market, prevailing in the stock market, will offer up extraordinary bargains sometimes, because somebody will sell a half a percent, or one percent of a company at a price that may be a quarter of what it's worth, whereas in negotiated deals, you don't get that.

An IPO situation more closely approximates a negotiated deal. I mean, the seller decides when to come to market in most cases. And they don't pick a time necessarily that's good for you. So, it has —

I think it's way less likely that, in scanning a list of a hundred securities that are trading in the auction market, well, in the — a hundred IPOs, if you scan a hundred IPOs, you're going to come up with something cheaper than scanning a hundred companies that are already trading in the auction market.

It is more of a negotiated sale. And negotiated transactions are very hard to get bargains. If you take the houses in Omaha, you know, somebody that lives next door to somebody who sold their house for 80,000 or — dollars, and their house is more or less comparable, they're not going to sell it for 50.

It just doesn't happen. People are — it's too important an asset, and they're cognizant of what it brings — what is being brought for similar properties. That's what happens in negotiated sales.

Now if, on the other hand, there were some — a whole bunch of entities that owned one percent of each house in Omaha, and you had an auction market on those one percentage points, they might sell at damn near anything. And occasionally, they sell at crazy prices.

So you're way — in my view — you're way more likely to get incredible bargains in the — in an auction market. It's just the nature of things.

And the IPO is closer — sometimes there will be IPOs in terrible markets, and they may come very cheap. But by and large, that is not when IPOs come. They come when the seller thinks that the market is ready for them.

And they come with an informed seller thinking it's a pretty good time to go public. And, you know, you'll make better buys, in my view, in an auction market.

22. Buffett and Munger don't shop at Whole Foods

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Good afternoon Mr. Buffett, Mr. Munger. My name is Mark Stender (PH) from San Francisco.

My question involves, if you live in California, which I understand you do some time of the year, it's almost mandatory that you shop at Whole Foods Markets.

They sell a lot of organic foods there. And I was wondering if anyone ever tried to feed you organic food, or organic food stock?

WARREN BUFFETT: I've never been near the place, but — (laughter) — Charlie, who I've never thought of as a health nut, but he may have some comment to make on this, being a Californian.

CHARLIE MUNGER: No, my idea of a good place to shop is Costco. (Laughter)

Costco has these heavily marbled filet steaks in the — (laughter) — finest grade. And the idea of eating a little whole grain whatever and washing it down with some carrot juice has just never appealed to me. (Laughter)

WARREN BUFFETT: We don't have a lot of arguments between the two of us about where to eat. (Laughter)

23. American business "has never let investors down"

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Hello, thank you. I'm Sherman Silber from St. Louis. I'm a fertility doctor in St. Louis. We kind of view ourselves as the Berkshire Hathaway of infertility treatment.

We don't know anything, really, about business. We're doctors and scientists.

And so, first I'd just like to say, I really appreciate the people that you have on your board, and would like to keep it that way. Because we do know a lot about character, and I'm happy to have our savings safe with you and the people of character that represent the company. (Applause)

I just had an opportunity a couple of weeks ago, I was talking to one of the former managers of the Fidelity Magellan Fund, managed huge amounts of money, and he never really met you. And I was saying, I may have a chance to ask Warren Buffett and Charlie Munger a question. What would that question be? I wanted to have some idea of something intelligent I could ask business-wise.

And he thought if he had the opportunity to talk to you, the best thing is to give you what would sound like a softball question, because you could maybe bring more profoundness to this than we hear, usually. What —

In view of the Iraq war, consumer debt that's increasing, declining job growth, declining pay in the jobs that are growing, prospects of increased interest rates, he has this view that the next five to 10 years are going to be very difficult.

What would your view be about this — the investment future — for the next five to 10 years, in view of all these negative factors going on?

CHARLIE MUNGER: That's too soft for me. I think Warren should take that. (Laughter)

WARREN BUFFETT: Well, I would say that at any given point in history, including when stocks were their cheapest, you could find an equally impressive number of negative factors.

I mean, you can — you could've sat down in 1974 when stocks were screaming bargains, and you could've written down all kinds of things that would've caused you to say, you know, the future is just going to be terrible.

And similarly, at the top, you know, or anytime, you can write down a large list of things that would be quite on the bullish side.

We don't pay — we really don't pay any attention to that sort of thing. I mean, we have —

You might say that our underlying premise — and I think it's a pretty sound underlying premise — is that this country will do very well, and in particularly, it will do well for business. Business has done very well.

You know, the Dow went from 66 to 10,000-plus in the hundred years of the 20th century. And we had two world wars, and nuclear bombs, and flu epidemics, and you name it, Cold War.

There's always — there are always — there's always problems in the future, there are always opportunities in the future. And in this country the opportunities have won out over the problems over time.

And I think they will continue to do so, absent weapons of mass destruction, which is another question. And business won't make much difference if anything really drastic happens along that line. So we don't — I don't —

I can't remember any discussions Charlie and I have had, ever, going back to 1959, that where we would've come to the conclusion at the end of them that we would've passed on a great business opportunity — a business to buy — because of external conditions.

Nor did we ever buy anything that we thought was mediocre simply because we thought the world was going to be wonderful. The —

It won't be the American economy, in my view, that does in investors over a five, or 10, or 20-year period. It will be the investors themselves.

If you look at the record of the 20th century, you'd say how can anybody have missed, you know, in owning equities during that time? And yet, you know, we had all kinds of people wiped out, you know, in the '29-'32 period. We had all kinds of things that were bad.

But if you had just owned stocks right straight through, didn't leverage them, you know, you would — you'd have gotten a perfectly decent return.

So we are unaffected, in essence, by the variables you mentioned. Just show us a good business tomorrow, and we'll jump at the hook.

Charlie?

CHARLIE MUNGER: Yeah, I think, but it's also true that both of us have said at various times over the last three years that we wouldn't be at all surprised if professionally invested money in America had a pretty modest result over a fairly extended period in the future, compared to the very dramatically high returns that it had achieved up to about three years ago.

And so far that's been proved out to be pretty much right.

WARREN BUFFETT: Yeah, our —

CHARLIE MUNGER: Certain stretches are easier than other stretches.

WARREN BUFFETT: Yeah, our expectations were more modest than most people's a few years ago. We didn't say the world was coming to an end or anything. We just said that people have gone crazy in certain sectors.

And that anybody that thought that you could, you know, sit at home and day trade, and make double-digit returns over time, or do anything, or that you were entitled to that, you know, by just sticking a little money in your 401(k) or something, was really living in a fool's paradise.

But that was never accompanied by any predictions of disaster for the American economy as a whole, or for American business as a whole. It's —

People get crazy notions from time to time in financial markets. I commented on this earlier, but they just believe things that there's — it's hard to understand how they can believe.

Now, to some extent they get sold that by other people. But American business, really, has never let investors down as a group, but investors have done themselves in quite frequently.

24. "Demented" derivatives aren't like insurance

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Sam Kidston, from Cambridge, Massachusetts.

I'd like you to ask to discuss the similars and differences between what you do in your reinsurance operations, and what Gen Re did in its securities division, as it would seem that reinsurance is often a form of weather derivative.

I would also like to ask you, why you are so comfortable writing what appears to be one type of derivative, and so uncomfortable writing another? Thank you.

WARREN BUFFETT: Yeah, the derivatives contracts that Gen Re wrote in Gen Re Securities, I would say bore very little relation to the insurance businesses we see.

I mean, we are insuring against events that people either can't or aren't willing to take on the risk themselves.

In the derivatives business, a lot of that was speculative activity of one sort or another. The more complex the arrangements were, the easier it was to claim that large profits were being made, when maybe large losses really awaited you over time.

They were created transactions without much economic necessity. In a great many cases, they were just facilitating speculation.

Insurance deals with taking on risks that people incur in their business or personal life, that they don't want to bear themselves, or that they're unable to bear themselves. There was very little connection between the business. I think that in going into the business, they dreamt up a lot of reasons for it.

You know, they said they're both in the risk business, and their clients were going to demand it and everything.

But when people want to go into a business, they always dream up reasons. In our view, it made no sense whatsoever. And I really see very little connection between them.

Do you, Charlie?

CHARLIE MUNGER: They're radically different. The derivatives business is chock full of clauses saying that if one party's credit gets downgraded by a rating agency, they have to start posting collateral. And that's just like a margin account.

And when you sign pieces of paper like that, you can go absolutely broke, into default and catastrophe, and having other people liquidating your positions under distress conditions, et cetera, et cetera. So there's a lot of irresponsible mechanics.

In attempting to protect themselves, they've introduced this enormous instability into the system, through all these clauses about collateral posting. And nobody seems to recognize what a disaster of a system they've created in an attempt to make each party feel safer.

It's a demented system. And you don't get properly paid in most cases for playing the game. And therefore, we're not in it.

WARREN BUFFETT: Absent the ability to raise new capital at the time, and who knows whether that would've been — they'd been able to or not — Gen Re, which had been rated triple-A — it still is because Berkshire's involved — but it had been rated triple-A — could well have run into really terrible financial difficulty post-September 11th, particularly if they'd fully recognized the liabilities that they'd already incurred, but not fully recognized, at that time.

Because their capital would've shrunk, they would've had way more in equities, which would have shrunk further. And who knows how far, you know, at the time, how far it would have gone?

Plus they would have had, in my view, they would have been downgraded quite significantly, and that might well have triggered things in their derivatives activities, which would have required coming up with loads of cash.

It was not built to last. And it is now built to last. But I would say that that threat exists with other financial institutions as well.

But I think many of the CEOs — or some of them anyway, I should say — don't really fully comprehend that.

When you get margin calls for huge amounts of money, you know, it only has to be one day when you can't meet it. That almost happened.

If you go back to October of 1987, there was a large wire transfer that didn't make it to the — for a while — it didn't make it to the clearing house at the — in Chicago. And that came close to halting the whole system at the time, and we were very close to closing the exchange.

And a lot of things would have unraveled. The money finally showed up. But it's dangerous to have a system where people are depending on billions of dollars coming in from other people.

Well, we had that on Salomon, on that Sunday in 1991.

If Salomon had gone bankrupt, the next day you would have had people on the other side of 1.2 trillion of notional amount of — something like that — of derivatives, who would have had a contract with a party where they would have been dealing with a bankruptcy court.

You would have had all kinds of security settlements that wouldn't necessarily have settled. You would have all kinds of confusion.

And believe me, it would have been huge at that time, between what was going on in Japan, what was going on in the U.K., and what was going on in the United States, because the accounts were all intermingled.

As a matter of fact, Salomon was a — was banking — was running a bank in Germany where — which took on large amounts of deposits from individuals, and just loaned it all to Salomon.

So it would have had a receivable from a bankrupt company and owed money to I don't know how many German depositors. There are all kinds of things that would have come out at that time. And who knows what the effect would be on the system?

You don't need to put more and more of those kind of linkages and strains on an economic system that already is pretty damn leveraged.

Charlie, got any further thoughts? We love talking about disasters, so don't stop us. (Laughs)

25. Salomon and Robert Maxwell, "The Bouncing Czech"

CHARLIE MUNGER: It's simply amazing what goes in these seemingly rational places. Salomon was at least as disciplined, and honorable, and rational as the other leading investment banks.

And yet, toward the end of our pleasant period, Salomon was begging for new investment banking business from [Robert] Maxwell. And his nickname was "The Bouncing Czech." (Laughter)

Now, and of course it wasn't very much after that that he committed suicide after massive embezzlements of pension funds, and a huge collapse.

Now, you'd think if a guy's nickname was "The Bouncing Czech," you wouldn't be madly seeking his investment banking business. But all the leading investment banks were.

WARREN BUFFETT: Yeah, I'm fuzzy it on now, but actually the morning, or the day he was discovered to be bobbing around in the ocean, the —

I think at Salomon, we had transferred a bunch of money to somebody over in Germany or Switzerland, and we were supposed to get some more money back that afternoon.

This is basically correct — I may be a little bit off on the details — but the money that got sent, got sent. But the money was to be received, did not get received. And then we went over to England and tried to collect it from his sons, and we got stiff-armed in one way or another.

I mean, we got what we deserved, frankly, in a transaction like that. But to the investment banker involved, his earnings that year was — were going to be affected in a significant way by whether he wrote a ticket or two more with Maxwell. And, you know, in the end, that carried the day.

And it's very hard to control people when their income depends on bringing in dubious people into the door. They care enormously about it, and you've got this big system that doesn't quite pick up on it.

And Charlie's mentioned before, you know, one of the underwriting clients that came forth, that Salomon took on, that professed to be doing wonderful things with money, and it turned out to be a huge fraud.

Well, it's tough to stop. You've got dozens and dozens of people running around out there all thinking about how big their bonus is going to be at the end of the year. And, you know, they are not inclined to run morality checks on who they do business with.

CHARLIE MUNGER: That was a wonderful experience. Warren and I, and Lou Simpson are all directors of a company, and we are by far the biggest shareholder. And we all said we should not be doing business with this guy. This is a very dangerous transaction.

And they told us it had been approved by the underwriting committee. And of course that settled matters. And —

WARREN BUFFETT: This guy had a neon sign that sign that said "Crook" on him, as far as we were concerned.

CHARLIE MUNGER: And he was waving it vigorously, yeah. (Buffett laughs)

But it had been through the underwriting committee. They — the transaction closed, but not financially. I mean, they had the underwriting, but they hadn't had the financial closing.

WARREN BUFFETT: Yeah, they caught him on the way to the bank. (Laughs)

CHARLIE MUNGER: You're right, they pulled back just from the edge of the precipice, from this big, fraudulent — and of course they got egg all over their faces.

That phrase reminds me of one of the leading lawyers of yore, and he said, "Captain of my soul," he says, "Or captain of my fate," he says, "Hell, I don't even pull an oar."

I mean, here we are — (laughs) — with all three of us on the board, you know, the biggest shareholder, and we can't even stop one stupid little underwriting.

WARREN BUFFETT: He did go to jail, though, I think, didn't he?

CHARLIE MUNGER: Yes.

WARREN BUFFETT: He claimed, incidentally, to be a huge shareholder of Berkshire Hathaway. And had made all this money. And I went to the shareholder's list, and admittedly he could have it in a street name someplace.

But it was a big quantity, he claimed. Though we — I couldn't find any record in any place. But he did have some kind of a little from an accounting firm that —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — was backing him up. Didn't back him up all the way, though, it turned out. (Laughs)

26. Hedge funds are a fad with huge fees

WARREN BUFFETT: Number 11, please.

AUDIENCE MEMBER: Good afternoon, I'm Manuel Fernandez, from Mexico City, Mexico. And I want to thank you for your valuable lessons on how to be good partners, you — and for exporting some good ideas and principles to the world for free.

My simple question is, do you think it makes sense for individual investors to invest a part of their capital in hedge funds, or a fund of hedge funds, somewhat like the $600 million investment Berkshire made in Value Capital?

WARREN BUFFETT: Yeah, I would say that people that are now investing in hedge funds, in aggregate, are going to be disappointed.

You don't get smarter because you're running something called a hedge fund, or something called private equity, or something, you know, called anything — an LBO fund.

But what you do gain periodically is the ability to merchandise those things. I mean, there are fads in Wall Street, and Wall Street will sell what it can sell, just remember that. You know, that may be as good as what the fellow quoted up in the upper levels there.

And the hedge fund right now is in the midst of a fad. It's distinguished not by the ability to make more money. It's distinguished by the extraordinary amount of fees that are collected.

And believe me, if the world on $600 billion of money, is paying 2 percent fees, and a percentage of the profits, and the losers go out of existence, and the winners continue for a while, and take money off the table, it is not going to be a great experience, in aggregate, for investors.

Obviously, there are a few smart, honest people out there running funds, and they can — they will do quite well. But if you buy them across the board, in my view, you're going to get a bad result.

Charlie?

CHARLIE MUNGER: Yeah, why would you want to invest with a guy whose basic thought process runs something like this, "If a second layer of fees on top of a first layer of substantial fees is good for an investor, then a third layer of fees must be better yet?" (Laughter)

Why would you invest with somebody with a proposition like that?

WARREN BUFFETT: It — just the idea of taking two percent, you know, plus percentages on top of that, that reflects — you know, it may be what the traffic can bear, you know, Collis P. Huntington style, but that reflects an attitude toward people that we tend to regard as partners, investors — I just think it's a basically unfair type of arrangement.

And I don't like getting in — in general, I think it's a mistake to get in with people who propose unfair arrangements.

You know, in effect they're getting — probably getting four times standard fees to begin with. And then on top of that, they say we want part of the action. And I would guess in many of those cases, that they don't have all of their own money in the fund themselves. Maybe they have a substantial sum outside.

Charlie and I both run — ran — partnerships in the '60s, and '50s with me, and into the '70s with him, that would generally be classified as hedge funds. They had the compensation arrangement somewhat similar, although not like they are now. And we did some —

They had some similarities, but I don't think we had quite the attitude toward the people who were trying to — that were asking to join us — that the present managers have. It's —

As Charlie said, the fund-to-funds type stuff, I mean, it's really sort of unbelievable just piling on layer after layer on costs. It doesn't make the companies that are underlying these stocks they buy any better. I mean, it —

And believe me, people don't become a genius just because you walk into some office, and it says "hedge funds" on the door. I mean they are — what they may be very good at is marketing. In fact, if they're good at marketing, they don't have to be good at anything else.

27. Basic principles and "uncommon sense"

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: My name's Arturo Brulenborg (PH). I'm from Washington, D.C. I'll be graduating from Harvard College in June and beginning a career in value investing, so I sure hope we're all right in thinking that this century will be just as good as the last for value investors.

You've been doing this since you were my age, if not younger. So I'm wondering what habit, or habits have contributed most to your ability to continue learning and improving your investment decisions in a changing business and financial environment?

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

But I know more about businesses than I knew 20 years ago, or 40 years ago. I haven't really changed the principles.

The last change — the basic principles are still Ben Graham. They were affected in a significant way by Charlie and Phil Fisher, in terms of looking at the better businesses. But they — but I didn't leave any of — I didn't leave Graham behind on that.

And I really haven't learned any new fundamental principles. But I may have learned a little bit more about how business operates over time.

And there's really nothing — I mean, you ought to get an investment framework that comes straight from, in my view, from "The Intelligent Investor," and from Phil Fisher, more from "The Intelligent Investor," actually.

And then I think you ought to learn everything you can about industries and businesses that — where you think you have the ability to get your mind around them if you work at them. And with that arsenal, you'll do very well, and if you've got the temperament for the business.

Charlie?

CHARLIE MUNGER: Yeah, well, of course I've watched Warren all these decades, and he's learned a hell of a lot, even the last 20 or 30 years. So it's a game of continuing to learn. And he can denigrate this little frou-frou that enables him to pick the biggest oil company in China, or this or that.

But those basic principles alone, that he knew a long time ago, wouldn't have given him the ability to make the recent investment decisions as well as he's made them. It's a life-long game, and it you don't keep learning, other people will pass you by.

WARREN BUFFETT: I would say temperament, though, still is the most important, wouldn't you, Charlie?

CHARLIE MUNGER: Yes, of course.

WARREN BUFFETT: Yeah, yeah.

CHARLIE MUNGER: But temperament alone won't do it.

WARREN BUFFETT: No, temperament alone won't do it.

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

WARREN BUFFETT: But you don't have to be blindingly, and have any blinding insights, or have a high IQ to look at a PetroChina for example, and —

CHARLIE MUNGER: No.

WARREN BUFFETT: You know, it, I mean, it's a — when you get, you know, a company that is doing 2 1/2 million barrels a day, that's 3 1/2 percent of the — or 3 percent — of the world's oil production.

You know, and they're selling based on U.S. prices using WTI — you know, as West Texas Intermediate — as a base price, and where they have a significant part of the marketing and refining in a country, the tax rate's 30 percent.

They say they're going to pay out 45 percent to you in dividends. Don't have unusual amounts of leverage.

If you're buying something like that at well under half what — or maybe a third — of what comparable oil companies are selling for, that's not high-level stuff.

I mean, you have to read some — you have to be willing to read the reports. But I enjoy doing that. But you wouldn't say that requires any high-level insights or anything, Charlie?

CHARLIE MUNGER: Well, when you were buying that block of stock, nobody else to speak of was buying. So —

WARREN BUFFETT: Thank heavens.

CHARLIE MUNGER: The insights can't have been all that common.

No, I think that takes a certain amount of what an old Omaha friend used to call "uncommon sense." He used to say, "There is no common sense. When people say common sense, they mean uncommon sense."

Part of it, I think, is being able to tune out folly as distinguished from recognizing wisdom. And if you just got whole categories of things you just bat away, so your brain isn't cluttered with them, then you're better able to pick up a few sensible things to do.

WARREN BUFFETT: Yeah, we don't consider many stupid things. You know, we get rid of them fast.

And in fact, people get irritated with us, because they'll call us, and when they're in the middle of the first sentence, we'll just tell them "forget it." You know, and we don't — we can see it coming.

And, you know, that's the way, actually, the mind works. There was a great article in The New Yorker magazine 30 years ago or so — little more than that. It was when the Fischer-Spassky chess matches were going on. And it got into this speculation of would the humans be able to take on computers in chess.

And, you know, here were these computers doing hundreds of thousands of calculations a second. And they said, "How can the human mind, when all you're really looking at is the future, you know, the results from various moves in the future, how can a human mind deal with a computer that's thinking it at speeds that are unbelievable?"

And of course, they examined the subject some. And a mind, like — well, in fact, all minds, but some much better than others — but a Fischer or Spassky, essentially, was eliminating about 99.99 percent of the possibilities without even thinking about it.

So it wasn't that they could outthink the computer in terms of speed, but they had this ability in what you might call grouping, or exclusion, where, essentially, they just got right down to the few possibilities out of the zillions of possibilities that really had any chance of success.

And getting rid of the nonsense, I mean, just figuring that, you know, people start calling you and say, "I've got this great, wonderful idea." Don't spend 10 minutes, you know, once you know in the first sentence that it isn't a great, wonderful idea.

Don't be polite, go through the whole process. And Charlie and I pretty good at that. We can hang up very fast, right? (Laughter)

CHARLIE MUNGER: Well, there you have it. All you've got to do is go at it in the way that Vasily Smyslov did when he was the world champion, and — of chess — and just do the same thing in investments. (Laughter)

28. Estimating intrinsic value

WARREN BUFFETT: OK, microphone 1. (Laughs)

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. My name is Richard Azar. I'm from Trinidad in the West Indies.

You guys have been very generous with your intellect over the years. It's been a huge help to me in my personal and financial life.

I wondered if it was appropriate for me to describe the methodology in which I'm trying to determine the range of Berkshire's intrinsic value, and if you can guide me on if my methodology is flawed, or is reasonably accurate.

WARREN BUFFETT: If it doesn't take too long, we'll be glad to, although I think I know the answer already. (Laughs)

AUDIENCE MEMBER: OK. We ended 2003 with about 5.422 billion of operating earnings. I estimated our look-through earnings to be approximately 915 million. So in total, that was about 6.337 billion of estimated look-through earnings.

I knew that we spent a billion-two on CAPEX, and our net depreciation on tangible assets was 829 million. So, there was a difference there of 173 million. And we spent more on CAPEX over the appreciation, over the last few years.

But in extrapolating out 20 years, I thought I might be kidding myself to ascertaining the differences between CAPEX and depreciation. And I'm using look-through earnings as a rough proxy for distributable earnings.

And I've assumed that Berkshire can grow its look-through earnings at 15 percent per annum, from years one to five, and at 10 percent per annum, from years six to 20. And the business will stop growing after year 20, resulting in a 7 percent coupon from year 21 onwards.

I discounted the cumulative flows in years one to 20 by 7 percent, and I discounted the terminal value by 7 percent. I added the two together, to get what I thought was the intrinsic value of Berkshire's cash stream.

I knocked off 103 billion of liabilities and minority interests. I divided by 1,537,000 shares, to arrive at what I thought was a conservative calculation of the range of Berkshire's intrinsic value.

Am I off the mark, or is that the sort of methodology you might use yourself?

WARREN BUFFETT: Well — (Laughter and applause) — well, you've done your homework. (Laughter)

The line of thinking is correct, it just depends on what variables you plug in. And we might have different ideas on variables, and neither one of us knows.

But the approach, in general, the approach of trying to figure out distributable cash over a period of time. The business today is worth, the present value at some number — you're using 7 percent, but the question of what number to use —

But it's worth the present value of all the cash it can distribute between now and Judgment Day. And if cash can be retained, and it's at a rate higher — it produces — at a rate higher than your discount rate, obviously, you'll get some benefit from that retention.

But, you know, I would say that your assumptions about CAPEX, and related to depreciation, I would expect CAPEX to be, on average, a little more than depreciation unless we run into highly inflationary times.

But of course, we have to keep buying businesses, and using the capital in the business that we retain. If we retain those earnings, we have to use that to buy more businesses. And then the question is, what kind of returns can we expect on those?

I don't quarrel with the approach you're using, but, you know, everybody has to do their own equation and plug in some numbers.

And I think we might settle for lower numbers on earnings gains than you postulated because we're very large, and it's — it gets harder all the time to deploy the kind of funds that keep flowing into Omaha.

Charlie?

CHARLIE MUNGER: Yeah, and you shouldn't necessarily get overly excited about last year, as Warren said, that was a very unusual year when everything worked together pretty darn well.

WARREN BUFFETT: Except interest rates on —

CHARLIE MUNGER: Yeah, well, but a lot worked together very well.

The interesting thing about Berkshire's present valuation is how much cash, and cash equivalents it has to do something.

And that is a very interesting question. How well are we going to do with this massive amount of investable cash and cash equivalents?

WARREN BUFFETT: Yeah, we should be out working now. I mean — (laughter) — that is the test.

I mean, we've got a bunch of good businesses. We've got a lot of money that we'd like to use to buy more good businesses. We may get lucky and deploy that quite rapidly. We may wait a long time.

Cash may pile up faster than we can use it, in which case we'll have to rethink the whole game.

But our hope is — and so far we feel OK about what's happened in that — our hope is that we can deploy the money that flows in at — in businesses that come close to being as good as the ones that we've bought over the years.

29. Timing of Berkshire earning reports

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Hi, Mr. Buffett, Mr. Munger, Whitney Tilson, a shareholder from New York City.

It's past three o'clock, and we've heard almost nothing about how these great businesses are doing right now, or at least in the first quarter.

And I recall at last year's annual meeting, you took the fairly unusual step, at least from my recollection, of putting up slides and actually giving us a preview of how phenomenally the businesses were doing.

And I can imagine that if you had the wind to your back a year ago, the situations in the first quarter of this year, you must really, really have the wind at your back. And I was wondering if you can share with us what you can?

WARREN BUFFETT: Well, we can't give you the speed of the wind.

The — we're going to have the 10-Q out when, Marc? Well, it's going to be out in a few days.

And if we throw out any numbers now, or make any commentary, we'd have to put that up on the website, and perhaps even try to cover the nuances in my voice. So I think you'll just have to wait a few days, and they'll go up, the figures will go up, at that time.

And if there are any surprises, they will be surprises then, and everybody will get them at the same time.

Incidentally, we're going to have a little more trouble in the next year or two, because the —

We like to publish everything — all the figures — or anything important if we can do it — we like to do that on Friday night after the close, or Saturday morning, so that everybody has an opportunity to look at them, and have a maximum amount of time to digest them before trading begins.

And the SEC is shortening up reporting times so that we're going to be scrambling just to meet whatever day of the month it is that recording requirements are met. And so we may not —

We won't have the luxury — although we'll try to do it when we can — we won't have the luxury of picking the Saturday before the due date, and targeting that as our release date.

You know, when we had 45 days, or what was it, yeah, 45 days to report, we could pick the Saturday before the 45 days.

If that gets down to 30 days, you know, if the 30th day is on a Tuesday, we're going to be hard put probably to get it done by that Tuesday. So we'll obviously put it out after the close, so people have between four o'clock and the next morning to digest it.

But we won't be able to follow the procedure that we've followed to date, which we regard as the best procedure of all, giving people close to two days to digest whatever is in the figures.

But I can't help you, Whitney, on how the first quarter looks. And Charlie, I don't think you'll want to add anything on that, will you? (Laughs)

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

WARREN BUFFETT: OK, number 3.

AUDIENCE MEMBER: Hello, Mr. Buffett, and Mr. Munger. My name is Justin Fong. I am 14 years old, from California. This is my fourth consecutive meeting attendance.

I read in a book that you prefer talking to young people about life and financial concepts because we still have time to implement them. Can you please share some of the concepts with us? Thank you.

WARREN BUFFETT: I didn't catch the last part.

CHARLIE MUNGER: I didn't. It's something about sharing concepts. You want to repeat it?

AUDIENCE MEMBER: Can you please share the life and financial concepts that you prefer talking to young people about?

CHARLIE MUNGER: Share — he wants to know your life concepts, and financial concepts, that are useful to young people.

WARREN BUFFETT: (Laughs) — well, that's a fairly broad question. But I think the financial concepts, you know, we've obviously spelled out in the reports. Charlie's probably better on the life concepts than I am.

It is true, that I do believe in spending the time that I spend giving talks, or answering questions, doing it with young people. I do, I'm sure, well over a dozen a year.

And I just think that, obviously, young people are more receptive to change, or to actually at even forming habits that are going to be useful in life.

And I think that people underestimate — until they get older — they underestimate just how important habits are, and how difficult they are to change when you're 45 or 50, and how important it is that you form the right ones when you're young.

But Charlie, what do you have to say on that?

CHARLIE MUNGER: Well, all the trite stuff is what works. I mean, you avoid doing the really dumb things, like, racing moving trains to the crossing — (laughter) — experimenting with cocaine — (laughter) — risking getting AIDS or other unfortunate ailments.

There are just a lot of standard things that take people down. And you just give those a wide berth.

And then you want to develop a good character, and good mental habits, and you want to learn from your mistakes, every single one, as you go along. It's pretty obvious, isn't it? (Laughter)

WARREN BUFFETT: Yeah, we would say even though we issue lots of credit cards and everything, we'd say, probably, if I had one piece of advice to give to young people, you know, across the board, it would be just to don't get in debt. It —

The game plays a lot easier if you're a little bit ahead of the game than if you're behind the game. And Ben Franklin said that long ago in better terms, which Charlie can recite.

But there's a real difference. I get letters every day from people that are in all kinds of financial trouble. And often it's health related, which is tragic. But very often it's — it relates to debt. I mean, they get behind the game, and they're never going to catch up.

And often — it may surprise you — but often, I write these people — they're very decent people, they've just made mistakes — and I just tell them the best course is bankruptcy.

I mean, they are not going to catch up. And they should start all over again, and they should never look at a credit card the rest of their life.

And — but it would have been better if they'd gotten that advice a little earlier. But it's very tempting to spend more than you earn. I mean, I — you know, it's very understandable. But it's not a good idea.

CHARLIE MUNGER: And of course you particularly want to avoid evil, or seriously irrational people, particularly if they are attractive members of the opposite sex. That can — (Laughter)

WARREN BUFFETT: Charlie knows more about this —

CHARLIE MUNGER: It can lead to a lot of trouble.

WARREN BUFFETT: The expert. The — yeah, the — you know —

It's better to hang out with people better than you. I found that very easy to do over the years. (Laughs)

But if you're picking associates, pick out those whose behavior is somewhat better than yours, and you'll drift in that direction.

And similarly if you hang out with a bad bunch, you're very likely to find your own behavior worse over time.

But all — like Charlie says, the trite advice which Ben Franklin was handing out a few hundred years ago, really works.

You know, just — we've said it, but look at the people you like to associate with. You know, what qualities do they have that you can have if you want to?

Look at the people that you can't stand to be around. What qualities do you have that they have? Can you get rid of them? You can do all of that a young age. It gets harder as you go along. It's not very complicated.

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

WARREN BUFFETT: And as advice a little more applicable to me and Charlie, I was reading about a woman that was 103, and they said, "What do you like about being 103?" And she says, "No peer pressure." (Laughter)

31. Buffett: Major commodity markets aren't rigged

WARREN BUFFETT: We'll go to number 4.

AUDIENCE MEMBER: Good afternoon. My name is Mike McGowan. I'm from Pasadena, California.

Everything you just said seems to apply to precious metals, specifically silver —

WARREN BUFFETT: Applies to what? I'm sorry I missed that.

AUDIENCE MEMBER: Precious metals.

WARREN BUFFETT: Oh, sure.

AUDIENCE MEMBER: Specifically, silver. As I recall, Berkshire Hathaway bought 129 1/2 million ounces of silver. And at the time, you said supply/demand fundamentals were good, you saw inflation kicking back, and lots of other reasons. I'm assuming you still own at least 90 million ounces of that.

The problem would be the pricing mechanism. Apparently the COMEX, or at least certain of the managers of the silver price on the COMEX, are in debt. The New York banks and financial institutions are short 400-plus million ounces. And it doesn't look as if they really want the price to go anywhere.

So given that Berkshire has all of this silver, do you see the price of silver actually trading in a free market at some point, or would you look at shares instead of the physical metal?

And otherwise, we're kind of at the point, I guess, where John Maynard Keynes said, "The market can remain irrational a lot longer than we can remain solvent."

WARREN BUFFETT: The — we have no comment at all to make on our present position in silver, if any, we may — we could own more, we could own the same, we could own less, we could own none. So — and we won't comment.

We commented one time because the Bank of England asked us to comment. And since it was the only time the Bank of England had ever talked to me, I felt quite flattered. (Laughter) The —

But I would say this. I would disagree very much with your thoughts that the market is in some way rigged, or something of the sort. The — there's —

I find that most of the people that write — or many of the people that write — on gold and silver tend to have various theories, some of which are conspiratorial, and there's always, you know, the selling forwards is doing this and that to the market, or that somebody's short.

You know, the answer is that there's plenty of silver above ground. Whether there's more or less than there was a few years ago, in terms of the supply-demand since then, I'm not a hundred percent sure. It's tough to figure out what goes on in China in a lot of things.

But I — there's nothing flawed, in my view, about the market for silver, or copper, or gold, or really any commodity that I can think of that trades in real quantity.

Charlie?

CHARLIE MUNGER: Yeah, I think it also should be pointed out that you're asking for the opinions of people who have not particularly distinguished themselves in this arena. (Laughter)

WARREN BUFFETT: He was pointing at me. (Laughter)

With good reason.

32. Buffett doesn't see Wells Fargo as a "big player" in derivatives

WARREN BUFFETT: We'll go to number 5.

AUDIENCE MEMBER: Good afternoon, Travis Keith (PH), from Dallas, Texas.

The OCC's quarterly report on bank derivatives shows that Wells Fargo has one of the largest derivatives portfolios of any U.S. bank.

In spite of your high-profile criticism of derivatives, Berkshire added to its position in Wells Fargo last year.

What about Wells Fargo's derivatives portfolio did you find less objectionable, and what disclosure did you examine in considering the risks of Wells Fargo's derivatives portfolio?

WARREN BUFFETT: I don't have their report here, but without looking at it, I would be willing to bet that JPMorgan Chase has a derivatives portfolio that's far, far greater than Wells.

I do not think of Wells, and I may be wrong, I do not think of Wells as being a big player.

Now, all the big banks have various derivative positions. But I do not — I don't think of Wells as being a big player in the derivative game. And I — you can't —

There is no perfect measurement of the size of a derivative position. I mean, you hear all these huge numbers thrown around, and they sound great, but they tend to exaggerate things in a huge — in a very dramatic way, in terms of trillions of this or that. But so —

You know, there can be — you could talk about a billion dollar notional amount of one kind of derivative, and it could have less danger in it than a $50 million position of — in some other type.

But I really don't think you'll find that Wells, particularly compared to a JPMorgan Chase, or a Citibank, or something of the sort, is a really big derivatives player.

And Charlie and I — at least I — and think Charlie'll agree — Wells, I think, is an extraordinarily well-managed bank.

I disagree with them violently on expensing of stock options. I mean, Dick Kovacevich, who runs that, and I would have entirely different opinion. He's written about it in the last couple of annual reports. And much as I — and I really admire the management. I think he's done a great job — but much as I admire the management, I voted the other — our Berkshire stock — the other way, and for expensing options. And I noticed that 57 percent of the stock at this meeting just the other day voted to expense options.

But even though I disagree with him on that particular accounting point, Wells has a — an absolutely terrific record. Dick is a terrific businessperson.

And I think in terms of taking risk, or handling the risk that he necessarily takes, I think that I would rank him very way up there in terms of bank managers.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that.

33. Leverage is the biggest danger to investors

WARREN BUFFETT: OK, we're going to take one more from number 6.

AUDIENCE MEMBER: Thank you very much, Mr. Munger and Mr. Buffett.

My question regards — well, I'm Michael Stofski (PH) from New York.

My question regards financial institutions and the potential of collapses.

And how is Berkshire protected, and how can the individual investor protect themselves against potential bank failures, stock brokerage failures, and things like that?

WARREN BUFFETT: Well, I think as a depositor with large banks, or as somebody that leaves their securities with large brokerage firms, I really don't think you to worry very much.

We have a "too big to fail" doctrine operating in this country, relative to what you might call the innocent parties in big financial institution failures. We don't have it in respect to the equity holders, nor should we have it.

But I would not — I don't worry about leaving my securities — my personal securities — or for that matter, Berkshire securities — with the large securities firms. I don't worry about my bank accounts at big banks, so —

CHARLIE MUNGER: But you're talking cash accounts?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah, cash accounts.

CHARLIE MUNGER: Not margin.

WARREN BUFFETT: Yeah. And the — but if you, in terms of owning the equities of companies like that, or in terms of the fallout, the big thing that will —

Really, the only way a smart person that's reasonably disciplined in how they look at investments can get in trouble is through leverage. I mean, if somebody else can pull the plug on you during the worst moment of some kind of general financial disaster, you go broke. And Charlie and I both have friends that have — where that's happened to them.

But absent leverage, and absent just kind of going crazy in terms of valuation on things, the world won't hurt you over time in securities.

And, I mean, you won't be subject to the financial cataclysms that — they don't need to do you in. If you have any more money during periods like that, you buy.

Berkshire, I think, is in an extraordinarily strong position in respect to any kind of a financial cataclysm. I think we would be definitely the last man standing, and then some.

And while we don't go around, you know, like undertakers looking for a plague or anything like that, you know, we would probably do very, very well in the end.

And that's happened a couple of times, actually, in the past, where we've had cash, and we've had courage when the world was panicking, and it's — we've done reasonably well during that period.

And we've never gotten hurt by what was happening in the world around us, at least in the last 30 or 40 years.

Charlie?

CHARLIE MUNGER: Well, I think that’s plainly right.

Morning Session - 2005 Meeting

1. Welcome

WARREN BUFFETT: Morning. I'm Warren, he's Charlie. We work together. We really don't have any choice because he can hear and I can see. (Laughter)

I want to first thank a few people. That cartoon was done by Andy Heyward who's done them now for a number of years. Andy writes them. He goes around the country and gets voices dubbed in. It's a labor of love. We don't pay him a dime. He comes up with the ideas every year. He's just a terrific guy.

He's unable to be here today because his daughter is having a Bat Mitzvah. But he's a very, very creative fellow.

He did something a few years ago called "Liberty's Kids." And if you have a child or a grandchild that wants to learn American history around the time of the Revolution, it's a magnificent series.

I think it's maybe as many as 40 or so half-hour segments and it's appeared on public broadcasting. It will be appearing again. You can get it and video form.

And, like I say, it's just a wonderful way to — I've watched a number of segments myself. It's a wonderful way to get American history.

The only flaw in it is that the part of Ben Franklin is handled by [former CBS News anchor] Walter Cronkite, and Charlie is thinking of suing. A little bit upsetting when Charlie is available.

Incidentally, we have "Poor Charlie's Almanack" next door in the exhibition hall. And it's an absolutely terrific book that Peter Kaufman has put together. And I think it's going to be a seller, a huge seller, long after most books have been forgotten.

It's Charlie at his best. And Charlie's at his best most of the time, but it's a real gem.

I want to thank Kelly Muchemore, who puts all of this together. I don't give it a thought. Kelly takes charge of this. She works with over 200 people from our various companies that come in and help make this a success. She does it flawlessly.

As I mentioned in the annual report, Kelly's getting married in October. So this is just a warmup. I mean, we're expecting a much bigger event than this come October.

2. Where daughter Suze draws the line

WARREN BUFFETT: I want to thank my daughter Suze, who does millions of things for me. She puts together that movie.

She does draw the line, occasionally.

A few years ago — we have a dinner at [Omaha steakhouse] Gorat's the day after the meeting. And we were in having — the whole family was there — having dinner. The place was packed and there was a big line that had formed outside.

Be sure not to go to Gorat's unless you have a reservation tomorrow, because they're sold out.

But the big line had formed and it started raining cats and dogs. And the waitress came to me. We were eating. Waitress said, "I got to tell you," she said. "It's raining like crazy outside and there's a long line and [Walt Disney CEO] Michael Eisner is standing out there getting soaked."

So I turn to Suze — and Michael and Jane [Eisner] are friends of my mine, good friends — and I said to Suze, "Why don't you go out there and help them out before they get drenched."

And she looked at me and said, "I waited in line at Disneyland." (Laughter)

That seems to strike a responsive chord.

3. Day's agenda

WARREN BUFFETT: We've flipped things this year. We're going to have the business session at about 3:15.

The plan is to have questions and answers. We have 12 microphones here.

We have an overflow room that's filled also, so we got another few thousand people there.

We'll break at noon and when we break at noon — and anybody that's been in the overflow room that wants to come in here, they'll be, I'm sure, plenty of seats in the afternoon session.

We will start the questioning as soon as I get through with a few preliminary remarks. We'll go to noon. We'll take a break, you'll have lunch.

Many people find that it helps the digestion to shop while you eat. And we have thoughtfully arranged a few things next door that you can participate in while you eat your lunch. Even if it doesn't help your digestion, it will help my digestion if you shop during that period.

4. Buffett on what he won't talk about

WARREN BUFFETT: During the question period, we can talk about anything that's on your mind. Just, there's 2 1/2 subjects that we can't talk about.

We can't talk about last year's Nebraska football season. We'll correct that next year. But that's off limits.

We can't talk about what we're buying and selling. I wish we were doing more of it, but we're doing a little, and I'll make reference to something on that a little later.

And finally, in connection with the investigation into the insurance industry practices that's taking place, there are broad aspects of it we can talk about.

I can't talk about anything that I or other people associated with Berkshire have disclosed to the investigators.

And there's a very simple reason for that: to protect the integrity of any investigation like this, they do not, the investigators, do not want one witness talking with other witnesses, because people could tailor their stories or do various things.

And so, witnesses are not supposed to talk to each other and, of course, if you talk — we don't do that.

And then beyond that, if we were to talk in a public forum, that could be a way of signaling people as to what you've said and then they could adapt accordingly.

So investigators, one thing they like to do, is they like to work fast if they can because they don't want people collaborating on stories .

And they — and to protect the integrity of the investigation, we won't get into anything that's specific to something that I or people associated with Berkshire may have told the authorities.

But there may be some broader questions that that we can talk about.

5. Preliminary Q1 earnings

WARREN BUFFETT: I can give you a little preliminary view of the first quarter with certain caveats attached. These figures — our 10-K — or 10-Q — will be filed in the end of next week.

And I caution you that, particularly in insurance underwriting, it's been a better quarter than — considerably better quarter — than I would normally anticipate.

One of the reasons for that is that our business actually does have some — the insurance business has some — seasonal aspect.

Now, it doesn't have a seasonal aspect, particularly, at GEICO or at National Indemnity primary business.

But when you get into writing catastrophe business, and we're a big writer of catastrophe business, the third quarter — the biggest risk we write in big cat area is hurricanes. And those are concentrated — they're actually concentrated in the month of September.

In this part of the world, 50 percent of the hurricanes, roughly, occur in September and about maybe 17 and-a-half percent in October and August, and the balance, maybe, in November and July.

But there's a concentration in the third quarter. So when we write an earthquake — I mean when we write a hurricane policy, for example — we may be required to bring the earnings in monthly on the premiums. But all of the risk really occurs — or a very great percentage of it — late in the third quarter, and we don't have any risk in the first quarter of hurricanes.

So we earn some premium during that quarter that really has no loss exposure. And then we get that in spades come September.

Even allowing for that we had an unusually good quarter. And I would still stick by the prediction I made in the annual report where I said that if we don't have any really mega catastrophes, I think we've got a decent chance of our float costing us zero or less this year, which means, in effect, we have 45 billion or so of free money.

In the first quarter, our insurance underwriting income — and all of these figures are pretax — our insurance underwriting income came to almost $500 million, which was about 200 million better than a year ago.

And GEICO had a very good quarter for growth. We added 245,000 policyholders, which is almost 4 percent, in one quarter to our base.

We were helped very much by this huge reception we're getting in New Jersey, because we weren't in there a year ago, so we're getting very good-sized gains there.

We're not getting 4 percent in a quarter from around the country, but the boost from New Jersey took us up to that.

And GEICO actually wrote at a 13 percent underwriting profit in the first quarter, which is considerably better than we expect over the full year. And we've reduced rates some places. And it's been an extraordinary period for auto insurers, generally.

But all of our companies in the insurance business did well in the first quarter.

Our investment income was up something over 100 million pretax.

Our finance business income was up, maybe, $50 million pretax. MidAmerican was about the same.

And all of our other businesses, combined, were up about — close to $50 million pretax, led by Johns Manville, had the biggest increase. That businesses is very strong, currently.

So if you take all of our businesses before investment gains, which I want to explain, if you take them all before investment gains, our pretax earnings were up 400 million or a little more.

Now, investment gains or losses: we don’t give a thought as to the timing of those. We take all investment actions based on what we think makes the most economic sense, and whether it results in a gain or a loss for quarter is just totally meaningless to us.

A further complicating factor, slightly complicating factor, is that certain unrealized investment gains or losses go through the income statement, whereas others don’t. That’s just the way the accounting rules are.

Our foreign exchange contracts are valued at market, really, every day, but you see it at quarter end.

And those foreign exchange contracts, which total about 21 billion now, a little more than 21 billion, had a mark-to-market loss of a little over 300 million in the first quarter.

And they bob up and down. I mean, sometimes they bob as much as 200 million or more in a single day.

And those mark-to-market quotations run through our profit and loss statement. Whereas if we own some Coca-Cola stock and it goes up or down, that does not run through our income statement. But with foreign exchange contracts, it does.

So there’s a $310 million mark- to-market — it shows as realized, it actually isn’t — investment loss on that.

And overall, the investment losses, including that 310, came to about 120. In other words, there was 190 million, or something like that, in other gains.

As I say, that means — at least to us — that means nothing.

And to underscore that point, if later in the year the Procter and Gamble-Gillette merger takes place, we are required under accounting rules, when we exchange our Gillette for Procter and Gamble stock, we are required under accounting rules to show that as a realized gain. Now that will show up as, probably, four-and-a-fraction billion dollars.

We haven’t realized any gain at that time, in my view. I mean, we’ve just swapped our Gillette stock for Procter and Gamble stock, which we expect to hold for a very long time.

So it's no different, in our view, than if we'd kept our Gillette stock. But the accounting rules will require that.

So if in the third quarter of this year the P&G-Gillette merger goes through, you will see this very large supposed capital gain recorded in our figures at that time.

And I want to assure you that it's meaningless and you should ignore that as having any significance, in terms of Berkshire's performance.

So, first quarter has gone by. We've got a good start on operating earnings this year. We won't earn at the rate of the first quarter throughout the year, in my view. I think it would be very unlikely, in terms of operating earnings. But the businesses are performing, generally, very well.

6. Insurance acquisition coming

WARREN BUFFETT: One other thing I should mention, and then we'll get on to the questions, that we can't announce the name, because it isn't quite complete in terms of the other party, but we will probably announce, very soon, an acquisition that is a little less — somewhat less — than a billion dollars, so it's a huge deal, in reference to Berkshire's size

But it is in the insurance field. I mean, we love the insurance business. It's been very good to us. We have some terrific managers in that field.

You'll see it in the first quarter figures, but you'll also see how we feel about the business by the fact that this acquisition, which I would say is almost certain to go through, will probably get announced in the next few weeks.

We're looking for bigger acquisitions. We would love to buy something that cost us 5 or $10 billion. Our check would clear, I assure you.

I think we ended the quarter with about 44 billion of cash, not counting the cash in the finance operations. So, at the moment, we've got more money than brains and hope to do something about that.

7. Q&A begins

WARREN BUFFETT: Now we're going to go around the hall here. We've got 12 microphones and — get oriented here — and we'll turn the spotlight on the microphone that is live.

People can line up to get their questions asked. I think we've got two microphones, also, in the overflow room.

And like I say, after lunch everybody should come in here because there's enough people that get so enthralled with shopping that they don't return. They'd rather shop than listen to me and Charlie, and we'll have plenty of seats for everybody in this main hall after lunch.

And so, with that, let's go to — have I forgotten anything, Charlie?

CHARLIE MUNGER: No.

WARREN BUFFETT: OK. (Laughter)

That may be the last you hear from him. You never can tell.

8. What Buffett looks for in managers

WARREN BUFFETT: We'll go to microphone number 1, please.

AUDIENCE MEMBER: Simon Denison-Smith from London.

You talk a lot about the importance of selecting terrific managers.

I'd just like to understand what your three most important criteria are for selecting them, and how quickly you can assess that.

WARREN BUFFETT: Yeah. I'll give you two different answers.

The most important factor, subject to this one caveat I'm going to give in a second, is a passion for their business.

We are frequently buying businesses from people who we wish to have continue manage than them and where we are, in effect, monetizing a lifetime of work for them.

I mean, they've built this business over the years. They're already rich but they may not be rich in the liquid sense. They may have all their money, or a good bit of it, tied up in the business, so they're monetizing it. They may be doing it for estate reasons or tax reasons or family reasons, whatever.

But we really want to buy from somebody who doesn't want to sell. And they certainly don't want to leave the business.

So we are looking for people that have a passion that extends beyond their paycheck every week or every month for their business.

Because if we hand somebody a hundred million or a billion dollars for their business, they have no financial need to work. They have to want to work. And we can't stand there with a whip. We don't have any contracts at Berkshire. They don't work, as far as I'm concerned.

So we hope that they love their business and then we do everything possible to avoid extinguishing, or in any way dampening, that love.

I tell students that what we're looking for when we hire somebody, beyond this passion, we're looking for intelligence. We're looking for energy. And we're looking for integrity.

And we tell them, if they don't have the last, the first two will kill you.

Because if you hire somebody without integrity, you really want them to be dumb and lazy, don't you? I mean, the last thing in the world you want is that they are smart energetic. So we look for those qualities.

But, we have generally — when we buy businesses, it's clear to us that those businesses are coming with managers with those qualities in them. Then we need to look into their eyes and say, do they love the money or do they love the business?

And if they love — there's nothing wrong with liking the money. But if — what it's really all about is that they built this business so they can sell out and cash their chips and go someplace else, we have a problem, because right now we only have 16 people at headquarters and we don't have anybody to go out and run those businesses.

So we — it's necessary that they have this passion and then it's necessary that we do nothing to, in effect, dampen that passion. Charlie?

CHARLIE MUNGER: Yeah. The interesting thing is how well it's worked over a great many decades and how few people copy it. (Laughter and applause)

9. Buffett on beer industry and its history

WARREN BUFFETT: Go to microphone 2, please.

AUDIENCE MEMBER: Good morning, Warren and Charlie. My name is Walter Chang and I'm from Houston, Texas.

Can you describe how you made your investment decision to invest in Anheuser-Busch and how you estimated its intrinsic value? How long did it take you to make this decision?

And is Budweiser inevitable, like Coca-Cola?

WARREN BUFFETT: I'm still drinking Coca-Cola.

The meeting might get a little exciting if I we were drinking Bud here. (Laughter)

We don’t get into much in the way of description of things we might be buying or selling, but the decision takes about two seconds.

But I bought 100 shares of Anheuser about — I haven’t looked it up — but I would say, maybe, 25 years ago when I bought 100 shares of a whole lot of other things .

And I do that so I can get the reports promptly and directly. You can get them to your brokerage firm, but I’ve found that it’s a little more reliable to put the stock in a direct name.

So I’ve been reading the reports for at least 25 years and I observe, just generally, consumer habits, and at a point — currently, the beer industry sales are very flat.

Wine and spirits have gained in that general category at the expense of beer. So if you look at the industry figures, they’re not going anywhere.

Miller’s has been rejuvenated to some degree. So Anheuser, which has had a string of earnings gains that have been quite substantial over the years and market share gains, is experiencing, as they’ve described — and they just had a conference call the other day — is experiencing very flat earnings, having to spend more money to maintain share, in some cases, having promotional pricing.

So they are going through a period that is certainly less fun for them than was the case a few years ago.

And it’s a fairly easy-to-understand product and consumer behavior is fairly easy to understand. It’s a very, very — exceptionally strong business.

In fact, what’s happened in the beer industry over the last 50 years has been fascinating to me and to Charlie because this is a brewing town that we grew up in, and Charlie knew the members of the Storz family, a number of them, well.

Storz had over 50 percent of the Omaha market in beer post-World War II and then basically disappeared as the national brands took over. So it’s an interesting phenomenon.

Beer business is not going to grow significantly in the U.S.

Worldwide, beer is popular in a great many places, and Anheuser will have a very strong position in it. But I would not expect the earnings to do much for some time, but that’s fine with us.

Charlie?

CHARLIE MUNGER: Yeah. At our scale of operation now, if we're ever going to buy into a terribly well-regarded company, we almost need a little patch of unpleasantness. (Laughter)

WARREN BUFFETT: That's been the best time to buy Berkshire, incidentally, too. I mean, we do —

What we're looking for is businesses with a durable competitive advantage. I don't think there's any question that Anheuser has a very, very strong consumer position. Now, as I said, Miller has been rejuvenated to some degree.

But the other thing about it is, of course, in beer you do not see the prevalence of private labels or generic products that you see in a great many consumer products that are being — that had strong positions over the years, that are being attacked . That's a small plus.

But beer consumption per capita is going no place. And there's nothing that will change that.

Interestingly enough, the average person in this climate drinks about 64 ounces of liquid a year. And I think it's roughly 27 percent of that will be carbonated soft drinks.

So almost — and, of course, of that Coca-Cola will be about — Coca-Cola products — will be 40-odd percent.

So, of the 64 ounces of liquid that Americans are drinking every day, you can figure something like 11 ounces of that, man, woman, and child, will be a Coca-Cola product.

Beer, as I remember — I could be wrong on this — but I think beer is about 10 percent of all liquids. So, one out of every 10 ounces that's consumed by Americans of any kind of liquid is, I believe, is beer.

Coffee, incidentally, despite what you read about — you know, the popularity of Starbucks, which is very real, of course, — but coffee has just gone down and down and down over the last 30 or 40 years.

Charlie, you have any thoughts about your consumption habits? That you can talk about? (Laughter)

CHARLIE MUNGER: Well, there are people here that may remember Metz beer.

In this country, we had more breweries — there were hundreds — and small places would have two or three brands. And this trend toward concentration into a few giants is, I think, permanent.

WARREN BUFFETT: Yes. Schlitz was number one, as I remember, after World War II, for a while. I think Anheuser was number four at that time.

There's an interesting book, if you're a beer enthusiast, it came out a few years — a few months — ago, maybe a little longer than that, by a Wall Street Journal reporter that sort of toured the country sampling beers. I don't know how it affected his writing. But it's a pretty good book, if you like reading about the history of beer.

10. Competition from hedge funds

WARREN BUFFETT: Let's go to number 3.

AUDIENCE MEMBER: Greetings from Bonn, Germany. I'm (inaudible). Thank you for another great year added to your track record of investing. And thank you again for allowing us to be partners at these favorable terms.

This year, I want to ask you another question about how you see Berkshire positioned versus others.

Last year, I asked you how you see the increased competition for buying companies through the rise of the private equity industry and how that affects Berkshire's ability to buy great businesses at fair prices, and you basically said that there are still enough business owners who would rather sell to Berkshire versus a private equity fund.

This year, I would like to hear your views on the hedge fund industry.

We see hedge funds going into all investment strategies. We know that you have spoken about the fees of the hedge fund industries, but I would like to hear from you how you see Berkshire positioned.

Are returns in strategies like merger arbitrage, like convertible bonds — are returns going down because of the increased competition? And are there other factors where Berkshire can be unique versus the hedge funds?

WARREN BUFFETT: Well, that's a great question. It's the $64 question.

There's no doubt about it that there is far more money looking at deals now than five years ago, and they're willing to pay out more for the good, but mundane, businesses that we've been successful at buying in the past.

And you mentioned the private equity firms and they're bigger than ever.

The hedge funds have gotten into the game, to some degree. And if someone is auctioning off a business today — this has changed just very slightly in the last four or five weeks because of some change in the junk bond market, but not in any significant degree — there were people lined up to bid on almost anything.

In fact, you have private equity firms selling their businesses to other private equity firms.

And there are a lot of companies that are being sold, that are being sold to someone who's buying them to resell in a fairly short period of time.

We can't compete in that field and that's, you know, that's a source of distress to us. But that's the way it is.

We will — it won't go on forever, in our view. We still occasionally, as this deal I mentioned to you, the party on the other side and we just — we made a deal that did not go through an auction process. And we see that occasionally, but we don't see it anything like we saw it four or five years ago.

So, in terms of the near-term outlook for Berkshire, in terms of doing what it's important that we do, do successfully, which is buy businesses and keep adding to this collection, we are not positioned favorably at all for that.

And we do find it extraordinary, both Charlie and I have over the decades, just how fast things can change.

There have been at least three times, maybe more, where it's looked to me in my own career, where it looked like there was so much money sloshing around that it would be impossible to do intelligent things with money.

And I actually terminated a partnership back at the end of 1969 because I felt that that the money was coming out, you know, of the woodwork. There were all kinds of people that wanted to use it and compete, and I just didn't feel we could do intelligent things.

Within four years, I saw the greatest opportunities that I've ever seen in my lifetime. And we've had several experiences like that.

You know, in 1998, when Long-Term Capital Management got in trouble in the fall of 1998 and other things were happening, you had incredible opportunities available in the investment world.

Now, people were just as smart then. They had all these people with 150 IQs running around, and they actually had money. But the world became paralyzed for a short period.

And you literally had so-called "on- the-run" Governments, which were the most recent issue, and "off-the-run" Governments, which were issued by the same government, the United States government, payable in dollars. You had a 30-basis point differential between the 30-year and the 29-and-a-half year.

Both bonds issued by the U.S. government, you know, one a half-year shorter. Both quite liquid, but the "on-the-run" being more liquid. And a 30-basis point differential in yield means about a three-point difference in price.

Well, you wouldn't believe that could happen in the United States of America in 1998, but it did happen.

And I think I have a slide here. Mark, if it — if we can put that up — that shows what high-yield bonds —the situation in those, just really less than three years ago.

In the fall of — yeah, there it is —I n the fall of 19 — in the fall of 2002, you had all these high IQ people in the financial world. You had lots of money.

And I don't know how easy it is to read those figures, but you'll see that a bunch of high-yield bonds — this actually is a table that involves a friend of mine, but we were doing pretty much the same thing.

And you can see that he was buying bonds at anywhere from a 25 percent to 60 or 70 percent yield basis, and within 12 or 14 months had sold these same bonds on a 6 percent yield basis.

You don't need to do that very many times in a lifetime.

But that was two-and-a-half years ago after all these people had graduated with MBAs, and studied modern finance theory, and had money coming out of their ears, and all had a desire to make money, and yet conditions like that could exist.

We bought about seven billion of junk bonds during that period, because it was a fairly short period.

But things do happen that change the landscape dramatically, I mean really dramatically, in financial markets from time to time.

But right now, we are positioned very badly in terms of buying businesses, and it's a big negative.

And your Berkshire stock will not do as well under these conditions as it would do if the conditions of five years ago or 20 years ago existed.

And I don't have any magic solution for that except just to tell you what the facts are.

Charlie?

CHARLIE MUNGER: Yeah. A lot of the buying by private equity funds in both real estate and stocks, and for companies, is fee-motivated.

In other words, the investment manager will rationalize any price paid because he likes the extra fees for managing the extra assets.

I have a friend that tried to buy warehouses with a lot of family money and he just stopped. Whatever he bid was always topped by some professional manager, managing other people's money on a fee basis.

So this is a very peculiar era where all these asset classes have been driven to very high valuations, by all historical standards.

Some investment operations are very ethical in this (inaubible).

I think Howard Marks is here today. He sent a lot of money back, and stopped soliciting money from his clients in certain activities where the opportunities went away.

That's the right way to behave, but it's not normal.

WARREN BUFFETT: Yeah, I don't think he'll mind — I didn't know Howard was here today — but those actually are Howard's figures for one of his funds.

And like I say, we were doing similar things. We didn't know it at the time but we found out we had some similar positions later on.

About five or six years ago, when the terms of these deals were somewhat different, I actually had a fellow call me, whose name most of you would recognize, and he started asking me questions about the reinsurance business because he was in — he said he was thinking about buying a given company, which got sold, and he didn't really know much about the business, but that unless he spent these x dollars, he was going to have to give it back to his investors in a few months because the term of the initial sign up period expired at that point, and any unexpended funds were to be returned.

And he was going to get 2 percent a year on those funds regardless of how they did. So he was looking at businesses that he didn't understand with the hope that he can place the money.

Charlie and I are at a disadvantage in buying businesses because we have almost all of our net worth in the downside as well as the upside.

You know, if we had a 2 percent fee and 20 percent of the profits and a goodbye kiss for the losses, you know, that's a different equation than exists at Berkshire.

We run it as if it's 100 percent our money, which it is close to 100 percent of our net worth.

And we will own the downside. And we don't get paid for spending the money, we get paid for making money.

And it's tough — competing right now is tough and likely to be relatively futile, although we have one or two things that could happen that could involve the expenditure of real money.

CHARLIE MUNGER: I don't think any of the businesses that have sold to us over the years, which are run by the kind of people we like being associated with, would have wanted to sell to a hedge fund.

So there exists a class of assets out there that doesn't want to deal with hedge funds or private equity funds.

Thank God. (Laughter)

WARREN BUFFETT: Yeah, we've seen no deal anybody else has made the last year that we wish we had made.

Now that was not the case 15 or 20 years ago when there used to be plenty of deals made with other people that we would have liked to have made if they'd come to us .

But I have seen nothing that — I've seen nothing that if it sold for 10 percent less than the advertised price that we would have had any interest in buying. So we are in a different world right now.

11. Buffett's early interest in stocks

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: I'm Dudley Shorter (PH) from Council Bluffs, Iowa.

When you were younger, what first sparked your interest in investing, and what advice would you give a younger person if they wanted to invest in the stock market? Thank you.

WARREN BUFFETT: Well, I'm not exactly — I got interested probably when I was, maybe, seven or thereabouts. I wasted my time before that. (Laughter)

It's a little like W.C. Fields. When he inherited some money, somebody asked him what he did with it and he said he spent half of it on whiskey and the rest he wasted. (Laughter)

So there I was, dawdling around. But I got — my dad [Howard H. Buffett] was in the business, so I would go down to his office, and I would see these interesting books, and I would read them and I would go down — he was on the fourth floor of what's now known as the Omaha Building at 17th and Farnam, and on the second floor was Harris Supplement Company, and they had a board, and I would go down there.

The market was open on Saturdays in those days, so I could — for two hours — so I could go down on Saturday, and I saw all these interesting things going across the tape.

And I just read a lot. I probably took every book in the Omaha Public Library, every book they had on investing — or the stock market — basically.

I was very interested in the New York Stock Exchange. I thought maybe I'd want to become a specialist when I grew up and maybe I still will.

But the — I took all the books out. I read them. And finally, when I was 11, I bought three shares of stock and I didn't know — I was fascinated by the subject.

My dad got elected to Congress, so now the library became even bigger, and I took all the books I could out of there on markets. And I used a chart and do all that sort of thing.

And then, finally, I read [Benjamin] Graham's book when I was at the University of Nebraska, "The Intelligent Investor," when I was 19, and that just changed my whole framework.

But the advice I would give is to read everything in sight.

And to start very young. It's a huge advantage in almost any field to start young.

If that's where your interest lies, and you start young, and you read a lot, you're going to you're going to do well.

I mean there are no secrets in this business that only the priesthood knows. I mean, you know, we do not go into temples and look at tablets that are only available to those who have passed earlier tests or anything.

It's all out there in black and white. It's a simple business.

It's not — it requires qualities of temperament way more than it requires qualities of intellect. I mean, if you've got more than 125 IQ, you can throw away the rest of the points or give them to your other members of the family or do something because you don't need it in investing.

But you do need a certain temperament that enables you to think for yourself. And then you have to develop a framework — and I developed it from reading Ben Graham, I didn't come up with it myself — very simple framework.

And then you have to look for opportunities that fit within that framework as you go through life, and you can't do something every day. You know, you can learn every day, but you can't act every day.

And I talked about reading the annual reports of Anheuser-Busch for 25 years, but I've read the reports of Coca-Cola and Gillette and all kinds of companies long before we invested in them.

And if you enjoy the game, you know, you'll find that like playing bridge or playing baseball or whatever, if you don't enjoy it you probably won't do well on it.

But I would advise you to start early. Read everything in sight. Look for the successful framework that's been successful for people, and there's nothing like Graham's, in my view, and you'll have a lot of fun and you'll probably make a lot of money.

Charlie?

CHARLIE MUNGER: Well, I'm at a little disadvantage here. Warren has made himself into kind of a dean of investors, starting as a boy, and he has a greater respect for the process than I do.

I have a good bit of [economist John Maynard] Keynes' attitude that money management is sort of a low calling, compared to being a surgeon or a lot of other things.

12. CEOs should know more about investing

CHARLIE MUNGER: I think the corporate types — the corporate managers — ought to study investing better because they'd be better managers.

And I think that everyone who thinks through the investment process learns more about how the world really works. And I think that's very worth having.

But I do not like as big a percentage of GDP as we now have going to money management and its attendant frictions.

And I don't like the percentage of the nation's brainpower that is now in all of these different forms of highly-compensated money management.

I don't think it's a good thing for the country, and I hate the fact that we've contributed to it by our own predilections.

WARREN BUFFETT: Charlie is only sitting up here next to me as part of his outreach program, actually. (Laughter)

Please don't take any pictures that you could blackmail him with, being associated with me.

Charlie made a very good point there about how managers would do better if they understood investments.

I find it absolutely fascinating, and I've seen this throughout my life, I've seen it close up.

I will have friends who are CEOs of companies and they'll have somebody else handle their money.

If you say to them, you know, should you buy Coca-Cola or Gillette or something like that, they'll say that's much too tough. I don't understand that sort of thing. What do I know about investing?

And then some investment banker walks in the next day with the idea they buy a $3 billion company, which is just buying a lot of shares of stock in one company, and they'll run through some little two-hour presentation and turn it over to a strategic planning group and think that they are then the ones that should make that decision as to whether to buy multibillion-dollar businesses when they really don't feel they're qualified to make $10,000 decisions with their own money.

And it's extraordinary what you see in corporate America and the acquisition activity.

It's a little like they say about making sausage and making laws, it's better unobserved.

Charlie, you have any further thoughts on that? You've seen a lot of it with me. (Laughs)

CHARLIE MUNGER: Well, I do think that the present era has no comparable precedent in the past history of capitalism.

I think we have a higher percentage of the attention of our intelligent classes into buying little pieces of paper and getting — trying to get rich doing it, and in promotional activities with big profit sharing fees.

I can recall no past era which had a similar concentration of this type of activity. Can you, Warren?

WARREN BUFFETT: No, but I think you would say, probably, too, that we've seen sort of baby versions of this, something subsequently happened, that —

CHARLIE MUNGER: Oh, yes. If you want to talk about what are the future implications, a lot that I see now kind of reminds me of Sodom and Gomorrah, and —

WARREN BUFFETT: We weren't there, incidentally. I mean — (Laughter)

CHARLIE MUNGER: No, but there's a published account. (Laughter)

And I think when you get as much sort of regrettable activity going on and sort of feeding on itself in frenzies of envy and imitation, that — it has happened in the past that there came bad consequences.

13. PetroChina investment

WARREN BUFFETT: On that cheery note, we'll move to number 5.

AUDIENCE MEMBER: Good morning. My name is Molly Fanner (PH). I'm 11-years-old and I'm from Long Island, New York.

I have two questions today and I have put them in the form of a poem.

Mr. Buffett, Mr. Munger, to get here we had to fly.

I came to hear your thoughts if PetroChina was at an all-time high.

My second regards a job that I know is just right for me.

To be a See's Candy taster, my sisters and I would work for free.

(Laughter)

WARREN BUFFETT: Well, if you come up front, I'll put you to work.

AUDIENCE MEMBER: Borsheims was for my mom.

And my father loves his stock.

I have a future tasting chocolate.

This weekend has really rocked.

Thank you very much.

And really, what is your view on PetroChina? (Laughter)

WARREN BUFFETT: If you come up at the break, Charlie and I will have taken all the pieces out of here that we like best, and you will get the rest. (Laughter)

Charlie, do you have anything to add to that?

CHARLIE MUNGER: She wants to know what you think about PetroChina. (Laughter)

WARREN BUFFETT: It's funny. I saw her out there in the shopping area and I knew that she had PetroChina on her mind. (Laughter)

We bought PetroChina a few years ago, again, after reading the annual report. And fortunately it was in English.

It was the first stock — Chinese stock — and really the last.

I mean, it won't necessarily be the last, but it's the only one that we've owned so far. We put about $400 million into it.

At the time, and still, it produces about 3 percent of the world's oil, which is a lot of oil. It produces, probably, 80 percent or so as much as Exxon Mobil will produce. And it's a huge company.

Last year it earned $12 billion. Now, if you look at the Fortune 500 list, my guess is you won't find more than about five companies in the United States that earn $12 billion or more. So it's a major company.

At the time we bought it, the total market value was 35 billion. So we bought it at about three times what it earned last year. It does not have unusual amounts of leverage.

It — in the annual report, they say something which very, very few companies do say, but which I think is actually fairly important. They say they will pay out about 45 percent of the amount they earn.

So, if you can buy it at three-times earnings, what turned out to be three times earnings, and you get 45 percent of 33 percent, you know, you're getting a 15 percent yield on your — cash yield — on your investment.

It's a very good annual report. Chinese government owns 90 percent of the company. We own 1.3 percent. If we vote with them, the two of us control the business. (Laughter)

It's a thought that hasn't occurred to them, but I'll keep pointing it out. (Laughter)

But it's, you know, it's a very major business and a very, very attractive — at what was a very attractive price.

Unfortunately, the government shares and our shares have the same economic interest but they are classified differently, so that the government's 90 percent are called one thing and the 10 percent with the public are called A-shares.

And we have to report in Hong Kong when we own 10 percent of a company — or we did then — 10 percent of a company shares, so unfortunately the 10 percent applied only to the 10 percent of A-shares and so we had to reveal our ownership when we only had 1 percent of the economic interest in the company.

So, we would have bought more but the price jumped up, and we are happy to have our 1.3 percent or whatever it is, and we think that they've done a good job in running the business.

They've got large gas reserves, which they're starting to develop now.

But it's a very major enterprise. Employs almost 500,000 people.

And the interesting thing was, a few years ago relatively few people in the investment world probably even thought about the fact that PetroChina was over there and was a much larger business than most of the — well, just about any oil company in the world, except for BP and Exxon Mobil.

Charlie, do you have thoughts?

CHARLIE MUNGER: Yeah. It would be nice if this sort of thing happened all the time, but that hasn't been true in recent years.

WARREN BUFFETT: But we never — I should emphasize — I mean, the annual report of PetroChina, which, like I say, it's easy to read. Understandable. They declare their policies. Anybody could get it. You can read it.

We did not — we did not go over and — we never had any contact with the management before we bought the stock. We'd never attended an investor presentation or anything of the sort.

I mean, it's right there in black and white, in a report that anybody can get.

And we just sit in the office and read those things, and we were able to put 400 million out that's now worth about a billion-two or something like that.

It was interesting. At the time — I think I'm right on this — at the time, Yukos, which is the big oil company in Russia, was probably far better known among the investment community in the United States than PetroChina.

And I compared the two. At the time, thought to myself, would I rather have the money in Russia or in China? PetroChina, in my view, was far cheaper. And I felt that the economic climate was likely to be better in China, you know.

Would I have — if it had been selling at the same multiple as a U.S. domestic company, would I have regarded it as more attractive? No.

I mean, there's some disadvantages, always, to being in a culture that you don't perfectly understand, or where tax laws can change, your ownership rules can change.

But the discount at which PetroChina was selling, compared to other international oil companies, was, in my view at the time, ridiculous. So, that's why we bought it.

And we will have the candy available for you at the break.

14. Profit margins squeezed by rising commodity prices

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Good morning, gentlemen. My name is Matt Sauer (PH) and I'm from Durham, North Carolina.

Many businesses are reporting rising costs and surcharges on such inputs as fuel, metals, and wood. They are often unable to pass along these costs to their consumers.

If commodities stabilize at price levels above those of the past decade, will corporate margins be compromised into the future?

WARREN BUFFETT: Well, it's a great question. I would say that that would depend very much on the industry you're talking about.

But, in our carpet business [Shaw Industries], for example, we've just been hit time after time, as I mentioned in the annual report, with raw material increases, because there's a big petroleum derivative factor there.

And we have lagged in terms of being able to put through those increases to our customers, simply because we want to protect the Nebraska Furniture Marts, or those that have ordered, for a reasonable period of time. And that squeezed margins in carpet.

We use lots of natural gas at Johns Manville, use lots of natural gas at Acme Brick, and that's tended to squeeze margins some.

I think, over time — I think there has been a lot more inflation in these basic materials. Steel has been off the chart.

I think, over time the businesses with strong competitive positions manage to pass through increases in raw material costs, just as they passed through increases in labor costs.

But you get these temporary situations where, sometimes, the costs are increasing faster.

I don't think — I don't think the American industry — I mean, a higher cost for oil, when we import 10 million barrels a day or more of oil, if we're paying $20-or-so more per barrel than we were a year or two ago, that's $200 million a day, is a tax, but it's more of a tax on the American consumer, probably, than on American business. The American business will probably be able to pass through most of those raw material cost increases.

It is worth pointing out that corporate profits, as a percentage of GDP, are right at the all-time high, leaving out a few aberrational periods.

And I would — you know, if I had to bet on the direction of corporate profits, as a percentage of GDP, over the next five years, I would bet they would go down somewhat. But that's because they're right at this very high level.

Interestingly enough, while corporate profits, as a percentage of GDP, are at this very high level, corporate taxes, as a percentage of total taxes raised in America, are very close to an all-time low.

So, American businesses managed to pull off a situation where they're making extremely good profits and paying a very small percentage of the total tax bill, as measured in this country historically.

And I'm not sure whether that could, or should, or will continue, but it's a very, very favorable period right now for corporate America.

But that's nothing to get bullish about, because you might expect something of a reversion to the mean.

Charlie?

CHARLIE MUNGER: Well, I can't add to that but I can restate it.

It's hard to know just which companies can pass through the increases in costs that come from higher commodity prices. And it's also important to know.

WARREN BUFFETT: We like buying businesses where we feel that there's some untapped pricing power.

We haven't been able to do much of that lately. But back in 1972, when we bought See's Candy, I think it was either — was it $1.95 a pound?

CHARLIE MUNGER: Something like that.

WARREN BUFFETT: Yeah. And they were selling 16 million pounds of candy a year, making four million pretax, with about 25 million purchase price, which I would have very foolishly refused to budge on, and in history have cost us a lot of money.

But one of the questions we asked ourselves, and we thought the answer was obvious, was, you know, if we raised the price 10 cents a pound, would sales fall off a cliff?

And of course, the answer, in our view at least, was that no, there was some untapped pricing power in the product.

And it’s not a great business when you have to have a prayer session before you raise your prices a penny. I mean, you were in a tough business then.

And I would say you can almost measure the strength of a business over time by the agony they go through in determining whether a price increase can be sustained.

And frankly, a good example of that is the newspaper business right now. Because 30 years ago, when the — whatever the local daily would be had an absolute lock on the economics of the community, because it had the megaphone through which merchants had to talk if they were going to get their message across to their audience — at that time, rate increases, both circulation and advertising, were something that were almost a big yawn to most publishers.

They did it annually. They did not worry about the fact that Sears or Walmart or Penney’s or whomever would pull their advertising. They did not worry that people would drop their subscriptions to the paper.

And they went merrily along, increasing prices, and they increased them when newsprint went up and they increased them when newsprint went down, and it worked.

And you got these very fat profit margins. And it looked like about as strong a business as you can imagine.

Now publishers find themselves in a position where they agonize over rate increases, both in advertising and in circulation, because they’re worried about driving away advertisers into other media.

And they’re worried about people, when they get a 20 cent increase, you know, per month, or whatever it may be, in their circulation prices, deciding, well, I think I’ll just drop it. And when they drop it they don’t usually take it up again.

So, that world has changed. And you could recognize the change in that world, simply, if you could get inside the mind of the publisher, in terms of how they felt about price increases.

You can learn a lot about — you learn a lot about the durability of the economics of a business by observing the behavior of — the price behavior.

I mean, you’re seeing that — talk about the beer business. Beer has moved up in price every year, but there have been some rollbacks in certain areas in the last year, which means that, you know, it’s getting a little bit more difficult to increase prices, even though they increase them at rates below inflation.

And those are not — that's not a good economic sign.

Charlie?

CHARLIE MUNGER: I have nothing to add to that.

15. Tax rate not a factor in Berkshire dividend calculus

WARREN BUFFETT: OK, we'll go to number 7.

AUDIENCE MEMBER: My name is Pete Banner (PH) from Boulder, Colorado.

First of all, Mr. Buffett, Mr. Munger, we shareholders consider you our heroes. We appreciate and very much value who you are and what you do in the world. So, thank you.

WARREN BUFFETT: Well, thank you, Pete.

And I will say in return that we think we've got the best group of shareholders in the world. And to some extent, it's evidenced by the fact we have the lowest turnover, and, I think, the most knowledgeable group, incidentally, too, of shareholders.

So, with that our mutual love affair can go on. (Laughter)

AUDIENCE MEMBER: Thank you very much.

Secondly, with taxes as they are today, 15 percent on dividends, how do you feel about declaring a dividend?

WARREN BUFFETT: Oh, you were setting me up. (Laughter)

No, there's no question about the fact that dividends are lightly treated now for taxation purposes.

But we have always said, and it's been true, that if there were no tax on dividends, to this point at least, we would have followed an identical dividend policy, because the test with us is whether we think we can retain a dollar, and in turn — and have it worth, in present value terms, more than a dollar.

If we can't do that, we should distribute any money that we can't — we can't utilize on that basis.

Now, when the cash piles up, like currently — it has currently — you can say it's pretty dumb to hold, you know, billions of dollars at — last year the rates were less than 1 percent after-tax — and, you know, what are you doing for shareholders with that?

And I would say that the burden of proof will certainly shift if, within a few years, we can't use a lot more money intelligently than we are now.

But, if we were — at the time at which we feel that the present value of the earnings we retain is not greater than a dollar comes, and it could come, and it's more likely to come when you get large like we are, then we should have a — not only a, you know, dividend policy that's X percent of earnings, we should pay out very substantial sums.

The test is whether the money can be used effectively within the business. So far, it has been.

That doesn't mean it was yesterday or the day before, but so far, it's produced more than a dollar's worth of market value for every dollar retained.

But that will be discussed — our directors meet Monday — that will be discussed then, and you are certainly — if we sit here a couple of years from now and we have not successfully deployed more cash, then I think that the burden of proof has shifted dramatically to us to explain why we would be retaining earnings at that point.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that, too.

16. U.S. trade deficit's economic threat

WARREN BUFFETT: Number 8?

AUDIENCE MEMBER: My name is Ola Larson (PH), from Salt Lake City, originally from Sweden.

I read your annual report where you mentioned how the current account deficit, or a trade deficit, has to eventually come to an end.

And in the report, you were reluctant to give views, a forecast of how this would come down from $2 billion a day.

Would you, nevertheless, be willing to share some thought on what — how it might come down, if you have any views on this?

WARREN BUFFETT: Well, that really is the $64 question, because, we are, in my view — and Charlie doesn't — he's not as on board on this as I am, so it's important that you listen to him on this, too.

The — it does seem to me that a $618 billion trade deficit and a larger current account deficit, rich as we are, strong as this country is, that something will happen that will change that in a major way at some point, and that the longer that it goes before changing, the more likely it is that something fairly significant happens.

But most economists — most observers — would still say that some kind of a soft landing is possible. Or they would say it's likely. They never, to my mind, they never quite explain, you know, what the soft landing is.

They just say it's, you know, it's likely to be a soft landing but it could be something different but we still think it will be a soft landing.

But I don't know what a soft landing is, exactly, in the sense of how the numbers come down quite significantly, and if they don't come down, the current account surplus — or deficit — means that we are transferring more and more wealth abroad and that we will, in addition to our trade deficit, we will, at some point, have a very significant deficit in terms of the net investment position that the rest of the world holds on us. So it becomes a compounding effect.

I do recommend — there was an op-ed piece in The Washington Post on April 10 by [former Federal Reserve Chairman] Paul Volcker, and he has expressed himself some on this, and he gets into the question of whether it can be a soft landing or not. But I think he certainly expresses some real apprehension about whether a soft landing will be the likely result.

In the kind of world we live in, with so much of the assets of the world, whether they be foreign exchange or whether contracts or whether they be stocks or bonds or junk bonds or whatever, I think as high a percentage is on what I would call a hair trigger now as has ever existed.

In other words, I think there are more people that go to bed at night with a position in foreign exchange, or bonds, or a carry trade, or stocks, or whatever, that some event that could happen overnight would cause them to want to change that position in the next 24 hours. I think that's the highest, perhaps in history.

Somebody [economist Thomas Friedman] has referred to it as the "electronic herd," that it's out there.

I mean people can with — they can give vent to decisions involving billions and billions and billions of dollars, you know, with the press of a key, virtually. And that electric — I think that electronic herd is at an all-time high.

I think that some exogenous event — it was almost Long-Term Capital Management in 1998 — but some exogenous event — and we will have them — will cause it — I think it could very well cause some kind of stampede by that herd.

You can't get rid — if you're the rest of the world — you can't get rid of dollars.

I mean, if you're sitting in Japan, China, or someplace, and you own a lot of U.S. government bonds, if you sell them to somebody in the United States you get U.S. dollars. So you still have U.S. assets. If you sell them to somebody in France, you've now got euros but they've got the [debt.]

You can't you can't get rid of those assets. But you can have people trying to head for the door very quickly with them, under certain circumstances.

Volcker said, in this thing, he said in the second paragraph, "Yet, under the placid surface there are disturbing trends: huge imbalances, disequilibria, risks — call them what you will. Altogether the circumstances seem to me as dangerous and intractable," and I emphasize intractable, "as any I can remember, and I can remember quite a lot."

Well, Paul Volcker can remember quite a lot.

And I agree with that. I don't — I have no idea — I have no idea on timing, whatsoever. In economics, it's far easier to tell what will happen than when it will happen.

I mean, you can see bubbles develop and things, but you do not know how big the bubble will get. For example, you know, this happened five years ago in the market.

So you — predicting timing is — I've just never been successful at it nor do I try to do it.

Predicting what will happen, I think, is a much easier sort of thing. And I would say that what is going on, in terms of trade policy, is going to have very important consequences.

It was not addressed in the last presidential campaign by either candidate in any meaningful way at all.

Now, I'm not sure if, you know, you were standing up in front of the American people, and somebody is giving you three minutes to explain this whole situation, when 90 percent of your audience couldn't define current account, you know, it's not an easy game. But it's an important one.

Now, Charlie is less enthusiastic about our foreign exchange position, somewhat, than I am, so I want to yield the floor here for a significant period of time while he gives you the other view.

CHARLIE MUNGER: Well, I'm, if anything, a little more repelled than you are by the lack of virtue in the way our nation uses consumer credit and the way we run the public finances.

And I have a feeling that eventually a lack of virtue is going to hurt one.

Where we differ is that I agree with [18th century Scottish economist] Adam Smith that a great civilization has a lot of ruin in that, meaning it will bear a lot of abuse.

And so I think there are dangers in the current situation that make it unwise for anybody to swing for the fences. But I don't think that we have a certainty that the system won't stand a lot more of the kind of abuse it's getting now.

WARREN BUFFETT: What do you think the end will be?

CHARLIE MUNGER: Bad. (Laughter)

WARREN BUFFETT: I knew I could count on him. (Laughs)

No, we are truly, in this country, like an incredibly, I mean incredibly, rich family that owns, we'll say metaphorically, millions of acres of land. They can't see, they can't travel to the outer reaches of their domain.

But, nevertheless, they sit on the front porch and wait for the produce to come in from this vast holding, and when they get it all they still want to consume about 6 percent more than everything that's been produced on the farm.

And they have the ability to do that by simply selling off a little piece of the farm every day, and every year, that they can't even see. So they don't feel any poorer at the end of the day or the end of the year, because it's still, as far as their eyesight can see, they own everything that God ever created.

And they can sell that little piece or they can mortgage it. They can send IOUs to these people that are giving them the extra goods to consume.

And we are very, very, very rich family. And we produce a whole lot and we consume a little bit more than we produce.

And we trade away a little bit of the farm or put a little bit of a mortgage on every day and the rest of the world is happy to take a little piece of our farm or take a mortgage on it because it's such a terrific asset and we've behaved so well over the years.

And so they're willing to work a little harder to send us something so that we can consume a little bit more than we produce.

It's been going on a while. It's accelerated a lot in the last few years. And more and more the rest of the world is owning part of us and we're going to have to service that ownership, either through interest if they took it in IOUs, or in some other way.

And it can go on a long time. But if it goes on a long time, the world will own a good bit of us and our children will be paying, one way or another, for the fact that we got to consume more than we produced.

It could happen — you could have — you've obviously had some less interest in the rest of the world accepting dollars by the fact that the dollar has declined somewhat in value in the last few years.

In other words, the investment in us is always going to be equal to the overconsumption. I mean, it's an equation.

But if people get a little less excited about one — enthused about one side of the equation — it reflects itself in the pricing mechanism.

And the world has demonstrated a diminishing enthusiasm for dollars in the last few years as they get flooded with them. We send $2 billion out every day, whether we like it or not and whether they like it or not.

Now, the question is, does that reach some tipping point at some point or does some exogenous event come about that causes people to want to rush for exits? Who knows?

I have a hard time thinking of any outcome from this that involves an appreciating dollar, but, as Charlie will point out in just a second, there have been times when we've been surprised.

Charlie?

CHARLIE MUNGER: Yeah, the counter-argument is that, what does it matter if the foreigners own 10 percent more of the United States, if, at that time, the total wealth of the United States is 30 percent higher than it is now.

And so, people who have that point of view just roll with it.

And some of them think that if we didn't manufacture anything in the United States and just sat here running hedge funds, we would have a wonderful economy because it comports with Republican principles.

WARREN BUFFETT: We could cut each other's hair, too, actually, I mean —

But back in the late 18th century, obviously, the idea of taxation without representation caused a certain amount of trouble, and ownership of the rest of the world — by the rest of the world of this country would be seen as a form of taxation, I think, 20 years from now, by the people who resided here.

If we — if, instead of fighting the Revolutionary War, we'd simply made a deal with England and said we'll give you three percent or five percent of our national product forever and you let us be free and we'll just mail it — send the royalty over every day — that might have looked like a good alternative to war in, you know, in 1776.

But I don't think that subsequent generations would have reacted well. I mean, something would have happened over time.

And I have a feeling that the idea of America paying tribute to the rest of the world because of the overconsumption patterns of a previous generation seems to be — I don't think that's a particularly stable scenario.

But that's why we have only 21 billion in foreign exchange contracts.

Charlie might have a little less, or maybe none, if he were running it entirely, and I might have somewhat more, if I didn't know I'd have him sitting up here next to me next year. (Laughs)

17. Housing market bubbles and irrationality

WARREN BUFFETT: Let's go to number 9.

AUDIENCE MEMBER: Hello. My name is Johann Freudenberg (PH) from Germany.

What do you think would be the consequences of a strong decline of the housing market for sales of carpet retailers and manufacturers? Thank you.

WARREN BUFFETT: Well, if there's a strong decline in the housing market, my guess is that whatever we lose in carpet we'll be making up for somewhere else, because it would — a lot of the psychological well-being, as well as the financial well-being, of the American people is tied up with the fact — or comes from the fact that they feel so good about what has happened with their home ownership over the years. And with many people it's been, by far, the best-behaving asset that they've had.

So, if there is indeed some kind of a bubble and it's pricked at some point, my guess is that we would feel that in various ways in our operating businesses, but that in terms of what we could do with our capital, the net effect to Berkshire might well be quite positive.

We're not big on macro forecasts. I mean, this foreign exchange thing is quite different than what we've done over time and the way we've made money.

So, we are — it isn't like we've got some great track record predicting macro factors and have made a lot of money doing that.

We've made money by looking at things like PetroChina, or whatever it may be, and just deciding that here is a very good business that's selling at a very cheap price.

Certainly at the high end of the real estate market in some areas, I mean, you've seen some extraordinary movement.

And I've referred to this before, but 25 years ago or so we saw the same thing in farmland in Nebraska and Iowa and surrounding areas. We had people running from cash — "cash is trash" — and people wouldn't, you know — they were worried about the fact that inflation was out of control in the late '70s, and before [former Federal Reserve Chairman Paul] Volcker did his stuff, people were fleeing from cash.

And one of the ways they gave vent to that fear was to rush into farmland. There was a farm about 30 miles north of here that sold for about $2000 an acre in, roughly, 1980. And a few years later, I bought it from the FDIC for $600 an acre.

And you can say, how can you go crazy about farmland? It's going to produce about 45 bushels an acre of soybeans, about 120 bushels an acre of corn. And there's no way you could dream about a tripling, or the internet causing, you know, cornmeals to go up or something of the sort.

But people went crazy on it. And the consequences were huge, in terms of banks failing, lots of banks failing in this area, banks that had gone through the Great Depression. But the people went — they just want a little crazy.

People go crazy in economics, periodically, in all different kinds of ways.

And, you know, you had the Resolution Trust Corp. come out of the savings and loan nuttiness that took place in real estate, where they finance everything that was put before them.

And, you know, I will not — I don't know where we stand in terms of the residential housing cycle in that it has different behavior characteristics, simply because people live in the houses in many, a great many cases. So it will not behave, necessarily, the same as other markets.

But when you get prices increasing at far, far greater rates than construction costs or inflationary factors, sometimes there can be some pretty serious consequences.

Charlie?

CHARLIE MUNGER: Yeah. It's — in a place like Omaha, there's not much of a housing price bubble, is there, Warren?

WARREN BUFFETT: No, there's not been a bubble, but I would say that residential real estate, probably, has increased in price at a rate quite a bit faster than the general inflation rate.

CHARLIE MUNGER: Yeah, but if you get to Laguna, California or Montecito, California, or the better suburbs of Washington, D.C., you have a real asset price bubble.

I have a relative that, to move to a good school district in the suburbs of Virginia, she had to pay four times as much as she can get from selling her nice Omaha house.

WARREN BUFFETT: Yeah. Well, I sold —

CHARLIE MUNGER: So that's a price bubble.

WARREN BUFFETT: I sold a house a few months ago in Laguna for $3 1/2 million. Now it sold the first day, so I probably listed it too cheap. So don't count on me for residential real estate advice.

But that house, the physical house, would probably cost a half a million or thereabouts. So, in effect, the land went for $3 million, implicitly, and the land is probably on the area of 2000 square feet, which is a little less than one-twentieth of an acre. Now, you've got streets and all that sort of thing involved.

But basically, I think that land sold for about $60 million an acre, which that fellow that you saw in the farm outfit in the movie finds like — sounds like a pretty, pretty fancy price for almost any kind of land.

Charlie, you've witnessed it firsthand, though, out there.

CHARLIE MUNGER: Well, yeah. There's — one of the Berkshire directors lives adjacent to what I regard as a pretty modest little house, which sold for $27 million recently.

Now these are houses that look right at the ocean, and there isn't a great deal of available shoreline in California, and there are a lot of people.

But you have some very extreme housing-price bubbles going on. And you would think there might be a real possibility that it could go in the other direction someday.

WARREN BUFFETT: At $27 million, I'd rather stare at my bath tub. (Laughter)

18. Catastrophe insurance: "everything correlates"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: David Winters, Mountain Lakes, New Jersey.

How do you try to manage risk at Gen Re and National Indemnity to be comfortable and maximize returns? Especially, how do you prevent a catastrophic loss or unexpected correlation? Thank you.

WARREN BUFFETT: Yeah, well, that's a very good question because we are doing things in different parts of our insurance operation where there is correlation.

And there's not only correlation among the insurance risks.

I mean, just, you know, take a major, really major, earthquake in California, in the wrong place. There have been about 25 6.0s or larger in the last hundred years, but most of them don't occur where a lot of people are.

But if you get the wrong one in the wrong place, it would not only hit National Indemnity and General Re, as you mention, but it might very well have a severe effect on See's Candy. It might very well have a severe effect on Wells Fargo.

We don't own Freddie [Mac] or Fannie [Mae] now, but we owned Freddie at one time. It could have had a severe effect on Freddie. It can have all kinds of secondary and tertiary effects that you might not think of initially.

So, we find when there's trouble, everything correlates. And it's — part of my job is to have at least a general idea of the sort of risk that the various enterprises might be running operationally, and then integrate that into my own notion of the risk that we run, in terms of investments, in terms of all kinds of things. And, you know, that is my job.

The most likely mega-cat, at any time, is a hurricane. But we have more exposure to that.

On the other hand, if you're talking 25 billion and up, maybe 100 billion and up, insured catastrophes, you know, a quake might be just as likely as some Force 5 hurricane that would come in at the wrong place.

But that — my job is to think absolutely in terms of worst case. And to know enough about what's going on, in both investments and operations, to make sure that no matter what happens, you know, I don't lose sleep that night, you know, over what can, you know, whether there's a 9.0 quake someplace or whether there's a Force 5 hurricane that actually goes up the East Coast and enters at places that very seldom does it enter.

Long Island, for example: huge amount of exposure. How often is Long Island going to, you know, really have a major hurricane? Not very often. I think there was one back in the '30s, but there were potato fields there in the '30s and now there's all kinds of insured value.

Everything will — everything that can happen, will happen.

I mean, in terms of our — what we know of history in this country, last three or four-hundred years, and then with the most severe quake, by far, was at New Madrid, Missouri.

And who would have guessed, you know, that that quake would happen? And there were two subsequent quakes that were far enough apart so that didn't exactly seem like aftershocks.

All three of those were higher than 8 on the Richter scale. Nobody thinks about that, but they've had them in Charleston, South Carolina.

They've had, I mean, it's — you will see things, maybe not in your lifetime, but if you take the centuries, some extraordinary things can happen. And it's Berkshire's job to be prepared, absolutely, for the very worst.

And, by and large, I would think hurricanes and quakes are the biggest thing now, but a few years ago we did not have nuclear, chemical, and biological risks excluded in policies, and we had huge exposure, subsequently gotten rid of.

But we take on large risks. I'll give you a couple of examples.

Just the other day — and nobody else will write this stuff, basically, because they would want to reinsure it with somebody else and they're not set up to do it — but one large airport, one large international airport, came to us and we wrote a policy for $500 million, excess of 2 1/2 billion, from any action that was not caused by nuclear, chemical, or biological sources.

So, if that airport is taken out in some way, but not by nuclear, chemical, or biological activities, the first 2 1/2 billion, somebody else worries about, and we get the next half-billion. There's a — sublimit is only a billion-six can be counted for business interruption. So you would need — and that airport would have to be out for a couple of years to have a billion-six of business interruption. So you need 900 million of physical damage on top of that.

But somebody is willing to buy that policy and there is a real risk.

We insured the NCAA Final Four down in St. Louis against being canceled, not postponed, or having the games, those final four games, moved to another city. But if it was canceled totally, and again, not through nuclear, chemical, or biological, we would have paid $75 million. Same thing at the Grammys.

I mean, we take on risks that very few people want to write. But in the end, we're willing to lose a lot of money in one day, but we're not willing to do anything that causes us any discomfort, in terms of writing checks the following morning.

Incidentally, while I'm on the nuclear — while we're talking about the pleasant subjects — I recommended in the annual report that book, "Nuclear Terrorism."

And if you go to lastbestchance.org, you can obtain, or will soon be able to obtain, a tape, free, that the Nuclear Threat Initiative has sponsored, which has a dramatization of something that is now fictional, but it's not fanciful. It's something that could happen, and which the Nuclear Threat Initiative is working to minimize the chances of.

And on that program, in addition to this dramatization of what could happen in that field, you have [former Senator] Sam Nunn and Senator [Richard] Lugar with [NBC News anchor] Tom Brokaw, discussing the subject.

It's an important subject. It didn't get a lot of attention, again, in this last campaign, although I think both candidates fully recognize the importance.

But we would regard ourselves as vulnerable to extinction, as a company, if we did not have nuclear, chemical, and biological risks excluded from virtually all of our policies, although we intentionally take on the risk periodically, but only in an amount that we feel we can handle.

We do not write it and give it away for free. And we do not want to write it promiscuously, because there could be events happen that would make it impossible for our checks to clear the next day, and we're not going to get ourselves in that position.

Charlie?

CHARLIE MUNGER: Yeah. We're likely to do better than most other people in dealing with what concerns you. We care more about it, that kind of correlation.

We just naturally have minds that think about tidal waves in California, where they've never had one in modern California civilization.

Can you imagine what a 60-foot tidal wave would do in California? There's nothing physically impossible in having a 60-foot tidal wave in an earthquake zone, which California is in. But it's never happened in modern history. But it's the kind of thing that we do think about.

And you think any other company has as much, as rigorous, nuclear and so on, exclusion as we do?

WARREN BUFFETT: Well, nobody's attacked it any more vigorously than we've attacked, I would say.

I mean, what you have here is, individually, we probably worry more about the downside than that just about any manager you can find. And collectively, you know, it's Armageddon around here every day. (Laughs)

But that's — you know, we care about that. We've never used a lot of borrowed money. Back when I started out, I mean, I had $10,000. But I just didn't want to borrow any significant amount of money.

There's no reason to. You know, we're living fine. We were living fine when I had $10,000.

And the idea that you risk what you need and is important to you for something that you don't need and it is unimportant, is just craziness. And we try to run Berkshire that way.

And you know, I had a 98- year-old aunt, my Aunt Katie [Buffett], that died last year. She had everything she had in Berkshire.

And the idea that I should be doing something to try and add a few dollars to my net worth, or a few percentage points to the record, and be risking the fact that she would go back to Social Security, is, you know — I just think that's kind of crazy for a manager.

But, you know, maybe if I had a two-and-twenty percent arrangement with my Aunt Katie, I'd be — differently, but I hope not. (Laughs)

19. Public education reform

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Hello. My name is Martin Wiegand from Chevy Chase, Maryland.

On behalf of the assembled shareholders, we appreciate you and the Berkshire staff hosting this weekend and would like to thank you for building this community of shareholders.

WARREN BUFFETT: Martin, thank you. (Applause)

I should point out that I dated Martin's aunt, but she only went out with me once. Maybe you could explain that, Martin. (Laughs)

AUDIENCE MEMBER: New board member Bill Gates has been talking about education reform in America, and columnist George Will quoted you in an article about Patrick Byrne's efforts to reform education in America.

Could you share with us some of your thoughts about these two efforts, or your efforts, to reform education? Thank you.

WARREN BUFFETT: Well, interestingly enough, we just dedicated a school here in Omaha yesterday which is named after my Aunt Alice, who taught in the Omaha public schools.

And we've — I think we've maintained quite an excellent public school system in Omaha. We also have an outstanding parochial school system here.

You know, it takes the interests of parents and, frankly, it takes the interests of the well-to-do in the school system to keep a first-class school system.

I've said that, to some extent, a public — a good public school system is a lot like virginity. It can be preserved but not restored.

In Omaha, we preserved it, but you preserve it by having the parents interested and involved in the public school system.

And Patrick's got an ingenious idea to make sure that more of the money goes to teaching and less to administration and overhead.

There's a variety of ideas around about how to correct a system where it's broken. And Charlie, as a big Ben Franklin enthusiast, has always said that an ounce of prevention is worth a pound of cure, and I think we've been spending that ounce of prevention, or providing it, here in Omaha.

I think it's a — you know, Charlie will have a lot more to say on this.

I admire the fact that people like Patrick and Bill Gates and a lot of other people, John Walton and Teddy Forstmann, all kinds of people — Bob Wilmers, up in Buffalo — are attacking the problem.

It's probably the — next to the nuclear, chemical, and biological problem — I mean, it's the number one problem of the country is making sure that the educational system is the best in the world.

We've got the resources and we're not providing it, we're not delivering it.

So, it's very complicated when you operate through thousands and thousands of school districts and you work with many, many unions, and you've had, to a great extent in many areas, the rich opt out of the system and set up a separate system.

You know, I am not as concerned about the public golf courses in Omaha as I might be if I played them every day instead of playing at a country club.

And if you have a two-tier school system, one for the rich and one for the poor, it's going to be hard to pass bond issues that benefit the people that don't have the money to send their kids to private schools.

I'm a big believer in the public school system, though, in terms of equality of opportunity in this country. (Applause)

Charlie's thought about education. He's actually come close to running a school. Cares about it enormously, so I'll turn it over to him.

CHARLIE MUNGER: Well I learned something rather interesting about Omaha public schools on my way to this meeting.

I stopped to sign some books in a warehouse in South Omaha, and one of the very nice people in the warehouse was married to an eighth grade teacher in the Omaha public schools. And we got to talking about "No Child Left Behind."

And he said his wife, this eighth grade teacher, had a very interesting system. For the numerous children who couldn't read, she records "books on tape," speaking slowly in her own voice.

And when some children are reading the books, other children are listening to the tapes, and that way the children who listen to the tapes are not left out when they ask questions about what went on in the books

Well, this is "No Child Left Behind," in a sense, but it's also a failure, in a sense. And I think it's very hard for a civilization to fix the situation once somebody is in the eighth grade and can't read.

So I think there's a lot of failure, even in relatively advantaged places like Omaha. And it's very serious failure. We never should have allowed it to happen.

WARREN BUFFETT: Yep. My friend Bill Ruane, who is here — I believe he's here — is doing something extraordinary, in terms of a program he has teaching kids to read. In fact, journalists who are here should seek out Bill and learn something about the story of what he's done in the last 10 years, in terms of moving reading abilities, and kids' enthusiasm for reading, which is more important because it's, you know — I talked about our managers and the important thing is that they have a passion for their business.

Well, passion for reading can be developed and Bill has shown that in programs that he — I think he first started them in Harlem. He sort of adopted a block up there and went from there. And he would be a very interesting fellow to get some views from on this subject.

You know, we've had this great success story in this country and a lot of it is because of people have had something closer to equality of opportunity in the United States than they've had in most parts of the world.

And you do not have equality of opportunity when my kids get to go to some school where I can attract outstanding teachers and where they're in the company of other kids that are also motivated and they're getting encouraged at home and all sorts of other things, and somebody else, who is born into a less advantageous family, really doesn't have a chance.

They go into something that's close, maybe, to an armed camp where the teachers are just sort of pushing them through. And there's no stimulus from the other kids except to do things that are counter to the interests of society.

And that just isn't a situation that really should be allowed to exist in a country where the GDP is almost $40,000 per capita

20. Bill Gates tops Churchill, Jesus, and Napoleon in survey

WARREN BUFFETT: Let's go on to number 12.

Oh, incidentally, I have to make one —

It was mentioned about Bill Gates being a director and I did — I got a little survey here that came out. Pricewaterhouse and the Financial Times cooperated on the survey.

And they asked CEOs around the world to choose — if they could pick anybody to choose from history or today to join their company's board, who would they choose?

And I'm happy to report that Bill came in number two. And, actually, number three was Winston Churchill. [Auto executive] Carlos Ghosn came in fourth. Jesus Christ came in fifth. Napoleon Bonaparte was sixth. And I won't give you the rest of the list but —

CHARLIE MUNGER: Who was one?

WARREN BUFFETT: Well, one was [former General Electric CEO] Jack Welch. I knew you'd ask. (Laughs)

But we didn't ask Jack, we asked Bill.

So, actually, I thought this quite an interesting list because I think many of the CEOs of the world would prefer people that are dead to be on their board. (Laughter and applause)

VOICE: It's too funny.

21. Zero-down mortgages fueling housing price bubble

WARREN BUFFETT: Now let's see. Where were we? We were going to number 12.

AUDIENCE MEMBER: Hello, my name is Robert Piton (PH) from Chicago, Illinois.

And on that note, maybe a merger of some sorts between Berkshire and Microsoft is in the works.

WARREN BUFFETT: I keep hinting but it doesn't do any good. (Laughs)

AUIDENCE MEMBER: The question that I have is, do you think the shift in the banking system during the '90s to finance home purchases with zero percent down impacted the overall savings rate, as home purchases are the largest investment most people make, and the overall rise of home prices driven by these marginal buyers?

If so, how would you suggest that we correct the problem.

WARREN BUFFETT: Yeah. Of course, any time a home is constructed, it represents somebody's savings.

I mean, the home buyer may buy it for nothing down, but that means he's borrowing 100 percent of the mortgage through a mortgage that somebody else has saved somewhere, maybe intermediated three or four times or something of the sort.

But home construction comes about through savings.

Now there's no question that terms have become easier and easier, and I've talked to certain mortgage bankers about this subject, but terms have become easier and easier as prices have increased.

Now, that is absolutely counter to, you know, how people think about lending in general. Generally, the more the asset class becomes inflated, the less a prudent banker will lend.

But of course, in this country, now you have mortgages intermediated in a way that the person buying the mortgage, in the case of — I'm thinking of Freddie [Mac] and Fannie [Mae] and other forms like that, so we're talking about the lower-priced houses — but the mortgage buyer does not need to care about what kind of mortgage — what kind of a financial transaction the purchase is.

All they have to do is look at the guarantee, and they look at that rather than whether somebody's put any money down, or anything of the sort.

So I think you've had easy financing facilitating a boom in real estate prices, even at the higher levels. And I think that that that, which has occurred in other asset classes in the past — I mean, that farm bubble I talked about was facilitated by the fact that banks in small towns, who generally had been very conservative in lending, went crazy around 1980 and they lent amounts that the farm itself could never repay.

They started saying a farm was an asset appreciation investment, not an income investment.

And once you talk about something that's an asset appreciation investment, ignoring the underlying economics of what you're lending on, you're really talking about the bigger-fool game.

You're saying, you know, this is a silly price but there'll be a bigger fool that comes along. And that actually can be a profitable game for a while. But it's nothing that bankers should engage in.

So I would say that easy lending, obviously, does contribute to, overall in the country, to a lower savings rate. But, in effect, somebody has to save for somebody else to borrow.

And what is happening now is the rest of the world is saving. So then in the U.S. — in global terms, I'm talking — but the rest of the world is saving.

And they're sending us $2 billion — I mean, we're sending them, in effect, claims for ownership of $2 billion — they're investing $2 billion a day in the United States.

But they — a lot of economists will say, well, that's what's really going on. The world loves our assets so much and they have so much confidence in America that the present current account deficit is driven by the fact they want to invest.

I don't believe that at all. I think it's just silly, frankly, to make that argument. They are investing because they have to, because of our consumption habits, and not because they want to. And I think the declining dollar is evidence of that.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that. It's obvious that the easy lending on houses causes more houses to be built and causes housing prices to be higher, probably, in the new field.

Eventually, of course, if you construct enough of new anything, you can have a countervailing effect.

If you build way too many houses, you'd eventually cause a price decline

WARREN BUFFETT: I'll give you a fanciful illustration.

Let's just assume that Omaha had a totally constant population. No one was allowed to leave. No one entered. Birth rate equals death rate, all of that sort of thing.

So the population was constant, and nobody could build any more houses. We just passed a city ordinance to that effect.

But every year, everybody sold their house to their neighbor. So, first year, everybody sold their $100,000 house to their neighbor, and they both switched houses, and that was fine.

And then the next year, they agreed we were going to do it at 150,000. And you'd say, well, how could that be?

Well, we would all go to Freddie or Fannie and get our mortgages guaranteed for a larger amount, and somebody in New York or Tokyo or someplace would buy the Freddie or Fannie paper.

And we'd have an influx of $50,000 per household. We'd all have the same number of houses. We'd all be living one house to a family. And we'd have marked up our houses, and we now have a bigger mortgage, but we'd have $50,000 more of income that year, just to service a little higher mortgage.

And we'd do the same thing the following year for 200,000, and so on.

Now, that would be very transparent, and people might catch on to the fact there was something funny going on in Omaha.

But you can have an accidental aggregation of behavior that somewhat leads to the same effect.

I mean, if you keep marking up something, and in the process, the payment for the marked up price comes from someone else who feels they are bearing no risk because they've got the government guarantee in between, the money can just flood in and everybody feels very happy for a long time.

And we don't have anything like the fanciful thing I've set forth, in terms of Omaha. But we have certain aspects of that, I think, going on in the economy.

Charlie, would you — I'm throwing this one at you. Would you agree or not?

CHARLIE MUNGER: Yeah, I do agree with that.

You have varied Ponzi effects in various parts of any modern economy. And they're very important and they're very little studied in economics.

22. "Not enthused" about gold

WARREN BUFFETT: Let's try number 13. I think, maybe, that's in the other room and we'll see whether we get a response and if not we'll —

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger My name is Martin O'Leary (PH) and I'm from Austin, Texas.

Mr. Buffett, given your past essays concerning the U.S. dollar and foreign exchange forward contract holdings that you have, and many countries' economic policies that have a tendency to debase their currencies, do you think that gold can be considered a viable investment alternative to paper currencies?

WARREN BUFFETT: Yeah, we're not enthused about gold.

People, historically, have felt that was the first refuge from a currency that was going to be — decline in value.

But, you know, so is a barrel of oil. So is an acre of land. So is a piece of Coca-Cola. So is See's Candy.

See's candy — if the dollar goes down 50 percent, we will be selling See's candy for double the present price. We'll be getting the same real price for See's candy.

People will work the same number of minutes or hours per week in order to buy a pound or two-pound box of the candy.

So we would much prefer a — some asset that is going to be useful whether the currency is worth what it is today, or 10 percent of what it is today, or whether people are using seashells in order to transact business.

Because people will go on eating and they'll go on drinking and doing various things. And their preferences will translate, in real dollars, into more or less the same economics for us.

And we would not trade the ownership of those kind of assets for us for a hunk of yellow metal, which has very little real utility except for people who are looking to flee from the dollar and, in our view, really haven't thought through the consequences of what fleeing would — where they should flee.

Charlie?

CHARLIE MUNGER: Yeah. If you have the opportunities of Berkshire Hathaway, averaged out, gold is a dumb investment.

WARREN BUFFETT: My dad [Howard G. Buffett] was a huge gold enthusiast. So I sat around the dinner table — my two sisters are here, too. They will testify to it.

We sat around listening to the virtues of gold, and that was in, we'll say, 1940. And gold, at that time, was $35 an ounce. And we would've had some storage and insurance costs.

And, you know, here it is, 65 years later. World wars, nuclear bombs, all kinds of things. And the compound rate from $35 to a little over $400, less those expenses, is not something that causes me to salivate.

23. The danger of earnings expectations

WARREN BUFFETT: Number 14.

Do we have a second microphone in the overflow room? Oh, there's only one in there. OK, then we'll go back to number one.

AUDIENCE MEMBER: Andrew Noble (PH) from England.

Apart from the catastrophic insurance events or Armageddon scenarios that you've been talking about earlier, in relation to the operations of Berkshire Hathaway, what are your greatest fears?

WARREN BUFFETT: Well, the greatest, I would say — we don't worry about the economics of the businesses we have.

We've got a very diverse group. By and large, they're very good businesses. By and large, they're run by some of the best managers in the country. But we worry about something going wrong.

I mean, you know, you heard about the Salomon [Brothers] thing in the movie. And, I mean, we've got 180,000 people out there, and I'll guarantee you something is going wrong someplace, as we talk. That's just the nature of it.

But, what you hope is that it's relatively unimportant or that we catch it. And — but that's, you know, that is something that we know will happen.

We try to have a culture that minimizes that. And I think we do have a culture that minimizes that.

We — it's very important, in our view, to have the right incentives. And many places, we think, have incentives that aren't so good.

I mean, when I get on an airplane, and we own the company, like NetJets, the last thing in the world I want to tell the pilot is that I'm running late and I hope we can get to New York a little faster.

I mean, that is dumb, to incent a pilot, who may be worried that, you know, somehow you affect his job or something, to get in a hurry about the takeoff or the checklist or whatever it may be.

And companies do that time after time in their compensation plans or things that they incent people, in our view at least, some of the wrong things.

That doesn't mean nothing wrong will happen under any circumstances. But you should not have a system that causes people to, for example, worry about quarterly earnings.

None of our — our managers do not submit budgets into Omaha. I have no idea what we're going to earn next quarter.

And I have no implicit body language out there, or anything of the sort, to our managers that I'm hoping to earn X dollars per share in the quarter.

Because in the insurance business particularly, you can report any numbers, basically, that you want to, if you write long-tail business for a short period of time.

And, you know, we've got 45 billion of loss reserves. Well, who knows whether the right figure is 45 billion or 46 or 44?

And if the desire is to report some given number in a given quarter, instead of saying 45 billion, you say 44-and-three-quarters billion, or something of the sort.

So we have no incentives, in terms of how people are paid, or in terms of the fact they just don't want to let me down.

Let's assume at the start of the year I asked everybody to submit budgets and then I went on Wall Street and preached a bunch of numbers.

Even if their compensation didn't depend on it, the managers would feel, you know, we don't want to let Warren down on this. So, you know, we'll take an optimistic view of reserves, and that's easy to do, at the end of the quarter and we won't let him down and then he won't look like a jerk in front of Wall Street.

So we try to avoid that sort of thing. But even then, that is what we worry about.

We don't worry about this place making money. I mean, we'll make money. And if we don't, it's my fault. That's not that's not the problem.

The problem right now, in addition to the one we just talked about, the problem is deploying capital, and that's my job, too.

And, you know, I haven't done a very good job of that recently, but with a little luck, you know, we will — and a different kind of market situation — we will get a chance to do that.

Charlie?

CHARLIE MUNGER: Yeah. Well, if you stop to think about it, the history of much of which we don't like in modern corporate capitalism comes from an unreasonable expectation, communicated from headquarters, that earnings have to go up with no volatility and great regularity — corporate earnings, I mean.

That kind of an expectation from headquarters is not just the kissing cousin of evil. It's the blood brother of evil.

And we just don't need that blood brother in our headquarters.

WARREN BUFFETT: Businesses do not meet expectations quarter after quarter and year after year. It just isn't in the nature of running businesses.

And, in our view, people that predict precisely what the future will be are either kidding investors, or they're kidding themselves, or they're kidding both.

Charlie and I have been around the culture, sometimes on the board, where the ego of the CEO became very involved in meeting predictions which were impossible, really, over time.

And everybody in the organization knew, because they were very public about it, what these predictions were and they knew that their CEO was going to look bad if they weren't met. And that can lead to a lot of bad things.

You get enough bad things, anyway, I mean. But setting up a system that either exerts financial or psychological pressure on the people around you to do things that they probably really don't even want to do, in order to avoid disappointing you, I mean, I just think that that's — it's a terrible mistake. And, you know, we'll try to avoid it.

24. We look for managers with great track records

(Gap in video recording resumes in middle of question)

AUDIENCE MEMBER: — quality is largely innate.

So if these characteristics are inherent and you were to attempt to consistently identify future great managers or entrepreneurs before there's a track record, how would you go about doing it?

And in particular, could there be a way to know that — before someone's made a lot of money, before they built the business that they love and feel passionate about, that they will develop those types of qualities later in life?

WARREN BUFFETT: That's a terrific question. And we have dodged it, largely, over the years by actually buying businesses from people where we've seen the record.

In other words, I'm not sure I can go — in fact, I'm quite sure I can't go — to an MBA class of 50 and sit down and talk with each one, examine their grades, examine their extracurricular activities, and whatever, talk to their parents, I'm not sure I could rank those 50 very well in terms of their potential for future business success. And, of course, some of it would depend on what areas they entered into in business.

So, I think it's tough. I think it's tough to go out to the practice tee, where people are not actually hitting balls but just taking practice swings, and say which one is, you know, is a 2 handicap and which one's a 15 handicap, and which ones, you know, can make it on the tour

I think I can tell a little bit, maybe, but not — but it's very hard to calibrate.

And I don't think we've had much success, but we also haven't tried very much, to identify people before they've had a record, to try and identify the ones that are superstars.

Instead, we've taken the easy way, and we go — and if somebody comes to us with a business that's done phenomenally for 10 or 15 or 20 years, or maybe for 50 years, and we've seen how — what their batting average is — we've actually seen they batted .350, or whatever it may be, in the major leagues. And we just make the assumption that we won't screw it up by hiring them.

And we also make the assumption that they'll live to be 100 or 120 or something and we buy the business.

And that's far easier — it is far easier to tell the great baseball batters after you've seen a couple seasons of their batting than it is to go to a college — in college baseball teams or high school baseball teams — and pick out the superstars.

The one interesting thing, and I wish I could remember where I saw this study and it may not even be a valid study, but I do remember seeing something many, many years ago where they tried to correlate business success with various variables.

And they took grades in school and whether they got MBAs and all that sort of thing, and they found that the best correlation was with the age at which they started their own business first.

The people that got very interested in starting a lemonade stands, or whatever, tended to have better — it tended to correlate better with business success than other variables.

We have found ourselves — we've got a lot of MBAs running businesses for us, but they ran them for a long time before we hired them or before we made the deal. And we've got others that never set foot in a business school.

And I do think there's a lot to wiring. I think there's also a lot to working with the wiring you have and developing it over time.

I don't think that it's all innate, and I don't think you can't improve. I know you can improve on what you're given at birth, but I do think an awful lot of it is wiring, more so than I would have thought 30 or 40 years ago.

I've certainly seen it in business. I can — there are people, no formal business train — Charlie never went to business school, I mean, but he thought about it. I mean, I never heard him — Charlie say anything dumb about business yet, except when he disagrees with me. (Laughs)

The truth is I've never heard him say anything dumb about business, period.

And there are other people. I've never heard [GEICO CEO] Tony Nicely say anything dumb about business, ever.

They just — they're wired so that they — that the, you know — it doesn't flicker. I mean, they get the answers. It doesn't mean they can — you know, they'd be a great ballroom dancer or a great baseball player, you know, or a great politician, but they are wired for business.

Charlie?

CHARLIE MUNGER: Yeah. Part of it is intelligence and part of it is temperament.

I don't know if Bill Ginn is in the audience, but by the time I was 14 years of age, I knew Bill Ginn would be rich.

He was a classmate of mine in high school, and a very intelligent man, and he wanted to be rich. And he was sensible in the way he handled life.

I think sensible people with the right temperament and the right intelligence, if they live long enough in our system, will get rich. But temperament is, I think to some extent, inherited, too. Don't you?

WARREN BUFFETT: Yeah.

His daughter, incidentally, is a partner with my daughter in a knit shop, which I hope you patronize while you're — (Laughs)

We've united the Ginn and the Buffett family. (Laughs)

Charlie, when did you first think business was something of interest to you?

CHARLIE MUNGER: Very early. (Laughter)

I loved games of chance and I love trying to learn how to win at them.

WARREN BUFFETT: Yeah. It's interesting for me, you know, simply to think about the question of whether the Final Four of the NCAA will be will be canceled, as opposed to postponed or transferred in locale, and decide if we're going to pay out $75 million the next day if it is canceled, and how much we want to receive in today to take care of that.

And that probably wouldn't interest — all kinds of people that wouldn't be interesting to. And since my dad wouldn't let me become a bookmaker, I went into investments. (Laughter)

25. Cologne Re stake

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Good morning. Jens (PH) from Germany.

After buying almost all of Cologne Re, how happy are you about the progress, and what are the plans for the remaining minority shareholders?

WARREN BUFFETT: Yeah. General Re, at the time we bought it in 1998, owned something in the 80s of Cologne Re, a large German company that they bought this 80-odd percent in, a few years earlier.

It's actually slightly more complicated than that because there was an arrangement where a certain purchase was deferred, but as a practical matter they owned in the 80s.

Right now, Gen Re owns about 91 percent of Cologne Re.

That's a subject that, obviously, it's not pressing with us, because we've owned it for seven years without taking our interest up, except periodically through small purchases.

And there's no particular reason to — why 100 would be better than 91 percent.

But if the price is attractive and shares are offered to us, we will always contemplate buying it. But it's not key to any strategy.

26. Munger defends AIG

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: I'm Christian Tukenberger (PH) from Switzerland, Europe.

What do you think of the two insurance — reinsurance, AIG and Converium, from Switzerland? Thank you.

WARREN BUFFETT: Well, I'm going to give you a chance at a second question because I don't really think I should comment on AIG.

There's, you know, they have said that they're going to have their 10-K. They hope to have it by, I guess, today.

I haven't received any late word whether it's been filed but they have — there'll be more disclosure on the situation at AIG, and I really don't know anything about what will be in that statement, and I'll just — I'll wait to read it. I'll read it with interest. But I — I have no particular insights on that.

Converium has had troubles in the United States, has been announced, but they also raised additional money. But again, I don't really have any specific commentary on those two companies.

Charlie?

CHARLIE MUNGER: Well, I'll be bold enough to make one comment about AIG. (Laughter)

I think whatever comes along, people are going to find that a lot that was very right was done over the years by AIG. There's a lot of ability in that place.

WARREN BUFFETT: Oh yeah. Extraordinary. I mean, Hank Greenberg was — he was the number one man in insurance. I mean, he developed an extraordinary company, in his lifetime.

It wasn't that much when it was handed to him. And he became the most important factor, I would say, by some margin, in the property-casualty business.

But in terms of evaluating where it stands now and what will be revealed when the 10-K comes out, I just have no idea.

27. Fannie Mae, Freddie Mac, and the home mortgage mess

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Good morning. My name's Mike Nolan. I'm here from Montclair, New Jersey with my 18-year-old son Brian, who's experiencing his first Berkshire annual meeting.

My question, and you touched on it a little bit in a couple of earlier questions, deals with the current regulatory environment in Washington, which appears to be growing much more negative on Fannie Mae, Freddie Mac, Farmer Mac, and so forth.

What might the implications for the U.S. consumer specifically, and the U.S. economy generally, be if the GSEs are effectively bridled or significantly restricted from their past charters?

Could this prick what you earlier referred, and some private economists are calling, a real estate bubble and what will be the fallout?

WARREN BUFFETT: Yeah. The GSEs, in effect, expanded their original charter and reason for being.

The thought, originally, was that they would guarantee mortgages and they had this very limited, I think, two-and-a-quarter billion dollar line of credit from the Treasury.

But they were they were brought in, to an extent, to do what FHA and VA had done for mortgages in their arena, was to give people confidence in borrowing money — or in lending money — far away from their own geographical location.

I mean, when the local — when I borrowed money on my house in 19 — bought it 1958 — I mean, I went down to see Mr. Brownlee (PH) at the Occidental Building and Loan, and he, you know, he knew something about me, and he knew something about my parents, and he knew where the house was and all of that.

But as the mortgage market became more institutionalized and it became more — the source of funds became geographically far more distant from the user of the funds, in order to have a market in which — which would be efficient, the GSEs were a very logical development.

And the GSEs came in, Freddie and Fannie, and the idea was that for a fee, which used to average about 25 basis points, they would guarantee these mortgages so somebody living 3000 miles away could buy them through securities and not worry about the individual property.

And then, the portfolio operations developed over the following years and, of course, they enabled the GSEs to earn high rates of return on capital, because, in effect, the GSEs were looked at as government guaranteed so that people would lend them money without worrying about the degree of leverage employed.

And, in effect, the GSEs became huge — they hugely developed what might be called the carry trade, using the government's credit, in effect, and the spread between what they paid on their money and what they got on mortgages.

So that became the dominant source of their earnings. They got very carried away with delivering promised rates of growth.

I remember reading in the Freddie Mac report some years ago, where they talked about delivering in the mid-teens or low-teens or something like that.

And I thought to myself, you know, that this is madness, because you can't do that when you're running a big carry trade operation. Interest rate — the slope of the curve will develop.

There's no way to lend money for 30 years to somebody who can pay you off 30 seconds later, to actually match assets and liabilities in a way that's risk-free.

The only way you could do it would be to issue a 30-year bond of your own, which you could call 30 seconds later, and people don't buy those bonds.

So, as a practical matter, you could not perfectly handle the risk of significant interest rate changes.

But the GSEs got caught up with delivering increasing earnings all the time to Wall Street.

So they first enlarged their portfolios and later, as we've seen, they got involved in some accounting shenanigans, which really sort of boggle the mind when you think of two of the most important institutions in the country, with all kinds of financial experts on the board and top-named auditors and everything, and turning out that billions and billions and billions of dollars were misreported.

It shows you what can happen in a system.

Now Congress is reacting, administration is reacting, [Federal Reserve Chairman] Alan Greenspan is reacting, in terms of saying that, you know, what have we created?

What is this — the situation where these two companies have a trillion-and-a half or more of mortgages they own, and people really think the federal government is on the hook, and the federal government does — wants to say it isn't on the hook.

But the truth is, it is on the hook. And institutions worldwide own the credit — own the securities — based on this implied promise. And it was all being done just because, basically, these companies wanted earnings per share to go up.

Now, they say they did it to maintain an orderly market, and all that stuff, in the mortgages. But they were really set up to guarantee mortgage credit.

And there's going to be reaction in Congress. It will be a huge fight.

Both of those institutions have been heavy supporters of various legislators over the years. They've got lots of clout. Not as much clout as they had a year ago, but they've got lots of clout in Congress.

And on the other hand, people have lost faith, to some degree, in what they've done.

And they've also seen that the consequences of the government issuing a blank check to two institutions that are trying to produce annual gains in earnings per share of 15 percent, and doing it by accounting means when they ran out of the ability to do it by other means.

So it's something that Congress should be giving a lot of attention to. They can't cut them off, in my view and, I think, most people's view. They can't say get rid of your portfolios or anything like that.

So my guess is that some kind of a curtailment comes in, some kind of tougher accounting requirements come in, sometimes it may be tougher capital ratios. And that over a long period of time, the government tries to figure out something that sort of eases them out of this position, where they were basically backing two entities that, at times, acted like the two biggest hedge funds in history.

Charlie?

CHARLIE MUNGER: Yeah. Well, he was asking, partly, is what happens if the government reins these two institutions in and forces a big reduction in asset base.

WARREN BUFFETT: I don't think they'll — I don't think the government is going to do something worse, they sell off hundreds of billions of dollars of mortgages, at all.

But if they curtail it — let's just say they say that from now on you got to operate in a runoff mode for a few years. There are plenty of people out there to buy mortgages.

They're already buying the securities of Fannie Mae and Freddie that are financing the mortgages. So it isn't like Fannie and Freddie, independently, were coming up with the funds to finance these mortgages.

They got them from somebody else and that somebody else can leave Freddie and Fannie out of the picture and buy the mortgages through some other form.

It would not be the end of the world, at all, if Freddie and Fannie no longer had new portfolio purchases. I don't think it would change things in any significant way, in terms of the cost of homeownership or anything else.

How about you, Charlie?

CHARLIE MUNGER: Well, I agree. I don't think it would have enormous macro effects if future growth were curtailed.

I do think a lot of the troubles that came, came from a large use of derivative books, and from Fannie and Freddie both believing a lot of silver-tongue salesmanship from derivative traders.

And, as many of you know, I think there is much wrong with derivative accounting and derivative trading operations in the United States, and I don't think the full penalties have yet been paid.

WARREN BUFFETT: When you can have a $5 billion mismark in one direction at one of these — and bear in mind these are among the most scrutinized companies in the world, and with outstanding people on their boards, in terms of financial expertise — if you can have a $5 billion mismark in one direction, while at the same time the other one has a 9 billion mismark in the other direction, you know, I would say we've come a long way from Jimmy Stewart and "It's a Wonderful Life." (Laughs)

CHARLIE MUNGER: Yeah.

28. UK reporting requirements are a deterrent

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Hi, this is Peter Webb from London, U.K.

The question I wanted to ask you: I've been an investor for many years and done very well following a similar sort of style to yourself. So thank you for that.

The big question I have is —

WARREN BUFFETT: Would you want to quantify that? You can always send us a check. (Laughs)

AUDIENCE MEMBER: But if there's a deal to be had, maybe we can speak afterwards.

WARREN BUFFETT: OK. (Laughs)

AUIDENCE MEMBER: The question that I have for yourself and Charlie is, over the time I've bought many different companies in the U.K. and Europe, and I've seen many American value funds buying the same companies, but I see very little activity from Berkshire and its subsidiaries.

And I didn't know whether that was a reflection on your views on U.K., Europe, and the world. Whether you just see a lack of investment opportunity? Is it outside your sphere of competence? Or is there some other reason that I see less activity from you in Europe?

WARREN BUFFETT: Yeah, it's a good question. We own, of course, as you know, 80 percent or so of MidAmerican Energy, which has a very large business in the U.K., but that's an operating business.

As you know, in the U.K. there's a rule that requires reporting when you own three percent of a company's stock. And actually, there's some conditions under which the ownership will be reported even sooner than that three percent.

There's a provision that — I think if there is an inquiry or anything, that it has to be responded to.

So, if you take a company with a market cap of, you know, £5 billion, if we bought £150 million of it, we would have to report, and that tends to mess up subsequent purchases.

So, we bought stock — we own stock in Diageo, which was Guinness at the time. We've owned stock in some other U.K. companies.

But we've thought twice before going over three percent, because of the reporting requirements, and then we'd have to report if we were selling, and all of that.

So that's a deterrent, but it's not an overwhelming deterrent. And if we, you know, if we get a chance to buy a significant piece of something that we think is cheap, particularly if we could buy it in one purchase. But there's a lot of special rules that kick in, over in the U.K., that do not in the United States.

Incidentally, there was something in the Journal the other day that said that we had to report if we bought over five percent of a company within 10 business days in the U.S.

That is not true. That was a mistake in the report. But it is the case in the U.K. that at 3 percent, reporting is triggered.

But there — we would feel very comfortable with lots of U.K. businesses. And, you know, they'd have — it'd be the same criteria we applied over here: a durable competitive advantage, and a management that we like and trust, and a reasonable price.

And we have seen some of those. There was an insurance company in the U.K., a year or so back, that I would very much have liked to have bought, but we couldn't come to terms on price.

But we have no bias whatsoever against buying businesses in the U.K. And as I say, we've — at Yorkshire and Northern Electric, you know, we have a business that, shows in our report, made close to $300 million after-tax.

And actually, considering my views on currency, you know, I would have — I'd give a slight edge to buying something where the earnings would be in sterling in the future, rather than in dollars.

Charlie?

CHARLIE MUNGER: Well, I regard it as kind of amusing that we ended up preferring the currencies of Europe when it's so much more socialized than the United States is. That's a queer occurrence.

WARREN BUFFETT: You actually prefer them or not, Charlie? (Laughs)

CHARLIE MUNGER: Well, certainly in recent — over a considerable period of recent months — we've actually preferred the currencies of socialized Europe to our own currency.

I just regard that as an odd occurrence for both of us. That wouldn't have happened.

WARREN BUFFETT: No. Up till three years ago, if I came back from Europe and I had a euro in my pocket I couldn't wait to run to the bank or someplace. I was afraid it would depreciate before I could get rid of it. But I changed my views a few years ago.

We hope to buy businesses, and stocks, other places in the world. And Charlie mentions the difference in political climate.

One thing: you read about slow growth in Europe and Japan and all those, and it's true. But usually — but the growth figures that you see are usually not on a per capita basis. And since the population of Europe has been, generally, very little changed, whereas the population of the United States grows one or one- and-a-half percent a year, if you look at growth figures in the United States and somebody says three- and-a-fraction percent, that's not on a per capita basis.

I mean, you've got to — you have to deflate that by the growth in population. Whereas, if you read about the growth in Europe, generally, you're dealing with a population base that hasn't changed.

So the differences in growth rate on a per capita basis are not as wide as the headlines would suggest.

29. Legal liability for someone else's accounting?

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Gentlemen, my name's Mike McCloskey. I'm from Toronto, Canada.

My question is: what obligation does a financial intermediary, or a party to a transaction, have to ensure that the other party to the transaction properly accounts for it.

WARREN BUFFETT: Well, that question may come up in a very real sense. (Laughs)

But, you know, we have lots of reinsurance transactions, obviously. Banks have lots of transactions with people.

Certainly, if you knowingly are doing something that causes a company that are participating in it, you know, you may have very serious obligations on that.

But on the other hand, if you're — I mean, we reinsure hundreds of companies. They have legal departments. They have auditors.

And there could be somebody out there today — well, they could be doing anything with their accounting. It probably wouldn't be limited to the contract they had with us. It might well be other things.

But it really gets down to whether there's knowing participation, I would say. Isn't that right, Charlie?

CHARLIE MUNGER: Well, as you say, it's a subject rife with ambiguities and different issues.

You have had some bartender liability, if you serve a drink to somebody that's already inebriated, why, some people say the bartender is liable.

On the other hand, radio stations are allowed, in America, to sell advertising time to people that use it for perfectly obvious fraud, and nobody ever sues the radio station.

It's very hard to predict what things are going to get legally shifted around so a supplier gets liability for its customer's behavior.

30. Invest in yourself and ignore asset allocation

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: My name is (UNINTEL). I live in Sacramento, California.

My question is related to the issue of U.S. trade deficit again and its implications on the future value of the dollar.

Do you think an individual or a business owner here in U.S. should be concerned about the purchasing power of his future dollar earnings or savings, and diversify his or her investments in non-dollar-based securities?

WARREN BUFFETT: I think it's very tough for individuals to either select individual stocks, select individual times to enter the market, select currencies.

I mean, I just think that's a game that they tend to get interested in at the wrong time. There's some adverse selection, in terms of when people who do not follow stocks carefully get interested in stocks.

I think that, you know, the best investment you can have, for most people, is in your own abilities.

I mean, when I talk to students, you know, I would pay a student — in many cases, I would be glad to, you know, pay them $100,000, cash up front, for 10 percent of all their future earnings.

So, I'm willing to pay 100,000 for 10 percent of them, I'm valuing the whole person at a million dollars, just capital value standing there in front of me.

And those — anything you do to develop your own abilities is probably going to be — or your own business — is probably going to be more productive for you than starting to think about individually making commitments into foreign exchange.

If you have a good business in this country earning money in dollars, you'll do ok. I mean, you may live in a world 20 years from now where a couple percent of the GDP is going to service the debts and the ownership that we've created now by running these deficits.

But you'll do fine in America. So, I wouldn't worry about that much.

Charlie?

CHARLIE MUNGER: Well, if you look at Berkshire, you will find that it really doesn't do much of conventional asset allocation to categories.

We are looking for opportunities and we don't much care what category they're in, and we certainly don't want to have our search for opportunities governed by some predetermined artificial bunch of categories.

In this sense, we're totally out of step with modern investment management, but we think they're wrong.

WARREN BUFFETT: Yeah. And incidentally, we have 80 percent of our money, or more — well over 80 percent — tied to this country and to the dollar. So it's not like, you know, we've left the country or anything of the sort.

CHARLIE MUNGER: When have you done a big asset allocation strategy?

WARREN BUFFETT: Never.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah.

We end up with peculiar asset mixes. I mean, if the junk bond thing had gone on a little longer, instead of having 7 billion in there, we might have had 30 billion in.

But we were doing that simply based on the fact that it was screaming at us.

And we do the same thing with equities. I mean, back — for many years, we had more than the net worth of Berkshire in equity positions. But they were cheap.

CHARLIE MUNGER: And I want you to remember one of my favorite sayings as you do this asset allocation. "If a thing's not worth doing at all, it's not worth doing well." (Laughter)

WARREN BUFFETT: You can see why Ben Franklin turned the mantle over to Charlie. (Laughter)

31. Lunch break

WARREN BUFFETT: We're going to take a break now, so you can all go out there and enjoy yourself in the adjoining room, and have lunch, and we'll be back here at 12:45.

And those in the other room might come back to this area because I think we'll have enough seats for everybody after lunch.

Afternoon Session - 2005 Meeting

1. Q&A resumes

WARREN BUFFETT: OK, we're going to start in just a minute or two, if you have a chance to sit down.

OK, let's go to station 9. And I've — I'll — we will go till 3 o'clock. We'll break until 3:15, when we'll convene the business meeting. No one has submitted any proposals for that meeting, so it may be relatively short.

At 4 o'clock, Charlie and I will meet in another room here — I'm not sure where — with any of those of you from outside North America that are here. We would like to especially thank you for coming this long distance.

2. We'll "do pretty well" when inflation is high

WARREN BUFFETT: So, with that, we'll go to area 9.

AUDIENCE MEMBER: Good afternoon. My name is Ken Goldberg from Sharon, Massachusetts — Massachusetts, having the distinction of being the birthplace of Benjamin Franklin.

And, thanks to New Jersey, the only state in the Union where one cannot buy GEICO auto insurance. (Laughter)

Earlier this morning, you discussed policies that have eroded, and that threaten to continue to erode, the U.S. dollar.

In some of your earlier letters to shareholders, you warned about the dangers of inflation and cautioned that shareholders should fully take inflation into account when evaluating the performance of a business.

To what degree do you expect a large decline in the value of the dollar to trigger inflation that would adversely impact Berkshire's equity holdings and its businesses?

And to what extent should we calibrate Berkshire's overall performance against the backdrop of a weakening dollar?

WARREN BUFFETT: Well, we think, by and large, we have businesses that will do pretty well in inflation. But inflation destroys value, but it destroys it very unequally.

The best business to have during inflation is one that retains its earning power in real dollars without commensurate investment to, in effect, fund the inflation-produced nominal growth.

The worst kind of business is where you have to keep putting more and more money into a lousy business.

In effect, the airlines have been hurt by inflation over the last 40 years, because now they have to put a whole lot of money in a lousy investment, which is a plane, compared to 30 or 40 years ago.

And they have to stay in the game. They have to keep buying new planes. And the new planes cost far more now, and the returns continue to be inadequate.

So the best protection is a very good business that does not require big capital investment.

And, you know, the best investment at all — of all — I mean, if you're the leading brain surgeon in town or the leading lawyer in town or the — whatever it may be — you don't have to keep re-educating yourself to be that in current terms.

You bought your expertise when you went to medical school or law school in old dollars, and you don't have to keep reinvesting. And you retain your earning power in current dollars.

We — Charlie and I are always suspicious that inflation will regain some of the momentum it had a couple of decades ago. We always think it's in sort of remission.

We thought the talk about deflation was total nonsense. And certainly, the trade picture is one that you would think would accentuate any inflationary trends that might otherwise be experienced. I mean, obviously, the price of oil in euros has gone up far less than the price has gone up in dollars.

And you and I are buying gasoline in dollars, so we have seen a bigger increase in our fuel costs because of the decline of the dollar than we would've seen if we lived in Europe, or some other — or Australia, for that matter.

So, it's — inflation is always a factor in calculating the kind of investment, the kind of business, that we want to buy. But it doesn't — it isn't like it crowds out all other factors. I mean, it's always been with us. We'll think about it always.

See's Candy has done fine during an inflationary period because it does not have huge capital investments that have to be made in current dollars.

Other businesses we have, you know, if we're — the public utility business, for example — it costs a lot more money to maintain capital expenditures now in dollar terms than it would've 30 years ago.

So you have to keep putting more and more money into a public utility. And you'd better hope that the rate of return allowed is commensurate in times of high inflation the same way that it might have been in low inflation with a lower rate of return.

Charlie?

CHARLIE MUNGER: Yeah. Well, so far, the facts that are driving the dollar down in relation to other currencies have been restraining inflation in the United States.

In other words, it's the competitive export advantages of the other people that are — that have so far restrained inflation here. So, it's —

WARREN BUFFETT: Yeah, you're paying less for shoes. You know, we got killed in the — in parts of our shoe business.

And 30 years ago, of the billion-plus pairs of shoes used in the United States, a very high percentage were made here. And now, virtually none are. But if they were all being made here, you would be paying more for shoes. There's no question about that.

CHARLIE MUNGER: Yeah.

3. Buffett: Don't bet against America

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: I'm a physician from St. Louis. And I want to thank you and everyone here, because I'm one of these doctors that really doesn't know anything about money or finance. The money comes in, but I don't know what to do with it.

I'm not able to really evaluate the financial strength of a company, but I can evaluate the ethical strength of a company. And that's why I feel real comfortable — I think most of us here — having our savings in Berkshire Hathaway. And the —

WARREN BUFFETT: Thank you. (Applause)

AUDIENCE MEMBER: This question has probably been asked in different ways already, but several years ago, a fellow I know who was — had been manager of Magellan Fund — warned that we were going to have a terrible decade or so in the stock market because of all the things people have brought up so far.

The increasing interest rates, and runaway spending, and decreasing dollar, and stagflation may be right around the corner, Social Security problems.

And even what Charlie Munger referred to, is that most of our best and brightest graduates, I find, are going into money management rather than — they're not becoming doctors or molecular biologists or Ph.D.s in chemical engineering.

And so, in view of the fact that a year or two ago, people — there was still an ebullience of emotion about the stock market going up and making everyone rich just by having their money in the stock market — it seems like that ebulliences dropped, and I'm hearing, in anticipation of a bear market.

And you wrote, I think several years ago, that it's hard to make money in a bull market. And the real opportunities come in a bear market.

So, I'm wondering if you would give us a clue as to what your strategies are going to be, if it's really true that the market gets dismal over the next few years.

WARREN BUFFETT: Well, if the market gets cheaper, we will have many more opportunities to do intelligent things with money. Now whether we will blow on the money in the meantime or something is another question.

But, you know, we are going to be buying things — one thing or another — operating businesses, stocks, high-yield bonds, whatever — we're going to be buying things for as long as I live, just like I'm going to be buying groceries —

CHARLIE MUNGER: Longer than that, Warren.

WARREN BUFFETT: Yeah. (Laughter)

Yeah. Charlie's just waiting to take over after I'm — (Laughter)

And I'm going to be buying groceries the rest of life. Now, would I rather have grocery prices go up or down if I'm going to be buying groceries tomorrow and next week and next month and next year? And the answer is obviously, if I'm a net buyer, I would — I will do better if prices are lower.

We have no — we're not good at forecasting markets. I mean, we, in a general way, knew that we were getting enormous bargains in the mid-'70s. We knew that the market went crazy to some extent in the late '90s.

But we don't have much — we don't spend any time — Charlie and I spend no time — thinking or talking about what the stock market is going to do, because we don't know.

We do know, sometimes, that we're getting very good value for our money when we buy some stocks or some bonds, as it may be. But we are not operating on the basis of any kind of macro forecast about stocks.

And there’s always a list of reasons — you gave a few — there’s always a list of reasons why the country will have problems tomorrow. But there’s always a list of opportunities which don’t get mentioned quite as often.

So, we don’t sit down and make a list of the bad things that are happening in the economy and the good things that are happening, and therefore expecting the stock market —

It might not — it doesn’t behave that way even if you could correctly forecast some of the bad things or good things.

Overall, I’m an enormous bull on the country. I mean, over time — I mean, this is the most remarkable success story in the history of the world, if you think about it. I mean, in 1790 we had less than four million people in this country.

We had — there were 290 million people in China. There were 100 million people in Europe. You know, and they all had the same intellect we had. They’re in the same general climate. They had lots of natural resources.

And 215 years later, those 3.9 million people, I think, actually, you know, have 30 percent or so of the world’s GDP. So, it does not make sense to bet against America.

That doesn’t mean all our policies are smart or anything, but I would not — I do not get pessimistic on the country. You know, I worry about the — I mean, the big worry is what can be done by either terrorists or governments that have access to nuclear, chemical, or biological weapons.

But, in terms of the basic economics of the country, your children are going to live better than you live. And your grandchildren are going to live better than your children live. And we do not focus on macro factors.

Charlie?

CHARLIE MUNGER: Well, I agree with you that the economics of the country are probably going to increase for a considerable period ahead. But I suspect that, in very important ways, we are at or near the apex of a great civilization. (Laughter)

WARREN BUFFETT: You heard it here first, folks. (Laughter)

If you leave the NCB — nuclear, chemical, biological — out of it, I do not feel that way. But, you’ll get to see which one of us is right 20 or 30 years from now.

It — I have seen more people pass up opportunities because they get focused on a single economic variable or a single problem that the country faces, and they forget about the good things.

I mean, if you can buy very good businesses at attractive prices, it's crazy to say, "I think I'll sit this out because it might get a little cheaper next year," or something of the sort, and because the world's going to go to hell.

We just — we've never operated that — we've never decided not to buy a business we liked because of a macro view. Have we?

CHARLIE MUNGER: Not yet.

WARREN BUFFETT: OK. (Laughter)

It's hard to get him to really agree with you. (Laughter)

I've been working on it for years.

4. GM and Ford haunted by past commitments

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Hello. My name is Randall Bellows. I'm from Chicago. And many years ago, Lauren, my wife, did a portrait of you drinking a can of Coke. Next year I'll bring one, drinking a can of Bud.

WARREN BUFFETT: I think you'd better stick with Coke. (Laughs)

AUDIENCE MEMBER: Oh, OK. I would like you to speculate on a couple of questions.

The first is, given the competitive disadvantage of General Motors and Ford with their huge health care liability costs for their employees and retirees, what do you think might happen there? Do you think there might be a bankruptcy to get rid of the liabilities or a government bailout?

And along that line, Charlie, you spoke several years ago about tort issues.

Do you feel there's anything coming in the way of asbestos reform or correction for those issues and the insurance companies that have been paying those billions? Thank you.

WARREN BUFFETT: Well, I would say that Rick Wagoner at General Motors and Bill Ford at Ford, both have been handed, by managers of the past, extremely difficult hands to play.

They're not the consequences of their own doing at all, but they have walked into what people call legacy situations.

But they have inherited a cost structure brought about by contracts that were put in place, maybe decades ago, that make it very difficult for them to be competitive in today's world.

I mean, just imagine if Ford or General Motors had signed contracts that made them pay several thousand dollars a ton more for steel than their competitors did. I mean, it would — people would immediately feel that was untenable.

So, General Motors and Ford are in the position of having commitments, which are, in strong contractual terms, to pay sums for retired, particularly, workers in both the annuity field and in the health field that are staggeringly high compared to some of their competitors.

And their competitors can buy steel at the same price, and they can buy aluminum at the same price, they can buy rubber at the same price.

And when you get all through with it, if they have huge advantages on the health care and the annuity side, it's not going to be a fair fight.

And those contracts, to some day — to some extent — go back to when General Motors had, for example, 50 percent-plus of the U.S. auto market. And now it has 25 percent. But I think even if it had 50 percent today it would be having trouble.

So, it's a very, very tough situation. I'm not sure what I would do if you put me in charge of — I mean, as Bill Buckley said many years ago when he ran for mayor of New York, they said, "What's the first thing you're going to do if you get elected?" He said, "I'll ask for a recount." (Laughter)

Well, that's a little the way I would feel if I got elected CEO of General Motors.

From the standpoint of the UAW, you know, they have a contract, they made a deal. And they've got $90 billion in the pension fund.

It's kind of interesting. The pension fund of General Motors possesses roughly $90 billion. The health care fund has a little more, too, another 20-some billion as I remember.

The whole equity of General Motors is selling for about 14 billion. So after all these years, there's 90 billion set aside for the retirees, and there's 14 billion of equity value that's been heading south for the owners.

And, it would seem that if General Motors had a steel contract that called for — let's say there's a ton of steel in every car — and I'm not saying there is — and if they were paying $2,000 a ton over market — or what their competitors were paying — people would say that that is not a viable situation for the long term.

But they're in a similar situation because the contracts they voluntarily signed.

And part of the reason they signed those — and undoubtedly — was that they bore no accounting consequences at the time.

It's a terrible mistake for managers not to think in terms of reality rather than the accounting numbers.

But back in the '60s, you did not have to account for pensions on an accrual basis. And up till the '90s, you didn't have to account for health care — or the late '80s, whenever it was — on an accrual basis.

And so people said, "Well, if we don't have to count it, it isn't real." Well, believe me, it's real. And the managers today are facing the consequences of that.

So, you know, they've got very tough hands to play.

And, you know, I read about it in the papers. I don't know what's going on there necessarily, but something will have to — in my view — something will have to give in that matter.

And before you answer the asbestos thing, Charlie, what do you think about them?

CHARLIE MUNGER: Warren gave a very optimistic prognosis — (laughter) — in my view.

I think — just because it hasn't happened yet doesn't mean that the problem isn't real.

If you jump out of the window on the 42nd floor, and you're still doing fine on the way down as you pass the 20th — (laughter) — it doesn't mean you don't have a serious problem. (Laughter)

If I were the governor of Michigan, or the president of the United States, or a director of General Motors or Ford, or a family member of Ford, I would want to address the problem right now.

I do not think it's getting better or that Yehuda is going to come over the mountain with a magic wand and make it go away. I think it would be better faced.

WARREN BUFFETT: You want to try the asbestos? (Laughter)

Give us another cheery — (Laughter)

Around the office he's known as Pollyanna. (Laughter)

5. Munger: "Terrible" and "gutless" behavior led to asbestos problem

CHARLIE MUNGER: Well, the asbestos thing has involved terrible behavior by some lying doctors, terrible behavior by a bunch of lawyers who suborned perjury, and gutless behavior by certain important courts, and even more gutless behavior by politicians who take care of themselves first, naturally.

And it's — these are the forces that are bearing on the problem. It's obviously not going to be handled very well. So, it's a perfectly terrible situation. You keep hoping that it will be so obviously bad that it will finally be addressed.

Some of that happened in California. The workmen's comp system in California had immense fraud in it, particularly egregious fraud by lots of doctors and lots of lawyers and lots of claimants. And it was so awful that it affected the whole employment prospects in California.

And with the [California Governor Arnold] Schwarzenegger revolution, that was partly corrected — I would say maybe 15 percent corrected. And, but it took —

WARREN BUFFETT: Five hundred pushups, Charlie.

CHARLIE MUNGER: What?

WARREN BUFFETT: Five hundred pushups unless it's 100 percent. (Laughter)

CHARLIE MUNGER: So, I think that if it gets bad enough, there is some possibility there will be more correction.

In a sense, it's totally crazy for a court system to be paying tons of money to people that have smoked two packs of cigarettes all their life and have one little spot on a lung that no honest doctor would know what the hell it caused.

And they aren't yet sick, and they're nearly dead anyway from their other behaviors and longevity.

And it's just, it never should have been allowed.

But once you get a powerful political force, even judges fear consequences. And it's very easy just to drift along with an evil system.

Luckily, we aren't using this particular — there are two kinds of asbestos, one of which is virtually harmless and the other which caused all this damage. And we stopped using the damaging asbestos.

And eventually the asbestos problem will go away. But how many people it will leave in some kind of financial wreckage before the storm is over, I can't tell.

I don't think the last Indian has bit the dust, do you, Warren?

WARREN BUFFETT: No, I'm — no.

CHARLIE MUNGER: I think the — but the behavior is so terrible. It's that kind of behavior that makes me talk about apexes of the civilization.

6. Our successors will provide the "same wonderful lack of oversight"

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: Now, Mr. Buffett and Mr. Munger, my name is Marc Rabinov from Melbourne, Australia.

I think it's rare for diverse collections of businesses to be successful. And I believe an important part of Berkshire's success has been your skillful oversight of the wholly-owned subsidiaries.

My question is, what advice would you give to your successor in managing our diverse portfolio of businesses?

WARREN BUFFETT: Yeah, well, it's a very good point that Charlie and I have been known to rail a bit about companies that go and buy this business and that business. And, of course, that's exactly what we've done ourselves over the years.

I think the motivations have been somewhat different, perhaps, than in many of the cases. And then I think the way we've approached it has been different.

We've — we have been reasonably successful although we've had some notable failures. But we've been reasonably successful in creating a climate where the people who built the businesses continue to run them with the same enthusiasm and energy after they sell to us that they possessed early on.

And I think that you can find all kinds of illustrations in the histories of businesses that are diversified. I mean, Gillette bought 20-some businesses. I remember, back in the '60s, Coke bought all kinds of businesses.

And certainly the cigarette companies did, all kinds of people. The oil companies for a while were doing it. And generally, the experiences were not very good when they got outside of their own fields.

But I think when those companies bought businesses, they really thought they were going to take them over and run them themselves. And Charlie and I are under no illusions that we can run the businesses that we buy as well as, or nearly as well as, the people that have been running them over time.

And, we don't have group vice presidents that — in Omaha — we don't have a whole bunch of directives going out. We don't have companies that were run one way and then we're going to run them entirely differently, and have them reporting in all kinds of special ways to us, and have a human relations department and a public relations department, then the legal department — all kinds of things in Omaha — telling them how to run their businesses.

We think that destroys — can destroy — many good businesses — certainly can destroy the incentive of the people that have already gotten rich to stay around and make us rich in turn. So, I think that has been an important difference.

I think it's been demonstrated well enough to all of those around Berkshire that it's been a very good place, generally, I think, for people, in terms of how they feel about working there. And I think they recognize it works.

So, the successor, to me, will come from within Berkshire. They will have seen how it worked. They will believe in it. They will be surrounded by people who have worked in this manner. And I don't think it will be the most difficult job in the world to keep that engine going down the tracks at 90 miles an hour.

I mean, it isn't like they have to create the system. They will inherit a system.

And I would be amazed if any of the three successors that we will talk about with the directors on Monday, if any of them would not recognize the inherent special values in the system as it now works and take up one of these other models that clearly has been disastrous for one company after another that's diversified.

Charlie?

CHARLIE MUNGER: Yeah. I don't agree with you that the success at Berkshire has come from our oversight of the subsidiary —

WARREN BUFFETT: No.

CHARLIE MUNGER: — companies. It's come from our lack of oversight of the subsidiary companies. And I think our successors will be able to provide the same wonderful lack of oversight — (laughter) — that we have provided.

And if you're not going to use a lot of oversight, you've got to be very careful in what you bring into your corporate family. And you've got to be very careful in treating, honorably and well, the people who are running the businesses over which you're not giving any oversight to speak of.

And I think our system is — it's very different from a General Electric system. And I think their system works very well for them, but I don't think it's the only system in the world that works in corporate capitalism. And I think the Berkshire system will work very well after we're gone.

WARREN BUFFETT: It's a very simple system. I mean, GE works exceptionally well. But when I go back to some of the conglomerates — and that's not a term that I shrink from, but most people do because they think it brings down their P/E or something — but we are a conglomerate. And I hope we become more of a conglomerate.

The — we don't — we haven't succeeded because we had great complicated systems or some magic formulas we apply or anything. We've succeeded because we don't have — we have simplicity itself.

We take people that know how to play their game very well, and we let them play the game. And it's just worked in one field after another. And every now and then we make a mistake. And we'll — you know, there'll be more mistakes made.

But overwhelmingly, it works. And it doesn't require some great business insight or anything like that, in terms of whoever's running this place, to keep that kind of machine in motion. I mean, it is not complicated.

The bigger worry would be that the culture would get tampered with in some way and people would try to oversteer, basically.

But that won't happen. Our board won't let it happen. And the ownership won't let it happen.

And I think we've got something that'll work for a very, very, very long time. And that's why I'm comfortable with the fact that every share I have will go to a foundation that I care about having — getting good financial results in the future.

And I'm quite happy to have them have 100 percent of their money in Berkshire.

7. Berkshire's best-ever investments: GEICO and Ajit Jain

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Jonathan Mills (PH) from London, England.

What has been the single best investment of your careers? And why do you consider it to be the best, excluding Berkshire Hathaway itself?

WARREN BUFFETT: Yeah, well probably the best investment, if you're talking about business, was getting Charlie as a partner. And he works cheap, too. (Laughs)

The — we've had — you can't measure it by dollar terms because, obviously, we're doing bigger things now than early on.

I mean, See's was an enormously important part of our success. It doesn't contribute a huge percentage of our net income now, but it provided income that let us buy other things in the past. It taught us a lot of lessons about business, all kinds of things.

So, we've — probably, in terms of what it's done already and where it's going to go over time, probably the single best investment was the first half of GEICO, which we purchased for $40 million. Now the second half cost us 2 billion. I'm glad I didn't buy it in thirds. (Laughter)

But, you know, that 40 million will — for half the company — will turn out very well.

But GEICO — some of our businesses have growth potential, some don't. And we don't require growth potential as part of a business.

If a business makes good money and we can use it to buy other businesses, one of the advantages of the Berkshire system is we have a tax efficient and kind of frictionless way of moving money to the best opportunities. And GEICO, internally, has still enormous possibilities for growth.

Incidentally, we've — you know, I watched that movie and I kept touting the American Express card. But here is our GEICO card, which I'm sure all of you are eligible for.

And I don't advise people using credit cards to revolve. But the truth is that people do, so use a GEICO card if you're going to behave in — if you're going to charge anything.

I still advise you to pay off your account before it starts revolving. And I think it's a terrible mistake for people to get hooked on revolving credit at high interest rates.

And I — that's the first thing I tell students is that, if they don't remember anything else I say, just, you know, don't fool around with charge cards and run up balances that keep getting larger and larger.

But GEICO — GEICO has well over six million customers now. As was mentioned, we entered New Jersey last year. We're adding very rapidly there. It's a great, great business model.

And it's run by a superb human being and businessman, Tony Nicely. And I think it's got a huge potential. But I love them all.

CHARLIE MUNGER: Well, but GEICO, after all, cost $2 billion for the second half and —

WARREN BUFFETT: Right.

CHARLIE MUNGER: — a significant number of tens of millions for the first half.

Now the search expenses that brought us Ajit Jain, now there was an investment that really paid a dividend. I can think of no higher return investment that we've ever made that was better than that one. (Applause)

And I think that's a good life lesson. In other words, getting the right people into your system can frequently be more important than anything else.

8. NYSE should not being trying to earn a profit

WARREN BUFFETT: OK. Let's try number 2.

AUDIENCE MEMBER: I'm Maggie Gilliam (PH) from New York City.

As someone who visited the New York Stock Exchange at a very early age and have been touting its merits over the years, could you comment a little bit about what you think of the shenanigans going on currently?

WARREN BUFFETT: Well —

CHARLIE MUNGER: Where?

WARREN BUFFETT: At the exchange.

CHARLIE MUNGER: Oh.

Warren, you're so good at this. (Laughter)

WARREN BUFFETT: You mean at shenanigans or —

I personally think it would be better if the New York Stock Exchange remained as a neutral — and it's not strictly a non-profit, it'll earn some money — but as a not-for-big-profit, we'll put it, institution.

I mean, the exchange has done a very good job over centuries. It's one of the most important institutions in the world. And the enemy of investment performance is activity. And the creator of profit in a profit-minded exchange is activity.

So, I personally would rather not have an exchange which is trying to increase its earnings per share annually, and thereby wanting to encourage people to trade more actively and create more income for itself.

That will not be, in my view, good for the American investor. So, I think that the exchange of yesterday may be better for the American investor than what looks like it may be the exchange of the tomorrow.

Now there may be all kinds of reasons that are — people find compelling why they want to turn it into a for-profit exchange.

But I know the American investor will not be better off if volume doubles on the New York Stock Exchange.

And I know that the New York Stock Exchange as a for-profit institution would be trying to figure out ways to have that volume increase and to perhaps even charge more money one way or the other.

I mean, you know, the profit of an exchange, the profit of the people working on them, in a sense that's the frictional cost of capitalism. That's coming out of the earnings of the businesses.

And, you know, IBM or General Motors or General Electric will not earn more money because their stock turns over more frequently.

But a for-profit exchange will earn more money. And I do not like the idea of the exchange getting on the side that's against the long-term interest of investors.

Charlie?

CHARLIE MUNGER: Well, I feel, on this one, the same as you do with — much more strongly.

I think we have lost our way when people like the governors of the stock exchange and the CEO fail to realize that they had a duty to the rest of us to act as exemplars, there was — of the right behaviors.

Once your activity is that freighted with public significance, I think you've got a duty to create the right appearances. You have a duty as an exemplar.

I mean, you do not want your first grade school teacher to be fornicating on the floor or drinking booze in the classroom or —

And similarly, you — I don't think you want your stock exchange to be all over the headlines with wretched excess. And I certainly don't think you want to turn the major stock exchange of the country into even more of a casino than it is already.

I think we have totally lost our way on this stuff. And I agree with Warren that it ought to be — (applause) — a public institution that cares deeply about its duties as exemplar.

WARREN BUFFETT: I wish I'd gone to first grade where he did. (Laughter)

CHARLIE MUNGER: I didn't hear that.

WARREN BUFFETT: I said I wish I'd gone to first grade where you did.

9. Buffett (D) and Munger (R) both endorse Social Security

WARREN BUFFETT: Number 3. (Laughter)

AUDIENCE MEMBER: Good afternoon, gentlemen. My name is Glen Strong (PH). I'm from Canton, Ohio. I want to extend a warm thank you to Warren's daughter, Susan, for the fine introduction that she provided for this gathering.

WARREN BUFFETT: Thank you. (Applause)

AUDIENCE MEMBER: Also, a special thank you to your wife, Susan. I thank her for the contributions that she made to the company and for the outstanding example that she obviously set for her husband and the many people that she must have come into contact with. (Applause)

Today, I'm asking for your opinion on Social Security. Shall we call it the government-sponsored Ponzi scheme for retirees?

I am interested in your views on private accounts, age adjustments for retirees, and tax adjustments for the employees. What would you promote if you were in the Oval Office? Thank you.

WARREN BUFFETT: Yeah, the Social Security was introduced in the, what, '36 or '37. My grandfather used to have Charlie bring two pennies to work at the Buffett & Son Grocery Store on Saturday in order to pay his share of Social Security.

Didn't want Charlie getting any false ideas that there was a free lunch in this world. And he gave him a half-hour lecture on the evils of socialism. So, we've had a lot of exposure to Social Security, the various arguments on it.

It was proposed, of course, as insurance, because basically that was the only way [President Franklin] Roosevelt could get it passed. The idea of transfer payments did not — would not have washed in the '30s, certainly.

You know, and I think the first woman that received a Social Security check paid in a total of $22 or something and got 2,400. So, it wasn't insurance. It wasn't insurance at all.

And the transfer payment by the people who are in their productive years to the people who are past their productive years — and we'll get into definitial require — terms as to whether it's 65 or 67 now, you're past productive years — but essentially it's a transfer payment.

I basically believe that anything that would take Social Security payments below their present guaranteed level is a mistake.

I think that in this country — extraordinarily rich country — that the people in their productive years can take care of those outside in both areas, even though the ratio of productive to non-productive has changed and is changing.

But we take care of our young. And a rich country takes care of its young and it takes care of its old.

And incidentally, taking care of its young, when we educate five children in the family, we don't expect that family to pay, you know, five times the tax or something like that.

We recognize that in taking care of the young, that it should not be based on a per capita basis or based on the size of the family. We provide good school — we try to provide good schools — and health and everything for the young overall as part of our overall responsibility.

I believe that a rich country should be doing the same for the older people. There are — you know, Charlie and I came into this world wired in a way that enables us to get very, very, very rich — rich far beyond any possible needs that we could have. And not everybody's wired the same way.

Now if you come into this world wired with an I.Q. of 85 or something of the sort, or disabled or whatever it may be, you know, you are not going to do as well in a market economy, remotely as well, as we do.

But you still provide much of what makes Charlie and I very rich. And, you know, and when it comes to fighting in Iraq or something of the sort, you know, then that becomes an equal opportunity type thing. But when it comes to making a lot of money, it's not equal opportunity in this country.

So I believe that a rich country like ours should not give lower benefits than what takes place now. And I certainly don't think that — and we've got all kinds of mechanisms for saving that are extremely good.

We have 401(k)s in the country. We have taxes on dividends and capital gains at 15 percent, so the money I earn gets taxed at a lower rate than the money that a receptionist in our office may earn.

And I would not be doing so well if I were stuck over in Bangladesh or someplace. So this society is providing huge benefits to me that other societies would not.

And I think that the obligation for the people who do well in this society is to provide a reasonable level of sustenance for those beyond their productive years.

We've got the capability to do it. You know, right now we quit taxing for Social Security at $90,000. But — and that means that everybody in my office is paying — or most of them — are paying 12.4 — 12.2 or 12.4 percent, counting what the company contributes, toward this.

People talk about double taxation of dividends; they're getting taxed for Social Security and they're getting taxed for income on their income. And they're paying a higher rate, or an equal rate overall, in many cases, to the same rate — compared to the rate that I pay. And I think that's sort of nonsense in this society.

So, I don't want to do anything — anything — that hurts the level of the bottom 20 or 30 percent, in terms of their income.

I see people living with fear about health care or living with fear about running out of money in their old age. And I think a society should try to minimize the fear that their inhabitants experience.

And that doesn't mean just fear of getting mugged or something. It means fear that the last 25 years of their life, they're not going to have much income.

So, I would — and the degree to which the administration or other people are worrying about the deficit in Social Security 25 years out, when they have a $500 billion deficit excluding the Social Security surplus now, I mean, just strikes me as nonsense. (Applause)

Here we are deploring something that's going to happen in 20 years that's a fraction of what is happening right now while they're cheering, you know, basically, and talking about further favoritism in the tax laws.

So, I have great trouble with people that say, you know, that this system can't sustain — right now, 4 and a fraction percent of our GDP goes to Social Security.

Fifty years from now, 6 percent — no, 6 and a fraction percent — well, believe me, our GDP will be far larger 50 years from now. And going from 4 percent to 6 percent does not strike me as a terrible prospect.

If you ask me what I would do to change it now, I would means test it. I would lift the $90,000 way up. In fact, I might apply it, you know, on all income. Then you'd really get people's attention.

But — and I would gradually — and we're in the process of doing this — but I would certainly increase the retirement age. I mean, the world in 2005 is much different than the world in 1937, in terms of longevity prospects and the ability to function productively.

Charlie, what do you say?

CHARLIE MUNGER: Well, that's the view from Berkshire's Democratic chairman. (Laughter and applause)

And the odd part of Berkshire on this issue is that the right-wing Republican who is speaking feels more strongly than Warren that the Republicans are out of their cotton-picking minds to be — (applause) — taking on this issue right now.

I do not — If the country is going to get richer at 1 or 2 percent per annum for a long time ahead, and it's going to have more old people who are living longer and spending money on medical care, the idea that eventually a higher share of GDP would be going through Social Security to retirees and so on than we now have is not anathema to me.

It's exactly — it's an exactly logical way to be spending money under different circumstances.

And if the government runs out a little short of money as it gets more Social Security obligations, I see nothing wrong with having some consumption taxes or whatever to pay in a reasonable way for what is a very reasonable expenditure.

Social Security is very successful. Apart from the disability element, which is relatively small, there's practically no fraud. It's hard to fake being dead. (Laughter)

And furthermore, it's a reward for work. All kinds of people are working in this country because they want to eventually qualify for Social Security, just as many people are doing dangerous military service because they want the pension that will come eventually.

So, Social Security is a very capitalistic institution with profoundly good effects. It's one of the most successful things the government has ever done in terms of efficiency and good effects.

And a Republican administration that may shortly have to do something really unpleasant, like face down North Korea or Iran over atom bombs, is wasting its good will over some twaddle that a bunch of economists that haven't thought it through properly devoutly believe? It's a very sad occurrence. (Applause)

10. Don't blame the ratings agencies

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Thank you. Bill Ackman from New York, New York.

Four of the handful of triple-A rated companies — AIG, Fannie Mae, Freddie Mac and MBIA — are under formal investigation for accounting shenanigans and are in the process of restating their financials.

Like Charlie said before, I think of a triple-A rated company as an exemplar, a company that should behave with the highest accounting and ethical standards.

My questions this leads me to are, how can investors comfortably invest in any financial service company when even — when a decent percentage of the triple-A rated companies have false and misleading financials?

And I guess the follow-up question is, why don't the rating agencies do some independent due diligence from an accounting standpoint so that they can help serve as a watch on this issue?

WARREN BUFFETT: Well, financial companies are more difficult to analyze than many companies.

I mean, the — it is more — if you take the insurance business, you know, the biggest single element that is very difficult to evaluate, even if you own the company, is the loss and loss adjustment expense reserve.

And that has a huge impact on reported earnings of any given period. And the shorter the period, the more the impact can be from just small changes in assumptions.

You know, we carry, we'll say 45 billion of loss reserves. But, you know, if I had to bet my life on whether 45 billion turned out to be a little over or a little under, I mean, it'd be a — I'd think a long time.

And you could just as easily have a figure of 45 1/2 billion or 44 1/2 billion. And if you were concerned about reporting given earnings in a given period, that would be an easy game to play.

In a bank, you know, it basically is whether the loans are any good. And I've been on the boards of banks. And that's — you know, I've gotten surprises. It's tough to tell.

It's — financial companies — if you're analyzing something like WD-40, you know, or See's Candy, or our brick business, or whatever, you know, they may have good or bad prospects but you're not likely to be fooling yourself much about what's going on currently. But with financial institutions, it's much tougher.

Then you add — throw in derivatives on top of it, and, you know, it's — no one probably knows, you know, perfectly, what some of the — or even within a reasonable range — the exact condition of some of the biggest, you know, banks in the world.

And — but that brings you back to the due diligence question of the agencies. You had very high-grade, very smart — financially smart — people on the boards of both Freddie and Fannie. And yet, you know, one was five billion and one was apparently nine billion.

Those are big numbers. And I don't think those people were negligent. And it's just, it's very, very tough to know precisely what's going on in a financial institution.

Charlie and I were directors of Salomon [Brothers]. And Charlie was on the audit committee. And I forget the size of a few of those things that you found. But, you know, what wasn't found — and that doesn't mean that people below are crooks or anything like that.

It just means that it's very tough with thousands and thousands and thousands of complicated transactions, sometimes involving — the computations involving — multiple variables, it can be very hard to figure out where things stand at any given moment.

And, of course, when the numbers get huge on both sides, and you get small changes in these huge numbers, they have this incredible effect on quarterly or yearly figures because it all comes lumped in — those adjustments — come lumped in a short period of time.

So I just think you have to accept the fact that insurance, banking, finance companies — we've seen all kinds of finance company — both frauds and just big mistakes over time — of just one after another over the years.

And the — it's just a more dangerous field to analyze. It doesn't mean you can't make money in it. We've made a lot of money on it. But it's difficult.

Now, obviously a GEICO, where you're insuring pretty much the same thing — auto drivers — and you get — your statistics are much more valid in something like that than they will be if you're taking something that — like asbestos liability — you're subject to far greater errors in estimation.

Doesn't mean that people aren't operating in good faith. But, you know, I would take — just take the asbestos estimates of the 20 largest insurance companies. I will bet you they're way off, but I don't know in which direction. And that's sort of the nature of financial companies.

I wouldn't fault the rating agencies in terms of not being able to dig into the financials and find things that —

You know, all of the companies that you've talked about have had big name auditors. And our auditors at Berkshire, how many hours did they spend last year?

You know, I don't know whether — what it would be, probably 60, 70,000 hours. And I'm sure at other — you know, if you take major banks, they're spending more than that. But, you know, can they be certain of the numbers? I doubt it.

Charlie?

CHARLIE MUNGER: Yeah. Warren is obviously correct that where you've got complexity, which by its very nature provides better opportunities to be mistaken and not have it come to notice, or to be fraudulent and have it not be found out, you're going to get more fraud and mistakes than you are if you're selling a business where you shovel sand out of the river and sell it by the truckload.

And just as a business that sells natural gas is going to have more explosions than a business that sells sand, a business like these major financial institutions, by its nature, is going to have way more problems.

And that will always be true. And it's true when the financial institutions are owned by governments.

In fact, some of the worst financial reporting in the world is done by governments and governments — institutions like government banks in China, et cetera.

So, if you don't like the lack of perfect accounting in financial institutions, you're in the wrong world.

11. We like our stocks but aren't buying more now

WARREN BUFFETT: Number 5?

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. Thank you very much for your wisdom and all your investment advice. I'm Adrian Sherr (PH) and I'm from Hong Kong.

Back in the old days in Hong Kong when somebody turned 100, they got to have tea at Buckingham Palace with the queen. I don't know what you have here in America, but I hope that in 2030 we come back to watch you do 50 pushups at the White House. (Laughter)

CHARLIE MUNGER: It's not the way to bet.

WARREN BUFFETT: Will you settle for 10? (Laughter)

AUDIENCE MEMBER: My question comes in two parts.

Firstly, in 1968-69, you liquidated all your partnerships. And I guess, aside from your holdings in Berkshire Hathaway, you got completely out of the market and stayed out.

In 2000-2001, you mentioned to us that in the coming decade the markets would go, at best, nowhere.

However, despite $50 billion in cash, you and therefore us, remain substantially invested in the market.

So my first question was, how and why is the investment climate different today than in 1968-69 that makes you comfortable remaining substantially invested?

WARREN BUFFETT: Yeah, well, we do own certain securities which we wouldn't — we probably wouldn't — buy at these prices. Some of them we would. Some of them we wouldn't.

We're not unhappy with anything we own. We're not happy with putting more money in, so we're in a zone in some of those securities that — where we wouldn't buy and we wouldn't sell.

Now part of it — that decision relates to the kind of quantities that we deal in. I mean, if we owned 100 shares of each one of the stocks that we own, you know, many billions of dollars' worth, it would be an easier decision to go in and out.

But we would face significant costs — including taxes, but on top of taxes — in trying to go in and out of the big positions we have. And basically we like the businesses.

So, we are not unhappy. We may feel like we wouldn't want to buy more here. But we are not unhappy about being in the businesses in which we have big equity holdings.

Now notwithstanding all of that, a lower percentage of our intrinsic value is represented by the common stocks we own than just about at any time of our history, with the exception of a couple — well, the period right there at the end of 1969 when we liquidated the partnership.

So, we have not made any big statement by purchases of stocks or the ownership of stocks that says we — in any way — says that we think that this is a particularly attractive time to own them.

But we are not unhappy with Coca-Cola. We are not unhappy with American Express. We are not unhappy with — we are not unhappy with Wells Fargo or Moody's. Those are very, very good businesses that we own.

Would we be buying them at today's prices if we, you know — well, the answer is we're not. You know, we've got money. And we may buy more later on. We're more likely to buy more later on than to sell those sort of investments.

But there is a zone, which because of size, because of taxes, where we would neither be a buyer nor a seller.

And we do not see lots of attractive stocks, but we also don't think that there's as much silliness in the market, by far, as there was 5 years ago roughly.

Charlie?

CHARLIE MUNGER: Yeah. One of the things that's interesting about Berkshire lately is that if you take the last four or five things we did in the stock market, with a goodly number of millions, but — billions, really — but small in relation to Berkshire's overall size — our record is much like it used to be in some of the best days.

Where we were able to move around with small amounts of money, the results were quite respectable. But where we were facing the problems of being enormously rich the way we were prevented from the nimble moneymaking record of the past, I don't think that's a permanent state of affairs, but it's never going away either. But it —

WARREN BUFFETT: Explain that one. (Laughter)

CHARLIE MUNGER: Well, I mean, it's that I think we may be able to deploy large amounts —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — of money eventually at very satisfactory rates. Whereas in recent times, we have deployed small amounts of money at very satisfactory rates.

And better small than nil. And small is still billions. (Laughter)

12. "I don't see gold as a store of value"

WARREN BUFFETT: Number 6. (Laughter)

AUDIENCE MEMBER: Good afternoon. My name is Mike McGowan (PH) and I'm from Pasadena, California.

I had a pretty good question on Prop 13, but after watching the movie I don't think I'll ask it.

WARREN BUFFETT: Good. (Laughter)

AUDIENCE MEMBER: What I'd like to ask about, I guess, is one quibble and then a question. The question being about financial education, or a study of financial history, that might help people in handling these markets or in — just dealing with investing at or near the apex of Western civilization.

When you mentioned your dad's lectures about "buy gold" back in the 1930s, and then saying, "Well, 60 years later, it hasn't done very well," gold was pretty much pegged at a set price back in the '30s for years and they didn't really let it loose until 1971.

And then it caught up. And then it's kind of bounced around. If you looked at gold maybe now, and derivatives and real estate bubbles and lots of other things, maybe gold wouldn't be such a bad investment, looked at in current terms.

So, my question would be, do you consider that you have some sort of an obligation or duty as financial exemplars to maybe pay a little attention to that classical kind of gold is the benchmark or the bedrock of a financial system, to some extent?

And that it might be nice to talk about it, in your — at least your annual letter to your stockholders — about how people might protect themselves in what's a fairly bubbleous kind of environment from, really, the decline in purchasing power or problems caused by the financial domination that we have today? Thanks.

WARREN BUFFETT: Yeah. I would say that gold would be way down on my list as a store of value. I mean, I would much prefer owning a hundred acres of land near here in Nebraska, or an apartment house, or an index fund.

Gold, we'll say, was freed up 30-odd years ago. But it adjusted to a market that still, if you go back to 1900, you know, you were talking $20 gold. Well, you take 20 to 400 in a hundred years.

The Dow went from 60 to, what, 12- or 13,000 — 12,000 or whatever it might have been — in that same period, and paid you dividends during the time you owned it.

It was 66, I think, at the start of the century. And I forget where it ended, but it's 11- or 12,000. And like I say, it was paying you something every quarter during that period.

And if you owned gold, you paid $20 in 1900 or thereabouts. And then you — we'll say you had $400 a hundred years later. And in the meantime, you paid insurance and perhaps some storage cost.

It really is not — it's not a store of value. And it's — I'm not arguing for paper money, but if you're worried about paper money —

And I think, you know, it makes a lot of sense to worry about paper money over long periods of time — but it's just about — you know, it's just about the last thing I would want to own under those circumstances.

You know, it has — a farm has utility, an apartment house has utility, a business, you know, will produce earnings. And some businesses will produce them in real terms as they go along.

You know, I'd rather have the ability to sell people a pound of candy 20 years from now. And if they're dealing in seashells, I'll get an appropriate number of seashells instead of paper money for it.

But I — it — I just don't — I don't see gold as a store of value. And it's — the truth is, it hasn't worked very well.

But forget about whether it's worked well the last hundred years or the last 50 years or the last 10 years, I see no reason, you know, why it would work well in the future.

I forget whether we're turning about three- or four-thousand tons of gold a year. And, you know, we take it out of the ground in South Africa and we put it in the ground at Fort Knox or someplace, you know, or in the New York Fed. I mean, and it doesn't do much along the way, for anybody.

So, I —

Charlie, how do you feel about gold?

CHARLIE MUNGER: Well, I think gold was — and similar items — that was a great thing to have if you were a well-to-do Jewish family in Vienna in 1935, because you had hazards where that gold had enormous utility to you. But for Berkshire Hathaway sitting here in 2005, it just doesn't interest us at all.

13. No stock bubble right now, but no bargains, either

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: My name is Al Henderson (PH) from Minnesota. I'd like to thank you both of you for being yourselves and doing so much for all of us and to help enrich ourselves and everyone else.

My question I have is — actually, you already referred to it — that you devote very little time to looking at the total market and look for individual opportunities most.

But I was wondering, in the past you made some excellent presentation on points to consider in projecting reasonable 10-year returns for the stock market and had to devise reduced expectations.

Where do we stand now on your stock market and economic measurements and expected 10-year returns?

WARREN BUFFETT: Yeah. Every now and then — I mean, and I agree — very infrequently, you probably can say something intelligent about markets as a whole.

I mean, that you do see circumstances that are extreme enough that you can make a statement that is likely to look reasonably intelligent five or 10 years later.

And I've seen a few of those times in my lifetime. I mean, I — and I've spoken out a couple of times. And I did in '69 and '74 and a few times. Most of the time, you know, you're in some in between zone.

Obviously, you get more for your money in equities now than you got, say, in the summer of 1999, which is when I delivered a talk out of Sun Valley that later got turned into an article for Fortune.

But that was an — I spoke out then because it was extreme. I mean, I knew in a general way that I was going to be right, particularly in certain aspects of the market, but I didn't know when, and then I didn't know how right or anything of the sort. And you could've done the same thing in the other direction back in the mid-'70s.

I think that if you had to make a choice between owning long-term bonds, which are now yielding — the Treasury — only a little over 4 1/2 percent, or owning equities for the next 20 years, and you couldn't make — change that decision, I would certainly prefer equities.

But I think people that have expectations that they can earn more than 6 or 7 percent in equities, and certainly when they start expecting double digits, I think the degree to what they have expectations, they can do that or that they can find somebody else to do it for them, I think they're making a big mistake.

But 6 or 7 percent is not the end of the world at all. In fact, it — and it gets treated better tax-wise right now than it has almost any — well, really anytime in my lifetime.

So — I don't think we're in bubble-type, at all, valuations in equities. And I don't think we're anywhere close to — remotely close to bargain valuations. And I don't think it's an extreme enough period that you can speak out in some very definitive way about the outlook.

But if you told me I had to go away for 20 years and choose between what's obtainable in an index fund of equities or be committed to long-term bonds, I would rather take equities.

But I think you will get a chance to do something that is more screamingly intelligent in not too many years — and maybe a lot shorter — than the alternatives that you're offered now.

Charlie?

CHARLIE MUNGER: Well, I can't improve on that at all.

14. "Bubble valuation problems" for real estate

WARREN BUFFETT: Well then we'll go to number 8. (Laughter)

AUDIENCE MEMBER: Hello. My name is Hamid Rezapour. I'm from Orinda, California. I had a question about real estate.

And I know this question was asked in previous shareholder meetings about, "How come Berkshire doesn't invest in real estate?" And I believe the answer was that, "We like operating business." So I want to make my question a little bit more specific towards commercial real estate.

So, considering the characteristics of larger-size commercial real estate investments like REITs that can have the behavior and financial returns of an operating business, why not invest in real estate?

Is it because you just don't like the returns? Or the business is just not attractive?

WARREN BUFFETT: Yeah, well, Charlie got his start in real estate. Right, Charlie?

CHARLIE MUNGER: Yeah. I would say, number one, that in a corporation like Berkshire, that's taxable under subchapter C of the Internal Revenue Code, owning real estate is grossly disadvantaged compared to owning it directly by individuals such as yourself. That's number one.

And number two, real estate — investment real estate — is having bubble valuation problems of its own right now.

All my rich friends who own real estate are selling their worst properties. And they're getting bids that come in higher than their highest expectations. And people are competing to take these things off their hands.

I do not find it exciting. And it certainly doesn't fit Berkshire. Name me a lot of C corporations that have been passive holders in real estate and have done well over a whole lot of years. It's almost a null class.

WARREN BUFFETT: Yeah, Charlie and I — I mean, both — more Charlie than I — we've had certain personal real estate investments over time. And it — you know, it's a field that, in general, we understand.

We don't bring that much special to the game, but we understand it. We've made money in it.

And actually, at the time that the NASDAQ about hit its high, REITs were quite cheap in my view. And I have less than 1 percent of my net worth outside of Berkshire, but basically I had that portion all in REITs. They were all small ones at that time.

And — but they were selling at discounts. At that time they were selling at discounts to the values of properties. And those values of properties were much more conservatively figured than today.

Today, you have very fancy prices on real estate. And on top of that, you have the REITs often selling at a premium, though. So, I regard REITs as quite unattractive now, certainly compared to five or six years ago. But that's a group of —

CHARLIE MUNGER: That's for an individual, you regard them as unattractive?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And for a corporation, that much more so?

WARREN BUFFETT: Yeah, right. Right. It — the situation changed dramatically from five or six years ago. I mean, the stock market, in many respects, from the 1999-2000 period, is down significantly. REITs are up significantly.

REITs were very unpopular five or six years ago. Now they're popular.

It's better to pay attention to something that is being scorned than something that's being championed. And there's really been a big change in the REIT situation in the last five or six years.

CHARLIE MUNGER: And the REITs have phony accounting.

WARREN BUFFETT: Otherwise, we love them.

CHARLIE MUNGER: Yeah. (Laughter)

WARREN BUFFETT: You don't want to bring up anything in these meetings. (Laughter)

15. Global prosperity helps the U.S.

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Good afternoon. My name is Carlos Lock (PH). I'm from Lawrence, Kansas.

The U.S. has had a dominant role in the world economy for about a hundred years. This dominance resembles that of an economic monopoly.

Would you say that the U.S. is a quote- unquote, "a castle with a moat?" And if so, how can we make the moat any bigger? Thank you.

WARREN BUFFETT: Yeah, well, the U.S. has been pretty remarkable, as I indicated in my earlier comment. I mean, you know, essentially, the same population pool pretty much, and they've garnered over this 215-year period, a remarkable share of the world's wealth.

And it's an interesting question as to just why this group of people here have been able to do so much better than the rest of the world, considering we're not any smarter or anything of the sort.

It's not an economic castle anymore. I wouldn't call it that.

What we do is no secret. And I think that the relative importance of America — I mean, we have been a dominant factor in the world, and post-World War II — and I think it will decline somewhat, although I'm not an alarmist on that.

But I think to some extent, the rest of the world, or much of the rest — or some of the rest of the world — is catching on and adopting, you know, sort of best practices, as they say in industry.

And our castle will grow in size, but there will be more castles around it. And I basically think that's a very good thing for the world.

I think the more prosperous, generally, the rest of the world is, you know, the better, generally, it will be for us. And, you know, I've talked about our trade problems. The more trade we have, the better.

We had 1.1 trillion of real trade last year in the country. We would've — with the world — and then we had another 600 billion — 6/10ths of a trillion — that, unilaterally, we bought.

Well, I would love to see the 1.1 trillion grow and grow and grow. It'd be good for us and good for the rest of the world. But I don't think that our prosperity will come — in the future will come at the expense of the rest of the world at all.

I do think that there were parts of the world that will grow economically from a lower base, but much faster than the U.S. And basically, I think that's a good thing.

I mean, there are six billion people in this world, and a lot of them don't live very well. And I would hope that 20 or 50 years from now that it's a higher percentage of them would live well and that — but I don't think it comes out of our hide at all.

Charlie?

CHARLIE MUNGER: Well, I don't think it comes out of our hide in that sense, but if we are now the richest and most powerful nation in the world and 50 or a hundred years from now we're a poor third to some country in Asia, sure, we're richer, but it's a peculiar type of richness where you've lost your relative position in the world.

It's not all — I think if I had to bet, I would bet that the part of the world that does best is Asia, in terms of percentage gains per annum.

And I think it might do amazingly well if it doesn't blow up in some way. And if it does amazingly well, it will eventually be a much richer place than ours.

WARREN BUFFETT: Mm-hmm.

16. "Unwise" economic policies, but no "Armageddon"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Good afternoon, gentlemen. I'm Thorsten Kramer (PH) from Cologne, Germany.

You've criticized the extraordinary large stake that the financial sector in the United States is currently representing in relation to GDP, which is also reflected in a total credit volume exceeding GDP by roughly 250 percent, significantly up from the level we've seen a decade ago.

A current account deficit and budget deficit running at 6 percent of GDP, in combination with a still accommodating easy money policy, and high asset prices, will have to be consolidated sooner or later.

How do you think the adjustment will take place? What are your two most likely scenarios how these huge imbalances might be consolidated? And is the dollar devaluation scenario your most favorite one?

WARREN BUFFETT: Well, as I said earlier, I don't see how the situation resolves itself with a stronger dollar.

Most people still seem fairly sanguine about the fact that there won't be anything terribly bumpy about it, that there'll be this so-called soft landing.

And I don't know whether that'll be the case or not. But I would say that we're running the risk of having markets that could get chaotic if certain events converged, superimposed upon those factors that you just listed.

But I don't — I'm not an Armageddon type at all on the economy. I mean, the things you named are important factors.

I think that absent something happening in the terrorism field, I think that, you know, the citizens of the United States, on balance, will be living better ten years from now than now, and 20 years from now than now.

But I do think that we're following policies that are unwise. But we've done that plenty of times over history. I mean, [investor] Peter Lynch has always said, you know, "Buy a business that's so good that an idiot can run it, because sooner or later one will." (Laughter)

We've got a country that's so good that we can have policies that are counterproductive — (applause) — and we'll still come out OK.

Just think of what we've had over the years. I mean, you know, Warren Harding, Chester Arthur?

I mean, we've had a lot of things in this country. We had the Civil War. We had all kinds of things over the years.

But the society has marched forward, with some fits and starts, but still at a very significant clip.

The real GDP per capita is seven times, in the U.S., what it was a hundred years ago. Just think of that. One century in the human pageant, and a sevenfold increase in GDP per capita. It's remarkable.

So, I acknowledge, you know, consumer debt doing what it's done and the trade deficit being what it is. And I think that those things — particularly the trade deficit — should be addressed, and promptly. But I don't think they pull down the whole place.

They may create, you know, very severe dislocations in financial markets from time to time. But that's been the history of this country. I mean, we have had very dramatic things happen in financial markets over the years. And the country survives despite that.

And sometimes there's great opportunity in those dislocations. There's likely to be.

So I'm not pessimistic about the U.S. at all. You know, I can't imagine anyplace that I would rather be.

But whether — when you say the two most likely outcomes, I think the eventual outcome is that the country does fine. But I think a — there's a significant possibility that you do have some chaotic financial markets at one time or another. But we've had them historically.

Charlie?

CHARLIE MUNGER: Yeah, we don't have any great record as macroeconomic predictors. And I don't see any reason why we should really start now.

Obviously, there are more chances for convulsion now. I mean, everybody from [former Federal Reserve Chairman] Paul Volcker on has looked at the current figures and said we could have some kind of convulsion as a consequence of (inaudible). Apart from knowing that, we have no contribution to make.

WARREN BUFFETT: Yeah, I do think, as I mentioned earlier, that far greater sums, relatively, in one asset class after another, are held by people who — where it's really on a hair-trigger type mechanism.

So, the creation of lots of new financial instruments, the piling up of huge amounts by intermediaries or agency activities in terms of money management, I think they lend themselves to more explosive outcomes on any given day than might have been the case some years back when I was selling utility stocks to people, a hundred shares at a time in Omaha.

I mean, those — that money was not on a hair-trigger basis. But as you turn it over to fund managers who think their job is to beat the S&P in — on a short-term basis — you are getting very short time horizons on huge amounts of money.

And those people may think they are operating independently in one sense. But they're responding to the same stimuli. And they can, as they did in the fall of 1998, they can all head for the exits — or try to head for the exits — at one time.

And the thing about financial instruments is there is no exit. I mean, the only way that you get rid of a financial — the only way you leave your seat in a burning theatre in financial markets is to find somebody else to take the seat. And that is not always easy.

CHARLIE MUNGER: I think it —

WARREN BUFFETT: However — go ahead.

CHARLIE MUNGER: — I think it's also true that the amount of credit being used, not only by hedge funds but by ordinary investors, is way heavier than most people realize.

It wasn't even controversial in this country when we came to introduce single-stock futures and what — you know, commonly traded puts and calls.

And ordinary people got in trouble. If I'd been running the country, I never would have allowed that. I don't know what good it does for the country to have a wonderful — a lot of trading in puts and calls.

One of my children knew a nice man who had a $2 1/2 million house and $5 million worth of wonderful securities.

But he couldn't live as comfortably — he never worked — as he liked to live on the income from his $5 million of securities. And he got in the habit of picking up easy money with the credit systems of the world. He kept selling naked puts secured by his account, including puts on a whole lot of internet stocks.

And in due time, he didn't have the $5 million of securities, and he didn't have the house, and he now works in a restaurant.

That kind of self-destruction wasn't possible before we created all these wonderful trading opportunities involving credit.

It was not a smart thing for this country to do, to legalize gambling everywhere and to bring it in a more facile form into our investment practices. (Applause)

WARREN BUFFETT: Is there anyone we've forgotten to offend? I mean, we — (Laughter)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — we don't want to miss anyone. (Laughter)

17. Why Berkshire's board is better

WARREN BUFFETT: Number 11, please.

AUDIENCE MEMBER: Good afternoon, Mr. Chairman, Mr. Vice Chairman. My name is Andy Peake. I'm from Weston, Connecticut.

Recently, we've seen a number of corporate boards take forceful action — Hewlett-Packard and Boeing, for example. We have also seen board members from WorldCom pay large amounts to personally settle lawsuits.

Today we see Morgan Stanley embroiled in a bitter battle, largely based on divergent views of how to govern the firm.

What responsibilities do directors have in this new environment? And what do you look for in your directors?

WARREN BUFFETT: Charlie, why don't you take that one first?

CHARLIE MUNGER: Well, we are completely out of step with modern practices with directors.

The modern practice is to have one from each diversity category, and to have a whole lot of people who need, more or less, the 100,000 or $200,000 per year that they're paid for being a director. And people think this makes the system better.

At Berkshire, all the directors are rich and they own a lot of stock in Berkshire. And they're all very smart. And they don't get any liability insurance provided by Berkshire.

So, we've been waiting for our system to spread, but it — we seem to be losing. (Laughter)

WARREN BUFFETT: Yeah, it's a tough job, at times, to be a director.

The real problem that you can face, and may often face, is when you're dealing with mediocrity.

I mean, if you have a baseball team and you have a .240 hitter in the majors, a .240 hitter in the majors is still a pretty good baseball player. But if your job is to have a winning team, you get rid of him. And you find somebody that can bat .280 or .290 and field just as well.

In business, the tough part is to get rid of something a notch or two above mediocrity, but not the best one that could be found.

And when people meet every couple of months, and they come from different parts of the country, and they have the normal social instincts — they don't like to have rump meetings or to sort of talk behind people's backs — it's very difficult for a group, and particularly if it's a group like Charlie described where a significant number of them, the directors' fees they earn are important to their well-being, and they like — they'd love to be recommended for another board and add another $100,000 a year to their income.

It's very difficult for somebody to lead a charge and all of a sudden start at the meeting or trying to arrange a rump meeting of some sort to say, you know, "We really think this guy at the head of the table's no good."

And changing — dealing with mediocrity is — or, like I say, a notch above it, is a difficult problem if you're a board member.

And we believe that, you know, independence is — it's a state of mind. I mean, it — and it's a willingness, but not the eagerness, to challenge the ideas of others.

And to — if you see a merger that doesn't make sense — and Charlie and I have seen a lot of them, and we've been on the boards, and sometimes we've spoken up and sometimes we haven't spoken up — to be able to — you know, you can — the group around you, in terms of social behavior, can only tolerate a certain amount of obnoxiousness on the part of yourself.

You have to sort of ration it out. And so you save yourself for big ones. And then, it's not necessarily an easy equation.

And certainly, I would say, of the things I've seen proposed in the way of major acquisitions and — a significant percentage of them I wouldn't do myself. But would I overrule somebody else?

I wouldn't get the votes probably anyway. And it's a very difficult thing to do. You could occasionally fire a bullet if you think it's important enough, and usually it doesn't do any good.

So, I — we have a group that has — every one of them has significant money invested in Berkshire. They all bought it in the market just like you did. I mean, nobody — I mean, I've been on all these boards and they keep handing me things.

And, you know, I had shares of this one and that one are given to me, or options or whatever, matching charitable contributions, all kinds of things.

But we have real owners on our board. And what they make for being board members is really inconsequential, as I get reminded occasionally — (laughter) — compared to their investment. And they're friends of mine.

They're smart. They're very smart. I mean, they are hand-picked, in terms of business brainpower and quality of a human being. And I really think that, you know, we have the best board in the country.

But the people that want — who make their evaluations by checklist, you know, whether — either in terms of diversity or in terms of supposed independence — although I don't know how anybody that's getting half their income from board memberships can be independent — you know, we don't — we may not stack up so well.

But it's the kind of board that I want to have, knowing that if I die tonight that virtually everything I have goes to a foundation. I want that foundation to have as much money over the years to spend as possible.

And there's no group of people I'd rather have in charge of the decision subsequent to my death than the people that we've got on our —

18. Short gap due to tape change at time of recording

Text on screen: "Tape Change"

19. Gates is smart but we must stock to our "circle of competence"

WARREN BUFFETT: (Laughter) No, the answer is that Charlie and I, in managing Berkshire, try to do things — put money in things — that we understand.

And when I mean understand, I mean, that we — where we think we know, in a reasonable way, what the economics will look like in five or 10 or 20 years.

And Bill [Gates] is a lot smarter about a whole lot of things than I am. But it's still Charlie and I that have the responsibility for managing the money.

And we'll stick in what we consider to be our circle of competence. And the fact that somebody else's circle is wider or different, you know, that's the way the world is.

I'll listen to any idea Bill has. Believe me, I will listen to him. I mean, he is a — he's not only a smart manager, but he's a smart investor. And I think, actually our ideas on investment overlap to quite an extent.

But I still wish I'd bought a little Microsoft when I first met him. (Laughs)

Charlie?

20. If corporate directors need the money, they're not independent

CHARLIE MUNGER: I think what has happened at Berkshire is just wonderfully for the good. And I do think we have a perfectly marvelous board. What makes me sad, as I said earlier, is I don't see more of the same practice followed elsewhere.

A director getting $150,000 a year from a company, who needs it, is not an independent director. That director automatically becomes an inside director. And so it's a typical government intervention. It's just — it says it's doing one thing and it does another.

WARREN BUFFETT: Yeah, I have never — I've been on 19 boards — I have never seen a director, where the directors' fees were important to them, object to an acquisition proposal, object to a compensation arrangement of the CEO. It's just never happened, you know — in my experience.

And you know, they do not — they frequently do not — behave as they would if they owned the place. And basically we want people that behave as if they own the place.

CHARLIE MUNGER: The correct system is the Elihu Root system. Elihu Root, who had three different cabinet appointments, if I remember right, said no man was fit to hold public office who wasn't perfectly willing to leave it at any time.

And if Elihu Root didn't approve of something the government asked him to do, he could always go back and be the most sought after lawyer in the world. He had an identity to go back to and he didn't need the government's salary.

And I think that ought to be more the test in corporate directorships. Is a man really fit to make tough calls who isn't perfectly willing to leave the office at any time? My answer is no.

WARREN BUFFETT: Yeah, we have one of our directors who was — who's been removed twice from compensation committees of other corporations because he had the temerity to actually question whether the compensation arrangement being suggested was the appropriate one.

I mean, it — the — it's not — being put on the comp committee of American corporations, as I've said, they're not — they're looking for Chihuahuas, and not Great Danes and Dobermans and —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. And I hope I'm not insulting any of my friends that are on comp committees. (Laughs)

CHARLIE MUNGER: You're insulting the dogs. (Laughter and applause)

21. Why we keep companies despite disappointing results

WARREN BUFFETT: OK, number 1. (Laughter)

AUDIENCE MEMBER: Hello. I'm Rory Johnson (PH). I'm from Suffolk in the U.K.

Do you have, or are there, any appropriate criteria, beyond purely financial returns, in assessing the success or otherwise of your investments?

WARREN BUFFETT: Well, I would say that the financial returns, achieved in a way that we want them to be achieved, are the determinant of whether we've made an intelligent commitment.

Now, we don't get rid of companies that don't meet our original expectations. There's a section in the back of our annual report on the economic principles. And I forget which one it is. It's toward the end.

But we say that Charlie and I have this quirk, which business schools would teach is a mistake, in that if we have a business that's underperforming and we could sell it and put — and achieve greater returns someplace else, we don't do it.

We say that if a business is going to permanently lose money, we'll get rid of it. If it has major labor problems over a period of time, we might get rid of it. But we are not going to engage in what we call gin-rummy type management where we pick up one card and discard another.

And so we will not — if a business has been disappointing to us, but we like the people there and we're not having — not because of labor problems — and we're not going to have to put money in incessantly, we will stay with it when business school theory and management theory would say get rid of it and do something else.

We don't disagree with the people that do it that way. It's just that we don't want to live our lives that way. And if we owned 100 percent of Berkshire we wouldn't do it that way.

And we don't — we just — we want the shareholders to know that we have this mindset that may produce slightly suboptimal returns because of our attitude. But that's the way we're going to play it, and we tell people ahead of time that that's the way we're going to play it.

We like being associated with the managers that we are, even the ones that are in — facing headwinds. I mean, but in a sense you almost identify more with the ones that are facing headwinds because they're doing a hell of a job under very tough conditions.

And every business decision or investment decision isn't going to work out perfectly. And some businesses are going to run into unexpected surprises.

But the people that have gone in with us have stuck with us in times like that. And our attitude is we'll stick with them.

So to the — I would say that how the people behave with us after we buy the business is an important part of how we feel about, you know, the whole relationship as well as the returns achieved.

Charlie?

22. Moral distinction between buying a stock and a company

CHARLIE MUNGER: Yeah. I think he's asking in part, are there some businesses we won't have as subsidiaries in Berkshire even though they're wonderful businesses? So, are we rejecting some business opportunities on moral grounds?

WARREN BUFFETT: Yeah, well we've referred in past meetings to one we did on that basis. We will own stocks of companies where we wouldn't want to own the whole business. I mean, you know, you can —

I'm not sure that the logic is perfect on that, but we would not have trouble owning stock in a cigarette company. We wouldn't want to manufacture cigarettes, you know. We might own a retail company that sells cigarettes. I mean, there's all kinds of gradations.

But we do not — there are things we don't want to own and be responsible for their businesses, where we have no problem owning their stocks or bonds. And some years back, Charlie and I went down to, where, Memphis?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah, we looked at a — and we were invited down, and we looked at a company that made a product that — perfectly legal — probably one of the best businesses I've ever seen, in terms of the economics of it.

CHARLIE MUNGER: Absolutely.

WARREN BUFFETT: Still doing very well. And we met in the room with — we went to a hotel. We met in the room with the people that had the business. And people were perfectly decent people. And they described the business to us. And we went down in the lobby.

And as I remember, we sat down in the lobby and just decided that we didn't want to be in that business. And, you know, the lines are not perfect on this sort of thing.

I mean, it — I'm sure that there may be ads in the Buffalo News that are selling some investment service or something that I would cringe at if I knew the people involved or what they were selling.

And it — if you own a big retail establishment, a retailer, general merchandise, you know, you're probably going to be selling cigarettes when you don't think that you should smoke yourself or that your children should smoke. And it's — they're not perfect.

But we have turned down some — the most dramatic being that one because we went — took us a trip of 1,000 miles or so to finally face up to the fact that we didn't want to own it.

Charlie, you have anything to add on it?

CHARLIE MUNGER: No, but that was interesting because we were young and poor then by modern standards. And, you know, we're very human. And we could see it was just, like, putting $100 million in a bushel basket and setting it on fire as we walked away. And — (Laughter)

WARREN BUFFETT: You're making me feel bad. (Laughter)

CHARLIE MUNGER: We made the decision all right and with no difficulty. But there was a certain twinge. (Laughter)

23. Munger's collected wisdom

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: My name is J Dwight. I'm from a small town in Maine called Wilton, Maine. My question comes more of a request.

And could Charlie Munger create a curriculum, or a list of reading and experiences, which he believes would lead to his concept of worldly wisdom? This would serve two great — three great purposes.

One, it would pass on the most valuable possession — that is your knowledge and experience — to us and to others in the future.

Two, it would preserve and enhance that wealth beyond the material riches endowed on future generations.

And three, it would begin to remedy the stunted educations of those like — Mr. Munger — are plunging along with ordinary will, with time to improve ourselves. Thank you.

CHARLIE MUNGER: Well, of course, Peter Kaufman has tried to do that in that book that he stitched together out of my old speeches plus a lot else.

And I didn't want to do it. And he went and saw Warren, and Warren got enthusiastic. And Warren suggested this ridiculous name, "Poor Charlie's Almanack." (Laughter)

And between the two of them, they really got me to do it. But the whole idea of doing it is with just the motivation you're talking about.

I think if you assimilate everything in that simple book, you will know a lot more than about 95 percent of your compatriots.

And it's not that hard to do. So, Peter Kaufman has made it easy for you.

WARREN BUFFETT: Yeah, I couldn't be more enthusiastic about what you suggested. And it's been done. And it's a sensational book. And anybody that reads it is going to learn a whole, whole lot about life.

And you'll learn even — to get you to read it, I'll tell you you'll even learn something about making money. The — and it's right next door here, they haven't sold out.

24. Future of pharmaceuticals is "too hard"

WARREN BUFFETT: Number 3, please?

AUDIENCE MEMBER: Good afternoon. Scott Jeffords (PH) from Davidson, North Carolina.

The major pharmaceutical companies have faced a myriad of fundamental and legal challenges in recent years.

With that in mind, and given the apparent ongoing nature of those obstacles, how should investors be thinking about the long-term prospects for this very important industry?

WARREN BUFFETT: Well, my answer is, I don't know. But maybe Charlie will. And it's — you know, it's a terrific question.

It’s just that — that industry is in a state of flux now. It does very important things for mankind. It’s historically earned good returns — very good returns — on invested capital.

But it’s going — it could well be that the world will unfold differently for those companies in the future than the past. It may — that may not be the case.

And I’m — I don’t think I’m really qualified to give you a good answer on that because much of it is in the political realm. And my judgment about the — what politicians will do is probably not better than yours.

Charlie?

CHARLIE MUNGER: I share Warren’s agnosticism on the subject. We just throw some decisions into the “too hard” pile and go on to others. (Laughter)

25. No “degree of difficulty” adjustment for investing

WARREN BUFFETT: Incidentally, there’s a lot of wisdom in that remark. I mean, there are things in life that you don’t have to make a decision on and that are too hard.

And many years ago on one of the reports, I said one of the interesting things about investment is that there’s no degree of difficulty factor.

I mean, if you’re going to go diving in the Olympics and try to win a gold medal, you get paid more, in effect, for certain kinds of dives than others because they’re more difficult. And they properly adjust for that factor.

But in terms of investing, there is no degree of difficulty. If something is staring you right in the face and the easiest decision in the world, the payoff, can be huge. And we get paid, not for jumping over 7-foot bars, but for stepping over 1-foot bars.

And the biggest thing we have to do is decide which ones are the 1-foot bars and which ones are the 7-foot bars so when we go to step we don’t bump into the bar. And that is something that I think we’re reasonably good at.

Now maybe we cast out too many things as being too hard and thereby narrow our universe. But I’d rather have the narrow — the universe be a little too — interpret it as being a little too — a little smaller than it really is, than being interpreted as larger than it is.

Charlie?

CHARLIE MUNGER: Obviously.

26. Avoiding emotional investment traps

WARREN BUFFETT: 4. (Laughter)

AUDIENCE MEMBER: Good afternoon. I'm Whitney Tilson, a shareholder from New York City.

And one of the things I find most refreshing and admirable about you, as corporate leaders, is that you're very candid about making mistakes, and — as you put it last year, Mr. Munger — rubbing your noses in it.

Last year, Mr. Buffett, you talked about the $10 billion mistake of starting to buy Walmart and then stopping after it had ticked up a little bit.

Today, you seem to allude to a somewhat similar mistake. You bought a stake in PetroChina. Then after it was disclosed that you owned it, it popped up a bit. And obviously in hindsight, you could have made a lot of money had you continued buying it.

If these emotional traps — I think you called it "anchoring" at last year's annual meeting — are the traps that even people as experienced as you gentlemen are, occasionally fall into, I sort of wonder what hope do the rest of us have?

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

WARREN BUFFETT: Well, that's a good question. And, of course, it first — the first step is in recognition of the fact that they can be traps and that you will be affected by them. And you will make some mistakes because of them.

But Charlie in his — in "Poor Charlie's Almanack," which I probably do take credit for the name of, and the — he talks about the various psychological traps that people fall into. And simply reading that section, you will come away wiser than before you started on it.

We will — our personalities are such that Charlie and I probably are a little less prone to some of those mistakes than other people are. But as our record clearly indicates, we still are prone to them. And we make them and we'll make them again.

We're probably a little less inclined to make some of them than we were 30 or 40 years ago. But, you know, the nice thing about it is, though, is that if you make fewer of those mistakes than others, you know, they will continue making their share and you'll get very rich.

Charlie?

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

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

27. Low Treasury yields are a mystery

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Hi, I'm Steve Casbell (PH) from Atlanta.

With signs of inflation, you know, in commodities and oil, why do you think the 10-year is still — you know, the yield is 4.2 percent? And, you know, is it that the market sees signs of deflation coming in the future?

And in addition to that, if you thought rates would stay at this level for an extended period, would you have a more favorable view of the market?

WARREN BUFFETT: Well, the answer to the second part is yes. I mean, if somebody guaranteed me that the 10-year rate would never go above 4.2 percent for the next 50 years, we would have to readjust, recalibrate every decision we make around Berkshire.

I think it was [Federal Reserve Chairman] Alan Greenspan, I don't know whether he's talking about the 10-year or what is the closest thing now to the 30-year — we don't issue 30-years anymore — but the — he referred to it as a conundrum.

And after I looked it up, I decided I agreed with him. (Laughter)

I don't understand it. And — but that's OK. There's a lot of things in financial markets I don't understand. And that doesn't mean I have to make a decision.

I don't have to either go long or go short, the 10-year. Although by keeping as much money as we do short, we are in effect at least making the decision that we don't want to be long, long bonds.

That doesn't mean we think it necessarily would be smart to be short them. But we do not want to be long, longer bonds. And I —

If you'd told me two years ago that every move that the Fed would make in the last two years, and you told me all the other variables that would take place, and you'd asked me what the 10-year rate would be at this time, I would have been very wrong.

So, you know, it's not a game I've excelled at so far. I'm puzzled by it. And we'll see where it is next year when we meet.

Charlie?

CHARLIE MUNGER: Yeah, I think the one thing you can confidently predict is there won't be some automatic and rational correlation between inflation and interest rates. There will be weird diversions.

WARREN BUFFETT: Do you want to elaborate on how these weird things will manifest themselves?

CHARLIE MUNGER: No, no. All I know is it happens.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Frequently very surprising.

WARREN BUFFETT: Well, it surprised us on this so far, didn't it?

CHARLIE MUNGER: Sure.

WARREN BUFFETT: Yeah.

28. "Finite" insurance

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Hi. Glenn Tongue from New York City. I hope this does not overstate your ground rules.

I've read what you have written about finance reinsurance in the annual report. There's been much erroneous stuff written recently about finite reinsurance. Can you simply explain the product and its importance to Berkshire?

WARREN BUFFETT: Yeah, well it's a good question because the term has been used, "finite reinsurance." And, you know, basically almost all insurance is finite.

I mean, if you have a $200,000 homeowner's policy, or if you have a 100/300 auto liability, that's a finite policy. The insurance company will pay you that much and pay you no more.

And with the exception of workers' comp, and maybe there's something else I'm forgetting about, but basically all insurance is denominated in some amount with a limit.

That 500 million we wrote on that airport, I mean, we can lose 500 million but I don't think we can lose 501 million. And so the — I think the term finite has gotten — it's gotten to be convenient to use without anybody totally describing it well.

Actually, when the SEC sent out its first request for information, I think they called it non-traditional insurance. And I think that may be a better term to use in terms of what's being looked at.

And there is nothing wrong — I mean, there's nothing wrong at all with finite insurance. We're issuing finite insurance policies every day at our — on our auto policies and everything else.

And there's nothing wrong, in my view, at all with retroactive contracts. For example, we wrote — a few years back we wrote a — and this is very rough, but it'd been in the press, so that I'm not violating any confidences of clients —

We wrote a contract as I remember — and I may be just a little off on this — that to pay, when INA was being sold to ACE, we — to pay 2 1/2 billion of claims from the past. And I think we got a premium around 1 1/4 billion on it.

Now, we were making an estimate or a guess as to whether the whole 2 1/2 billion would be paid, how fast it would be paid, and a lot of things.

And ACE, on the other hand, was getting rid of 2 1/2 billion of potential liabilities, and they did not have the capital strength of Berkshire.

And that contract went before the Pennsylvania Insurance Department. It was improved. I mean, it had value to both parties. It had — you can argue it had value to the public in that Berkshire was a stronger insurer.

Actually, in the first quarter of last year in our 10-Q, you will see that we recorded a loss of $100 million because the payment pattern on that contract turned out to be faster than we anticipated.

I mean, there was risk involved. But it was all retroactive and a perfectly proper contract, in my view, or I think anybody's view. And we would do more of that business. In fact, we looked at a very, very big one here recently.

What I think the — and understandably — the authorities are looking for is that contracts that had no purpose and that were possibly misused by some party in accounting. And the facts on that remain to be seen.

But I think calling it finite, it just isn't the right descriptive word. I think that, like I say, non-traditional — we can have a lot of non — we issue non-traditional products all the time.

I mean, I talked last year about the billion-dollar thing for PepsiCo. That certainly isn't traditional. But it's real insurance.

And the question is whether risk is transferred. But the risk on the ACE contract, for example, was several.

One is, we had a risk as to whether the whole 2 1/2 billion would be paid. Second, was how fast it would be paid. And the third risk is what you can do with the money in between. And money hasn't been worth very much to us lately. So, there was risk in that. And that's what insurance is all about.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with you about the word finite reinsurance. It's — absolutely — you could hardly not invent a worse word to use to describe a new class of insurance. It's just a meaningless rubric.

And, of course, non-traditional is imperfect, too, because we have traditionally issued non-traditional insurance. (Laughter)

And — but we have to use some words to describe what's happening.

There's no question about the fact that the corporate world has gotten more and more interested over the last 10 years in having regularity in earnings reports. And they've turned to a huge variety of ways to try and do that.

And reinsurance is a very minor part of the whole picture. But there has been more reinsurance sought because people were more anti-volatility, in terms of reported results.

WARREN BUFFETT: But, of course, insurance is a way to reduce volatility, and a perfectly proper way. I mean, if you pay $1,000 a year on your auto premiums for the next 30 years, it isn't —

You are going to have a more regular income stream than if you wait and have one $25,000 accident one year and don't pay the premiums in the other years.

So, I mean, people have bought insurance to reduce the volatility in their own personal results and their own business results. So, reducing volatility, per se, is not bad at all. It's the reason —

CHARLIE MUNGER: No.

WARREN BUFFETT: — there are $400 billion worth of insurance premiums paid in this country every year. But that doesn't — you know, you can also get into abuses of that. And that's what they're — the people are looking to find and see what the real situation is.

29. Buffett: I make mistakes but don't agonize over decisions

WARREN BUFFETT: Number 7?

AUDIENCE MEMBER: Wow, this more nerve-wracking than I thought it would be. Hello, Warren, Charlie. My name is Aki Progakis. I'm from Montreal, Canada.

Warren, I wrote a letter back in January. I wrote a letter to you recommending a beautiful Canadian retail company in which I described my analysis to you.

I'd like to thank you for taking the time to respond to me. You said some nice kind words. That meant a lot to me. And I think you're an amazing individual. My question go — (audio dropout) — people, what is the single most difficult decision you've had to make in your lifetime, whether it be business or personal?

WARREN BUFFETT: I think I'm going to let Charlie answer that one first. (Laughter)

CHARLIE MUNGER: Yeah. I would argue that that may be one that you shouldn't ask. (Laughter and applause)

Or let's put it this way, I think you should answer it with several interesting examples before you ask us to answer it. (Laughter)

WARREN BUFFETT: That's a (Inaudible). (Laughter)

It's interesting. As Charlie was talking, I was — I have — I can't think of a lot of difficult — I can think of a lot of wrong decisions I've made. But I certainly can't think of anything I agonized over making for any long period of time.

Like I say, that isn't — you know, I mean, it's calling balls and strikes. I mean, you got a second there and if you don't do it in that — you're no longer an umpire.

So, I've made plenty of wrong decisions. I'm going to make plenty more. That's just part of living.

But I don't think in terms of being difficult as measured by the time it took me to do it or the — not a lot of them pop to mind. And if they do I'll probably give you the same answer as Charlie.

Charlie, have you thought of any more there while we were talking?

CHARLIE MUNGER: No. Let's go on to another.

WARREN BUFFETT: OK. (Laughter) That was not a bad decision.

30. Real estate brokerage will get a "lot bigger"

WARREN BUFFETT: Number 8. (Laughter) But thank you.

AUDIENCE MEMBER: Good afternoon. My name is Franklin Grin (PH). I'm from Philadelphia. And I'm interested in real estate.

You've already covered many different areas today about real estate, such as the real estate bubble, the long-run performance most people have obtained in their personal holdings of real estate, the GSEs, the REITs.

But one of the things that appears in today's newspaper is quoting Mr. Buffett about building a brokerage powerhouse. And that seems to say that you envision changes in the way in which people buy and sell their houses and other kinds of related things.

So, I was wondering if you could tell me a little bit more about that area of where you envision Berkshire Hathaway going.

WARREN BUFFETT: Yeah, I'll be glad to. But the — we are hoping to build a powerhouse that's built very much on the model of today. In other words, we do not envision big changes in residential real estate brokerage, which is what we're in.

We — as we put in — they talk about sides in real estate, the buy side and the sell side. We participated in sides that totaled $50-odd billion last year. And we are the second largest residential real estate brokerage firm in the country.

But we expect that business really to be conducted quite similarly in the future to how it has been in the past. Now there are people that disagree with that and think that way more will happen via the internet.

But, you know, the purchase of a home is the single most important transaction for most people in their lifetimes. It's — it can be partly emotional. It's partly something that they appreciate people guiding them through.

It's something where I think one-on-one will be very important in the future as it has been so far.

And in this country, there are going to be millions and millions and millions of homes that get sold every year. It's — just in terms of people moving and dying and moving up in their economic potential.

So, there — the real estate brokerage business is going to be a very, very big business. And I think it will tend to be a very local business.

And we have bought leading local firms in a number of markets. And they have retained their individual identity. We have not gone for a Century 21 or something approach, where we put them all under the umbrella of a single brand.

Rather we have these individual brands in given communities. And they're usually very strong brands in each community. But we've only scratched the surface.

And I would expect — and it has nothing to do with the potential for real estate or anything. It just relates to the fact that tens and tens and tens of millions of people own their own homes. And some are going to move around every year.

And there's — I think that they're going to continue to have a real estate broker involved in most of the transactions. And we would like to be very big in that business. We already are big, but we're going to —

I would think it's almost certain that we will be a lot bigger in that business five or 10 years from now — I mean, a lot bigger — than we are now. And it's a question of acquiring these firms.

Generally, they're — you know, they're proprietorships. They're owned by a single individual or a family. And they come up periodically because of the family circumstances or the individual circumstances of somebody.

But there's a lot of them out there. And we're a logical buyer. And we've been found to be a good owner. So I think it's going to be a good-sized field for us over time.

Charlie?

CHARLIE MUNGER: Yeah, we voted by buying the brokerage operation instead of the real estate. Obviously, we regard it as having better economics than the underlying real estate which Berkshire could buy.

31. Munger: "Stupid and dishonorable accountants"

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Hello. My name is Martin White. I'm in the insurance business in London. And quite separately, together with other volunteers, I also help to run the only independent lobby group for private shareholders in the U.K.

I would like to ask you your thoughts on two aspects of worldwide solvency and how assets and liabilities are recognized in everyone's accounts. I suppose both are about whether the regulators have the bottle to do the right thing in spite of possible complaints from companies.

One aspect is about how insurance liabilities and assets are valued for solvency purposes and the discussions that are going on to develop new accounting standards worldwide. The other aspect is about derivatives, the potential "weapons of financial mass destruction."

For those derivatives which don't have quotes, I suspect we could find out how big a black hole there might be if the regulators around the world required everyone to report at the same date for each derivative they have, their current recognized asset or negative assets, and most importantly, who the counterparty was.

So, the regulators, sharing information collected from both sides, could see what the worldwide aggregate misstatement was.

On insurance solvency, if we started with a fair attempt at mean discounted liabilities, and then added a large chunk for safety, and for reinsurance assets, did the same, discounted, but this time the safety chunk was deducted, life would be a lot simpler and there would be a lot more consistency and, I suspect, safety, than under the current undiscounted regime.

I think both problems need regulatory attention. What are your thoughts?

WARREN BUFFETT: Well, on a subject of discounting reserves — which essentially means taking what you expect to pay in the future and then taking in the appropriate interest rate and carrying at some lower figure now, because you don't have to pay now, but later —

You know, I can certainly make the purist argument — or the argument of the purist — for the fact that that might be the most accurate way. And certainly, of course, in the life insurance field, it is prevalent.

But I would say there has been such a tendency of managements to understate reserves worldwide, and in some cases by extraordinary amounts, that I think anything that pushes in the direction of carrying those reserves at even lower amounts —

And I realize you stuck in that part about the healthy bumping of them, too — but I think anything that — any accounting that lets — gives people a rationale for making reserves even lower than they have been, on balance, is dangerous.

There is such a tendency on what they call long-tail business — or business where you don't expect to actually make the payments for a few years or more — I think there's such a tendency to view those with optimism, particularly when somebody's going to retire in a couple years or their options are about to run out or whatever it may be, that I don't like giving them the extra leeway of discounting on top of that.

The derivatives question you raise is really interesting, but it would be mind-boggling to implement.

I mean, it's always fascinating to me how people can write a derivative contract, you know. And both sides of it — the trader will be, perhaps at least, showing a profit on it, you know, by the end of the month or something of the sort, that — you know, usually the contracts aren't that precisely matched because you have all kinds of other contracts that bear on the one you're doing.

But I would say that the trader's estimate, and maybe the auditor's estimate, of the value of all derivatives contracts outstanding in the world, would end up with — quite a large positive sum for something that essentially will wash out as a zero sum.

And I can tell you from the fact that I inherited a book of 23,000 contracts that's far, far, far from the largest or the second largest or the third largest in the world.

And the complexity of those contracts, and the complexity of unwinding them now where we're three years into it — and we've done an awful lot of it, but we've been operating in a benign environment —

I don't think any regulator, and I'm not sure any auditor, when you get up to really extensive derivative books, in effect, can get their minds around evaluation.

I know that, you know, as I pointed out in our report, ours were supposedly marked to market. And people think of that as something that you just go out and hit bids and, you know, within a few days wind up something.

And if you're trading government bonds, you know, you can do that. And if you're trading actually active equities, you can do it. But when you start trading derivatives, it's unbelievable what you can find. And I've had a couple of experiences with them.

Charlie, what are your thoughts?

CHARLIE MUNGER: Well, my thoughts are that stupid and dishonorable accountants allowed the genie of totally improper accounting to come out of the bottle and descend in the derivative books of the world.

Once that has happened and people have used it to create masses of assets and masses of earnings reports and bonuses and status and so on and so on and so on, getting the genie back in the bottle is no small task because you have these huge vested interests who are fighting you.

And what ordinary housewife, as she puts the toast in in the morning, is thinking, "My god, I've got to do something about derivatives?" You know? (Laughter)

So the people that are — have vested interest in the current system are powerful. And the rest of the people don't care. And so this evil genie stays out of the bottle and does more and more mischief with each passing day.

If you're trying to fix this, you are going to have a very interesting life. (Laughter)

32. Q&A ends

WARREN BUFFETT: It's 3 o'clock now. If you haven't had enough, [TV journalist] Charlie Rose has a show on, on Channel 12 tonight at 8 o'clock where there's another hour and a half of interviews he did with me and with Bill Gates and various people.

Morning Session - 2006 Meeting

1. Welcome

WARREN BUFFETT: Good morning. I'm Warren; he's Charlie.

There's one thing I should probably clear up first because I know it's puzzling you. In the movie, he always gets the girl.

Now, that's hard to figure out, isn't it? But I've — Charlie — but I finally understand what the — what's happening.

It's something called the "Anna Nicole Smith Rule." That's when choosing between two old rich guys, pick the older one. (Laughter)

Now, in a few minutes we're going to open this up to your questions. We have a number of zones, and we'll just proceed around zone by zone.

But before we do that, there are a few people I would like to thank, and then there's a couple of short announcements I'd like to make.

First of all, if can we get the spotlight up there on Andy Heyward, Andy does that cartoon for us every year. He travels around. He gets the voices in there. Andy, where are you? (Applause)

He comes up with the ideas.

Andy is the — runs DiC Entertainment. DiC is the one I've told you about in the past that produced "Liberty's Kids," which I think is probably the best way not only for youngsters to learn American history, but for people my age as well.

I mean, it's a terrific series of young kids — a couple of young ones in the time of the American Revolution. And I watched several of those episodes, and I'd forgotten a lot of American history since I was in school. It's just a really — it's a wonderful series.

It appeared on PBS over time. And if you're looking to learn American history or have your children or grandchildren learn it, you couldn't do better.

And in the months ahead, he's working on the — what do we call it? — it's the "Secret Millionaires Club."

But it's going to be a program that's designed to teach young people some of the very basic lessons of — about money. How to avoid getting into trouble with it, how to use it effectively, and what your attitude should be toward it.

So, we're looking forward to getting that out early next year. I'll guarantee you that it will be a terrific program for teaching children and your grandchildren something about the subject of money.

I also want to thank Bob Iger. Bob is up there. Bob runs Disney. He's doing a terrific job, and — (Applause)

I thought we could originally entice the "Desperate Housewives" into appearing simply by the chance to appear with Charlie. But after we made that appeal, we then went to Bob Iger and said, "See what you can do for us, Bob." So thank you, Bob.

Also in that section, I'd like to have a special introduction for the man that first taught Charlie and me something about the value of franchises and the advisability of buying great businesses instead of cheap businesses.

Prior to the purchase of See's Candies in 1972, I intended to look primarily at financial measures in buying businesses and buying things that were cheap in relation to book value, and we always tried to get a lot of tangible assets in relation to our money.

But we found out that the intangible assets, if properly nourished and if properly identified, you can make a whole lot more money with than buying a lot of tangible assets cheap.

And in 1972 — early in '72, Charlie and I went to See's Candy, which had been in the hands of the See family for many decades, and we bought it.

And, of course, Charlie and I didn't know a thing about making candy — we were pretty good at eating it — and we needed someone to run the place.

We met a young fellow there. It was clear to both of us that he was the ideal person to run See's Candy, and in just a few minutes we made a deal with him that's lasted a lifetime.

And if Chuck Huggins and his wife, Donna, would stand up, I'd love to have you give them a real well-deserved round of applause. (Applause)

As you notice, my daughter Susie produced that movie. She does every year.

She works hard on it, and we don't pay her anything, although she does remind me occasionally when I'm out at Borsheims that she worked very hard on the movie — (Laughter) — and I'll see her there on Sunday.

And, Suz, if you would take a bow, please. (Applause)

And the impresario of this event, I just turn it over to her every year and forget about it.

But she puts on this show. She brings all the exhibitors in. She arranges everything. She moves into the hotel across the street a few days ahead of time, or a week ahead of time, and makes sure everything hums.

And Charlie and I just come down on the day of the meeting and take a bow. And that's Kelly Muchmore-Broz.

Kelly, are you here? Where's Kelly? There she is. Give her a big hand. (Applause)

We wouldn't be having this without her.

2. Berkshire directors introduced

WARREN BUFFETT: Now I'd like to introduce our directors. We're going to get to the business meeting at 3:15. We do the Q&A first, and we get to that later on.

But for those of you who won't be around — and a lot of people tend to leave at lunchtime — I'd like to introduce the various directors. You've met Charlie and myself.

If you'll just stand individually, we can withhold the applause, if any, until the end. (Laughter)

That way that embarrassing applause meter that we had on the Omaha Idol Show will not cause anyone distress.

Howard Buffett — Howie — Malcolm Chace, Bill Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott, Jr. It's a terrific group of directors. (Applause)

I know of — I literally know of no directors of any large, publicly-owned companies that have, universally, as significant a percentage of their net worth in the company, purchased in the open market, as that group. Do you, Charlie?

CHARLIE MUNGER: None.

WARREN BUFFETT: None. OK. (Laughter)

That may be all you hear from him, folks — (Laughter) — so kind of savor a little bit.

3. Jamie Lee Curtis

WARREN BUFFETT: I also would particularly like to thank Jamie Lee Curtis, even though she came up with the wrong guy at the end.

Jamie cooperated on this. We're going to have, as a thank you — Jamie is very interested in the Park Century School. One of her sons goes to that school. It's for gifted, but learning-challenged students.

They're having an auction tonight, but it will continue subsequently. And Bill Gates and I have autographed a Monopoly set, and we will personally inscribe it to whoever the winner of that auction is.

So if you want to go to eBay and check that out, we promise that we will not similarly autograph anything else. So I hope that Jamie Lee and the school have a big success on that.

4. Berkshire's Q1 earnings

WARREN BUFFETT: We have two announcements, one relatively unimportant but, nevertheless, pleasant, and that is that we released our earnings yesterday after the close.

And I think we can put those up on the screen. Having any luck on that? Did we withdraw those earnings, Marc? Oh, they still have another six hours of audit or so.

And, as you can see, we don't pay any attention to realized gains or losses. We had some gains this year; we had some losses in the first quarter of last year.

So — but that's meaningless in the short term. Over time, obviously, it makes a difference.

But the — you know, we do not pick anything to buy or sell in any given quarter or any given year in the way of securities based on the effect it will have on our income account for that period. It's totally immaterial.

In fact, we'd rather sell things that we have a loss in, just from a tax standpoint.

If we have some high-tax cost stocks and some low-tax cost stock, we'll sell the high one and record the loss because we would get a better tax result that way for the short term. So we ignore that.

But if you look at the operating earnings, you'll see that in those main divisions that I take in the annual report — I show our four major businesses and then investment income is aside of it — things worked out pretty well in the first quarter for all of them.

I would caution you that, in our insurance underwriting, our worst quarter would normally be expected to be our third quarter. You're not going to have hurricanes in this hemisphere in the first quarter.

The real exposure — the worst exposure — is in the third quarter, and then there's a lesser exposure in the fourth quarter.

We write a lot of catastrophe insurance business.

Earthquakes, as far as we know, don't have any particular seasonal aspect to them, but hurricanes definitely do.

And the interesting thing is that under standard accounting, if we write a hurricane policy for the calendar year 2006 and we receive a million dollars of premium, we would earn a quarter of a million in the first quarter and a quarter of a million in the second quarter and so on.

We would earn a pro rata throughout the year. And that, in our view, actually is not proper accounting, but it's required accounting.

The real exposure to loss is primarily in the third quarter.

So you can't take our insurance underwriting results in any way for a rather benign quarter, like the first quarter, and extrapolate them for the year. But, nevertheless, it was a very good year — a very good quarter.

GEICO had excellent growth, I believe that our — well, I'm almost certain that our growth in the first quarter was better than any of our main competitors, and, actually, by — probably by some margin — the underwriting was very good. Our reinsurance underwriting was very good.

Gen Re had a good quarter. Our smaller companies had a good quarter.

So things, generally, have been working very well in all four sectors.

And that's nice, but that's not terribly important. I mean, five years from now, nobody will remember whether the first quarter or the second quarter was good at Berkshire Hathaway.

5. Acquisition of "really extraordinary" ISCAR

WARREN BUFFETT: But what did happen, and which we announced last night — which was very important — the acquisition of a large, extremely well-managed, profitable, really extraordinary company called ISCAR.

And up until October of last year, I knew nothing of ISCAR. I did not know about their extraordinary management.

But I got a letter, and I got a letter from Eitan Wertheimer, and — maybe a page and a half, page and a quarter — and he told me something about this business.

And sometimes character and talents sort of just jump off the page at me, and this was one of those letters, and it came from Israel. And I expressed an interest, after reading this letter, in getting together with Eitan.

And not long thereafter, I met not only Eitan, but his CEO and president, a remarkable man named Jacob Harpaz; Danny Goldman, the CFO. And we met in Omaha. They subsequently met Charlie.

And this all came to fruition yesterday when we signed a contract. Now we have — well, before I go on to this, maybe Charlie would like to say a word or two about ISCAR.

He's the — hard as it is for you to believe, he is not only — he's as enthusiastic about this as I am.

Now, have you ever seen that before, I'd ask you? Charlie likes this one extraordinarily well. Charlie?

CHARLIE MUNGER: Well, this is a company that, from very modest beginnings, grows to be the best company in its field in the world. It's not yet the biggest, but that leaves them something to do.

The average quality of the people in this company is not only extraordinary, it's off the chart. And the beauty of this, as you look at the two of us, is they're all young.

No, this is a real quality enterprise, and these people know how to do some things that we don't know how to do. A lot.

So, of course we're enthusiastic about the company. I'm always enthusiastic when I get to deal with some of the best people in the world.

I would like if we could get the spotlight down there. They're right down here in front. I would like, individually, three managers to stand up.

And then Eitan is going to talk to us a bit, and then we have a — I think we've got it arranged so that we can have a short movie that will tell you something about ISCAR.

But, first of all, if Eitan Wertheimer would stand up and we can get the spotlight on him? Over there. OK.

Eitan, let me introduce the other two, and then can we have you speak to the group?

Jacob Harpaz is the president and the CEO. (Applause)

Take a good look at these people because they're going to make you — they're going to do very, very well for you.

And Danny Goldman. Danny, would you stand up? (Applause)

Thank you. And if you'll give the microphone to Eitan, I think Eitan would like to talk to the group just a bit.

EITAN WERTHEIMER: Good morning, everybody. It's Omaha. It's spring. The fields are green. The days get longer. And we bring a big family into a new home.

I'm standing here before you representing 5,869 people, not only the people, but the families, their past and their future.

It took us three years to look what to do next. We are successful. We still have a lot of mistakes ahead of us to do.

Until we found one day somebody came to us and asked, "Have you heard about Berkshire Hathaway and Mr. Buffett?" We said, "Yes, we heard, but we never thought about it."

And when we started studying about the company, we understood that this is the right combination for us, a family company with a strong culture and a culture we'd love to keep, a young group of people that will love to work, maybe not for very long, but not less than 20, 25 years from today.

And we decided, let's try it. And we had a very interesting lesson from Warren, we had a very interesting lesson from Charlie, and we survived both of them. (Laughter)

I'm very happy that I represent here, not only the people that make the products and go to the customers, I also in a way represent the big family of customers that make — manufacture things.

They make cars go faster and safer. They'll make airplanes fly. They will make the mold to make the bottles for the Coca-Cola. They'll make a washing machine. They'll make the tools to make a carpet.

They'll make many things. And many times the people that manufacture are a little bit in the shade.

And I'm very proud to stand as a manufacturing guy, and say I'm standing for all of them, all our customers, which I must thank them every morning, not only for buying, but also for trying new ideas that we bring and working very hard to stay competitive.

Whoever will stay competitive will be there long-term. And this is also our goal.

Here is Mr. Harpaz, Jacob. In reality, my job is not to disturb. He, in a very gentle way, fired me ten years ago.

He performed and did better things than I could do, and it didn't make sense that I'll disturb him; so I went on to do other things. We've been in the company only 34 years, and the real job is done by Jacob and many, many other people.

I'm sure that you have seen the film "In 80 Days Around the World." And we prepared for you, "In 61 Companies Around the World." And I hope you enjoy it.

We definitely have to fulfill a lot of expectations. We definitely have to work very hard to make everybody very proud that we joined the family, also our people and for sure everybody in this room.

So let's hope we'll all be successful, and let's look into the future. And I'm looking forward to come every spring, to Omaha, where the fields are green and the days get longer. Thank you. (Applause)

ON TAPE, ANNOUNCER: IMC presents "Better Solutions for a Better World."

In 1889, the appearance of the first automobiles brought with it the need for sophisticated solutions in metal processing. Such were the beginnings of a new company, launched by engineers in the U.S.: Ingersoll.

In the decades to follow, another plant was set up in Germany. Since its creation, Ingersoll has established strong ties with industry, which has placed it firmly in a leadership position.

For over a century, time after time, Ingersoll has proved that the best solutions begin with the best engineers.

In 1999, Ingersoll joined the IMC Group and discovered that the sky is not the limit but only the starting point.

Meantime, at the turn of the 20th century, another metal processing plant was established on the other side of the world in South Korea: TaeguTec. In joining the IMC Group in 1997, TaeguTec reinforced its position as the main supplier of cutting tools for industry in the Far East.

Today TaeguTec has achieved unparalleled success, penetrating new markets, streamlining production process, and showing that precise global thinking can cancel distances.

In the middle of the 20th century, in the north of Israel, Stef Wertheimer had predicted, from his little shack in Nahariya, the global need for more advanced cutting tools. "The new world demands better solutions," said Wertheimer, and established ISCAR.

In a relatively short time, ISCAR has become the second largest cutting tool manufacturer in the world, a leader in the area of metal removal.

ISCAR has revolutionized every aspect of machining. Its mission: to apply innovation, quality, and automation on the highest technological level.

Among ISCAR's groundbreaking achievements are the revolution in cutoff applications; development of SELF-GRIP in the '70s; the pioneering triumphs in milling; the HELIMILL in the '80s; the CHAMDRILL; the revolution in drilling in the '90s and tangential positive milling; the innovative TANGMILL.

These innovations and more have reinforced ISCAR's position as the world's leader in development of cutting tools.

The combination of Ingersoll, TaeguTec, and ISCAR has given rise to the IMC Group, taking the best of all worlds and creating the world's best tools.

Today's rapidly advancing world demands that we constantly elevate standards, apply ourselves more and more to provide ever-smarter and precise solutions, pushes us to advance to improve ourselves, to lead.

ON TAPE, EITAN WERTHEIMER: You have to be a full line supplier. To be a global company means to be local in many countries, in many places around the world."

ON TAPE, ANNOUNCER: Other IMC Group companies:

IT.TE.DI Italy, designers and manufacturers of PCD diamond tools for high-precision aluminum machining in the automotive and aerospace industry;

UOP Italy, producers of high-quality solid carbide and high-speed steel standard tools and special tailor-made designs for applications in the aerospace and dye and mold industries;

Outiltec France, expert creative solutions in extra-long gun drills for deep drilling and applications that require unique geometries;

Unitac Japan, deep-drilling BTA-style tools with brazed and indexable heads;

And Wertec Italy, design and manufacturer of unique counterboring tools for deep and complicated boring applications.

ON TAPE, JACOB HARPAZ: If you look outside and you see some cars over there, be aware that in each car at least one part is manufactured by one of the IMC companies, for sure.

ON TAPE, ANNOUNCER: Automotive.

ON TAPE, EITAN WERTHEIMER: Before you have a product line, the geography spread, the people that understand the language, you cannot start thinking, “May I try or may I not try to become automotive supplier?”

ON TAPE, ANNOUNCER: We at IMC have made the automotive industry the foremost objective for all the factories of the group. All the Ingersoll vessels connect to contribute massively to the work of the automotive industry in North America.

At the same time, on the other side of the globe, TaeguTec cutting tools joins the momentum of the rapidly-developing Japanese and Korean automotive industries.

The alliance between ISCAR’s developments and the IMC Group has led to comprehensive solutions, which contribute to the efficiency of global automotive production and pave the way for production cost savings.

ON TAPE, JACOB HARPAZ: We’re not only selling tools, we are selling technology. We are selling the customer a better way to make profit. And we believe, by giving a solution, it can increase its productivity. And the bottom line for the productivity, making more profit for his company.

ON TAPE, ANNOUNCER: Heavy industry.

The power of IMC comes clearly to the fore in heavy industry. The unique combination of the three main manufacturing plants creates new opportunities.

The geographic location of Ingersoll and TaeguTec has led the companies to develop specific heavy industry specialization. The innovative geometries developed by ISCAR, together with the design and production of tools made to conform to the special requirements of this industry, places IMC at the forefront of this important industry.

Aerospace.

The blend and precision and inventiveness ought to go far.

If you want to reach far and high, you must be on top of the game in technology, in understanding materials, (inaudible).

The aerospace industry demands machining solutions for exotic and difficult-to-process materials, proficiency in lightweight materials, such as aluminum, and the ability to machine parts that require massive processing capabilities.

The grouping of the three plants and the profound understanding of cutting materials and complex cutting geometries, along with the expertise and building large-size tools, make IMC the strategic partner for the aerospace industry.

General engineering.

All this vast engineering experience accumulated in every field, in every industry, and in every corner of the world, has paved the way for the development of new, groundbreaking tools, which streamline production processes, shorten machining time, and reduce costs for every customer in the world of general engineering.

ON TAPE, JACOB HARPAZ: After releasing the product into the market, we put another team — our own team — and they'll now compete against the release of the product.

ON TAPE, EITAN WERTHEIMER: In exhibitions, we are recognized as a very, very innovative company. Many times the sentence is, "Let's go there because they must have something new. They always have something new." That's a big compliment, and innovation will make the difference.

ON TAPE, STEF WERTHEIMER: I believe that, in a way, industry is an art in itself. It's art. It's creation. You create something.

ON TAPE, ANNOUNCER: You can see it immediately upon entering an IMC branch or factory. The house of IMC is, first and foremost, a home for employees and customers as one. Years of experience have taught us that this is a vital element for success.

ON TAPE, EITAN WERTHEIMER: Many companies have buildings and machines and a lot of real estate, but it's only people that have a chance to make any difference.

ON TAPE, JACOB HARPAZ: I believe with the ambition of the people, with the hard work of the people, we are going to reach the position of being number 1.

ON TAPE, ANNOUNCER: The world demands better solutions. That is why we're here. IMC. (Applause)

WARREN BUFFETT: This is an important acquisition, as we paid $4 billion for 80 percent of the company. The family remains in partnership with us. They retained 20 percent.

It's the first business we've purchased that is based outside the United States. We have others that have operations there.

I think you'll look back on this in five or ten years as being a very significant event in Berkshire's history.

And it's interesting. In this world, in which many businesses get auctioned off, figures get dressed up before they sell them and leveraged up and so on, we continue to hear from people periodically who consider their business as too important to auction.

And we've never really bought one at auction — have we, Charlie — that I can remember?

CHARLIE MUNGER: I can't remember one either.

WARREN BUFFETT: Yeah. So there's a benefit in that.

Because, in effect, the people that pass through that filter of caring enough about their business that they don't simply put it up like a piece of meat at an auction are also the people, in our view, that make the best managers and make the best partners over time.

There is something going on in their brain that says this business is so important, and the people that are here are so important, and the customers we take care of are so important, that we actually care about the home in which these businesses reside.

And I think that filter works very much to our benefit. We've bought a number of businesses in the last 15 or 18 months where people have felt that way, and I think the crowning one here is ISCAR.

So, I welcome our new friends from Israel. I'm going to go over there and visit in September to see if there are any more girls out there like you, see if we can drum up a little more business.

6. Questions and answers

WARREN BUFFETT: And with that, let's go on to the question period.

And we will do this until noon, at which time we'll break for 45 minutes or so and come back, and then we'll continue until about 3 o'clock.

Then we'll break for about 15 minutes, have the formal business meeting from 3:15 to 3:16. (Laughter)

And then at 4 o'clock, Charlie and I are meeting with all of the people who came from outside of North America.

This year we had about 550 requests for tickets from countries outside of North America, as opposed to about 380 last year. So we're looking forward to meeting all of you that have come a long way to attend this meeting.

7. We can "easily handle" Social Security

WARREN BUFFET: Now, we've got a dozen zones in here, and we'll start off with zone number 1.

AUDIENCE MEMBER: Yeah. My name is Edward Jannig (PH) from Denver, Colorado.

First, I want to thank Charlie and Peter Kaufman for their wonderful book. I think Benjamin Franklin would be very proud.

My question is, last year when asked about Social Security, you said that a country as rich as the U.S. should take care of their old people.

This year I read Pete Peterson's book, "Running on Empty," and I was wondering, from the standpoint that is the greatest benefit to society, where should you draw the line on entitlement spending?

And I was wondering if you gentlemen disagree on the subject at all.

WARREN BUFFETT: Now, you always have the question in every society — whether it's formalized or not — you have the question of how you take care of the old and the young.

You know, you have people in their productive years turning out goods and services, and you have people that are too young to participate in the turning out of those goods and services but that, nevertheless, need them, and you have people that are old in the same position.

And starting in 1935, I believe, we statutorily formalized that idea. We'd always felt that way about the young, that school should be there for them when they couldn't pay for them themselves, and that the society owed a duty to both classes. But in 1935, we took up the idea that the government would provide this base limit.

Now, I think there's some merit to the argument that the 65 became outmoded as longevity improved. And that is now being changed, to some degree, and I think there's probably some more change needed.

But this country has an output of almost $40,000 of GDP per person. And some people, like Charlie and myself, are very lucky to be wired in a way that in a market system we get enormously wealthy.

And other people are not so wired, and they come out and they, in a market system, do not necessarily do so well, and they're fairly lucky if they provide for themselves during their working years and they do not have the ability to earn at a rate that takes care of them in later years.

And society has taken that on. Our country can easily handle the Social Security question.

I mean, it — and it's kind of astounding to me that a government that is quite happy to run a 3- or $400 billion deficit now worries a lot about the fact they're going to have a $100 billion deficit or something in Social Security 30 years from now. I mean, there's a little bit of irony in that. (Applause)

It is true that, if we maintain the present age brackets, that eventually you have one person in the older years for every two that are producing in the younger years.

But we produce more every year as we go along. And there will always be a struggle in a representative society, in a democratic society, between how you divide up that pie.

But we have a huge pie. We have a growing pie. And we can very easily take care of people, in a manner at least as well as we take care of them now, in the future from that growing pie without the people in their productive years not — also having a gain in their standard of living.

CHARLIE MUNGER: Yeah. I think the world of Pete Peterson, but I don't come to the same conclusion.

Of course, if we didn't tinker with Social Security, it would eventually run low on funds.

But if the country is going to grow at 2 or 3 percent per annum for decades ahead, it's child's play to take a little larger share of the pie and divert it to the people who are older.

It would be crazy, I think, to think you would always freeze the share of money going to the old at exactly the same sum no matter how rich you got.

It's a perfectly reasonable thing to do to pay a little more in the future to support what I regard as one of the most successful programs in the history of our country.

Social Security has a low overhead and does a world of good. It's a very reasonable promise to make, and I wish my own party would wise up a little on how little an issue it is. (Applause)

WARREN BUFFETT: This is what happens when you ask a couple of guys our age how you feel about treating older people. (Laughter)

Incidentally, the — currently — and everybody likes to talk about the unified budget — you didn't hear talk about the unified budget 30 years ago on the national level.

But the unified budget means that the Social Security surplus now gets counted toward reducing the overall budget. So they're very happy at present to take the Social Security surplus and trumpet the number that is after that.

But then when they start talking about a Social Security deficit out 20 or 30 years, they tend to get — they want to separate that off and get very panicky about it. So I think there's a lot of hypocrisy in the argument.

8. Different businesses, different compensation

WARREN BUFFETT: Let's go to number 2.

AUDIENCE MEMBER: Good morning. My name is Phil Rafton (PH), shareholder from Orinda, California.

My question for you: How would you design a compensation system in a very cyclical industry that can swing from boom to bust?

You want to tie compensation to results in some way, but this can lead to huge swings in pay. And, for example, today in booming industries, like energy and mining, profits are large as a result of the boom in the industry and not necessarily the results of management skill.

Conversely, when the industry is down, profits are low due to no fault of management.

So, again, my question: How do you design a compensation package to best reward management performance?

WARREN BUFFETT: Yeah. That's a terrific question. Because if you're running a copper company now with copper at 3.50 a pound, you can coin money even if you happen to be the village idiot, you know.

And, similarly, when copper was 80 or 90 cents a pound, which has been most of our adult lifetime, in that general — there were fairly sparse times in mining much of the time.

And we design compensation systems at Berkshire. We have dozens and dozens of companies. Some of them are capital-intensive. Some of them are cyclical. Some of them don't require much capital.

Some of them are terrific businesses if no one runs them. Some of them are very difficult businesses, even if the best of management comes.

And we have a wide variety of compensation systems. You're wise when you say, "How do you design one for that kind of a situation?" Because so often people come in with, sort of, standardized systems or whatever the highest system they see is, and then apply it to their own benefits.

Most people, if left to select their own compensation systems, will come up with the appropriate, from their standpoint, comparable arrangement.

If we owned a copper mining company in its entirety, we would measure it, probably, more by cost of production than we would by whether copper was selling for $2.00 a pound or a dollar a pound.

I mean, they — the management has control — depending on the kind of ore bodies and everything — but they certainly have control over operating conditions. They do not have control over market prices.

And we would have something, I think, that would not fluctuate a lot in a business like that, the bonus available, but it would probably tie to what we thought was under the control of the individual who's managing the business. That's what we try to measure.

We try to understand the industry in which they operate, and we try to understand the things that the manager can have an impact on, and how well they're doing in that.

We measure, at GEICO, for example, we measure by two unit measures: one is growth — unit growth — and one is the profitability of seasoned business.

New business costs money. We want new business; so we don't charge that against the manager or the 20,000 other employees who share in it.

We do not want to pay for anything that is not under their control. We do not want to pay for the wrong things.

And I would say, in a cyclical business, that you — you know, if oil is $70 a barrel, I don't think any particular management deserves credit for it. In fact, they all sort of deny that they've got anything to do with it when they get called before Congress.

But I would not give them credit for the fact that oil is $70 a barrel or $40 a barrel. I would give them credit for low finding costs for — over time.

I mean, what you really want to do, if you have a producing oil company, is you want a management that, over a five- or ten-year period, discovers and develops oil at lower-than-average unit cost.

There's been a huge difference in performance in that among even the major companies, and I would pay the people that did that well. I would pay them very well, because they're creating wealth for me.

And I would not pay the guy a lot of money that simply is cashing in on $70 oil and that really has got a terrible record in finding it at reasonable prices. Charlie?

CHARLIE MUNGER: Yeah. It's easy to have a fair compensation system like we have at Berkshire.

And a lot of other publicly-traded corporations also have fair compensation systems, but about half of them have grossly unfair systems in which the top people get paid too much.

We know how to fix Berkshire, but our ability to influence the half of American industry where the compensation systems are unfair has so far been about zero.

WARREN BUFFETT: Yeah. One thing you may find interesting, we have — I don't know — 68 operating companies. We probably have — I probably have responsibility for the compensation system of, perhaps, 40 managers or thereabouts, because some of them have businesses grouped under them.

I can't think — again, I can't think of anyone we have lost over a 40-year period because of differences in views on compensation.

I also — we've never had a compensation consultant come into Berkshire. They may have had them at the subsidiaries, but they're smart enough not to tell me. (Laughter)

They — it's never happened. I mean, we do not — and we do not have lots of meetings. We don't spend a lot of time on it. It is not rocket science.

It's made more complicated than it needs to be, more confusing than it needs to be, because having a system that is complicated and confusing serves the needs of some who want to get paid a whole lot more than their worth.

And the system won't change because it's working to the advantage of the people that have their hand on the switch, the people that pick the human relations consultants and pick the people who are on the comp committee.

I was put on one comp committee, and Charlie can tell you what happened. (Laughter) He was there.

CHARLIE MUNGER: Yeah. We were the biggest shareholder at Solomon. Two of us were on the board, and Warren was on the comp committee.

And in that frenzy of envy, which characterizes compensation in investment banking, Warren remonstrated, softly, I thought, towards a slightly more rational result, and he was outvoted.

WARREN BUFFETT: Charlie used the term "envy" rather than "greed," which is interesting, because that's been our experience, is that envy is probably a bigger motivation, in terms of people wanting to be in that top quartile, or whatever it may be, than greed.

It's a very interesting phenomenon that you can hand somebody a $2 million bonus, and they're fine until they find out that the person next to them got 2-million-1, and then they're sick for the next year. (Laughter)

Charlie has pointed out — you know, of the seven deadly sins — that envy is kind of the silliest because you don't feel better. You know, I mean, if you get envious of somebody, you feel worse the whole time.

Now, you know, gluttony — you know, I've had some of my best times while being gluttonous. (Laughter)

There’s a real upside to gluttony. (Laughter)

We won’t get into lust. (Laughter)

But I’ve heard that there are upsides to that, occasionally.

But envy, you know, all you do is sit around and make yourself sick and can’t get to sleep. But that’s — it’s part of the human psyche, and you see it big time and you get this irony.

The SEC wants even more transparency on pay, which I think, you know, basically is a good idea except for the fact that it becomes a shopping list for every other CEO when they see that somebody is getting their haircuts paid for by the company.

They decide that they, too, need their haircuts paid for by the company, and they suddenly become big tippers.

9. Our managers are “trained” by our culture

WARREN BUFFETT: Let’s move on to number 3.

AUDIENCE MEMBER: Greetings to all of you from the Midwest of Europe. I’m Norman Wintrop (PH) from Bonn, Germany.

Thank you very much for writing your shareholder letter in such a way that we feel treated as partners.

Warren, in the shareholder letter, you ended with your thoughts on managing Berkshire Hathaway in the future.

May I ask you, how do you train your successors? What do you tell them? How do you summarize to them what is important to you?

And how, if you are able to do so, how would you measure whether or not they have lived up to your expectations?

WARREN BUFFETT: Well, that’s a good question.

And, I think, actually, in reading that letter — you know, that’s part of the — part of the reason it’s written — is to convey, not only to our partners, our shareholders, but also to our managers and anybody else in the public, you know, what Berkshire is all about.

This meeting, you know, in terms of what we do is intended to give a personality and a character to Berkshire. And we don’t say it’s better than anybody else’s, necessarily, but we do think it’s us.

And we think — we want managers to join us who believe in the sort of operation we have, a partnership with shareholders, a lifetime commitment to the businesses. We want those people to join us.

We want what they see after they join us to underscore the values we have. So everything we do we hope is consistent with what most people would call a "culture" at Berkshire.

So the written word, what they see, what they hear, what they observe. And that is training in itself.

It's the same sort of training you get as a child. I mean, you — when you are in the home and you're learning something every day by the behavior of these terribly important people, these big people that are around you.

And a home has a culture. A business has a culture. To some extent, a country can have a culture. And we try to do everything that's consistent with that. We try to do nothing that is inconsistent with that.

And, believe me, if you're a bright Berkshire manager — and they are bright — you know, they buy into it to start with, they see that it works, you know, and it doesn't require formal lessons or mentoring or anything of the sort.

I mean, if you talk to our Berkshire managers, you would find that they think consistently with how, in effect, Charlie and I think.

There are plenty of people that don't, and they don't join us.

I mean, you know, we hear all the time from people — I've got one coming in a little while, actually, that, you know, nothing is going to come of it because this guy — I mean, his brain processes things different than mine does.

And I'm kind of interested in learning about his business, so we'll get together, but it wouldn't fit. You know, it would just not — it would be a mismatch.

And the nice thing about it is our culture is so well-defined that there aren't many mistakes, in terms of people entering it or behaving in a way inconsistent with it. So I think that — I don't think there's any formal training necessary.

I mention in the annual report the fact that, if I die tonight, there are three obvious candidates to take my place.

Now, the board knows which one of them they would agree on tonight. Might be different three years from now, but any of those three would not miss a beat in terms of stepping into the culture that I hope we have here, because it's theirs too.

Charlie?

CHARLIE MUNGER: Well, you know, if Warren has kept the faith until he's 75 years old in maintaining a certain kind of culture and a certain way of thinking, do you really think he's going to blow the job of passing the faith on?

What could be more important, in terms of his duties in life? You all have something — (Applause)

You all have something more important to do than worry about the fact that the candle is going to go out at Berkshire just because some people die.

This is a place where the faith is going to go on for a long time.

Of course, at headquarters, we aren't training executives. We find them. And they're not hard to find.

You know, if a mountain stands up like Everest, you don't have to be genius to recognize that it's a high mountain. (Laughter)

10. Irrational pricing of closed-end funds

WARREN BUFFETT: OK. Number 4?

AUDIENCE MEMBER: My name is Yuen Gunn (PH), and I'm from Whitehaven in England.

Actually, the last time I was this nervous asking a question, I'd just presented my wife with an engagement ring from Borsheims. (Laughter)

WARREN BUFFETT: Well, I hope you get nervous again. (Laughter)

AUDIENCE MEMBER: My question for you is, with the enthusiasm at the moment for emerging markets, many closed-end funds which contain emerging market stocks are trading at significant premiums to their net asset values, even when open-ended funds can be used to acquire similar portfolios of stocks for the net asset values.

This doesn't seem very rational to me. Why do these premiums persist, and do you agree that it's irrational?

WARREN BUFFETT: Yeah. I would say it would tend to be. I don't know anything about the specifics that you're referring to on emerging market funds. I haven't looked at the size of the premiums.

But, history would certainly show that most closed-end funds — just about all closed-end funds — eventually go to discounts.

I actually worked — well, I'll skip that analogy. But the — overwhelmingly, closed-end funds have gone to discounts.

You know, initially, if they're sold with a 6 percent commission, of course, the initial people are getting 94 cents of net asset value by paying the dollar, but I know I — if I saw two — if I had an interest in buying into emerging markets through other people's management and I could buy an open-end fund at X, or an asset value, and I had to pay 120 percent of X for some closed-end fund, you'd have to convince me very strongly that the management of the closed-end fund was better.

So I think you're right. I don't — again, I don't know the — if the premium is a few percent, it doesn't really make much difference.

But occasionally, Charlie and I have witnessed in the past closed-end funds that have sold even at 30 or 40 percent premiums over asset value.

Overseas Securities was a tiny fund that used to do that for years and baffled everybody. But eventually they will come back down to earth.

Charlie?

CHARLIE MUNGER: I've got nothing to add. (Laughter)

WARREN BUFFETT: He's hitting his stride now. (Laughter)

11. Corporate boards should think like owners

WARREN BUFFETT: Number 5?

AUDIENCE MEMBER: Warren and Charlie, I want to thank you for putting a once obscure Midwestern city on the map last year with your acquisition of Pete Liegl's company, Forest River.

I'm Frank Martin (PH) from Elkhart, Indiana, the RV capital of the world. I also want to thank —

WARREN BUFFETT: Glad to have you here, Frank.

Frank has just brought out a book, incidentally, that's a history of some of his annual letters. It's a good book, and I recommend you get it.

AUDIENCE MEMBER: Thank you, Warren.

I also want to thank you for your influence over Robin Williams and other Hollywood stars. Those of you who have seen the movie "RV" realize that Warren will go to no ends to promote the products of the companies he acquires. (Laughter)

WARREN BUFFETT: A few people have already noticed that, actually, Frank. (Laughter)

AUDIENCE MEMBER: On a more serious note, there's a small but growing trend in American business governance to move from plurality voting for directors to majority voting, long the standard in Great Britain.

What do you see as the upside and downside of majority voting, as it relates to raising the standard of ethics in the corporate boardroom?

WARREN BUFFETT: Charlie, you want to take a swing at that?

CHARLIE MUNGER: I don't think it'll have any effect at all on ethics in the corporate boardroom.

There get to be fashions in the governance subject. I think that the troubles in American corporations are not going to be fixed by something like that.

All these reforms have to be considered in the light of the kind of people that are likely to be activist in using new powers, and that crowd is a mixed crowd, to put it gently.

WARREN BUFFETT: The question in the boardroom is to what extent — and you have to understand, it's partly a business situation; it's partly a social situation.

The question is to what extent do the people that are participating there think like owners, and whether they know enough about business so that even if they're trying to think like owners, that their decisions will be any good.

And Charlie and I have been on boards of companies with dual voting. Berkshire has that, although it's so minor that it doesn't really make any difference. But we've been on other boards.

I have never really seen any difference in behavior based on the nature of the votes that got them into the boardroom.

But there's an enormous difference — I think you'd be blown away if you watched boardrooms over the years — there's just an enormous difference in terms of, really, the business savvy of the people in the room, the degree to which they are thinking like owners as they go along.

And I've seen no — I don't know that dual voting or the lack of dual voting really is going to have very much to do with that.

The key — I've mentioned it in the past — there's all these fashions, as Charlie says, in corporate governance.

But the job of the board is to get the right CEO, to prevent that CEO from overreaching. Because sometimes you have some people that are very able, but they still want to take it all for themselves.

But if they take nothing and they're the wrong CEO, they're still a disaster. So low pay itself is not the criteria.

So you want the right CEO. You do not want them overreaching.

And then I think the board needs to exercise independent judgment on important acquisitions, because I think CEOs — even smart CEOs — are motivated, frequently, in acquisitions by other than rational reasons.

And in those three areas, you know, American directors have — I don't think they've given a tremendous account of themselves in recent years, whether at dual system places or otherwise.

The only cure to better corporate governance, in my view, is that the very large shareholders start really zeroing in on whether those questions I just mentioned are being addressed properly.

If they go on to all these peripheral issues, you know, they have a lot of fun and they get in the papers. You know, they have little checklists and they can issue grades and all that. It isn't going to do anything in terms of making American business work any better.

But if the eight or ten largest shareholder groups, if the really large institutional investors say, you know, "This compensation plan doesn't make any sense and we're not voting for the directors, and here's why we're not voting for the directors," you'd get change. But so far, they've been unwilling to do that.

It takes the big shareholders. It's not going to be done by any coalition of small shareholders or people sticking things on ballots. But the big shareholders of this country, you know, basically they — some of them farmed out their voting, even.

I was amazed to find that out, that a number of very large institutional investors have actually just turned their voting process over to somebody else. They don't want to think like owners. And, you know, they bear — we all bear — the penalty for that.

12. Tech is still in the "too hard" pile

WARREN BUFFET: Number 6?

AUDIENCE MEMBER: Hello. My name is Andy Pollen (PH) from Adrian, Michigan. Thank you, once again, for having me to Omaha.

My question is for Warren, but, Charlie, please add your thoughts as well.

Warren, I've heard you say many times that you don't understand technology and that you rely on Bill for that, and that's fine. And I see from this year's movie that you're learning, so that's good.

WARREN BUFFETT: Slowly.

AUDIENCE MEMBER: I'm also curious to hear what you've learned so far about the other information technology companies, such as IBM, Sun Microsystems, Oracle, Dell, EMC, and Intel.

WARREN BUFFETT: I know — what I've learned is I know enough not — to know that I don't know enough to make an investment decision.

The — Charlie and I have circles of competence that extend to evaluating a number of types of businesses, and there are a whole lot of businesses that we won't be able to evaluate.

Some of them, I don't think — I think very few people can evaluate.

I mean, you get outside of — you just get into businesses that — where the future is so likely to be different than the present that maybe there's a few people that have great insights on it, but we sure don't.

We are best at the businesses where we can come to a judgment that they're going to look a good bit like they do now five years from now, ten years from now. They'll be bigger. They'll be doing different things, but the fundamentals will be the same.

ISCAR will be a bigger company five years from now. It may be a much bigger company, and we may get a chance to do interesting acquisitions.

But what you saw there, the fundamentals, won't change. The way the people think won't change.

I can name a number of businesses that are bound to change dramatically. I mean, when you think of how much the telecom business, for example, has changed over the last 15 or 20 years, it's startling.

Even with hindsight, it's a little hard to figure out, you know, who was going to make all the money and so on. There's just — there's just games that are too tough.

Charlie says, you know, "We've got three boxes at the company: in, out, and too hard." (Laughter)

And a lot of things end up in the "too hard" pile, and it doesn't bother us. You know, we don't have to be able to do everything well.

If you go to the Olympics, you know, if you run the hundred meter well, you don't have to throw the shotput. You know, some other guy can throw the shotput and you'll still get a gold ribbon, you know, if you run the hundred meter fast enough.

So, we try to stay within the circle of competence.

Tom Watson, Sr. — I think it was Senior — yeah, Tom Watson, Sr. — many years ago said, "I'm no genius, but I'm smart in spots, and I stay around those spots."

Well, that was pretty damn smart, you know. And we have found a lot of our managers who don't think, you know, they can solve every problem in the world, but they run their businesses extraordinarily well.

You do not want to — Frank Martin mentioned Forest River. You do not want to go and compete with Pete Liegl and his business. He's going to kill you. He's very, very, very good.

But he doesn't come around and try and tell us how to run the insurance business, because that's not his game.

We look for people that are very good at things they understand. And we don't get any inferiority complex at all about the fact that — well, I — you mentioned Intel, I believe.

I was virtually there at the birth of Intel because I was on the board of Grinnell, and Bob Noyce was the chairman of the board of Grinnell. And we bought — at Grinnell — we bought $300,000 worth of their original debentures.

And, you know, I knew Bob was always a very, very smart guy, but I wouldn't have had the faintest idea how to evaluate the future of Intel then, and I really don't have it now, you know.

And I think they probably had a few surprises themselves in the last few years with AMD and what's been happening in their business.

But what that's going to look like in five years, I don't have any idea. And I'm not so sure, if you're in the industry, you'd know exactly what it was going to look like in five years. Some businesses just are very, very hard to predict.

Charlie?

CHARLIE MUNGER: Yeah. One of the foreign correspondents last year, after looking at us carefully, said, in effect, “You guys don’t seem smart enough to do so much better than other people as you’re doing.” (Laughter)

WARREN BUFFETT: Were they looking at me or you, Charlie?

CHARLIE MUNGER: Both. (Laughter)

“Have you got an explanation?” And we said, “We know the edge of our competency better than most people do.”

It’s a very useful thing to know the edge of your competency. And I always say it’s not a competency if you don’t know the edge of it.

WARREN BUFFETT: I’ll have to think about that a little bit. (Laughter)

Bill will explain it to me later.

13. Too many tax breaks for the rich

WARREN BUFFET: Area 7, please.

AUDIENCE MEMBER: I am John Bailey (PH) from Boston, Massachusetts.

I wanted to ask, Warren and Charlie, if you could consider three hypothetical securities for a long-term investment.

The first would be, like, a share in median family income for the United States. The background there that, in real terms, median family income has been stagnant for approximately 30 years.

The second security would be a share in all corporate income in the United States. The background there that corporate income has been taking an ever larger slice of GDP for several years.

And, finally, a bit more abstract, a share in all capital assets in the United States, and I would like to include all intangible capital assets, if possible.

So would any of these be of interest for a long-term holding, perhaps 20 years or so? And, if not, why not?

WARREN BUFFETT: Well, I think I’d rather buy ISCAR. (Laughter)

The corporate profits, as you point out, have been close to their highs, except for a very few years post- World War II, as a percentage of GDP. It’s hard to imagine being much larger.

It's interesting. While corporate profits is reported — you take S&Ps, percentage of book, percentage of sales, put on the line, they're all on the high end.

Corporate income taxes, really, are not that high relative to the total revenues of the country. So you can see that there's been a little disconnect there in some manner.

But median family income is something that Charlie and I have never even considered. We're not shooting for that.

It is certainly true that, in the last five to ten years, that the disparity in income has widened significantly and that the tax breaks for the wealthy have been extraordinary.

I've pointed out in the past that most of the members of the Forbes 400, myself included, pay a lower percentage of their income to the U.S. government, counting Social Security taxes, than does the receptionist that works in their office.

That was not true 30 years ago, and I don't think it's something that should be true in a rich society, but it has happened.

And I just computed my 2005 return. In 2004 — and I have no tax shelters. I don't have a tax adviser. I just do things, and at the end of the year I add it all up.

In 2004, my rate was the lowest of the 15 or 16 people in the office, and in 2005, my rate was even lower.

And that's courtesy of the U.S. government. It's not courtesy of a lot of tax write-offs or anything of the sort.

And I think that's — I think it's crazy, and I don't think the American people understand it very well. And I think that if they did understand it, they should, and would, be quite unhappy about it.

So I think that — I think that the lower incomes, median — and the medium — people making medium amounts of income, have not shared in the prosperity of the last decade or so in a way that's all proportional to the way the wealthy participate in it.

The last point you mentioned was too esoteric for me, so I'll pass it over to Charlie.

CHARLIE MUNGER: Yeah. The main figure that matters to all of us, including the people at the median, is how does GDP per capita grow? And those figures have been very good.

And so, I wouldn't get too wild on the subject of median income. It isn't like we're all permanently in some status from nobody moving from status A to status B.

There’s a huge flux, both up and down. And what’s really important is that the pie keep growing at a decent clip.

All that said, I think that Warren is right, that some of those tax changes were a little crazy. I mean, they caused more envy than we needed. But I don’t think it’s all that important.

WARREN BUFFETT: Yeah. We might think it was more important if we were working at the median income, Charlie. (Laughter)

14. Munger: Ethanol is “stupid”

WARREN BUFFET: Let’s go to Number 8.

AUDIENCE MEMBER: Good morning. I’m Diane Ryan (PH) from Kansas City.

My question is, what is your opinion on the economics of ethanol and as — just as a fuel additive?

And, as a potential investor, should I be looking at that industry?

WARREN BUFFETT: Well, I don’t know enough to answer the latter part. I know we don’t — Charlie and I would not know enough to evaluate ethanol projects.

We’ve been approached on them. And, of course, they’re quite popular now.

But in terms of figuring out what an ethanol plant is going to be earning on capital five or ten years from now, it’s far easier for us to figure out whether people will be drinking Coca-Cola, or even eating See’s Candy, which I highly recommend. (Laughter)

So, you know, it will depend on government policy. It will depend on a lot of variables that we’re not particularly good at predicting.

It’s easy to raise money for it now. I mean, it’s a popular item. You know, it’s hot.

And our general experience is that we don’t look at things very much that are hot at any given time.

I know nothing about the — you know, the biochemistry or anything of the sort.

I have a son who was a head of the ethanol board in Nebraska. And if I notice that he suddenly starts getting richer than I am, you know, I will suspect that I should start looking at ethanol very hard.

But so far, I haven’t seen tangible evidence of that.

There's no question ethanol usage is going to grow. I mean, that we will see.

Generally speaking, ag processing — agriculture processing — businesses have not earned high returns on capital. I mean, if you look at Cargill, you look at ADM, you look at the big processers, that has not been a great business.

Ethanol could prove an exception, but I'm not sure how you gain a significant competitive advantage over time, you know, with any given ethanol plant.

And if you get too many of them around, you know, it will not be a good thing when you're turning out a commodity.

Charlie?

CHARLIE MUNGER: Well, my attitude is even more hostile than Warren's.

I have just enough glimmers of thermodynamics left in me to suspect that it takes more fossil fuel energy to create ethanol than you can get out of the ethanol you've created.

If so, that's a very stupid way to try and solve an energy problem. (Applause)

WARREN BUFFETT: Well, considering my family situation, I would say I have friends who like ethanol, and I have friends who don't like ethanol.

And I want my position to be perfectly clear: I'm for my friends. (Laughter)

15. Watch out for speculative commodity bubbles

WARREN BUFFETT: Let's go to number 9.

AUDIENCE MEMBER: Hello. My name is Johann Freudenberg (PH) from Hanover, Germany.

Do you think we are in a commodity bubble? Thank you.

WARREN BUFFETT: Well, certainly — not in agriculture commodities, they haven't done anything, if you're talking about wheat or corn or soybeans or something.

But if you get into the metals, oil, there's been a terrific move. The most extreme, probably, has been copper, I would say.

Oil, if you go back a few years to when it was $10 a barrel — it's been more extreme than copper — but you were undoubtedly — it's like most trends. At the beginning, it's driven by fundamentals, and at some point, speculation takes over.

The very fact that — the fundamentals cause something that people looked at for years without getting excited about. Fundamentals change the picture in some way.

Copper does get a little short, you know, or people get a little worried about currency and, maybe, gold goes up or whatever it may be.

But, you know, it's that old story of what the wise man does in the beginning, the fool does in the end.

And with any asset class that has a big move, that's based initially on fundamentals, is going to attract speculative participation at some point, and that speculative participation can become dominant as time goes by.

And, you know, famous case always being tulip bulbs. I mean, tulips may have been more attractive than dandelions or something, so people paid a little more money for them.

But once a price history develops that causes people to start looking at an asset that they never looked at before and to get envious of the fact that their neighbor made a lot of money without any apparent effort because he saw this early and so on, that takes over.

And my guess is that we're seeing some of that in the commodity area. And, of course, I think we've seen some of it in the housing area, too.

How far it goes, you never know. I mean, it just — some things go on to just unbelievable heights, and then, you know, silver went back and that was manipulation, to some extent, but it got up to $50 an ounce very briefly back in the early '80s.

But the eyes of the world that never looked at silver when it was $1.60 or — or $1.30 back in the '60s, you know, everybody in the world was looking at it. And some were shorting and some were buying, but it becomes a speculative football.

And my guess is that an awful lot of the activity in something like copper now is speculative on both sides of the market.

If — you know, if it goes to $5 a pound, who knows? But it — you are looking at a market that is responding more to speculative forces now than to fundamental forces, in my view.

Charlie?

CHARLIE MUNGER: Well, I think we've demonstrated how little we know about commodity prices by our very skillful operations in silver.

WARREN BUFFETT: I think you can change that from "our" to — it's mine, actually.

I bought it very early. I sold it very early. Other than that, everything I did was perfect. (Laughter)

We managed to minimize things there with great efficiency, or I managed to. Charlie didn't have anything to do with that. I was the silver king there for a while.

We did make a few dollars on it. But we're not good at the game of, when it gets into the speculative area, figuring out how far a speculative boom will go.

If the fundamentals are attractive, we think we're getting a lot for our money, buying equities or whatever it may be, we'll make some money.

We will — we may not make as much money — remotely as much money — as somebody who is, you know, plays out the last 30 days or 30 weeks of a real wild orgy.

I mean, these things, they tend to be the wildest toward the end.

But that gets back to the question, you know, of Cinderella at the ball. I mean, you know, you're there. You're having a wonderful time. The punch bowl is flowing and the dance partners are getting prettier all the time.

And you know at midnight, it's going to turn to pumpkins and mice.

And, you know, you look around the room and you think, "Just one more dance, one more good-looking guy," you know, "one more glass of champagne."

And you think you're going to get out of there at midnight, and, of course, everybody else thinks they're going to get out of there at midnight, too. And in the end, it does turn to pumpkins and mice.

And in this game, as I've said — you know, Adam Smith said it many years ago — a fellow named Jerry Goodman wrote under the pseudonym of Adam Smith — says the problem with that particular dance for Cinderella is that there are no clocks on the wall.

You know, and in the markets — if you're talking copper now, if you're talking Internet stocks in 1999, if you're talking uranium stocks in the 1950s — there are no clocks on the wall.

And the party does get to be more fun, you know, minute after minute, hour after hour, and then it does turn to pumpkins and mice.

16. "Brazil would not be off limits"

WARREN BUFFETT: Number 10?

AUDIENCE MEMBER: My name is Luisa Loredo (PH). I'm a student at University of Kansas, and I'm originally from Brasilia, Brazil.

My question is for both Mr. Buffett and Mr. Munger.

The stock market in South America has been growing quickly in the last few years. What do you think about investment opportunities in South America, given the political environment and underlying risks?

WARREN BUFFETT: Yeah. We would — our problem in many markets is that we have to put a lot of money to work to move the needle at Berkshire. We've got a market value of 135 billion or something like that.

So we are looking to put out hundreds and hundreds of millions of dollars at a minimum when we look at marketable securities. And that really narrows the field in terms of countries or in terms of businesses within those countries.

But, you know, we made an investment about three years ago in PetroChina. Now, PetroChina is one — probably one of the — well, it is one of the five largest oil companies in the world — and, yet, we were only able to — even there — to get 400 and some million dollars into it, which fortunately is worth a couple of billion now.

But here it's a country the size of China, largest company in that country, and even there we only got 400-and-some million dollars in, although we would have liked to have gotten more.

But we weren't afraid to go into China. We wanted to get paid more for going into China, and we did, because we don't know the game as well there. We would feel the same way in Brazil.

I mean, we — a great beer company down there that a friend of mine ran, and, you know, we should have been in that. We knew he was a great manager, and he was going to do a great job with it.

So, Brazil would not be off limits at all, but we'd have to be able to get a lot of money into a business we understood at an attractive price.

We would want it to be cheaper than if it were in the United States. We wouldn't understand the tax laws as well, the nuances of governance, a whole bunch of things. But after allowing for that, at a price, we would do it.

We're unlikely to put a lot of money into — Brazil is a big country, but we're unlikely to put a lot of money into really small economies because we can't get enough money into them. Charlie?

CHARLIE MUNGER: No more.

17. Outlook for Clayton and manufactured homes

WARREN BUFFETT: Number 11?

AUDIENCE MEMBER: My name is Jeff Bingham (PH). I'm from Chicago, Illinois.

I have a question regarding the manufactured housing industry. What is your outlook on demand for the industry? And, correspondingly, in your opinion, will lending increase in a meaningful way over the next few years?

And are the homes priced attractively relative to competitive products, like stick-built housing and apartments, in the face of continued site rent increases at the community level and, in some cases, lenders requiring shorter maturities on mortgages?

WARREN BUFFETT: It's been kind of an interesting history on manufactured housing. If you go back — you have to go back 30 or 40 years — 40 years, I think, almost, to have — find volume as low as it's been in the last couple of years. And the houses are better than — by far better — than they were then.

There have been years when 20 percent of the housing — the new housing product in the United States — was manufactured housing. One out of every five.

Last year, leaving out FEMA demand, you know, we were bumping along for the third year, I believe, just a tiny bit over the 130,000 level, you know, which is like 6 or 7 percent — probably 7 percent — of new housing starts.

So, the percentage of the total new housing stock that has been manufactured housing in recent years has really been very low, while the houses are better — considerably better — quality than in the earlier years.

You can look at the house. We've got two houses out there on the exhibition floor, around $45 a square foot. You know, that's good value.

There's a lot of resistance, through local zoning laws and that sort of thing by the local builders, to the influx of manufactured housing. We've made progress on that in some areas. We're actually developing subdivisions in that business.

The houses were mis-sold four or five years ago in huge quantity because you had manufactured housing retailers selling the properties, getting any kind of a down payment, taking the loans — selling to people that shouldn't be buying them — taking the loans, securitizing them, so somebody in some insurance company someplace lost significant sums of money.

So you had, really, an abuse of credit in the field. And there's a hangover from that, and it's taken a long time for that hangover to work its way through.

I think Clayton Homes, which we own, has done a terrific job in both the financing — they should be financed on shorter terms, incidentally.

I'm — if you put them on owned land, that's one thing, but financing them for 30 years, in my view, was a mistake.

But the terms got very lax for a while, and, you know, we're bearing the consequences of that now.

But I think the market will get bigger, but I do not think it will get bigger this year. I see a year that, counting some FEMA demand and some hurricane-induced demand, maybe 150,000 units, 145,000 units. And by industry standards, that's down a lot.

Now, the number of plants is down a lot and the number of retailers are down a lot.

Clayton's position is very strong. And their record is so much better than anybody in the industry that you have to look very hard to find number two.

Charlie?

CHARLIE MUNGER: Yeah. You asked about stick-built housing and how competitive it was. That's been one of the troubles of the manufactured housing game is that the stick-built housing has gotten so efficient.

But there the system is aided greatly by Berkshire's subsidiary MiTek. So — and stick-built housing is amazingly efficient when it's done in big quantity with systems like MiTek provides.

And if it weren't for that, there would be a lot more manufactured housing.

Personally, I think manufactured housing is going to get a lot better and take a lot more of the market. It may take a considerable period, but that is so logical that I think it will eventually happen.

WARREN BUFFETT: Yeah. Somewhere down the road, you would expect 200,000-plus units for the industry. But I don't think you'll see it in the next year or two.

The industry has to think through — and they have, they've made a lot of progress on this — but they have to think through what's the logical way of financing these things, and what's the way to make sure that the person who buys it really has an asset that's in excess of their loan value five and ten years down the road.

And, really, very little consideration was given to that five years ago. It was just a question of put together the papers, sell it on Wall Street, and let somebody else worry about it later on.

Clayton did a way better job than other companies in that respect, but those were the industry conditions that existed then.

But I think Clayton will be — Clayton could easily be — the largest homebuilder in the United States in future years because we will be a big part of an industry that, as Charlie says, should be doing more volume.

CHARLIE MUNGER: I also think that some of the sin that was in the manufactured housing finance a few years ago has shifted into the finance of the stick-built houses.

There is a lot of ridiculous credit being extended in America in the housing field. And it had a horrible aftermath in the manufactured housing sector, and my guess is there will be some trouble in the stick-built sector in due course.

WARREN BUFFETT: Well, dumb lending always has its consequences and usually on a big scale, but you don't see it for quite a while. So, therefore, it's like a disease that doesn't manifest itself for, you know, a few weeks.

And you can have an epidemic of something like that, and by the time you know you have an epidemic, you're very well into it. Well, that's what happens in dumb financing.

And you had that — you periodically — you certainly had it in commercial financing in the '80s, and you had the RTC and the savings and loan crisis and all of that because, literally, one dumb project was put up after another.

A developer will develop anything he can borrow the money against. It's that simple. And when the lending institutions pour the money out for something, it will get built.

And that happened in manufacturing housing. It happened in commercial real estate in the '80s. I think it's happened in conventional housing here in recent years.

And if you look at the 10-Qs that are getting filed for the first quarter of some lending institutions, and 10-Ks that were last year, and you look at the balances increasing on loans for interest that's accrued but was not paid because people had adjustable mortgages, but they're only adjustable so far, but the lending institutions are taking in the income as if it were paid, you'll see some very interesting statistics.

CHARLIE MUNGER: Yes. And some of this dumb lending is being facilitated by contemptible accounting. The accounting profession has not stopped compromising its way into terrible behavior.

WARREN BUFFETT: Our auditing bill just went up.

18. No interest in investing in Russia

WARREN BUFFETT: Number 12? (Laughter)

AUDIENCE MEMBER: My name is Elliott Samuels (PH). I'm from New York City.

Thanks to high energy prices and other factors, Russia has been one of the best performing markets recently. The country's financial condition has stabilized since the 1990s.

A fledging middle class is taking shape as personal incomes grow. And there are also risks — political, legal — risks to minority investors.

But there are also potentially great values among second tier companies there.

I was wondering, what needs to happen in Russia for you to invest there, whether for Berkshire or for yourself, and what kind of companies would interest you there?

WARREN BUFFETT: Sounds like you may own a few Russian stocks yourself. The — I would — as you know, in 1998, Walter Wriston said sovereign governments don't default.

In 1998, in Russia, at least, he was proven wrong. And Charlie and I were — inherited a business at Salomon that was in the oil business big time-out in the — in Siberia.

And there came a time when — we got to dig the holes. We sent the money in. And as long as we were drilling, we were welcome. And then when we wanted to start taking the oil out, after our money had been used to drill the holes, they weren't quite as friendly. In fact, it was really kind of extreme what took place with us.

So, having had a few experiences like that, it might take us quite a while before we wanted to sink a lot of money into Russia. It may be different now, but I don't think it's any certainty.

I had breakfast in Sun Valley three years ago this July, I believe it was, with [Mikhail] Khodorkovsky, and we had a translator there. And he talked to me about whether — he was thinking about listing Yukos on the New York Stock Exchange, but he said, you know, it would require registering with the SEC or something, and he wasn't sure whether that would be too dangerous.

Well, I don't think he listed it there, but he went back to Russia, and he's been in jail now for — well, just about ever since.

And Yukos was put into bankruptcy with tax claims, and, you know, it — I don't — I just think it's a little hard to develop a lot of confidence that the world has changed permanently there in terms of its attitude toward capital, and particularly toward outside capital.

Charlie, what are your thoughts?

CHARLIE MUNGER: Yeah. The situation reminds me a little of POLY Petroleum, which, years ago, was much traded in Los Angeles.

The saying always was, "If they ever do find any oil, that old man will steal it." And I'm afraid we have some of that problem in many of the countries in which we're seeking for oil.

WARREN BUFFETT: Didn't we really have the livelihood of our guys threatened over there, Charlie?

I think we sent in some people to get out the equipment, and they said if we sent in the people to get out the equipment, not only would the equipment not get out, but the people wouldn't get out.

So we understood the situation. That was not that long ago.

CHARLIE MUNGER: No.

19. Hottest real estate markets are cooling off

WARREN BUFFETT: Number 1 again.

AUDIENCE MEMBER: I'm Lori Gold (PH) from San Francisco, California.

My question is, what are your thoughts about the residential real estate market in the U.S., where it's headed? And how is California different, if so?

WARREN BUFFETT: Well, Charlie is our California expert. We've managed one time to develop a great piece of property in California. We spent about 20 years or so developing it, Charlie, or —

CHARLIE MUNGER: Yes. And we got our money back with interest.

WARREN BUFFETT: Barely. (Laughter)

CHARLIE MUNGER: Barely, yeah.

WARREN BUFFETT: We finished it at just the wrong time. We — the land value that we nurtured — that was a terrific piece of land. Charlie lives there. And I don't think it's an exaggeration to say we spent 20 years —

CHARLIE MUNGER: No.

WARREN BUFFETT: — working on developing the land. And the land value, which, in effect, we cashed out for, what, 5 or $6 million, now would have an — the implicit land value — would be what?

CHARLIE MUNGER: Maybe a hundred million dollars.

WARREN BUFFETT: Yeah. But we finished it at the wrong time.

So, you know, it's a wonderful — the climate is wonderful. Everything is wonderful about this property.

It's just that, from time to time, even in great localities — you've seen it happen in New York a couple of times, you know, in the last 30 years, where the swing in property values has just been huge.

And what we see in our residential brokerage business — and we're in, I don't know how many different states — is we see a slowdown every place.

Now, we see it most dramatically in some of the — what have been the hottest markets.

In the markets where you're going to — in my view — you're likely to see the greatest fall-off and where you've had the biggest bubble are the ones — they tend to be the high-end market, and they tend to be ones where people have bought for investment or speculation, rather than use.

People will pay $300,000 for a house and mortgage it for 270,000, and if the value goes to 250, if they have a job and everything, they won't move out.

I mean, you don't lose a lot of money even though the market value on a given day is less than the loan value when families stay together and employment is present and all that.

But when you have investment-type holdings, speculation-type holdings, when you, in effect, have had the day traders, you know, of the Internet move into the day trading of condos, then you — then you get — then you get a market that can move in a big way.

First it sort of stops, and then it kind of reopens. Real estate is different than stocks. If you own a hundred shares of General Motors, it's going to trade on Monday and that's what it's worth and you can't kid yourself about it.

But if you own real estate, you know, there's a great tendency to think about the one that sold down the street a few months ago. And there's a great tendency to think, you know, you only need one buyer who hasn't gotten the word that things have slowed down and you'll make your sale.

I can tell you that in Dade and Broward County, for example, in Florida, where the average condo is about 500,000, if you go back to December of 2004, there were less than 9,000 condos listed for sale, and I think 2,900 of them sold in the month so you were — turnover one every three months, less than that.

Now, the listings are up to 30,000, and the sales are down to under 2,000 a month. Well, 30,000 is $15 billion worth of properties. And you are — very likely, you can get real discontinuities in a market like that, where all of a sudden people realize that the whole supply-demand situation has changed.

So I think we've had a bubble, to some degree, and it's very hard to measure that degree until after it's all over.

But I would be surprised if there aren't some significant downward adjustments from the peak, particularly in the higher-end properties.

CHARLIE MUNGER: Yeah. The man is right that the bubbles came in Manhattan and in certain places in California. In Omaha, housing prices are quite reasonable. So it's — the country is not all the same, at all.

20. Attendance estimate and Furniture Mart sales

WARREN BUFFETT: We just got an estimate of the attendance at 24,000, which was about what it looked like from the tickets we had gotten. I thank you all for coming, on that note. (Applause)

Even better, the Furniture Mart, which had sales in 1997 of 5-and-a-fraction million, 2003 sales of 17 million, sales last year of 27 million, is up so far 2 1/2 million, with the best yet to come.

So we're — I would say we're likely to do over 30 million at the Furniture Mart. And that, incidentally, is about equal to a normal monthly volume for the store. So you're doing your part. Thank you. (Applause)

21. Don't like excess cash, but we hate dumb deals

WARREN BUFFETT: Number 2?

But you can do more. (Laughter)

AUDIENCE MEMBER: Good morning. My name is John Norwood (PH) from Des Moines, Iowa.

I have a two-year rule for my closet. If I don't wear a particular pair of pants or a shirt within two years, I give it away to Goodwill so that someone else can put it to better use.

With 40 billion in cash, I'm wondering whether Berkshire Hathaway should have a similar closet rule for deployment of surplus shareholder cash.

WARREN BUFFETT: It won't go to Goodwill, I promise you that. (Laughter)

AUDIENCE MEMBER: Thank you. And wouldn't it be better if you had a smaller budget and fewer gifts you needed to — you and Charlie needed to shop for? Wouldn't you have more time for the beach and a better chance of hitting some home runs?

WARREN BUFFETT: Yeah. I don't think we'll hit any home runs, under any circumstances. But the — you might consider a normal level of cash at Berkshire as being about 10 billion, although we — you know, there could be circumstances where we'd go below that.

But because of the catastrophe insurance business we're in and all of that, we do not — you know, we do not scrape the bottom of the barrel, but we don't need anything like 40 billion.

I think you'll see in the 10-Q that we have — I think it was about 37 billion at the end of March — double check that — and I'm not counting the cash and the finance business — yeah, 37-something — and we're spending 4 billion on ISCAR.

We've spent — we're spending some money on some other things as well.

But we would be happier — much happier — if we had 10 billion of cash and all the balance in things that we liked very much.

And we work toward that end at all times. But there is nothing even about the way businesses come to us.

We've got one idea at present, low probability, but that would take — could take — as much as 15 billion or close to 15 billion of cash. And whether it comes to fruition or not, who knows, but we do work on them.

And, what we care more — we don't like having excess cash around. We like even less doing dumb deals because we do them forever.

I mean, if we make a dumb deal, it just sits there. We don't resell it three months later by having an IPO of it or something of the sort.

So you're right to say that we should be very uncomfortable about the fact that we've got the cash. But it's also important that we not be so uncomfortable that we go out and do something just to be doing something.

I would say it's likely, but far from certain, that three years from now we have significantly less cash and, I hope, significantly more earning power. But the goal of that cash is to be translated into permanent earning power over time.

Like I say, with the 4 billion that we've just committed on ISCAR, you know, we love having that 4 billion employed there instead of sitting around in short-term securities.

And that's our job. Charlie and I don't do anything else, except appear in movies and that sort of thing.

But the — you know, you're right to keep jabbing us on that because — but we jab ourselves. You know, we — neither one of us is — basically likes cash.

We always want to have adequate cash and we always will have adequate cash. And we are the biggest player in the world in cat insurance, and people come to us because they know we're going to run a place that's very strong financially. But it doesn't have to be as liquid as we are now.

We spent 5 billion — well, we didn't spend that much. At the Berkshire level, we spent about 3 1/2 billion on PacifiCorp.

You know, we contracted (inaudible) earlier, but we will get more chances, I think, in that field, but you never can tell when they'll come.

So come back next year, and I hope we have less cash.

OK. We'll go to 13 now.

OK. Charlie, would you like to add anything on that?

CHARLIE MUNGER: Yeah. I think you may get some perspective on what bothers you if you go back to the annual report of Berkshire ten years ago and then compare that report with the last one.

Despite the great difficulties of deploying cash, we managed to put an awful lot of wonderful stuff into Berkshire in the last ten years. So, we aren't altogether gloomy about that process continuing. (Applause)

22. Should have sold Coca-Cola at "silly" price

WARREN BUFFETT: I neglected to go to the adjacent room, which has a number of people in it as well. So I'm going to go to No. 13 now, which will come from the ballroom.

AUDIENCE MEMBER: This is Phil McCaw (PH) from Connecticut.

I wonder — it's been some time since you've commented on Coca-Cola. And now that you're off the board, I wonder if you feel free to comment on it?

WARREN BUFFETT: Yeah. Well, I won't make particularly different comments than from when I was on the board.

But Coca-Cola is a fabulous company. Coca-Cola will sell over 21 billion cases of various products — more Coke than anything else — around the world this year, and it goes up every year.

It's interesting. The stock in, what, 1997 or '98, whenever it was, sold over $80 a share when the earnings were — I don't remember whether they were $1.50 a share, or something like that — and the earnings then were not as good quality as the earnings are now when, you know, they were $2.17 or something like that.

And every year the — you know, they have — they account for a little greater share of the liquids consumed by people in the world.

They make fabulous returns on invested capital. You know, it's a business that has — exclude the bottling part of it — has 5 or 6 billion of tangible assets and makes a similar amount.

So, there are not lots of big businesses in the world that earn 100 percent pretax on tangible assets.

And it will be a great business, and it's been a great business.

The stock got to what, in retrospect, clearly was a ridiculous level, but you can't hold the present management, Neville Isdell, responsible for that.

And he — you know, if the company sells 4 or 5 percent more units this year than last year, and the population of the world goes up 2 percent, it just means that more people are putting that particular source of liquid down their throats than the year before, and that's been going on ever since 1886.

So it strikes us as a really wonderful business that sold at a very silly price some years back.

And you can definitely fault me for not selling the stock. I always thought it was a wonderful business, but clearly, at 50 times earnings, it was a silly price on the stock.

So we like it. We'll own it ten years from now, in my view. Charlie?

CHARLIE MUNGER: No more.

WARREN BUFFETT: This peanut brittle gets caught occasionally, but it's worth it. It's worth it, definitely.

CHARLIE MUNGER: Why don't you share with me?

WARREN BUFFETT: What? Oh, you want some, huh? Get your own box next time. (Laughter)

23. Reinsurance rate variations

WARREN BUFFETT: Now, do you want us to go to 14 or not? Yes. OK. Number 14.

AUDIENCE MEMBER: My name is John Gosh (PH) from Key West.

Have insurance rates hardened as much as you anticipated, and have you seen a significant flight to quality in the last few years?

WARREN BUFFETT: Yeah. I think you're probably asking more about reinsurance rates.

Actually, in auto insurance, you can figure it out. Our policies are up more than our premium volume. So the average premium in auto insurance, which, after all, is close to 40 percent of the whole market for insurance — the average premium in auto insurance is actually down a little bit.

But in reinsurance, in which we are a big player, you will — there's great variances.

If you take insurance for marine risks in the Gulf Coast — drilling rigs and offshore platforms and that sort of thing — those prices are up very dramatically, but they should be.

I think in the last couple of years, there's been, like, 2 1/2 billion of premium in the Gulf Coast and 15 billion in losses. So if you paid out 15 billion and took in 2 1/2 billion, the more astute of you would figure that you needed a little more money for that particular risk.

We have been, historically — at least in recent years — the largest writer of cat — catastrophe — mega catastrophe insurance in world, and I think we will be this year. In fact, I'm almost sure we will be this year.

Our mix has changed some. Prices are up a lot, but what we don't know is whether exposures are up even more.

We don't know whether the experience of the last two years, we'll say, with hurricanes in this hemisphere, is more to be relied upon than the experience of the last hundred years.

You can take the hundred-year experience and it tells you one thing, and you can take the last couple years and it tells you something else. And which is more meaningful? We don't know the answer to that.

We do know that it would be kind of silly to assume that the 100-year experience is the relevant criteria when conditions — we know certain atmospheric conditions have changed. We know water temperature's changed.

But we do not know all of the variables that are into the propensity of hurricanes to occur and the degree to how intense they may be if they do occur. We don't know the answer to that. We don't think anybody else knows the answer to it, either.

So we are getting more money for hurricane insurance. We're getting appreciably more money.

If the last two years are the relevant years, we're not getting enough. If the last hundred years are the relevant years, we're getting plenty. And we will know more as time unfolds.

The really scary possibility is that variables are changing in some way so that the change is continuous and that what we've seen the last two years is not a worst-case example at all.

And, of course, you get into chaos-type theory with some of these variables where the outcome is not a linear relationship to the input, and you can dream up some pretty scary scenarios on this.

I don't know whether they're true and nobody knows.

We are willing to write certain areas, certain coverages, because we believe the prices are adequate, and we can sustain the losses.

We're willing to lose many billions of dollars in a given catastrophe if we think we've been paid appropriately for it.

But it is not like figuring out the odds on flipping coins or rolling dice or something like that. You are dealing with changing variables, and you — the worst thing you could have would be a 100-year history book in making those judgments.

The third quarter, we will have a lot of exposure for wind. We don't have as much exposure now — well, we may. I'd say we're getting there. But we don't have as much — certainly as much as we had a couple of years ago.

Prices — question about prices hardening. Prices are getting — are hardening — in that particular area. And if they get to what the — where we really feel they're appropriate — you know, we might take on a fair — we will take on — a fair amount more risk.

If they don't get there, even though they're higher than last year, we won't write — you know, we're not interested in writing it, because it's a dangerous business.

And we don't believe in modelers at all. I read all this stuff about modeling. I wrote about that a few years ago. It's silly. You know, the modelers don't know a thing, in my view, about what's going to happen.

And we get paid for making guesses on it. If, over a lifetime, the guesses are decent, we will know that, you know, we were doing the right thing.

But if this year goes by and nothing happens, we still don't know whether we were right on the prices.

Because if you get a 25 percent rate for something and it doesn't happen in a year, that does not mean that you didn't need 40 percent or 50 percent. It just means that if you do it enough times, you will find out whether, overall, your judgments are any good.

It's still a business we like. We bring a lot to the party. Everybody knows we can pay. You get into the question of creditworthiness.

If there is some super, super catastrophe — and I regard, sort of, the outer limits of that being a $250 billion insured loss — for reference, Katrina was a — presently estimated — was about a $60 billion loss.

So, if something comes along that's four times Katrina, which could happen, you know, we can pay, and we can comfortably pay. We would probably have about 4 percent of that, maybe 10 billion.

A very large percent of the industry would be in very, very serious trouble.

So, we can play bigger than others, and we can survive better than others if something bad comes along. And we will see, over a five- or ten-year period, how we do. You can't judge it by any one year.

Charlie?

CHARLIE MUNGER: The record of the past, if you average it out, has been quite respectable.

And why shouldn't we use our capital strength to get into volatile stuff that makes other people frightened?

24. NetJets losses and retroactive policies

WARREN BUFFETT: Do we go back to number — to here? One more. Number 15?

AUDIENCE MEMBER: Hello?

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: I'm Marc Rabinov from Melbourne, Australia. I had a two-part question on the 2005 annual report.

Firstly, NetJets is a substantial part of our operations. Unfortunately, its value is obscured by losses in recent years, and I can't estimate its value from the report. I was hoping you might be able to help me on that.

The second thing, how do I value the Berkshire Hathaway reinsurance group in light of the deferred charges on retroactive policies? Thank you.

WARREN BUFFETT: The second question, that — about the — we have an item that's about $2 billion on the asset side.

I think I'm addressing the question of deferred charges on retroactive policies. That reflects the fact that those retroactive policies, where we insure — we reinsure, in effect — the losses that somebody has already incurred, although they may not know how much they've incurred, and we have limits on these.

But we set up a factor that, essentially, recognizes the fact that we will have that money for a considerable period of time. We set up an asset, and that gets amortized over the length of time we have that asset.

That number, which I think has gotten as high as 3 billion over the years, since we haven't done any of those — any big contracts recently, is down around 2 billion.

There's nothing magic about that. It means that we're going to amortize that 2 billion over the lifetime of the use of the funds, and we think we'll make money, net, during that time.

But we misguessed on one a couple years ago and took a $100 million charge, for example, in the first quarter of — I think it was the year before last.

The other question was about NetJets, wasn't it, Charlie?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: And I didn't get it all. I love the Australian accent of our gecko, but I didn't pick up the exact nuances of what you asked.

But my guess is you asked about the earnings and operation of NetJets.

And NetJets has grown rapidly, and so far, our expenses have grown faster than our revenue.

We've got the top service in the world. We've got, really, the only worldwide service. We have a very strong position, particularly in larger airplanes.

But I'd have to tell you that I did not anticipate — I thought we would have economies of scale, to some degree, and so far you can almost argue that we've had diseconomies of scale.

And our expenses, particularly last year, you know, basically got out of hand. And there are various reasons I could give you for that. All I can tell you is, it's being addressed.

Rich Santulli, who runs that operation, you could not have a better operator. He loves NetJets. He works at it 16 hours a day. He's — there's nobody in the world I would have run that except for Rich.

I think it's an important service. It's tough to make money with airplanes. They're capital-intensive. We've had fuel do what it has, although that's a pass-through to people, but it still affects the business.

And I would — I had expected we would be profitable last year, and as I put in the annual report, I was dead wrong.

I think we will be profitable before long, but you should take my prediction there with — probably with — a certain amount of skepticism until it actually happens because I, like I say, I've been wrong.

We've got a good business in that almost anybody looking for a large plane on a fractional jet program comes to us. We are able to get full price for our service. But there were a variety of inefficiencies last year which added up to a lot of dollars.

And you know, you're entitled to hold me accountable for the fact that we paid a lot of money for the business many years ago, and we haven't earned any money since.

And we've got a much bigger business now, probably five times or so the size of the business we bought. That may be some solace to — I looked at Raytheon's figures the other day. They lost a lot of money, and they have the second largest operation.

They sell their — they sell airplanes too, so they may not feel it the way I do.

But if I had to bet one way or the other, I would bet we will be making money before long, but I've lost that bet in the past.

Charlie?

CHARLIE MUNGER: Yeah. The product integrity is so extreme between flight safety and NetJets. The pilots are subjected to real oxygen withdrawal in the course of the safety training so they will recognize the subtle sensation that you get, and not everybody does that. It's an expensive, difficult thing to do.

In place after place after place, that system is very obsessive about product integrity, and it's my guess that that obsession, in due course, will be rewarded.

25. Why Buffett bought, and sold, silver

WARREN BUFFETT: OK. We'll go to Number 3.

AUDIENCE MEMBER: Dear Warren and Charlie, I'm Oliver Couchet (PH) from Frankfurt in Germany.

Here's a question to the Silver King: Some commodity investors give you as a reference as one of the largest owner of physical silver. Could you please clarify what kind of exposure you or Berkshire currently have in silver?

And, further, could you please help us to understand how you determine the value of a noninterest-bearing precious metal?

WARREN BUFFETT: Do you have any silver on you, Charlie? We had a lot of silver at one time, but we don't have it now.

The original decision — my decision — was that the production of silver and the reclamation of silver — I don't remember the numbers exactly now — but they were running, perhaps, 100 million ounces or thereabouts, less than the consumption.

And, now, a lot of consumption has gone down in photography, but that's where the reclamation was, too, so that those tended more to balance each other out.

I haven't looked at the figures for the last year or so, but silver was out of balance.

Now, on the other hand, there were enormous quantities of silver aboveground, and there were huge quantities of silver that could possibly be removed from other uses, perhaps, you know, in jewelry and all kinds of things, that could conceivably add to supply as they did in the early 1980s when the Hunt Brothers thing took place.

But, overall, silver was being produced and reclaimed at a lesser rate than it was being consumed.

And added to that was the fact that there are relatively few pure silver mines. Silver is largely produced as a by-product of copper and lead and zinc, and so that it was not easy to bring on added production.

So, all of that added up to the fact that I thought that silver would get tight at some point.

And, as I said, I was very — I was early in that conclusion, and I was early in selling.

So we have no silver now, and we did not make much money on it.

And you're right that it doesn't earn anything. So you sit with it. It's not like sitting with a stock where, in most cases, earnings are piling up for you.

You have to hope that it — you have to hope that a commodity moves in price, because it is not producing anything as it sits there looking at you. And that's one of the drawbacks of commodities.

Charlie?

CHARLIE MUNGER: We didn't get where we are by owning noninterest-bearing commodities. I don't think it's a big issue around here.

WARREN BUFFETT: We actually owned oil at one time too, didn't we? But we didn't make much money on it. We made a little money.

CHARLIE MUNGER: No. You made quite a bit out of oil.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: But, you know, it's a good habit to trumpet your failures and be quiet about your successes. (Laughter)

WARREN BUFFETT: Yeah. We have more to trumpet than we have to be quiet about. (Laughter)

26. "We don't play big trends"

WARREN BUFFETT: How about number 4?

AUDIENCE MEMBER: Good morning. My name is Bill Gurn (PH). I've traveled from the United Kingdom.

And I would like to ask if you think it's a good investment strategy to invest in regions of high resources per capita?

In particular, I should like to ask if you think that the analysis per capita should lead to higher growth for businesses in that region, plus the bonus of a relative exchange rate growth? Thank you.

WARREN BUFFETT: I'm not sure about the per capita part, Charlie.

CHARLIE MUNGER: My understanding is he was talking about investing in a region with high resources per capita. I think he means natural resources.

WARREN BUFFETT: Yeah. Are you thinking of places like Canada or something of the sort where the —

AUDIENCE MEMBER: I can clarify. Yes, high natural resources, but also good infrastructure. Thank you.

WARREN BUFFETT: And whether there would be relative currency strength in those as well and —

CHARLIE MUNGER: No. Whether it's a good area for us to be operating in.

WARREN BUFFETT: Well, that would be a little macro for us. We really just zero in on, you know, whether people will keep eating candy and whether we can charge a little more for it next year.

We don't play big trends. You know, we don't think about demographic trends or anything of the sort. We think about our own age as getting older.

But other — big trends, they just don't mean that much. There's too much money to be made from year to year to think about things that take decades to manifest themselves.

So I can't recall of a decision we've ever made on a purchase of a business or a stock or a junk bond or a currency or anything else based on a macro.

CHARLIE MUNGER: Not only that, we've recently failed to profit much from one of the biggest commodity booms in history.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And we'll probably continue to fail in the same way. (Laughter)

WARREN BUFFETT: But we'll search for new ways to fail. I mean, we're not trying to limit ourselves. (Laughter)

It's probably true, incidentally, in a country like Canada, where you've got, probably, millions of barrels of oil of — millions of barrels a day — of oil production coming on and where there's, you know, relatively few people and where there's already a surplus.

When they're running a significant current account surplus, that — you know, it's not strange that their currency should be strong relative to a country like ours where we're running a huge current account deficit and we don't have that same natural — the gain in natural exports coming on that they do.

But that — there's so many more important factors that are going to hit us immediately that that's what we really think about day-to-day.

27. Nuclear threat is "ultimate problem of mankind"

WARREN BUFFETT: Number 5?

AUDIENCE MEMBER: Good morning. My name is Glen Strong (PH). I'm from Canton, Ohio.

I'm an optimistic person, and I'm sure it would be more enjoyable to discuss the Chicago Cubs' march to the World Series.

WARREN BUFFETT: You are optimistic. (Laughter)

But everybody has a bad century now and then, as somebody said about the Cubs. (Laughter)

AUDIENCE MEMBER: However — (Laughter) — I have an information deficit on a certain topic that I hope you can fix. Please gaze into your crystal ball.

As an investor, I want to know how to address the risk of nuclear terrorism in the United States.

Consider a scenario where terrorists have detonated a nuclear device in a major U.S. city. I know there would be a terrible cost in human lives.

Gentlemen, what would happen to our economy? How would it respond? How resilient would it be? Thank you.

WARREN BUFFETT: Well, it would certainly depend on the extent of it.

But, if you're asking how to profit from that, there's probably some dealer that will sell you mortality derivatives. But I'm not sure that's what we would be thinking about then.

No. I agree with you. I couldn't agree with you more about that being the ultimate problem of mankind, not necessarily a terrorist-type usage, but a state-sponsored usage of weapons of mass destruction.

And it will happen someday. The extent to which it will happen, where it will happen, who knows. But we've always had evil people. We've always had people who wish evil on others.

And, you know, thousands of years ago, if you were psychotic or a religious fanatic or a malcontent and you wished evil on your neighbor, you picked up a rock and threw it at them, and that was about the damage you could do. But we went on to bows and arrows and cannons and a few things.

But since 1945, it's — the potential for inflicting enormous harm on incredible numbers of people has increased, you know, at a geometric pace.

So it is the problem of mankind. It may happen here. It may happen someplace else.

People say it's a — sometimes they say, "Well, you know, if we'd solve poverty, we'd solve this." Well, I will just remind you that nuclear weapons have only been used twice, and those were by the richest country in the world, the United States, in 1945.

So, people will justify their use under some circumstances, if they feel threatened. They will justify them for religious reasons. They will do all kinds of crazy things.

And the — what holds it in check is the degree to which the lack of knowledge of how to do it is controlled, and the degree to which the materials are controlled, and which the deliverability is circumscribed.

And we're losing ground on all of those fronts. The knowledge is more widespread. The possibility of getting your hands on materials — you know, the Dr. Khans [Pakistani nuclear scientist] of the world and so on, has increased.

And it will be a — it's a real problem, but we won't be thinking about what Berkshire did that day in the stock market.

And I don't know how money attacks that. I mean, I've always saw that as the top priority, I think should be the top priority for philanthropy, in my particular case.

But it's a difficult — it's a very difficult — it's a worst-case problem. You know, you have 6 billion people in the world, and you have a certain percentage of them who are, one way or another, a little crazy, or very crazy, and some of whom in that craziness would manifest itself by trying to do great harm to a lot of people.

And it's — only one of them has to succeed.

I don't know how many we've intercepted over the years. I'm sure we've intercepted a lot of incipient ones.

But it is a worst-case problem, and one will succeed at some point. And it may be state-sponsored; it may be terrorists.

But, you know, Berkshire is better set to survive than anybody else, but it won't make much difference.

Charlie?

CHARLIE MUNGER: Well, I think that the chances we'll have another 60 or 70 years with no nuclear devices used on purpose is pretty close to zero.

So, I think you're right to worry about it, but I don't, myself, think there's much that any of us can do about it, except be as sensible as we can and take the consequences as they come.

WARREN BUFFETT: The only thing you can do about it — but you only have one vote — is to elect leaders who are terribly conscious of the product — problem — and who devote a significant part, you know, of their thought and energy into minimizing it.

You can't eliminate it. You know, the genie is out of the bottle. And you would like to have the leading — the leaders — of the major countries of the world regarding it as their primary — as a primary — focus.

Actually, in the 2004 campaign, I think that both candidates said it was the major problem of our time. But, you know, they probably suffer from the same feeling that I do, that it's very hard to address.

28. A Berkshire stock buyback won't be a secret

WARREN BUFFETT: Number 6?

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger. My name is William Schooler (PH), and I'm a shareholder visiting from Spicewood, Texas.

I would like to thank you both for being so generous to the public with your ideas.

Last year, I read "Poor Charlie's Almanack" and came across a passage on share repurchases.

It reads, quote: "When Berkshire has gotten cheap, we've found other even cheaper stocks to buy. I'd always prefer this. It's no fun to have the company so lacking in repute that we can make money for some shareholders by buying out others," end quote.

Last year, you bought stock in some great businesses trading at fair prices, such as Walmart and Budweiser, but did not attempt to buy our own shares.

Would shareholders be correct to infer from this decision that you both felt Walmart and Budweiser were trading at a deeper discount to their intrinsic values than Berkshire was?

And would it be possible to buy as much Berkshire in the open market as you did Walmart without running up the share price?

WARREN BUFFETT: Most of the time, we would not be able to buy an amount that would be material, in terms of increasing the value of the remaining Berkshire shares. But that doesn't mean it would never happen.

But it — if you look at the trading volume on Berkshire — and, [CFO] Marc [Hamburg], you might put that up, if we can, in a second — we probably have less opportunity than most companies if our stock is selling — should be selling — below intrinsic value to have anything meaningful happen.

We would also have — if we regarded some other company as worth X, a good business, and we could buy it at 90 percent of X, we might be doing that now, whereas we wouldn't have done it many years ago.

But we might require a somewhat greater margin, in terms of buying Berkshire shares, simply because our view on that might be less — we probably have more knowledge on it, but we might be less objective than on some other things.

We think that when we buy — if we were to buy in Berkshire shares — and, if you remember, four or five years ago I announced we would if the price stayed the same — that the case ought to really be compelling, and if it's compelling, we ought to do it. It was compelling at that time.

But simply the act of writing about it — you know, a little bit of a Heisenberg principle — the act of writing about it, in effect, eliminated the opportunity to do it, which is fine.

Because we do not — we are not looking to make money off of buying from shareholders at a depressed price.

On the other hand, if the price is sufficiently depressed, we will announce again that we intend to do it, and then we'll see whether we actually get a chance to do it. Charlie?

CHARLIE MUNGER: Yeah. The whole climate in the country is different now.

It used to be that almost every company that bought in shares was buying them in at an obvious bargain price. Now I think a lot of share buying is designed to, sort of, prop the stock price.

In other words, it's not bargain-seeking. It's more like Sam Insull.

WARREN BUFFETT: Yeah. Forty years ago, 30 years ago, it was a very fertile field for making money to look at companies that were aggressively buying in their shares, the most extreme case probably being Teledyne.

But those people were buying overwhelmingly — Gurdon Wattles was doing it at the companies he controlled — those people were motivated simply by the fact they wanted to buy the stock below what it was really worth and — significantly below — and you could make money with that group, and we did a little of that at the time.

I would say in recent years, that motivation has been swamped by people who either think it's fashionable to buy in shares, or by people who really like the idea of trying to prop their stock up somewhat.

And the SEC has certain rules, in terms of the way you conduct your repurchases to prevent daily, sort of, propping up.

But I think there's a lot of motivation that our stock has got to be cheaper than other people's stock, and we've got a wonderful company, and we're just going to buy the stock come hell or high water, and that is not the way we would go about repurchasing shares.

We've got — well, we had up there, I think — some figures that showed the turnover of Berkshire shares compared — in a year — compared with a few others I picked out.

I think Berkshire has the lowest turnover, by some margin, of any major company in the United States.

And I put Walmart up there because the Walton family owns about the same — in fact, they own more — of Walmart than I do of Berkshire.

So, this is not a function of simply the fact that we've got concentrated holdings with the Buffett family.

This is a reflection of the fact that we've got a really unusual shareholder body in that they think of themselves as owners and not as people who are moving around with little pieces of paper every week or month.

We have the most — in my view — we have the most what I would call honest-to-God ownership attitude among our 400,000 or so shareholders of any company — of any big traded company — in the United States.

People buy Berkshire to own it, and hold it, and that's reflected in our turnover. That does mean if, for some reason, the stock gets cheap — real cheap — that we would not be able to buy a lot of stock in.

But we don't want — we are not looking to buy out our partners at a discount. If it sells there and we tell them we're going to buy it, we'll buy it. But that's not a way that we're trying to make money.

Charlie, any more?

CHARLIE MUNGER: No. I've said my piece.

29. Advice to young investment professionals

WARREN BUFFETT: Number 7?

AUDIENCE MEMBER: Good morning. My name is David Saber (PH), shareholder from Minneapolis, Minnesota. Looking for some advice you might give the young professionals here.

I could be classified as one of those helpers you describe in your annual report. In fact, most of my friends are helpers, and some could be classified as super helpers.

Most would love to step out and explore some of their more innovative ideas, innovative business models, strategies, and things of that nature.

But the risk of giving up a significant salary, health insurance, flights, other ridiculous corporate perks some of us young professionals earn.

What advice would you have for us in pursuing those dreams?

WARREN BUFFETT: Charlie, what do you think?

CHARLIE MUNGER: Well, there's certainly a lot more helpers in the economy than there used to be, and the ones that come here tend to be the very best of the helper class.

So, I don't think you should judge the helper class by those you meet here. We get the best of them.

And as to what the young helpers ought to do so that they'll eventually be like Warren Buffett, I would say the best thing you can do is reduce your expectations. (Laughter and applause)

WARREN BUFFETT: I think I've heard that before.

Well, you know, as I wrote about — and I — trying to tweak the system a little bit — but it is an interesting business in that the activities of the professionals are self-neutralizing.

And if you're going to — if your wife is going to have a baby — you're going to be better off if you call an obstetrician, probably, than if you do it yourself. You know, and if your plumbing pipes are clogged or something, you're probably better off calling a plumber.

Most professions have value added to them above what the laymen can accomplish themselves. In aggregate, the investment profession does not do that.

So you have a huge group of people making — I put the estimate as $140 billion a year — that, in aggregate, are, and can, only accomplish what somebody can do, you know, in ten minutes a year by themselves.

And it's hard to think of another business like that, Charlie.

CHARLIE MUNGER: I can't think of any.

WARREN BUFFETT: No.

But it's become a bigger and bigger business.

And, as I've pointed out in the report, the main thing that's been learned is that the more you charge, at least temporarily, the more money you bring in, that people have this idea that price equals value.

It's useful to get into a business like that.

Sometimes, if I'm talking to the people at a business school and I ask them what the — what a great — to name me a great business — and, of course, one of the great businesses is a business school because, basically, the more you charge, the more your prestige is, to some extent.

And people think that a business school that charges 50,000 a year tuition is going to be better than one that charges 10,000 a year of tuition.

So there's some of that that — well, there's a lot of that that's gotten into the investment field recently, and you now have large — certain large — portions of investment management that are charging fees that, in aggregate, cannot work out for investors.

Now, obviously some do, you know. But you cannot be paying people 2 percent and 20 percent where they get up it in the good years, and they fold their partnerships and start another one if they have a bad year and that sort of thing.

You can't have that coming out of an economy that's only going to produce, we'll say, you know, 7 percent or something like that a year for investors, and have people net better off. It isn't going to work.

And then the question that you will have is, "How do I pick out the few exceptions?" And everyone that calls upon you to sell you this will tell you that they are an exception.

And, I am willing to bet a significant sum of money, we'll put it up, to anybody who wants to name ten partnerships that are $500 million or more of management and pit those, after fees, against the S&P over a ten-year period.

It — you know, it gets away from the survivorship bias and all that kind of a thing. And it isn't going to happen.

But a few will do well. They're bound to do well.

And, actually, I think I do know how to pick a few that will do well. I mean, I did it in the past.

When I wound up my own partnership in 1969, I told people to go to either Bill Ruane or Sandy Gottesman, and that would have been a very good decision, whichever place they went.

So, if you know enough about the person, know enough how they've done it in the past, know enough about their personality, honesty, and a whole bunch of things, I think that occasionally you can make a very intelligent choice in picking an investment manager.

But I don't think you can do it if you're sitting running a pension fund in some state and you have 50 people calling on you.

You're going to go with the ones that are the best salespeople and not the ones that are the best investors. Charlie?

CHARLIE MUNGER: Yeah. On that state pension fund investment subject, I think it ought to be a crime to entertain, in any way, a state pension fund official, and I think it ought to be a crime, if you are a state pension fund official, to accept the entertainment.

It's not a pretty scene, a lot of investment management, in America now. And, human nature being what it is and the amounts of money being what they are, I don't think much is going to be improved.

30. Break for lunch

WARREN BUFFETT: Well, we wanted to leave you in a good mood for lunch. So — (laughter) — we will break now, and we'll come back in about 45 minutes or so.

And those of you who are in the other rooms, by then the crowd thins, for some explainable reason, and you can all join us here in the main room. And we'll be back in about 45 minutes.

Afternoon Session - 2006 Meeting

BACK TO TOP

1. Buffett favors path to citizenship for some illegal immigrants

WARREN BUFFETT: OK. We'll go to zone 8.

AUDIENCE MEMBER: Where's the light?

Good afternoon, Mr. Buffett. First of all, I want to thank you for responding to all my letters throughout the years. I will always treasure them.

Last week, demonstrations in many cities across the United States took place on the subject of illegal immigration. Many companies want to stay in the U.S. but have grown dependent on cheap, illegal labor as a way to remain globally competitive.

A recent Businessweek article describes Shaw's competitor, Mohawk Carpets, and their employment of illegal immigrants. If illegal immigration reform were to occur, how would you see this affecting Shaw, Clayton, and other Berkshire subsidiaries?

WARREN BUFFETT: Yeah. I didn't read that, and I don't know much about the Mohawk situation. I don't — I don't know anything about it.

I'm sure in Nebraska, you know, there are very substantial numbers of illegal immigrants employed. Meatpacking has been an area that a number have gone into.

And I actually was down at the Omaha airport about 2 years ago, and there was a very large plane there, and I saw these — well over 100 people that were in shackles that were being put on that plane.

I kind of wondered what they did, if they ever had some kind of emergency on the plane. But they were being deported. So there's a lot of it goes on in Nebraska.

You know, I think it's a problem that should be addressed and addressed promptly. I don't believe in shipping 11 million people back away from the United States. Whatever acceptable way that the country can handle giving those people citizenship, I, basically, would support.

I think we ought to enforce the rules in the future. I think they ought to be liberal rules, but I think they ought to be enforced.

But I don't think it would make dramatic differences. I mean, if one meatpacking plant employs people at subpar wages, you know, the rest of them are going to do the same thing.

You may end up paying a little bit more for meat in the end, but I do not think it would have a dramatic effect on the economy or even on specific industries, except to change, maybe, relative prices a bit.

But I don't think it would have a dramatic effect on the economy if the people that are here illegally became legal in some manner.

You know, who's to say if Charlie and I had been born into some terrible situation in some other country, we wouldn't have tried to get into this place ourselves.

So it's a — I'm pretty empathetic with it, but I believe that we do need to have laws that are enforced in the future. I don't think we should send 11 million people back.

Charlie?

CHARLIE MUNGER: If you don't like the results, I think you should get used to it because we never seem to have the will to enforce the immigration laws. I just think that what you've seen is what you're going to get.

WARREN BUFFETT: I don't — in terms of the carpet industry specifically — you mentioned Clayton Homes. I wouldn't — I would think the mobile manufactured housing industry — I'd be surprised if there was any unusual number at all of illegal immigrants, but I — the answer is, I don't know that for sure.

But I don't see any change in those industries.

2. Business schools have improved "considerably"

WARREN BUFFETT: Number 9?

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. My name is Jeremy Cleaver (PH), and I come from Lawrence, Kansas. I'm a Jayhawk.

And what do believe is the best finance program in the U.S.? (Buffett laughs)

Also, I will be graduating in a year. Could you compare and contrast the financing opportunities now and when you graduated college?

WARREN BUFFETT: He comes from a school that has set some classes up in the last couple years that are absolutely terrific.

I've had — I will have in this school year, probably close to 40 schools where the students come out. And now I usually double up schools, because 20 of these a year is about all I can handle.

And we've had some terrific groups come out. And I would say that the teaching in finance departments, based on what I've seen, has improved quite a bit over 20 years ago. But that was from a very, very low base.

The orthodoxy of 20 or so years ago where, really, you know, the flat Earth was being embraced, has improved considerably.

And one particular place is KU. Professor Hirschey has done a great job. (Applause)

Missouri, Florida, Columbia, a lot of good schools — Stanford — have got people in those departments that are doing a very good job.

And 25 years ago, you'd have had a tough job getting a position at a finance department, and you certainly would have had your advancement stifled, unless you went along with the orthodoxy: efficient markets and modern portfolio theory and a lot of stuff that, not only wouldn't do you any good, but might get you in trouble.

And that has — that's improved a lot. And I enjoy seeing these groups of students as they come out, because it's quite encouraging. Now, they all think they're going to get rich by, sort of, copying what Charlie and I did many, many years ago. I wish them well.

It's — the amount of brain power going into money management gets a little distressing, particularly to Charlie. But I would — you know, it's a great time to be 22 or 23 or 25 and getting out of school.

So, you can look ahead to a very — I think a very interesting future in this country, even though you may find that the method of using the talents you have in investing get used in a somewhat different manner than where they — where they're used presently.

I mean, right now an awful lot of the students that come to visit Omaha say private equity or hedge fund, and it's hard to imagine a world where everybody is running a hedge fund. I'm not sure exactly what we would do for food and clothing, and a few things like that.

But I am encouraged by the kind of students I meet. When the KU group comes up — we had a great time. They put on various skits. They tried to sell me companies. I'm hoping they succeed.

We haven't had any luck yet, but they keep coming up with good ideas, and I'll keep pursuing them. And one of these days, every one of those students will get — I've offered them two B shares, and that's a limited-time offer to try to spur extra activity.

And I hear from a lot of students later, and I think a lot of them have their heads screwed on right. Charlie?

CHARLIE MUNGER: Well, I've heard that something like half of the business school graduates in the elite eastern schools want to go into private equity or hedge funds.

And those whom I bump into seem to judge their progress in life as to whether or not they're keeping up with their age cohort at Goldman Sachs. That appears to be the minimum standard by which progress of life is measured, and this can't possibly end well. (Laughter)

WARREN BUFFETT: You can see why they come —

CHARLIE MUNGER: — in terms of satisfying all these expectations.

WARREN BUFFETT: That's why they come to see me instead of Charlie. (Laughter)

He'd give them better advice, don't misunderstand me, but go away with very long faces.

3. New CEO will go through a "media probation-type affair"

WARREN BUFFETT: Number 10?

AUDIENCE MEMBER: My namaste and good afternoon to Swamiji and respected Charlie Munger. Yes, I did say "Swamiji." I see your inner dress crowned by your truth, by your humbleness, by your simplicity.

But your outer dress — I mean your wealth — is for the needy, at large. So you look upon us, your children, your friends, and your partners.

My name is Shekhar Agarwal. I'm from Sugarland, Texas, suburb of Houston.

Since May '99, I got interested in Berkshire Hathaway. And I have read a lot of what you have written. So, I can judge a little about you.

By the way, I bought B shares March 3, 2000, at 1410 before they hit the low on March 10, and it became at that time 40 percent of my portfolio, and I still own all those shares and many more.

As you tell the students who come to Omaha to run a portfolio with real money to have a real feeling and real learning, I had the same experience with you.

You know, three years back, I had a chance, with my wife, my daughter, and my 6-year-old son, who is with me today, to spend a few minutes with you when you came to Houston during the opening of a new Star Furniture store.

As we were posing for a family picture with you, my 6-year little one was standing just beside you, while you were sitting on a high-bar chair. And you said to this stranger, "Son" — you said

— “Son, you come and sit in my lap.” Sir, Swamiji, that is your simplicity. That is your humbleness.

And you talk about the contribution of Ajit Jain and ask us to bend really down if we see him, or name our children Tony to honor his contribution. Well, 40 years of selfless services to this corporation and to the humanity, you rightly deserve this distinction or this title of ”Swamiji.”

There is a beautiful, beautiful — (Applause) — beautiful prayer in the Holy Vedas that says “tvam jīvehiṁ śaddhā-śataṁ.” It means, “The Almighty God says, ‘Oh, my child, may you live hundred and longer peacefully.’”

So that’s my wish. That’s my prayer on your 75th birthday. And, Swamiji, I’m waiting for my chance to touch your feet and get your blessings. (Applause)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Let me finish, please. Swamiji, I have a question anyway. (Laughter)

A lot of business people have a great amount of respect and trust for this 75-years-young teenager girl who is sitting by the phone waiting for it to ring, and now and then that phone rings.

I have no concern about the next CEO of Berkshire Hathaway to take this company forward, but I do wonder about this phone. It may not ring as often as it does now, until the new CEO earns the respect and the trust of these phone dialers.

Do you see that a concern? And do you think it is a good idea that you may become the only chairman, and let someone else become the CEO, and let him earn the respect and trust under your umbrella while you are still young and healthy? Thank you very much.

WARREN BUFFETT: Yeah. Thank you. (Applause)

I don’t think there’s any question, but — that my successor, you know, will go through, sort of, a media probation-type affair for a year or so.

And people will, understandably, wonder whether the culture is going to be different under the successor than it’s been at this point.

That’s going to happen. It won’t be the end of the world. It will mean that the phone will — it — the phone probably won’t ring less, it will just be a different kind of suitor that is calling.

The investment bankers will all try out this guy to see if he’s softer than I am and wants to participate in auctions and all of that sort of thing.

But I think it will become evident — and it will take a year, two years, maybe — I think it will become evident that the culture is the same, that the yardsticks, the metrics, the attitude towards shareholders, the whole thing, will not change, the board will not change.

But I think there will be a hiatus of sorts where people do not have the same feeling immediately that joining Berkshire is going to be the same experience as it — with our companies — as its been in the past. But it won't last long.

I can tell you that the successors that the board has in mind — you know, they're very smart. They understand. They've bought into the whole corporate personality we have.

And they will develop — be somewhat different in style, but they will — they will develop the confidence of the world that — and to possible sellers of businesses — they will develop the confidence that it's going to be the same Berkshire going forward.

But it's a good question. And there will be — there will be a period when the phone won't ring for a while until people realize that Berkshire is, sort of, one-of-a-kind, and it's continuing to be one-of-a-kind.

I don't think it would work well, you know — but it's the kind of the thing we talk over with the board, though — but I don't think it works well to have, sort of, a half-and-half arrangement.

I mean, you could say that I could handle, or encourage the handling, of the deals and somebody else could, sort of, be the operating guy. But the truth is, we don't need an operating guy.

You know, we've got people running the businesses that are running them, and they're very good at it. And the main thing to do is to not destroy or damage the spirit they bring to it and the fact that they like this method of operation.

So it would — I'm not sure what a chief operating officer would do at Berkshire except expose the fact that I wasn't doing anything. (Laughter)

And as long as I'm around, they're not going to get the calls on the deals. I mean, people are going to want to talk to me. I mean, that's not a handoff that would work.

So I think we'll go along in this mode. And, you know, you will have a period, everybody — there will be stories a year after I die that, you know, says one year later and what's happened and all that sort of thing, but that will fade out.

And my successor will put his own particular stamp on the place, but he won't mess with the culture. They're too smart. They've seen it work too well. So that — the calls will start coming in again after a while.

We will still represent, sort of, a one-of-a-kind place for the owner that really cares about the future of his business.

For one reason or another — tax reasons, family division of shares or something — you know, they have to — they have to solve the ownership problem.

But they want to solve it in a way that really doesn't change the psychic ownership of the place and the management of the place. And they can't find that elsewhere, and they'll continue to find it at Berkshire.

Charlie?

CHARLIE MUNGER: Well, speaking for the Munger heirs, I would rather the current method of operation continue to wring the last drop of good out of Warren. (Laughter)

WARREN BUFFETT: At low pay.

CHARLIE MUNGER: Yes, yes.

WARREN BUFFETT: Part of Charlie's instructions under all circumstances.

No, if we — if we thought there was some better way to make this place function better or to even make the transition easier to the next person, you know, we'd be delighted.

But I really think it's going to work pretty darn well. If I die tonight, the person who will take over tomorrow will not get as many phone calls for a while, perhaps, but very, very smart people. Know the business. You know, they know a lot about all businesses. They've got a general business knowledge.

I use "they" because there's three candidates, but there would be one specific one in mind. They know how to make deals. These people are plenty deal-savvy, and they know how to avoid other kinds of deals, which is equally important.

And the world would not fully grasp that for a year, maybe even two years. But once it happened, you can argue that it would be even stronger than before because at that point people would realize that it was institutionalized and not just a person.

You've got a — kind of a hat — I mean, I don't want to compare myself because it's not in the same league, but, you know, everybody, when Sam Walton died in, I think, 1991 or something, wondered whether Walmart would continue in the same tradition.

Well, the fact that it did has made that place a lot stronger than if it had just depended on the guy in the pickup truck. I mean, it was not — it was the creation of one person at Walmart, but it was not required for the continuation at all. And we're not in the same league, but it's the same idea.

4. Go with your gut when picking a charity

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: My name is Martin Wiegand from Chevy Chase, Maryland. Mr. Buffett and Mr. Munger, on behalf of the assembled shareholders, we thank you and all the Berkshire staff who put so much work and thought into making this weekend such a wonderful community-building event. (Applause)

WARREN BUFFETT: Martin, is Janie (PH) with you?

AUDIENCE MEMBER: Yes, sir.

WARREN BUFFETT: OK. Well, she sent me some great sweetbreads the other day. I love them. Keep them coming. Thank you. (Laughter)

AUDIENCE MEMBER: Through the years, you have generously helped us thinking through capital allocation decisions for funding our businesses and feeding our families.

Would you please help us think through the capital allocation decisions we face when it comes to charitable giving, particularly as it concerns how we pick effective charities? Thank you.

WARREN BUFFETT: You know, it's tough to give other people advice on that. But, you know, you have to pick the things that are important to you. And, you know, many people — majority in the United States — it's their church. You know, there's more money given to churches than anything else.

Many people — very many people — it's their school, or schools generally. You know, I think, to a great extent, you should pick whatever gives you the most satisfaction, and that will probably be something that you know, something you've, maybe, benefited from yourself.

I look at it a little differently. The amount of funds are different, too, but I like to think of things that are important but that don't have natural funding constituencies.

But that isn't something, you know, for millions of people to be following as an example or something. Nothing wrong with doing something that gives you plenty of personal satisfaction and does some good for other people in the process.

So I would not be reluctant — I would not feel I had to be as objective about that, necessarily, as I was about buying securities or something of the sort. I would, kind of, go where my gut led me and make it something you participate in.

And, like I say, I think if you're doing it with large sums, you may have some reason, maybe even some obligation, to try and think about where really large sums can have an important impact on a societal problem that might not get attention otherwise. And, you know, that's, sort of, where my own thinking leads me.

But I would — I would go with something where I felt I knew where the money was going to go and I knew some good was going to come out of it. And maybe, by observing what took place, I could make the next gift more efficient than the last gift and more beneficial.

Charlie?

CHARLIE MUNGER: I've got nothing to add. But I have a question: would you pour me a cup of coffee? (Laughter)

WARREN BUFFETT: We don't sell coffee, Charlie. We sell Coke. (Laughter)

We get the profit on one out of every 12 Cokes. So I don't care whether you drink them, just open the can. (Laughter)

5. We like the regulated utility business the way it is

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: Good afternoon. My name is Robert Piton (PH) from Chicago, Illinois.

And my question is, did the possible future deployment of telecommunications services over power lines factor into Berkshire's decision to invest in the utility space? Thank you.

WARREN BUFFETT: Yeah. The answer is no. We're in the utility business — the regulated utility business — because we like the business as is.

Where it leads, you know, will be determined — well, in specific states — by what they want us to do and maybe by technological changes, generally.

But we're going to earn a return on capital employed if we do an efficient job, keep consumers happy, whether we transmit it the old way or, you know, some new processes come along.

So it's a business where we're trying to be efficient, which means serving our customers while keeping their costs down as much as possible. And we will — even in terms of what generating sources we use — we are following the will of the people in the states in which we operate.

There are different costs associated with different forms of generation. And we feel that if people want to elect a more expensive way to generate electricity but one that they're more comfortable with in terms of the environment, you know, that's the decision of the people whose state in which we operate.

And we — so I do not see us — I don't see any large developments that change the economics of what we're doing. And we're certainly not going in — we're not buying an electric utility because we expect it to generate revenues from activities other than that.

Charlie?

CHARLIE MUNGER: Nothing to add.

6. "Media businesses do not have a great outlook"

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: OK. First, my name is Egil Dahl. I'm a retailer from Norway. I would like first to thank you gentlemen for the opportunity to come here and ask two of the best businessmen in the world a question.

My question is regarding the media and entertainment business. Do you think that the nature of newspapers, magazine, television, and maybe movie and music business as well, are about to change permanently and become less predictable because of new technology and internet?

And the second part is, if not so, do you think that some of these businesses represent good purchases at the moment because the market thinks so? Thank you.

WARREN BUFFETT: Well, people are always going to want to be entertained and they're going to want to be informed and some mix thereof. But, you know, we only have two eyeballs, and we only have 24 hours a day.

So if you go back 50 or 60 years and think about how people got informed or entertained then, the choices were far fewer. You had the local movie theater, and you had the radio, and you had newspapers.

And as the years have gone by, what technology has done is opened up a huge variety of ways of being informed faster, certainly. And whether it's better or not depends on who you ask.

And certainly entertained in way many more forms, many that are free. And it hasn't expanded the time you have for entertainment or for acquiring knowledge.

And any time you get more and more people competing in any given area, generally, the economics deteriorate.

And the economics have deteriorated for newspapers, although they're still enormously profitable in relation to tangible equity employed, but they do not have the same economic prospects, if you look at the future stream of earnings, that it looked like they had 20 or 30 or 40 years ago.

And television, again, the margins have been maintained surprisingly well, but the audience keeps going down and — for any given means of distribution.

So, that has to erode economics over time. Cable was thought to operate pretty much all by itself, and the telecoms come in.

And very few businesses get better because of more competition. They like to talk about it, you know, but it — you know, the idea —

I had one friend in the newspaper business. And I think Charlie used to tease her a bit by saying that her idea of a competitor was a corpse laid out on a slab with a toe twitching, you know. And the — it is not a better business when more people compete.

So I think that, generally speaking, the economics of media businesses do not have a great outlook, I mean, compared to — like I say, they're enormously profitable now, in returns on tangible assets.

I mean, it's a business — you know, a license from the federal government became a royalty stream on huge amounts of money.

I mean, there were only three highways between — electronic highways — between Procter & Gamble and Ford Motor and the eyeballs of several hundred million people, and those three highways could make a lot of money when there were only three highways.

But you keep building more ways to — for the P&Gs, or the Gillettes, or whomever it might be, or Ford Motor, or General Motors — to get to those eyeballs, and you decrease the value of the highways. It's not complicated.

So, I think you will see — it's hard to imagine those businesses having great prospects in aggregate.

We owned the World Book. We still own the World Book. We were selling 300,000 sets a year or something like that in the mid '80s. It's a very valuable product. It sold for $600 or thereabouts, and it was worth it.

But the problem became that you could get that same information, or a good bit of the same information, you know, very, very cheap through the internet.

And you didn't have to cut down trees. And you didn't have to run paper mills. And you didn't have to hire United Parcel Service to deliver a very bulky package.

And it isn't that the product we have isn't worth the money; it's that people have lots of other alternatives. And that's true in information and entertainment in a big, big way, and it won't stop, in my view.

Charlie?

CHARLIE MUNGER: Yeah. It's simplicity itself. It will be a rare business that doesn't have a way worse future than it had a past.

WARREN BUFFETT: Give them the bad news, Charlie. (Laughter)

The thing to do was to buy the NFL originally or something like that.

I mean, you know, there still is only — you know, there are certain primary events, but it's the people who transmit them — there's more ways to transmit those events, and so the value gets extracted in a much different way.

7. "Significant consequences" from U.S. trade imbalance

WARREN BUFFETT: Area 2?

AUDIENCE MEMBER: Good afternoon. My name is Yuji Siamoto (PH) from New York City.

I would like to ask Mr. Buffett regarding your views in respect to currency: the renminbi, the yen, and the euro, in particular.

During the visit by Hu Jintao, this issue of the currency level had become a big issue. And increasingly, this is becoming a very, very important issue for economic health of this country.

United States is becoming highly dependent on very cheap, underpriced Chinese exports in all consumer goods. You go to Walmart, and most of the high product — high-end product electronics — or most of the — any value-added products — are manufactured in China.

U.S. is almost addicted to very low-priced Chinese goods, thanks to artificially maintained currency level. At the same time, U.S. is becoming addicted to very cheap capital from China and Japan, as they provide infusion of capital to U.S. Treasury markets, thus keeping the interest rate low for mortgage rates.

I see a great danger if this is maintained for long time, as U.S. becomes addicted to this cheap Chinese or Asian exports for all our consumption, and also for all of our cheap mortgage rates.

And this is almost like being addicted to opium, as Chinese were addicted to opium during Opium Wars.

And should government try harder to break this vicious cycle? And, if so, what would you think about the currency level?

And you have — previously, you have held very strong views about the dollar, but what are your views now, and are you capitalizing on your views on the currency?

WARREN BUFFETT: Yeah. Well, my views — and Charlie may disagree — but my views are strong as ever, perhaps a bit stronger. The — we are doing less directly in currency futures because the — as I explained in the annual report — the carry cost has gone from being positive to quite negative.

So there are better ways, in my view — considerably better ways — of mitigating the consequences of the dollar becoming a lot weaker in the future.

We like the idea of developing earning power in other currencies around the world, and, in effect, in ISCAR itself, the — a large portion of the earnings are not in dollars, and we're doing it in other areas as well. We will hold less in currency futures unless the carry picture changes.

But the fundamental picture, what, in my view, is almost — you never say "certain," but a very high probability of happening, is that the U.S. currency weakens over time.

No idea about the next 6 months or year or anything, but over a long period of time, weakens against other currencies because we are following policies that don't seem much — don't seem to leave much alternative.

Here is a quote referring to running a large current account deficit that was given on February 28, 2002. The quote is, "Countries that have gone down this path invariably have run into trouble, and so would we. Eventually the current account deficit will have to be restrained."

Now, that was said by a very smart fellow whose name was Alan Greenspan. And at that time, the current account deficit was 385 billion, and it will be more than double that now.

So here, 4 years later, we have gone down that path, which he talked about, and we've gone faster and faster down the path. And he says, invariably, it runs into trouble.

Now, in his later years as Fed chairman, he did not emphasize this view as much. He never repudiated it, but he sort of talked about other things more.

But it — it's going to lead to something, and it — in my view, it's likely to be something significant. And people talk about a soft landing, but they never explain to me exactly how it's going to take place.

And Chairman Bernanke recently gave a talk where he said the probabilities were that the ending would be good but that he couldn't rule out the possibility otherwise.

I think you will see significant consequences at some point. We will have, at Berkshire, a fair amount of our earning power coming from other countries with other currencies, but we will always be primarily in the United States.

And, you know, we may — one consequence certainly seems possible is significantly higher inflation as the years go by.

Because as you owe more and more money as a country, it gets more and more tempting to devalue what you owe by paying in a cheaper currency than in the one in which the debts were incurred.

Charlie, what do you have to say on this?

CHARLIE MUNGER: Well, I don't feel I have any special capacity to predict whether the euro was exactly priced right, right now. I don't consider it a big deal that Berkshire has had the position it's had.

In effect, about half of our surplus cash was stashed short-term in currencies other than the dollar. I regard that as almost a nonevent. Now, as it happened —

WARREN BUFFETT: Well, we made a couple billion dollars off it. (Laughter)

CHARLIE MUNGER: Yeah. I was — as I was about to say, that as it's happened so far, it's been a very profitable nonevent, but... (Laughter) Generally —

WARREN BUFFETT: If it doesn't mean anything to him, he can always give his share to me. (Laughs)

CHARLIE MUNGER: Yeah. Generally speaking, it can't be good to be running a big current account deficit and a big fiscal deficit and have them both growing.

I mean, a great civilization may be able to stand something like that for a way longer period than you might have thought at the outset.

But you think that in the end, there would be a comeuppance and that we would have to change policies, perhaps painfully. In fact, I would say almost surely painfully. Wouldn't you, Warren?

WARREN BUFFETT: Yeah, I would. And it's interesting because I think almost everybody says it's unsustainable, and then they never explain how it doesn't keep being sustained until something comes — very unpleasant comes along.

But then they also say that there will be a soft landing, and I don't always get from A to B to C when I listen to them. The —

Certainly the longer it goes on, the greater the credit — the greater the net debtor position the United States is in, the more people see that we are, sort of, addicted to this kind of behavior, the more chance there is at some point, probably brought about by some other extraneous affair, that currency doesn't —

There aren't some big adjustments that take place and, perhaps, some chaotic markets in which currency adjustments play a part. But knowing when or exactly how, it's impossible to say that sort of thing — predict that sort of thing.

Charlie and I, in the 1980s, saw something called "portfolio insurance" — and that was a very popular term then — catch on with institutions.

And what happened was that a group was around selling the idea that this was a sophisticated, superior way for large institutions to manage money. And they charged appreciable sums for people — to people — to set up mechanistic procedures for dealing with stock market fluctuations.

They did this with pension funds and various big guys. And it was very popular, and the academic literature was full of it, and people were teaching about it in the schools.

And then October 19, 1987, came along, and a relatively small portion of American money invested — American investments — were being guided by this portfolio insurance doctrine.

But just that small amount of money was a leading factor in producing a 22 percent change in the value of American stocks in one day.

Every one of these people individually thought what they were doing was intelligent, but, when aggregated, and having to follow a given signal, in effect, you created a doomsday machine. It was out of control, and some really chaotic things happened then.

I would say the potential for that sort of thing — not that exact thing at all, but that sort of thing to happen in the world ahead is — it's probably magnified quite a bit from what existed in the '80s.

And currency enters into it, but it's not — who knows where it starts or exactly why somebody yells "fire." But when "fire" is yelled, there will be — the currency markets will play a part in the rush for the door.

8. "CPI has understated inflation"

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Hi, there. Alex Rubalcava from Los Angeles.

Warren, you just brought up the topic of inflation, and so I wanted to ask, do you believe — or do you believe that the Consumer Price Index is a good and true and accurate measure of inflation?

WARREN BUFFETT: Well, that's a good question. Bill Gross has written a little bit about that in some of his PIMCO methods and — messages. And, you know, if you go out to the Furniture Mart and construct a price index, it hasn't moved very much.

I mean, it makes it very tough for comparable store sales when you were selling DVD players at X few years ago, and now you're selling them at a quarter of X. So there's certain areas that there have been a huge — in effect, deflationary aspects.

But I do think the CPI — and, like I said, Gross has written about this — but the CPI is not particularly a good index.

I always get a kick out of when they talk about the core CPI, and then they — and they say that excludes food and energy.

You know, food and energy strike me as pretty core to anything, in terms of the average — I can't think of anything that's much more core.

The CPI, as you may or may not know, many, many years ago had housing figured in directly.

There is no — the CPI now has a rental — which is an imputed rental type computation. It's still a large portion of the CPI, but it does not reflect the new housing prices, or —

And rentals — the rental factor has lagged, in my view, significantly below what housing costs really are for an American family. And since housing is a big portion, I don't think it picks it up well.

So I would say that the CPI has understated inflation for a great many people.

Now, if you're older and you own your own house — I mean, everybody has their own way of living.

And, I mean, if all you do is drink Coca-Cola all day, you know, Coca-Cola hasn't gone up in price enough, in my view, and you — my CPI has not changed very much.

But for somebody buying a new house versus 6 or 8 years ago and driving 30 or 40 miles to work or having a lot of driving in the family, the CPI has gone up a lot more than the government figures would indicate.

Charlie?

CHARLIE MUNGER: Yeah. I see it at Costco where there's been almost no inflation in the composite product that flows through Costco, and, yet, in other places you get these dramatic rising figures.

I don't feel sorry for the people that pay $27 million for an 8,000-foot condo in Manhattan. You know, if they've had little inflation, I guess it doesn't matter to the rest of us.

But it's almost weird the way the situation works in terms of how it's —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — it comes in just a few places.

WARREN BUFFETT: If you look at the Costco annual report or the Walmart annual report — these are huge enterprises — and you'll see their LIFO adjustment is just peanuts.

CHARLIE MUNGER: Almost nothing.

WARREN BUFFETT: Yeah. Just peanuts — is Costco on LIFO for —

CHARLIE MUNGER: Sure.

WARREN BUFFETT: — for fuel? I know they're on LIFO generally. Are they on it for gasoline or not?

CHARLIE MUNGER: I think so. I can't imagine they're not.

WARREN BUFFETT: Yeah. But they wouldn't have a large inventory relative to —

CHARLIE MUNGER: No.

WARREN BUFFETT: — their sales volume. But they — at Walmart, it's inconsequential. I just got through reading their annual report, and the LIFO adjustment isn't worth a hiccup, you know, basically.

And you're dealing with 300 billion — well, in the United States a little less than that — but $200-and-some billion worth of sales, and the LIFO adjustment would have picked up changes in prices of that mix overall relative to their inventory level.

So in jewelry, you know, because of gold and some things, we had some big LIFO adjustments last year.

Steel, we've had big LIFO adjustments. We have a steel service center in Chicago and we buy a lot of steel at MiTek and there's a big LIFO adjustment. So it's very uneven.

Carpet went no place for 20 years, but because it's petrochemical-based, there have been substantial price changes in the carpet business in the last couple years.

And our LIFO — we had a LIFO net — a minus LIFO figure, in effect — 3 years ago, and now we have 100 million or so of LIFO adjustments. So there's been a significant price change there.

I think overall, though, for a typical young family, that the CPI probably underestimates the burden they have faced, in terms of their own living situation.

9. Why we don't "do deals" with investment banks

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi. I'm Mike Kelly (PH) from Iowa City.

We've heard a bit about ISCAR today. Could you tell us some things about some of the other acquisitions of the past year?

WARREN BUFFETT: What would you like to know, Mike? (Laughter)

AUDIENCE MEMBER: Um.

WARREN BUFFETT: I mean, we described it a bit in the annual report, but —

AUDIENCE MEMBER: Right. Well, I believe since the annual report, there have been a couple others. Russell, for instance.

WARREN BUFFETT: Yeah. Russell is in the works. There's just been a proxy statement that isn't out yet, but it's been filed with the SEC. You can get a copy of the filing. But that is one in process and is probably a couple months off from actual completion.

You know, we — I described the Business Wire situation in the annual report where I got a letter from Cathy after reading — reading a Wall Street Journal article. And, you know, these — they just all sort of pop up.

Medical protective, I think I suggested to Jeff Immelt at GE, that if — I knew they were interested in doing things with their insurance assets, and I suggested that was one portion of their insurance assets that Berkshire would have an interest in. And he and I met one time and we made a deal on that one.

PacifiCorp — that originated with Dave Sokol and the people at Scottish Power. I'm not even exactly sure what the sequence was.

But the one thing we haven't done is we haven't participated in any auctions.

I get books occasionally on various businesses, and the projections are just plain silly in these books. I mean, it's a — I would — maybe that's why they don't sign their names in the books, the people that write them, because they'd be embarrassed about the projections they put forth.

I would just love to meet the people that write those investment banking books and make them a bet on the earnings that they project four years out. I would win a lot of money over time. They wouldn't be met.

But we get the calls, occasionally, from the people that care about where their businesses end up.

We're going to close on Applied Underwriters in just probably a few days, and those are two terrific guys, built it up from absolutely nothing.

Actually, I bought a tiny business here in Omaha — as I explained in the report — that's why it's here.

But they wanted to come with Berkshire. They think their own — they're keeping 19 percent of the company. They think their own future will be the best in many ways, including financially, I'm sure, of being associated with us. They feel it's the best place for the people, have the most opportunity to grow. And, you know, they came to us directly.

You know, I don't know how many stories you read about a $4 billion deal, as appeared today in connection with ISCAR, where it doesn't say anything about an investment banker, on either side.

But you'll see more of those, I think, with Berkshire over the years.

Charlie, do you have anything in particular to add on our acquisitions recently?

CHARLIE MUNGER: Well, the interesting thing about it to me is the mindset. With all of these new helpers in the world, they talk about doing deals. That is not the mindset at Berkshire. We are trying to welcome partners. It's a total different mindset.

The guy who's doing a deal, he wants to do the deal and unwind the deal and — not too far ahead and make a large profit, et cetera, and that's not our mindset at all.

We like the things that we can buy and that never leave us, and we like the relationships that last and are fruitful, not just for us, but for the people working there and the customers and everybody else.

I think our system is going to work better, long term, than flipping a lot of deals. And we have so many new deal flippers in the game that I think they're going to get in one another's way.

In other words, I don't think there's enough money out there to have all this new class make all the money they expect to make on a permanent basis just flipping, flipping, flipping, flipping.

WARREN BUFFETT: They'll make it on fees, fees, fees, fees. (Laughs)

CHARLIE MUNGER: Warren reminds me, once I asked a man who just left a large investment bank — and I said, "How does your firm make its money?" He said, "Off the top, off the bottom, off both sides, and in the middle." (Laughter)

WARREN BUFFETT: I know which firm he's talking about, too. (Laughter)

CHARLIE MUNGER: That's not our culture. And a lot of you have been here so long, you can see that's not our culture. But in the end, it may be that Omaha will do better than Wall Street.

10. Salomon's 1991 reprieve prevented "absolute chaos"

WARREN BUFFETT: Number 5. (Applause)

AUDIENCE MEMBER: Hi. Steve Rosenberg (PH) from Michigan, originally. First, I'd just like to thank you both very much for continuing to serve as role models for integrity and common sense.

Can you describe a little bit more specifically — (Applause) — how a derivatives meltdown might progress and, ultimately, get resolved after it's been precipitated, and is there a plausible way to resolve it without some sort of a major bailout that would exacerbate a too-big-to-fail moral hazard problem?

WARREN BUFFETT: It's really hard to tell. I mean, it — you know, it — what will cause people to yell "fire," what will — how many people will rush for the exits, what they'll do when they get there — it happens occasionally.

You know, with LTCM — Long-Term Capital Management — in 1998, you know, it affected the financial world in a big way. It didn't affect it in the biggest way. I mean, the feds stepped in. But there were some pretty — pretty strange things happened during that period, in markets.

What happened in the junk bond market in 2002? I mean, it closed for a while almost, and it was chaos. So it's very hard to know exactly what would happen. I'll give Charlie a question here.

In 1991, when we were in Salomon — it was in August, middle of August — and on a Sunday we were within, probably, a half an hour of seeking out a federal judge to turn over the keys to the place to him and go into bankruptcy.

And, fortunately, the Treasury reversed itself, and we got out of that particular predicament. But the law firm was drawing up the papers for bankruptcy.

Now, that was on a Sunday. What would have happened Monday — and we had a good — we had, for those days, a good-sized derivative book. It would be peanuts now, but it was — it looked big at the time. We had a lot of security settlements due the next day.

Now, it happened to be the same day that Gorbachev was spirited away, and the Dow opened down a couple hundred points the next day off of a much lower Dow.

Now, if you had superimposed upon that the fact that Salomon failed in Japan starting at 7 o'clock or so the previous night and that it was — if you were delivering securities to them against payment the next day, you weren't going to get paid.

And if you were expecting securities from them, you weren't going to get those securities. And, by the way, you had a — I think a 6- or $700 billion derivative book.

And people who had traded off those derivatives had to try and figure out where they stood and scrambled around and whether their counterparties were any good.

What do you think would've happened on that Monday, Charlie?

CHARLIE MUNGER: Well, it could have been absolute chaos. That was a very interesting story with an interesting moral. Nick Brady really prevented that bankruptcy.

And he knew about Berkshire Hathaway from having been a family shareholder with the Chaces way, way back. And that had caused him to follow the matter with interest, particularly since he'd sold his own stock and watched his relatives, the Chaces, hold theirs.

So he knew about us, and I think he trusted you, Warren. And I think that mattered that day. So these old-fashioned reputational —

WARREN BUFFETT: Well, what would have happened the next day? I —

CHARLIE MUNGER: Well —

WARREN BUFFETT: It was terrifying. I'll put it that way.

CHARLIE MUNGER: Yeah, it was terrifying. And — but there was an element of personal reputation in the avoidance of finding out what would have happened that next day.

WARREN BUFFETT: Kim Chace, who I introduced you to earlier, his father actually introduced me to Nick Brady many, many years earlier, mid '60s, when Nick was working — was at Dillon Read and Malcom Chace said, "I'd like you to meet" — I guess he was a nephew or grandnephew.

In any event, I went over to Dillon Read and — I would have been in my 30s then — and Nick was a few years older — and we had a good time talking.

And then in 1991, he was secretary of the Treasury. And the Treasury had issued a death sentence to us at 10 o'clock in the morning on Sunday, and, fortunately, Nick, reversed that about 2:30 in the afternoon.

And if he hadn't, I don't know what would have happened. But that would have been kind of a pilot case for a mild derivatives daisy-chain-type panic. But that would be nothing compared to something now.

If — now, there's way more of the stuff that is collateralized these days than formerly, but it would not be a — it's not an experiment you would want to voluntarily conduct, I'll put it that way.

11. We love reading them, but newspapers are in trouble

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Hi. My name is Jeremy from San Diego. And, first of all, I want to thank you all for the tremendous impact that you've had on my career as a professional investor.

My question is also about the newspaper industry that the gentleman earlier touched on.

And for some of those same points that you brought up, some of the largest newspaper stocks seem to earn incredible return on invested capital as compared to a lot of the businesses in the S&P 500.

My question is more specifically related to valuation. If either of you were looking at a newspaper stock today and watching them fall, as some people may categorize falling knives, what would you use to determine — or how would you determine a very comfortable margin of safety to protect yourself against the deteriorating aspects of the newspaper industry?

WARREN BUFFETT: Yeah. Well, the question is what multiple you — what multiple should you pay for a business that's earning $100 million a year — call it pretax — whose earnings are going to go down 5 percent a year compared to what you should pay for a business with a — that's earning $100 million a year whose earnings are going to go up 5 percent a year.

And I would say that — I'm not saying that those are percentages I predict on newspaper companies — but certainly newspaper companies face the prospect of their newspaper earnings eroding.

And we've seen some of it already. We see every trend pointing in that direction. We own a newspaper ourselves.

And, you know, I do not think the circulation of our paper will be larger in five years, and I don't think the advertising pages will be greater.

And I think that's true even of newspapers that operate in more prosperous — or, actually, more growing, I should say — areas of the country than we do.

So — but I don't think — I don't think most owners of papers still have quite gotten to the point where they start projecting out declining earnings.

Certainly multiples on newspaper stocks are unattractively high if you would see some decline, like 5 or 6 percent a year on earnings, occurring to this point. They just — they're not cheap enough to compensate for that sort of erosion in earning power.

And then you face the added risk that they may have, sort of, a perception lag and that they may continue to use some of that money to buy other newspapers at prices which, again, don't make much sense.

It's pretty hard in a declining business to buy things cheap enough to compensate for the decline.

People in the business always tend to think that they're seeing the first robin, you know, or something, and that it's going to get better. And I would say in the newspaper business, the decline, if anything, is accelerated somewhat. I —

You know, when they take — when they take people out to the cemetery, they're taking newspaper readers, and when people graduate from school, they're not gaining newspaper readers.

And that may not change things overnight, but it goes in the wrong direction. And the less the readers, the less the readership, the less compelling argument to have to advertisers.

So that virtuous circle where everybody read a paper because every ad was in it, and every ad was in it because everybody read a paper, that virtuous cycle is going in the other direction now. And I don't think present prices for papers compensate for that.

And you are now hearing from a couple of guys that just love newspapers.

We think newspapers are indispensable, but we don't have a lot of — we have less company in that view. We love — I read five newspapers every day. Charlie probably does about the same.

CHARLIE MUNGER: Four.

WARREN BUFFETT: Yeah, he's — well, it shows too. The — (Laughter)

The — we couldn't live without them. But a lot of people can, and more people can every day. And though we started out — we love the idea of buying newspapers. We traveled to Cincinnati, cheap hotels, all kinds of things, to buy newspapers.

But — and we thought, incidentally, we loved them as products, and we thought they were the greatest of businesses, the ultimate bulletproof franchise. But it became apparent we were wrong.

You know, we still love them as news — as products, but we were wrong about the bulletproof franchise. And, you know, we've got to believe our eyes, in terms of what we're seeing in that world.

Charlie?

CHARLIE MUNGER: Yeah. I have an even greater sin to admit to. I once thought General Motors was a bulletproof franchise. And — but we have a wonderful way of coping with a lot of these things. We have this "too hard" pile.

I don't know if Warren is buying General Motors or not, but I have a good guess.

And it's just too hard. If something is too hard to do, we look for something that isn't too hard to do. (Laughter)

What could be more obvious than that? (Laughter)

WARREN BUFFETT: It may mean that we don't do very much. (Laughter)

CHARLIE MUNGER: Yeah. Yeah.

WARREN BUFFETT: We won't get into specifics. The news — it's — I don't think anybody has watched the newspaper business much more carefully than Charlie and I have for, really, 50 years.

We used to — we always talked about every paper in the country, and the potential for buying it and, all that sort of thing.

And it was a — it was easily understood. I mean, it was about as easy an economic — a business economics problem — as you could imagine. And we slowly woke up to the change on it.

Actually, I wrote in the 1991 annual report, the newspaper — the very — the preprints of the world, you know, started turning the newspaper into a wrapper. It contained a whole bunch of things that could have been contained in some other package.

Now, your newspaper wasn't reproducible in some other package, but this thing was carrying around a bunch of preprints. Now, the question is there a bunch — is there — are there easier ways to carry around those preprints?

But there was nothing magical about the paper except it got inside the house and brought the preprints inside the house. And as the newspaper lost penetration, it became a somewhat less efficient way of getting things into the house and other ways became more efficient at getting things into the house.

So these things — it's not a hard business to understand. And it has been interesting to me to watch both owners — direct owners — and investors in the business sort of resist seeing what's right in front of them, you know?

It just — it went so long the other way that you couldn't make a mistake buying a monopoly newspaper. Nobody ever made a mistake buying one, you know, until, what, 1975 or '80 or something like that.

CHARLIE MUNGER: Yeah. If the technology had not changed, they'd still be impregnable franchises. But the technology did change. Fortunately, carbide cutting tools appear to have no good substitute. (Laughter)

WARREN BUFFETT: It's a lot better business over time, if you have the right management. Now, it takes very good management. Nice thing about the newspaper business 30 or 40 years ago, it took no management at all.

I mean, if you had an idiot nephew, you know, you — that would be a perfect — or a network television station. I mean, they were going to make money no matter what happened.

They were going to make more money if they were under good management. I mean, if Tom Murphy was running your television stations, you were going to do much better than if you had your nephew doing it, but the nephew would have done all right. (Laughs)

12. Don't let your fear overcome your logic

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Hello, Warren, Charlie. My name is Matt Peterson (PH). I'm a shareholder from Seattle, Washington, and it is a true pleasure being here today. My question for you is simple.

The two of you have had a — many great opportunities throughout your years to work with many fine mentors and teachers.

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

WARREN BUFFETT: Well, the interesting thing, you don't have to look at the present-day ones, necessarily.

I mean, if you wanted to look at great business careers, you could look at Tom Murphy or Don Keough on our board.

And you can learn everything you could learn about being an outstanding businessperson by just studying them. And you don't have to study somebody that is 55 and currently in some executive position. Their lessons are timeless.

And there's going to be a study — I think the Harvard Business — somebody sent it to me from the Harvard Business School, you know, on Cap Cities.

But there's been others in the past. And, you know, if you learn the lessons of Tom Murphy, you don't need to learn any other lessons in terms of business.

And I would say if you learn the lessons of certain investors in the past, you know, you don't need to worry about a contemporary example.

Charlie?

CHARLIE MUNGER: Well, I think it's also true that Warren and I are not following very well the 40-year-old investment professionals. Isn't that right? (Laughter) Are you hiding something from me?

WARREN BUFFETT: I didn't know there were any 40-year-olds. (Laughs)

I thought they're all 25 now.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: The — investing is not that — is really not complicated. I mean, the basic framework for it is simple. Now, then, you — you have to work at it some to find the best pockets of undervaluation, maybe, or something.

But you didn't have to have a — you didn't have to have a high IQ. You didn't have to have lots of investment smarts to buy junk bonds in 2002 or even to do some of the stuff that was available when LTCM got in trouble.

You really had to have, sort of, the courage of your convictions. You had to have the willingness to do something when everybody else was petrified.

And — but that was true in 1974 when, you know, we were buying stocks at very, very low multiples of earnings. It wasn't that anybody didn't know that they were cheap.

They were just paralyzed for one reason or another. And, you know, that — the lesson of following logic rather than emotion, you know, is something that — it's obvious. And some people have great trouble with it, and others have less trouble.

Charlie, can you give them any more?

CHARLIE MUNGER: Well, I think this is different. When we were young, we had way less competition than you people have now.

There weren't very many smart people in the investment management field. (Laughter) There really weren't. And you should have seen the people who were in the bank trust departments. (Laughter)

I mean — so, now we've got armies of brilliant young people and all these private partnerships and all these proprietary desks in all the big investment banks. It's a — and we've got a vast amount of talent in the investment management business.

So — and there's a lot of competition. Now, if there were suddenly a crisis now, there would be 500 firms that would be studying it intensely, each having capital that they could commit on a hair trigger. In our day, we would frequently be all alone.

WARREN BUFFETT: But in 2002 —

CHARLIE MUNGER: We'd be the only buyer.

WARREN BUFFETT: But in 2002, Charlie, there were tons of people that had investment experience and high IQs and lots of money was around. It wasn't a question about money, it's just they were terrified of that particular arena.

CHARLIE MUNGER: Well, when you have a huge convulsion, which is like a big fire in this auditorium right now, you know, you get a lot of weird behavior. (Laughter) And if you — (Laughter) — and if you can —

WARREN BUFFETT: Particularly at the head table. (Laughter)

CHARLIE MUNGER: — and if you can be wise when everybody else is going crazy, sure, there will still be opportunities. But that may give you long, dull stretches, if that's your strategy.

WARREN BUFFETT: Three years ago — two — three years ago you could find a number of securities in Korea, population 50 million, advanced society, strong balance sheets, strong industry positions, at three or so times earnings. Now —

CHARLIE MUNGER: But that took a convulsion to create that, a real — a big convulsion.

WARREN BUFFETT: Yeah. But the convulsion happened three or four years earlier —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — five years earlier. And plenty of smart people in Korea in the investment business, plenty of smart people here scouring — the information was all available.

You can go to the internet and get information about Korean companies that's just as good as you get it from the SEC. And there they were, dozens of companies at very, very, very cheap prices. Now, where —

CHARLIE MUNGER: It did —

WARREN BUFFETT: — were all these smart people with all this money —

CHARLIE MUNGER: It did happen. But if I asked you to name 20 more like it, you would have great difficulty.

WARREN BUFFETT: Well, if I have 20 more like it, I'm not going to name them. (Laughter)

13. If we were starting out again …

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: My name is Simon Denison-Smith from the UK.

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

WARREN BUFFETT: Well, it's somewhat interesting that we formed the first partnership 50 years ago last — 2 days ago, Thursday, May 4, 1956, which was 105,000. (Applause) That's my sister clapping. She was in the partnership. (Laughter)

The — we would — if Charlie and I were starting all over again and we were in this, Charlie would say we shouldn't be doing this. (Laughter)

But if we were to succumb to Satan and engage in the same kind of activity, we would, I think, be doing something very similarly. If we were investing in securities, we would look around the world, and we would look at a Korea.

And Charlie says you can't find 20 of them, but you don't have to find 20 of them; you only have to find one, really. You do not have to have tons of good ideas in this business, you just have a good idea that's worth a ton, occasionally.

And in securities, we would be doing the same thing, which would probably mean smaller stocks — it would mean smaller stocks — because we would find things that could have an impact on a small portfolio that will have no impact on a portfolio the size of Berkshire.

If we were trying to buy businesses, we'd have a tough time. We would have no reputation, so people would not be coming to us. We'd be too small a player, if you're talking about a million dollars. So we would not have much success, I don't think, with small amounts, buying businesses.

Charlie started out, you know, in real estate development because it took very, very little capital, and you could magnify brain power and energy — or, I should say, brain power and energy could magnify small amounts of capital in a huge way that was not true in securities.

You know, my natural inclination was to look at securities and just kind of do it one foot in front of the other over time. But the basic principles wouldn't be different.

You know, I think if I'd been running a partnership a couple of years ago with a small amount of money, I think I'd have probably been 100 percent in Korea.

And, you know, I would be looking around for something that was very mispriced and which — and that I understood. And every now and then, that's going to happen.

Charlie?

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

And in the real world, you have to find something that you can understand that's the best you have available. And once you've found the best thing, then you measure everything against that because it's your opportunity cost.

That's the way small sums of money should be invested. And the trick, of course, is getting enough expertise that your opportunity cost — meaning your default option, which is still pretty good — is very high.

And so, the game hasn't changed at all in terms of its basic arithmetic. That's why modern portfolio theory is so asinine. (Laughter)

WARREN BUFFETT: It really is, folks.

CHARLIE MUNGER: Yeah. When Warren said he would have been all in one country, that's pretty close to right. He wouldn't have quite done that when he had the partnership, but he would have been way more concentrated than is conventional if you listen to modern portfolio theory.

Most people aren't going to find thousands of things that are equally good; they're going to find a few things where one or two of them are way better than anything else they know. And the right way to think about investing is to act thinking about your best opportunity cost.

WARREN BUFFETT: Number 9.

CHARLIE MUNGER: By the way, that's in the freshman course in economics everywhere in the basic textbook; it just hasn't made its way into modern portfolio theory.

WARREN BUFFETT: We don't get asked to do book reviews. (Laughter)

14. Munger thinks Prof. Jeremy Siegel is "demented"

AUDIENCE MEMBER: It's Anvayas Vegar (PH) from Munich, Germany. Thank you very much for the open discussion that you had with us.

Actually, I'd like to ask a question on a book, so I'll come back to the book review.

Jeremy Siegel had some ideas in his second book, and I would like to understand what — how this would impact your investment strategies, if there are any changes from his ideas, and how you react to these recommendations that he makes? Thank you.

WARREN BUFFETT: This is which book? Jeremy Spiegel?

AUDIENCE MEMBER: Jeremy Siegel, the second book, “Why the Tried and the True Triumph Over the Bold and the New.”

WARREN BUFFETT: That — it’s had no effect on us.

Charlie?

CHARLIE MUNGER: No, is that the fellow who’s very optimistic about common stock investment over long periods of time?

WARREN BUFFETT: The University of Pennsylvania. Yeah.

CHARLIE MUNGER: Yeah. Well, I think he’s demented. (Laughter)

WARREN BUFFETT: Well, he’s a very nice guy, Charlie. But — (Laughter)

CHARLIE MUNGER: Well, he may well be a very nice guy, but he’s comparing apples against elephants and trying to make accurate projections. (Laughter)

15. “Things are really screwed up if you’re getting calls on Sunday”

WARREN BUFFETT: Number 10. (Laughter)

AUDIENCE MEMBER: I’m Bob Klein (PH) from Los Angeles. You so eloquently stated that you can’t see who’s swimming naked until the tide goes out.

Could you discuss the issue of trying to employ a rational decision-making process in investing, or in business generally, as opposed to focusing on outcomes or results of just a few instances or over a short period of time?

For example, it may not be a good idea to underwrite some insurance policies if competition has lowered the premiums too far. And, likewise, in the stock market, momentum investors may get good results for a while. But buying high and trying to sell higher isn’t a good long-term strategy.

So I’d just like to hear you guys provide some detail on the importance of using an effective decision-making process, even though it may lead to some bad outcomes and underperformance in the short run.

WARREN BUFFETT: Yeah. Well, Ben Graham said long ago that you’re neither right nor wrong because people agree with you or disagree with you.

In other words, being contrarian has no special virtue over being a trend follower.

You're right because your facts and reasoning are right. So all you do is you try to make sure that the facts you have are correct. And that's usually pretty easy to do in this country. I mean, information is available on all kinds of things. Internet makes it even easier.

And then once you have the facts, you've got to think through what they mean. And you don't take a public opinion survey. You don't pay attention to things that are unimportant. I mean, what you're looking for is something — things that are important and knowable.

If something's important but unknowable, forget it. I mean, it may be important, you know, whether somebody's going to drop a nuclear weapon tomorrow but it's unknowable. It may be all kinds of things. So you — and there are all kinds of things are that knowable but are unimportant.

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

What others are doing means nothing. It's what Graham writes in Chapter 8 of "The Intelligent Investor," that the market is there to serve you and not to instruct you. That's of enormous importance.

When people talk about momentum in stocks or charting or any kind of things like that, they're saying that the market is instructing you. The market doesn't instruct us; the market is there to serve us.

If it does something silly, we get a chance to do something because it's doing something silly. We do it. But it doesn't tell us anything. It just tells us prices.

And if the price is out of line where the facts and reasoning lead you, then you — then action is called for. And if it doesn't, you forget it and go play bridge that day and the next day, see whether there's something new. And the nice thing is there always is something new.

I mentioned the LTCM crisis. We were getting calls on Sunday from people that had portfolios that were in trouble. Now, I will tell you that if — you can make a lot of money on Sunday.

You may not get a chance very often, but any calls you get on Sunday you're probably going to make money on. (Laughter)

Things are really screwed up if you're getting calls on Sunday. And all you have to do is make sure that you're the callee and not the caller — (laughs) on Sunday.

But if you get those calls — you get a call on a Sunday and somebody says that the off-the-run is trading 30 basis points away from the on-the-run, you know, all you have to do is decide whether — how you handle that particular piece of information — whether it's correct in the first place — but how you handle that piece of information, whether you can play out your hand.

You never get in a position, obviously, where the other fellow can call your tune. You have to be able to play out your hand under all circumstances. But if you can play out your hand, and you've got the right facts, and you reason by yourself, and you let the market serve you and not instruct you, you can't miss.

Charlie?

CHARLIE MUNGER: Well, I would say some of you probably can miss. (Laughter)

WARREN BUFFETT: I would say Charlie can't miss. I'll put it that way. He'll agree with that.

Do you have anything further to add?

CHARLIE MUNGER: No.

WARREN BUFFETT: OK. (Laughter) At least I've got him off that previous subject.

16. How to read Berkshire's annual report

WARREN BUFFETT: Number 11. (Laughter)

AUDIENCE MEMBER: Hello. I'm Randall Bellows from Maryland. I would like to know how you would look at the Berkshire annual report.

What numbers in the balance sheet or the cash flows would tell you that Berkshire is underpriced? And what numbers would you look at to determine if Berkshire is overpriced? Thank you.

WARREN BUFFETT: We try to — and we take it very seriously — we try to put everything in that report that we would want to know if the positions were reversed.

If I were sitting with all of my net worth in Berkshire and had been on a desert island for a year and I — and the manager was reporting to me about the business, we'd try to have that same information that I would want from him. And we would try to present it to you in a way that's understandable.

And we don't leave out things that we think are important. We try not to put — I mean, there's — it runs about 76, I think, or maybe even 80 pages this year. I mean, there's — you can drown people in information that really doesn't make much difference.

But we've tried to organize it in a way by talking about these different groups of businesses. We try to explain how we think about it, in terms of things like the amount of operating earnings we've generated and the investments we have.

It's really as if it's a report that I was making to Charlie or Charlie would be making to me if one of us were inactive in the business and the other was running it.

And so I think — I mean, it may take a few hours to do it, but I think if you regard yourself as a serious owner of Berkshire, it's really worth reading the whole report.

Thinking about: what is there? What are these guys going to do with it? What are they trying to attempt? What are the odds they're going to be successful in that attempt? What are they —?

You know, what is it worth if they don't succeed very well in deploying additional capital? What might be the case if they were successful in deploying excess capital and incremental capital?

But I can tell you that, obviously, we think it's very important.

What counts is the kind of businesses we have, the kind of managers we have running those businesses, what those businesses are likely to earn over time — and we've expressed ourselves a little on that —

And then what are the resources that are available to keep adding to that collection of businesses? What are the kind of businesses we are looking to add?

And I think — you know, I think you'll find the information that you need to evaluate Berkshire, and it's not a — you know, you don't carry it out to four decimal places.

Charlie and I, if we had to stick a number down on a piece of paper right now as to some pinpoint number — we wouldn't do it because we know that's impossible. But if we had to stick a number down, it would be a different number between the two of us.

It would be a different number if I did it today from tomorrow, probably. But we'd be in the same ballpark, and we'd be looking at the same things. And the things we would be looking at we report to you in that report.

I would focus — you know, the real question of what Berkshire is going to be worth 10 years from now will depend on the — earnings that we have developed — annual earnings that we've developed by that time, the quality of those earnings, the possibilities going forward from that point of those businesses, and the liquid assets we have.

And we've worked on increasing both of those elements over the years, and we'll keep working on it. And it's a lot tougher, in terms of percentage gains, from this point forward than it was in the past.

There's no way in the world that we can replicate what's happened in the past. It just won't happen. The question is whether we can do a reasonable job or not.

Charlie?

CHARLIE MUNGER: Yeah. I generally try and approach a complex task, like the one you presented, by quickly disposing of what I call the no-brainer decisions and — meaning the easy ones.

I think, if you go through all the operating insurance that don't involve surplus cash, and the insurance operations, that that's the easiest valuation process in Berkshire.

And the insurance operation is very interesting, and so is the process by which the huge amounts of excess cash are continually redeployed. But I would go at it in that sequence: taking the no-brainers first.

17. Buffett's key insurance question

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: David Winters, Mountain Lakes, New Jersey.

Would you please discuss how your underwriting standards have changed as the weather patterns seem to become more severe, the challenges of global terrorism seem to escalate, and unforeseen super-cat events, such as earthquakes and pandemics, go into your thinking, and just what the prospects are for the development of the float?

WARREN BUFFETT: Well, the development of the float is a different question. That really depends on how much business we write in the future and the nature of the business, whether it's long-tail or short-tail.

I think it will be very hard to increase our float of 48 or -9 billion at a big clip in the future. I mean, I've been amazed as what's happened in the past. And it's done way better than Charlie and I ever would've dreamt.

But, you know, we have — we're getting to where we're close to 10 percent of the float of the entire American insurance — property-casualty insurance industry — and some of it's abroad that we have.

But it just can't — it can't grow at very rapid rates. But it can be very attractive, and so far, it has been.

In terms of the questions about underwriting in terms of pandemics or terrorism and all of that, I mean, you know, I'm aware of them. You're aware of them.

We get propositions offered to us virtually every day, and in the end I — mostly Ajit, I mean, in this particular case, in terms of big-type contracts — financial-type contracts I would evaluate. He would —

But we talk about what we think the probabilities are of $50 billion events and up, or $20 billion events and up. And, he's the fellow that does most of — he applies it, but we kick around the possibilities.

But that's all there is to it. I mean, it's a question of making judgments about whether you're getting paid enough. And if we have a lot of money, you know, 30 years from now, it will mean that our judgments overall were decent.

And if we have a big loss on one this year, it does not mean that our judgment's wrong because it — it's going to lead to peaks and valleys. But there's no magic to it.

There's probably — I would feel that the earthquake experience of the last 100 or 200 years has more validity than the windstorm or the hurricane experience of the last hundred or 200 years. I don't know that for sure, but I would bet real money that way, and we have.

What is — what will hurricane experience be like 10 years from now, in terms of the number of those that hit the United States and the ferocity of the ones that do hit? You know, I don't know. But I'll keep thinking about it every day.

Charlie?

CHARLIE MUNGER: Well, I think the laws of thermodynamics are such that if the oceans get warmer — I think they are getting warmer — the weather is going to be — have more high-energy uproar in it.

So I think we'd be out of our minds if we wrote weather-related insurance on the theory that global warming would have no effect at all. And the natural reaction is to raise your prices, as the risks go up.

And whether you've raised them enough, and carefully controlled your risks enough, that's the art of the business.

WARREN BUFFETT: Yeah. And you have this possibility that, you know, 1 percent changes or 2 percent changes in something can produce 100 percent of probabilistic changes in cost.

It’s an explosive sort of equation that you’re dealing with. And, you know, but that’s the game we’re in, and we don’t have to play it ever.

If we don’t like what we’re being offered — and we didn’t like what we were being offered a while back in many areas — somebody else can take our place in line. We’ll be happy to have them.

18. Health care is in Berkshire’s “too hard” pile

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: Dear Warren and Charlie, my name is Dr. Rashad Patel (PH). I’m a family physician from Taunton, Massachusetts. Two years ago I wrote you a letter; you responded with me back quickly. Thank you for that.

My question is, what are the criteria or principles to find a person like you in health care? It seems that a person moves up the ladder in this ethical business, they are more prone to become more unethical, get more options, sell shares, open a shop next door.

How do you find those checkpoints? Can you please express your view, on this soon $2 trillion economy, how to find the leaders so we don’t get a surprise in dog-eat-dog world?

WARREN BUFFETT: Charlie, did you get that? (Laughter)

CHARLIE MUNGER: Well, I will try that. I’m not sure I understood the whole — I think she’s asking about the health care business —

WARREN BUFFETT: That part I got.

CHARLIE MUNGER: — and whether or not, with the — much bad ethics being present — we have anything to contribute about doing well in that sector. Is that about right?

AUDIENCE MEMBER: Yes.

CHARLIE MUNGER: Yeah. Oh no.

WARREN BUFFETT: Now I understand the question, I still —it’s still yours. (Laughter)

I’d be glad to answer it, but I’m eating candy at the moment. (Laughter)

CHARLIE MUNGER: That has tended to go into the too hard pile — (laughter) — at Berkshire. (Applause)

A lot of people have made a lot of money writing health insurance. And I've watched the behavior of some of those people, wearing my hat as the chairman of a big central city hospital.

And you are right, there's a lot of bad ethics in health care. There's also a lot of good ethics. It's a very, very complex field with a lot of change, a lot of technological differences.

And in terms of investments, I think the policy has generally been that it all goes into the too hard pile. We don't — unless Warren has something he's keeping secret from me.

WARREN BUFFETT: No. We have not owned much in health care. My only expertise is in diet. (Laughter)

But I appreciate the seriousness of the question. You know, there — it is just — it is a very, very tough problem on which I have no particular insights.

CHARLIE MUNGER: And you're right. The worst of the ethics is really bad.

19. "A complicated bankruptcy can offer opportunities for profit"

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Hello. My name is Barry Steinhart (PH), shareholder from New York. My question relates to the Chapter 11 bankruptcy process.

I know you have been active in the past in some activity in the bankruptcy court. And if you had thoughts on possible reforms in that area, if you believe that any reforms are necessary?

WARREN BUFFETT: Well, that's a good question. Charlie is probably better qualified to answer than I am. I mean, we have bought Fruit of the Loom out of bankruptcy.

And we have had some involvement in owning junk bonds. You know, we get — we think about the bankruptcy process. But in terms of the practicalities of improving on it, what do you think, Charlie?

CHARLIE MUNGER: Well, I think much of that is pretty horrible.

You have a competition there, where the courts themselves have gone into bidding contests to get bankruptcy business attracted. Meaning that the —

There are various courts that can handle bankruptcy cases. And they have found that if they develop a culture where they overpay a lot of people egregiously, they can attract more business: lawyers, trustees, consultants, et cetera, et cetera.

I find it so unpleasant to watch that I don't pay as much attention to bankruptcy as I probably should. You know, I'm an old man, and I don't like to have an upset stomach. (Laughter)

WARREN BUFFETT: But we will — we look at — at least I do, I'm not sure about Charlie — but he — you know, bankruptcies will be something that we will — one way or another, over the next 20 years — we'll have various ways of participating.

And we have bought — well, we bought certain of the bonds, for example, of Enron after they entered bankruptcy — we bought something called the Ospreys.

And a complicated bankruptcy can offer opportunities for profit. Now, there's so many people looking at bankruptcies currently, or potential bankruptcies, it's a field that I would say does not have a lot of promise right now, but it has had promise in the past.

We actually, in the Fruit of the Loom situation, I first went into that just by buying some Fruit of the Loom bonds, but — when I had no notion that we might conceivably end up with the company. But, you know, I knew enough about it to buy the bonds.

And Enron comes along, and it's a big mess. The Penn Central came along 20-odd years ago, and it was a big mess, and there was a lot of money made in the Penn Central, simply because it was such a complicated mess.

So anytime there's something big, complicated, there's certainly a good chance of mispricing. Now, lately the mispricing may be more on the high side than on the low side. But, over time, you're going to find some — there will be some attractive things to do in bankruptcy situations.

We've had other bankruptcy situations where we've gotten involved in the process and then been outbid. It happened at Burlington and it happened at Seitel. And — but we owned all the bonds at Seitel, so we came out fine.

It's something to understand if you're in the business of buying investments or businesses. And I would say that, you know, if we're around for another 10 or 15 years that we'll do something or other, maybe substantial, in the bankruptcy field.

The Enrons — the payment is still being made in various ways. But the Ospreys, which were kind of a complicated situation — the whole thing was complicated.

But, you know, we didn't buy at the bottom or anything like that. But, you know, we considerably more than tripled our money in something that you could have put a fair amount of money in. So they can be interesting.

Charlie, do you want to —

CHARLIE MUNGER: Well, I remember the Eastern Airlines bankruptcy, where there were a lot of employees that would've — and communities that would've been affected. And the courts in that case, I would say, abused the senior creditors horribly.

And so you could have read a law book and reached one conclusion, and if you'd bought the wrong securities, why, you would have found out you'd guessed wrong. It's a very interesting field.

WARREN BUFFETT: Yeah. It — and it can be very unpredictable. In the Penn Central case, you had an incredible variety of claims. I mean, you had leased lines and you had all kinds of first and second liens and everything.

And the judge, as I remember — I may be wrong a little bit on this on the details — but as I remember, the judge just looked at this incredible — probably the most complicated bankruptcy that had come down the pike in the history of bankruptcy to that point — and he just said, "This is just too damn complicated. I'm just, sort of, going to ignore the various priorities and all this. I'm just going to" — perhaps you might call it substantive consolidation, or something — "I'm just going to put this all together, and I'm going to give you a quick, fast solution."

And I think it was a very smart way to handle things, because otherwise I think Penn Central might still be going. But it wasn't what the book said would be done at —

Judges can determine things in a very big way. I remember when we were in Cincinnati on that newspaper case I mentioned earlier, I said to Charlie — a judge had stayed an order, I think, for a week or something like that.

And I said to Charlie — I said, "How much power does a federal judge have?" And Charlie says, "Well, for a while, as much as he thinks he has." (Laughter)

I learned a lot out of that.

20. Buffett endorses Procter & Gamble-Gillette merger

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Good afternoon, gentlemen. Long-time listener, first-time caller here. This is my first shareholder meeting. Thanks for hosting. You guys do a great job. I'm looking forward to coming back for several more years.

My name is Craig Beachler. I'm from Cincinnati, where my paychecks are signed by Uncle Procter and Mr. Gamble.

Thinking about that, I know that when the P&G-Gillette merger was announced, you called it a, quote, "dream deal."

Considering that P&G is primarily thought of as a consumer products company, what are your thoughts on the short- and long-term fit for P&G's pharmaceutical business?

WARREN BUFFETT: For just the pharmaceutical business or, did you say, or —

AUDIENCE MEMBER: Long-term growth of P&G as a whole.

WARREN BUFFETT: As a whole. Yeah. Well, you know, I think it's clear that P&G is a consumer powerhouse of sorts. And I think Gillette — in its field, they have just about as strong a consumer position as anybody will ever have.

And when you get into blades and razors, stronger than the — most of the P&G brands, strong as they may be. And I do think that the big retailers are becoming — and more so all the time — brands of their own. And they are become — and there's more and more concentration going on.

So I think the struggle between the manufacturers of brands and retailers will go on and on and on and become more intensified. So I would think, if I were on either side of that equation, I would want to be strengthening my hand.

And I think that — I think the future of both Gillette and P&G are better as a combined enterprise than they would have been as a separate enterprise.

And I think that's particularly true because of the strengths of the Walmarts and the Costcos and — you name it — around the world. I don't know.

How do you see it, Charlie?

CHARLIE MUNGER: He also wants you to tell him how P&G will be affected by its pharmaceutical business.

WARREN BUFFETT: I don't know a thing about that.

CHARLIE MUNGER: That makes two of us. (Laughter)

WARREN BUFFETT: I really don't. I'd help if I could, but I can't.

21. "A strategic buyer is some guy that pays too much"

WARREN BUFFETT: Number 4?

AUDIENCE MEMBER: Hi. My name is Andy Von Dorn (PH), and I'm here from Omaha.

I'm currently employed by Oriental Trading Company, and they just announced that they were putting themselves up for sale.

I was just wondering if Berkshire would have any interest in a company like Oriental Trading Company as an acquisition.

WARREN BUFFETT: That's interesting, and I didn't know they put themselves up for sale. But I looked at it — whenever it was — four or five years ago when Terry Watanabe sold it.

And I haven't really followed it since then, but just from listening to what you say — and I have no knowledge of it at all — but it sounds to me as if some private group bought it and now they're reselling it.

And we get approached on that sort of thing all the time, where a financial group has bought the business and then wants to resell it fairly quickly. And they almost — well, they invariably, I would say — auction the business.

They seek what they call a strategic buyer. A strategic buyer is some guy that pays too much. (Laughter) Because — you know, and he wants to justify it, so he says it's strategic. I mean, I have never understood being a strategic buyer.

Every time somebody calls me up and says, you know, "We think, maybe, you're the logical strategic buyer for that," you know, I hang up faster than Charlie would. (Laughter)

The — and I'm not talking to the specifics of this one at all because I really don't know on Oriental Trading.

But the idea that we're going to find a business to buy from some guy who, from the moment he bought it a few years ago, has been thinking, "How do I get out of this thing?"

You know, "What do I do to make it earn — have those figures for a couple years look a certain way so that I can get the maximum amount in a couple years?" You know, that — we're just not going to make any attractive buys there. We won't trust the figures.

You know, we — it just — it's — what we like is a business that — where the guy before was running with the idea of running it a hundred years, and taking care of the business in every way possible and was not contemplating sale, but, for one reason or another, finally needs to monetize the company.

We won't — we will not get any sensible buys, really, from the resellers.

Some of the — it's amazing to me what's going on. Some of these things, literally, you know, Fund A is selling to Fund B to Fund C.

I mean, I've seen some that have changed hands three or four times. They're just marking them up, and everybody's getting two — they're getting 20 percent of the profit so they mark it up.

And probably Fund C or Fund D may be owned by the same pension funds that own Fund A, except that everybody's just taking a big 20 percent slice out of it every time they move it from one place to another.

We're not buyers of anything the financial buyers have been in in recent — you know, and currently own.

Charlie?

CHARLIE MUNGER: In the 1930s there was a stretch when certain kinds of real estate — when with certain kinds of real estate — you could borrow more against the real estate than you could sell it for.

And I think that's happened in some of these private equity deals, and it's weird. It's weird. This is not our field. (Laughter)

22. Looking for bright spots in U.S. trade imbalance

WARREN BUFFETT: Number 5?

AUDIENCE MEMBER: Hi. I'm John Golob from Kansas City.

I'd like to get you back to the current account deficit. I was looking for reasons not to despair, so I have a couple of factoids I'd like to throw at you and see how you react.

If you add up all of the current account deficits over the last couple of decades, you get about $4 1/2 trillion. Now, you'd think that means our net indebtedness to a foreign investor should be minus 4 1/2 trillion, but it's not.

It's only 2 1/2 trillion because capital gains for domestic investors has exceeded those for foreign investors. So, essentially, $2 trillion of our current account deficit has been financed by cap gains.

Now, the other factoid is that if you look at the income on assets, the U.S. investors are still in a net positive position. That is —

WARREN BUFFETT: They went negative in the last quarter, actually.

AUDIENCE MEMBER: Oh, excuse me. So it's been close. So I guess my question is, do these facts influence your concern or maybe mitigate your concern about the current account deficit?

And the second part of the question is, do you have any cultural reasons why the U.S. should earn more on investments abroad than foreign investors earn on domestic investments?

And, of course, the dollars explain a little bit of it because we're not paying any interest on those dollars. But I'd like your comments.

WARREN BUFFETT: Yeah. Well, those are a couple interesting points. But, we have earned more on American assets owned outside this country than people outside this country have earned on assets in this country. I mentioned that in the annual report this year.

It did flip. The net balance flipped in the other direction in the most recent quarter, and my guess is it keeps going in that direction. There are a lot of reasons for that.

One important reason a year or two ago was the fact that foreigners owning our Treasury bonds were getting as little as — you know, a little over 1 percent.

So if the rest of the world owned a trillion of our bonds and got 1 percent, that was 10 billion, and if we owned a trillion of their bonds and got 4 percent, you know, that would have been 40 billion.

And the higher — the lower interest rates in this country, the higher interest rates abroad — just simply meant that you got paid — that you were going to have — with a balance of investment — you were going to have a favorable net balance in interest income in this year. We were earning more on our assets abroad than they were earning here.

That is turning somewhat. I mean, our interest rates have been increased.

Now, they didn't all own short maturities or anything of the short — sort. And it may well be that our direct investment — as opposed to our marketable securities investment — our direct investment abroad was made in earlier times and returning higher returns. But, over time, it's going against us.

Now, when you get into the net debtor position that we're in, which you — is now over 3 trillion, that varies with what the dollar is doing.

Because, say, in recent weeks, the dollar has weakened, and that means that brings down, actually, our net debtor position. That's why inflation could be something that becomes a real attractive possibility to politicians in the future.

But I wouldn't — it's not a huge factor. I know what you're talking about in terms of those year-to-year variances in the net debtor position.

They're affected much more by the actual currency that's — change that's been made — because they're expressed in dollars. And if the dollar gets weaker, it makes us look better for the time being.

Overall, that will not be what determines the consequences three, five, or 10 years from now, in terms of the current account problems, or in terms of the possibility of them — of currency — exacerbating some other kind of chaos in markets.

Charlie?

CHARLIE MUNGER: This is not a field to which I've devoted the same attention as Warren. And — but I do share his general pessimism that, eventually, there will be a price to pay for the course we're on.

Where I've disagreed a little with Warren is I've always feel there's more ruinous behavior that could be tolerated in a great place, probably, than he does.

It's just amazing how much ruinous behavior you can get by with if you're a successful governor — government.

Now, if you start with a lousy reputation as a government, it doesn't work that well. But when you start with the reputation the United States had, the people who expected instant calamity, I think, were wrong. It —

WARREN BUFFETT: Yeah. If you landed from Mars, you'd probably still rather land in the United States than anyplace else.

CHARLIE MUNGER: If you stop to think about this subject, do you want to invest in Europe where, you know, 10 or 12 percent of the young people are unemployed because of their crazy employee security policies?

And a lot of 28-year-olds are living at home and going to university because it's a fairly comfortable way to, kind of, while away the time with the state paying for most of it?

Do you want to go into a place with fabulous assets, like Brazil, with a lot of political instability that you fear, or Venezuela?

So it isn't as through all the other options look wonderful compared to us. And so, I don't think it's just totally irrational that everybody still likes the United States in spite of its faults.

And so that gives me some feeling that what happened with regard to fiscal misbehavior on our part could go on quite a long time without paying the due price.

WARREN BUFFETT: Yeah. And I agree with that, although there's always the potential, when you're doing something dangerous, that it can get accelerated.

Generally speaking, if you had to bet on anybody to get away with misbehavior fiscally for a long time, you'd bet on the United States.

And we still think it's by far the best place to be, and we have a majority of our assets in it. We just recognize certain things going on that could cause significant problems, particularly in markets.

23. Key distinction between insurance and gambling

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Hi. It's Peter Webb here from London, UK.

Your views on gambling are well-known, and I think most people would agree that gambling is for the fiscally challenged.

But when I look at the insurance industry, what I see is an industry — I can't even say it — I see an industry that's based upon probabilities, and people not knowing those true probabilities, and money being made for the house in the same way as you see in a gambling market.

So the question I have for you is, how do you reconcile your views with gambling versus the insurance industry, and is the insurance industry for the fiscally challenged?

WARREN BUFFETT: Well, gambling, I think — I think the distinction that usually is made is that gambling involves creating risks that don't need to be created.

I mean, if the — you want to go out and gamble on where a little ball is going to fall on a wheel that's revolving, that is not something that — that is a created risk.

Whereas, if you've got a home or a business, you know, on a coastal area, the risk is there.

It wasn't created intentionally — I mean, you say you built in that place, but — and then the question is who bears it. So there's a transfer of — in the case of cat coverage — large existing risks as opposed to the creation of a risk that is not required.

I mean, you can watch a football game without betting on it. But you can't live in a house, you know, on a Florida coast without having a risk that your entire investment disappears.

So that's the distinction, basically. I hope you're right that the house wins in both cases. (Laughter)

Charlie?

CHARLIE MUNGER: Well, I don't think I can add to that either. The whole concept of house advantage is a very interesting one in modern commerce.

A lot of the investment management operations, which were not ordinarily spoken of in the past in croupier terms — but the terms of a lot of private equity investment now —

I think the proprietors of the partnerships are taking a house edge that looks a lot like the rake of the croupier in Monte Carlo, except it's bigger. (Laughter)

WARREN BUFFETT: Is there anyone we've forgotten to insult? (Laughter)

Want to make sure we don't miss anyone here. (Laughs)

24. Selling short isn't unethical, but it's tough to make money

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: I'm Tom Nelson (PH) from North Oaks, Minnesota.

What are your thoughts on the issue of illegal naked short selling?

WARREN BUFFETT: Well, as you know, I — you may know — I have a friend that's been fairly outspoken on that. And we — from our standpoint — we have no objection to anybody selling Berkshire short at all.

The more shorts, the better, because they have to buy the stock later on. And some of our shareholders may make some money lending — we — Charlie and I can't do it, but there's nothing I would love better, if it were legal, than to lend my stock to shorts and have them pay me something for doing it.

I might want to get prepaid, in certain cases. The — (Laughter)

There's nothing evil, per se, about — in my view — about selling things short.

I would say that it's a very, very tough way to make a living.

It's not only often painful financially, it's very painful emotionally because it — a stock that you sell short — a stock that you buy at 20 can go down 20 points, and a stock that you sell short at 20 can go up an infinite amount.

And you don't think about that until you've gone short and it goes up 10 or 15 points, and then you don't sleep very well. So it's a very tough way to make a living.

There are people on the short side that have done, and that do things, to try to make stocks go down, some of which are appropriate and some of which are inappropriate. There are people on the long side that have done the same exact — the same sort of things go on.

So I don't see any — I have no ax to grind in the least against short sellers.

And in terms of — it's called naked shorting, which you — which means that you don't have the stock lined up to be borrowed and maybe you have a whole bunch of fails-to-deliver and that sort of thing.

I don't have a great problem with that. If anybody wants to do that with Berkshire, you know, they — more power to them.

Short sellers — the situations in which there have been huge short interests very often — very often have been later revealed to be frauds or semi-frauds. Now, the one my friend runs is not at all.

But the — the batting average — I mean, I've — over the years, I've probably had a hundred ideas of things that should be shorted, and I would say that almost every one of them have turned out to be correct.

And I'll bet if I'd tried to do it and make money out of it, I probably would have lost money, I would have had no fun, and the opportunity cost, as Charlie said, would have been enormous.

Because if somebody's running something that's semi-fraudulent, they're probably pretty good at it and they're working full time at it and they've succeeded for a while and they may keep succeeding.

And if they succeed and you go in at X and it goes to 5X, you know, all you're hoping after a while it that it goes back to X again or something of the sort.

It's a very tough psychological game to play. Few people may be well-suited for it.

I would never put any money with a short fund, but not because I would think it would be ethically wrong. I just think they're unlikely to make money.

Charlie, do you have any thoughts on short selling or naked short selling?

CHARLIE MUNGER: Well, I think you're absolutely right there — in the sense that it's — that would be one of the most irritating experiences in the world, to figure out something is crooked and foolish and so forth and then short it at X and have it go to 3X.

Now you're watching all these happy crooks splashing around in your money while you're meeting margin calls. (Laughter)

Why would you want to go in hailing distance of an experience like that?

WARREN BUFFETT: Well, we've hit 3 o'clock. We're going to adjourn until 3:15. We will then have the business meeting of Berkshire. And you're all welcome to stay, you're all welcome to shop, you're all welcome to enjoy Omaha, and thanks for coming. (Applause)

25. Berkshire formal business meeting

WARREN BUFFETT: OK. We'll now convene the business part of the meeting. I introduced the directors to you before.

Also with us today are partners in the firm of Deloitte & Touche, our auditors. They're available to respond to appropriate questions you may have concerning the firm — their firm's — audit of the accounts of Berkshire.

Mr. Forrest Krutter, the secretary of Berkshire, will make a written record of the proceedings. Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at this meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 8, 2006 — being the record date for this meeting — there were 1,260,704 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 8,407,392 shares of Class B Berkshire Hathaway stock outstanding, with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 1,096,383 are represented at this meeting by proxies returned through Thursday evening, May 4.

WARREN BUFFETT: Thank you. That number represents a quorum, and we will therefore directly proceed with the meeting.

First order of the meeting will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: Motion has been moved and seconded. Are there any comments and questions?

We will vote on this motion by voice vote. All those in favor, say “aye.”

VOICES: Aye.

WARREN BUFFETT: Opposed? Motion is carried.

26. Election of Berkshire directors

WARREN BUFFETT: The only item of business before this meeting is to elect directors.

If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so. If you wish to do this, please identify yourself to meeting officials in the aisle, who will furnish a ballot to you.

Those persons desiring ballots, please identify themselves so that we may distribute them.

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WARREN BUFFETT: I move that Warren Buffett, Charles Munger, Howard Buffett, Malcolm Chace, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Thomas Murphy, Ron Olson, and Walter Scott be elected as directors.

VOICE: Second the motion.

WARREN BUFFETT: It’s been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Malcolm Chace, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott be elected as directors.

Are there any other nomination? Is there any discussion?

Nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections the ballot on the election of directors voting and the proxies in accordance with the instructions they have received.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballots of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 1,125,034 votes for each nominee.

That number far exceeds the majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren Buffett, Charles Munger, Howard Buffett, Malcolm Chace, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott have been elected as directors.

27. Formal business meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn? If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move that this meeting be adjourned.

VOICE: Second.

WARREN BUFFETT: Motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say “aye.”

VOICES: Aye.

WARREN BUFFETT: All opposed say “no.” The meeting is adjourned. Thank you. (Applause)

Morning Session - 2007 Meeting

1. Jimmy Buffett sings "Berkshire Hathaway-ville"

ANNOUNCER: And now, please welcome the charming, insightful, witty, rather brilliant, debonair, influential, well-heeled yet down-to-earth, talented, surprisingly modest, handsome, and refined exemplar of unflappable character, Mr. Buffett.

(Applause and cheers as musician Jimmy Buffett comes on stage with a guitar)

JIMMY BUFFET: Who were you expecting? My junior partner? (Laughter)

For those of you who don't know, I'm the distant cousin, Jimmy Buffett.

This would be a good day to rob a bank in Omaha. Everybody's here, you know, so — (Applause)

I couldn't be around for the game with LeBron James. I was busy working on my wardrobe for this surprise appearance.

This is my first time in the Qwest Center, so I feel very at home in large spaces like this. It's great to be back in Omaha. (Applause)

That's the good news.

The disturbing news is, as a long-time Berkshire Hathaway stockholder and shareholder, the big question is, you know, those guys are getting up in age, you know, Charlie and Warren.

Who are they going to leave it to?

Well — (laughter) — I got news for you. We did a genetic test, Warren and I did. You won't see that in your program or in the shareholders report. And somewhere back about 6,000 years ago, in some ancient village in Scandinavia, they were trading Buffett genes, and I got the talent. He got the business.

So, later on in life, after Doris [Buffett, Warren's sister] introduced us — I don't know, 30 years ago — I started figuring out, so I better get that business thing going as well.

So, since blood is thicker than water, I am your new chairman. So, I hope you like that. (Applause)

Don't run out to sell. I'm keeping my mine. (Laughter)

So, on the way out here on the plane, I figured — it was an interesting day, if you read The New York Times business section yesterday. There was a lot going on.

So, I thought I would — this song has done very well for me, so I thought I would bring this for my first appearance in Omaha at the Qwest Center — I would rewrite a little “Margaritaville” with a little Berkshire — well, actually we’re wasting away in Berkshire Hathaway-ville this — today.

I’ve never sung this early in the morning, except on the [NBC] “Today” show, so you’re not paying, so don’t worry about it, so — (Laughter)

Don’t worry, I’m a semi-professional. This is OK.

I will be looking at these notes. As you can tell, Warren gave me a really big budget for a teleprompter here. (Laughter)

All right. So, you can sing along if — but you will not know — you’ll know a few of the words to these songs. But then I’ll try to do this slowly, and I have my bifocals, so I think we’re in good shape here, so —

We’ll start the morning off with a little hymn.

(Singing to the melody of “Margaritaville”)

Nibblin’ on sponge cake,

And Omaha beef steak,

Watchin’ you stockholders buying the rounds.

The Qwest Center’s rockin’,

The press is all blockin’.

There isn’t a doubt

Warren’s big in this town.

Wastin’ away in Berkshire Hathaway-a-ville,

Searchin’ for my lost box of See’s.

Some people claim that Charlie Munger’s to blame,

And you know, Rupert Murdoch is peeved.

From World Books to sofas,

Jet planes, diamonds, and (inaubible),

(Inaudible) in euros,

Let’s not forget euros.

(Spoken)

Uh oh. I made a mistake here. All right. Hold on.

You won’t pay for that, OK?

Are you going anywhere? We’ll start again.

From — from —

Let me get these bifocals off here.

(Singing)

From World Books to sofas,

(Inaudible) and (inaubible),

Jet planes, diamonds, and underwear cover the floor.

(Spoken)

It was the Fruit of the Loom that got me.

(Singing)

Tool books (inaudible).

Let’s don’t forget euro,

Make all those —

(Spoken)

Oh, this is a good line. I got to —

(Singing)

Make all those hedge funders

Want to go and buy stores.

Wastin’ away again in Berkshire Hathaway-ville,

Searchin’ for some good companies to buy.

Some people claim privatization’s to blame,

But we know, this holding company’s on fire.

So, who was the wizard,

Who thought up the lizard,

To sell car insurance to humans while making some jokes?

Projects we’ll surmount,

But I still want that discount.

Can someone show me where they’re sitting those rich Geico bulbs?

Wastin’ away again in Berkshire Hathaway-ville,

Searchin’ for my lost shaker of salt.

And some people claim that Doris Buffett’s to blame,

But I know this is all Warren’s fault.

And some people claim that ukulele’s to blame,

If there’s a God, he’ll turn that thing into (inaubible).

(Applause)

(Spoken)

All right.

So you thought I was kidding about that running the company stuff, didn’t you?

So — I was. (Laughs)

That's a big relief there. So, with a great bit of pride and admiration, please welcome my junior partners, Warren and Charlie. (Applause)

WARREN BUFFETT: Separated at birth. Separated at birth. (Laughs)

Thanks, Jimmy.

JIMMY BUFFETT: All right.

WARREN BUFFETT: OK.

I actually had asked Charlie to do that number — (Laughs)

2. Opening remarks

WARREN BUFFETT: Got a lot of people to thank, starting off with Jimmy. Wonderful.

We hid him out — came in last night kind of late and we — to be sure it was a surprise, we stashed him away over at the Hilton, and I just want to say thanks to him.

We both got the commercial gene, but unfortunately, he got the singing gene. I got this voice you're hearing.

We — the movie, as we mentioned, we get a lot of help from a lot of people. They all do it just for the fun of it.

I particularly want to thank Andy Heyward of DIC who did that cartoon. He's done them now for a number of years. They come back here to get my voice recorded and to get Bill's [Gates] voice and Charlie's voice. They do it all themselves just to participate in the movie.

Andy and I — I'm working with Andy on a cartoon series that will be out pretty soon, which we're aiming toward younger people to try and work a little financial education into a good time on Saturday morning for kids.

And we'll see how that all comes out. But Andy is wonderful to work with. It's been — (Applause)

WARREN BUFFETT: My daughter Suze puts that movie together. It's a lot of work and it's a labor of love. She does a terrific job, and I just want to thank her for — as usual. (Applause) Thank you.

WARREN BUFFETT: Then finally I want to particularly thank the grand impresario of this whole affair is Kelly Broz.

And Kelly puts this all together, the exhibition hall. I just turn it over to her. I forget about it, and Charlie and I just show up on Saturday morning.

And Kelly is having her 50th birthday tomorrow. So, Kelly, would you stand up and take a bow, please. Yeah.

(Singing) Happy birthday to you. Happy birthday to you. Happy birthday, dear Kelly. Happy birthday to you.

For Kelly. (Applause)

WARREN BUFFETT: Now, today we're going to follow the usual format. We have a number of microphones placed around this room and we have overflow rooms. We will go from one station to the other, keep going until about noon or thereabouts, and then we'll break for 30 or 45 minutes for lunch.

We'll come back here, and we will then go until about 3 o'clock, continuing the same routine.

We don't prescreen the questions or the questioners. It's whoever got in line first for the microphones.

At 3 we will take a break for a few minutes. We will reconvene at 3:15 for the official business meeting.

We have an item of business — normally we take care of business in about five minutes, re-elect the directors. But today we have an item on the proxy relative to our holdings of PetroChina.

We were not required to put that on the ballot. The SEC told us we didn't have to, but we really thought it would be a good idea to do it so that all of you that are interested can hear about our reasoning and the reasoning of the people who disagree with us. We'll give them plenty of time to tell you why they think we're wrong and we'll respond.

And I hope anybody that's interested at all on the subject, I hope you stay right until 4 o'clock when we will adjourn, because Charlie and I are then going to greet, perhaps, as many as 600 shareholders who have come from outside of North America.

We have a record number. I think we have a hundred or so from Australia, and we have close to that number from South Africa.

We have shareholders from all over the world. So we feel if they come all the way to Omaha, Charlie and I would at least like to shake their hands, and we have that from about 4 till 6:00 o'clock, and then we'll be doing some other things this evening.

But that is the drill for this meeting. We won't elect the directors until the regular meeting, which commences at 3:15, but I would like to introduce them at this time and we have a few special announcements in that connection.

3. Berkshire directors introduced

WARREN BUFFETT: But we start off — this is Charlie, this fellow that's been making all the noise over here. (Laughter)

He's quite hyperkinetic. But we seem — I think he's on his medicine. (Laughter)

Charlie, incidentally, can hear quite well and I can see, so we work together. I have a little — I thought I was doing pretty well when I remembered his name, actually.

But our combined ages are 159 for those of you who can't work with big numbers.

So Charlie. And then we have — and if you'll stand as I read your name — Howard Buffett. (Applause)

Bill Gates. (Applause)

Sandy Gottesman. (Applause)

Charlotte Guyman. (Applause)

A former Omahan, Don Keough. (Applause)

Tom Murphy. (Applause)

Ron Olson. (Applause)

And a lifetime Omahan, Walter Scott. (Applause)

Now, in addition, we have with us a director whose family has been involved with Berkshire Hathaway and its predecessor companies for over a hundred years. His father played a very key role in Buffett partnership obtaining control of Berkshire Hathaway in 1965.

He was supportive in every possible way, as his father, and now his son. And Kim Chace has been on our board for a great number of years. He's been a — just like his father before him, he's been a wonderful director.

He's been a great friend. He will be leaving the board this year, but Kim is here with his family and, Kim and the family, if you would stand up, I'd like the shareholders to recognize you. (Applause)

WARREN BUFFETT: And then finally we will have a new director get elected, and I've got the votes in my pocket so there's no question about it, and that is Sue Decker. And, Sue, if you will, please stand. (Applause)

4. Q1 earnings are "good"

WARREN BUFFETT: Just one or two items of business the — before we start the questioning.

We did report our earnings yesterday after the close, and I can't see the — are they up on the monitor?

But it was a good first quarter. We had a good year last year. The insurance earnings are going to go down. There's no question about that. How much they go down depends on Mother Nature and a few other factors.

But it's been an extraordinary period for insurance. I mean, nothing bad happened last year, and the same was true in the first quarter.

As you might expect, that favorable experience has caused people to lower prices in some areas quite dramatically. And the nature of insurance, if you write a one-year contract, say, six months ago, you were still getting premium at the old rate, if you write at a one-year policy, for another six months.

So there's a lag effect when things are getting either better or worse. And the lag effect from this point forward, we will — our insurance rates results will show the effect of lower prices.

They will probably show — certainly we have the most benign hurricane season imaginable last year. We have less hurricane exposure that we've written this year but, nevertheless, as natural catastrophes occur we will be paying out lots of money if and when they occur.

It couldn't get any better than it was last year from our standpoint. So things in the insurance world, our insurance earnings, underwriting earnings, are bound to decrease.

Now, what we really hope over time is more or less to break even on the underwriting of insurance. So when you see a significant profit like last year or underwriting profit this year, just look at that as kind of the good side of what will later be an offset to it in a way of an underwriting loss.

But if we break even in insurance on underwriting, we do very, very well because we generate lots of float and we earn money on that float and our float is at an all-time high.

So this is really the frosting on the cake when we have an underwriting profit, and it's not to be expected to necessarily — well, it won't occur year after year. Ever since we've been in the insurance business, about half the years we've made money underwriting and half we haven't.

I think our mix of business now is such that we'll even maybe do a touch better than that in the future, but we won't do anything like what we did in the last year and in the first quarter this year.

There's one unusual item in our balance sheet that you should be aware of. March 31, you'll see our receivables went up by about $7 billion. That was because of the Equitas transaction I described in the annual report.

On March 31st, the deal, basically, was closed at the end of the quarter. So we had a receivable of 7 billion, and then a couple of days later we were given 7 billion of cash and securities. So that receivable very quickly turned into liquid assets, cash.

And we sold all those securities we got. So we had 7 billion transferred from receivables to cash very early in April.

Other than that, most of our noninsurance businesses did fine. The residential construction-related businesses are getting hit, in some cases getting hit very hard, and in some cases getting just — but still reflecting decreases in their business.

And my guess is that that continues, perhaps, for quite a while. So you will see lower earnings coming from the companies that are related to residential construction such as Shaw, Johns Manville, ACME Brick, and that group.

But overall, compared to the companies they compete with, our managers continue to do an absolutely sensational job.

We have the greatest group of managers and, for that matter, we've got the greatest group of stockholders, of any company I know of in the world, and Charlie and I are very grateful.

You saw in the movie Charlie and I going over there to give the fellows in Israel a lot of advice on how to run their operation better.

And Charlie might want to — you might want to comment on ISCAR.

CHARLIE MUNGER: Well, that was a great experience, and ISCAR is a very great company. I have never seen anything as automated as that ISCAR operation. I think they regard it as a disgrace if any human hand has to do anything.

WARREN BUFFETT: We bought it without looking at it, but after we looked at it, we really liked it. (Laughter)

For those of you who won't be around for the 3:15 — and I hope everybody that's interested sticks around for that — it will be an interesting discussion.

But we do have a preliminary vote. Again, I can't see the vote up there. But, [CFO] Marc [Hamburg], is the vote up there? Unable to hear anything there, but I assume it.

The — basically, I can't see it from here, but it's about 2 percent are in favor of the resolution and about 98 percent opposed. And that was true of both the A and the B stock.

So there really wasn't any great difference in the way people voted on the proposal. And even if you leave out my personal vote, which was against, it's about a 25-to-one margin that voted in opposition to it.

And anybody that wishes to vote in person or to change their vote, be sure and stay for the meeting at 3:15, and I think you'll find the discussion very interesting if you care to stay.

5. Buffett sees no private equity "bubble" about to burst

WARREN BUFFETT: Let's get a map here. Here we are. We will start with area 1, which I think is over here, and there we are and we have a questioner.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Kevin Truitt (PH) from Chicago, Illinois.

Thank you both for, again, hosting this "Woodstock for Capitalists" for your shareholders and fellow capitalists. I have two questions. My first question is for both Mr. Buffett and Mr. Munger.

WARREN BUFFETT: I don't like to interrupt you, but we're only letting everybody do one question, so pick whichever one you feel the strongest about getting an answer for, please.

AUDIENCE MEMBER: OK. First, given the ocean of equity money that is out there — private equity money — that is out there today chasing deals, and with the quality of the deals continually diminishing as the quantity of good deals continues to go down, and given the fact that these private equity funds are getting their equity portion of the money from pension funds and college endowments and using very high levels of borrowed money from the banks, this has the look, feel, and smell of a bubble that is about to burst and is likely to end badly for many of the deal-makers and the investors.

What events, in your opinion, could cause this bubble to burst, and how do you think this is likely to all end?

WARREN BUFFETT: Well, as you were reading off that list, we are competing with those people, so I started to cry as you — (laughs) — explained the difficulty we have in finding things to buy.

The nature of the private equity activity is such that it really isn't a bubble that bursts.

Because if you're running a large private equity fund and you lock up $20 billion for five or longer years and you buy businesses which are not priced daily, as a practical matter, the plug will not — even if you do a poor job, it's going to take many years before the score is put up on the score board, and it takes many years, in most cases, for people to get out of the private equity fund even if they wished to earlier.

So it does not — it's not like a lot of leverage can lead to in-marketable securities or something there. And the investors can't leave and the scorecard is lacking for a long time.

What will slow down the activity — or what could slow down the activity — is if yields on junk bonds became much higher than yields on high-grade bonds.

Right now the spread between yields on junk bonds and high-grade bonds is down to a very low level, and history has shown that periodically that spread widens quite dramatically.

That will slow down the deals, but it won't cause the investors to get their money back.

There's one other aspect, of course, that — of this frenzied activity, you might say, in private equity is that if you have a $20 billion fund and you're getting a 2 percent fee on it or $400 million a year, which seems like chump change to those that are managing them but sounds like real money in Omaha — if you're getting 400 million a year from that $20 billion fund, you can't start another fund with a straight face until you get that money pretty well invested.

It's very hard to go back to your investors and say, well, I've got 18 billion uninvested and I'd like you to give me money for another fund.

So there's a great compulsion to invest very quickly because it's the way to get another fund and another bunch of fees coming in.

And those are not competitors for businesses that Charlie and I are going to be particularly effective in competing with.

I mean, they — we are going to own anything we buy forever. The math has to make sense to us. We're not given to optimistic assumptions, and we don't get paid based on activity.

But I think it will be quite some time before — it's likely to be quite some time — before disillusionment sets in and the money quits flowing to these people that are promoting these. And whether they can continue to make deals will depend on whether people will give them lots of financing at what I would regard as quite low rates.

Charlie?

CHARLIE MUNGER: Yeah. It can continue to go on a long time after you're in a state of total revulsion.

WARREN BUFFETT: The voice of optimism has spoken. (Laughter.)

6. I didn't do enough to "sell" Berkshire internationally

WARREN BUFFETT: We'll go on to 2. And I should have mentioned at the start. We really only take one question per person because there's a lot of people waiting and some people get very talented about rolling four or five into one, but we — we've gotten more talented about unraveling them, so try to keep it to one. Area 2, please.

AUDIENCE MEMBER: Greetings to all of you from the Midwest of Europe from the city of Bonn in Germany.

My name is Norman Rentrop. I'm a shareholder in Berkshire since 1992, as well as a shareholder in Wesco and Cologne Re.

I'm a great admirer of both of you and want to thank you again for sharing your wisdom with us and for continuing to stay humble by managing Berkshire for the benefit of all of us without any big 2 and 20 percent fees, without stock option plans. (Applause)

WARREN BUFFETT: Be careful. You're giving Charlie ideas here. (Laughter)

AUDIENCE MEMBER: And I want to applaud you in setting another great example by donating most of your wealth to charity and for donating — (applause) — and for donating it in a very intelligent and selfless — that it's not your name on the foundation — way.

Now, I'm a little disturbed by the remarks from another great investor, from John Templeton, who continues to say that you are narrow-sighted in not investing more overseas.

You do focus on the U.S. with relatively little, so far, internationally. You explained that it doesn't really matter whether a company is headquartered in the U.S. or London or Munich or Paris, and that you would pay almost as high an amount for such companies as for similar U.S. companies.

You were audacious to invest your petty cash in South Korean stocks.

Coca-Cola went totally global many years ago; whereas, Hershey's missed the opportunity to go global, leaving the chocolate globalization to Swiss-based Lindt & Sprungli.

Now, what would it take you to go totally global with Berkshire by investing internationally in a big way?

WARREN BUFFETT: Well, that's a very good question. And I would say that I know I probably bought my first stock outside the United States at least 50 years ago.

It is not that we have not looked in the marketable securities field beyond this country, and we've made some investments there.

It really wouldn't make any difference to us if Coca-Cola was based in Amsterdam or Munich or Atlanta as long as they had the business they had.

So we're very involved in international business, but the hard fact is that in terms of buying entire businesses, we were simply not on the radar screen to the same extent — close to the same extend —outside the United States as we became in the United States.

When we started in the United States, really, nobody knew anything about Berkshire, either, so we had — we had a selling job to do here, but we did not do the selling job — or I did not do the selling job — well abroad.

And thanks to Eitan Wertheimer, he found us. And I think has contributed in a very significant way to getting us better known.

We have no bias against buying either marketable securities or entire businesses outside the United States.

Eitan is even planning a little procedure to get us even better known — get Berkshire even better known — outside the United States, and I'm going to participate in that with him within the next six or eight months.

But we can be very validly criticized for not being a better effort to get on that radar screen.

I think we're — I think it's improving. We own a number of non-U.S. securities. We own stock in — just stock, marketable securities — we own two that are based in Germany, and we own others — as it's been pointed out — we own, for example, 4 percent of POSCO, which is based in South Korea. That's over a billion-dollar investment at current market.

And we have — I can think of a half a dozen or so marketable securities investments outside the United States.

We don't have to report those in the 13F — I believe I'm right on this, [CFO] Marc [Hamburg] — so they don't necessarily get picked up the same way as do our domestic investments by reports we make to the SEC.

There's a problem — for example, in Germany we have to report our holdings in Germany if our holdings exceed 3 percent.

Well, if you're talking about a company with 10 billion in market value, that means at $300 million we have to tell the world what we're buying, and telling the world what we're buying is not the favorite activity of Charlie and myself.

So — and it tends to screw up future buying. So that 3 percent threshold, which exists in the UK, exists in Germany, is a real minus to us, in terms of accumulating shares.

But I can assure you that the entire world is definitely on our radar screen, and we hope to be on its.

Charlie?

CHARLIE MUNGER: Well yes. I'd say that John Templeton made a fortune going into Japan very early and having the Japanese stocks go up to 30 or 40 times earnings.

And that was a very admirable piece of investment. But, you know, we did all right in the same period. (Applause)

7. CEO compensation is a "joke"

WARREN BUFFETT: Let's go to station 3, please.

AUDIENCE MEMBER: Hi. (Inaudible). I lived most of my life in India, but now in Hoboken, New Jersey.

Warren, first thank you for replying to my letter. I misspelled your name, and where I come from if I did the same thing, the reply would have been, more on, get my name correct before asking a question. So thank you once again.

Investment managers nowadays are benefiting a lot more at the expense of the investors and the (inaudible).

My question is both to you and Charlie is, what do you think is the best structure/fees that managers should have that will give him an opportunity to maximize the time (inaudible) and money (inaudible) over the next few decades and being fair to the profession — the investors and himself? Thank you.

WARREN BUFFETT: Before I answer that, I think I should tell you a very short story. It's a little embarrassing, but I got worried a few years ago about Charlie's hearing.

But I mean, the guy's been my pal for 45 or 50 years. I didn't really want to confront him with this apparent evidence of old age.

So I went to a doctor and I said, "You know, I got this good pal. I don't think he's hearing so well. I really don't want to confront him with it, so what do you suggest I do to check this out?"

He said, "Well, stand across the room, talk in a normal tone of voice, see what happens."

So the next time I was with Charlie, I got across the room and I said, “Charlie, I think we ought to buy General Motors at 30. Do you agree?” Not a flicker. Not a flicker.

I went halfway across the room. I said, “Charlie, I think we ought to buy General Motors at 30. Do you agree?” Nothing changes.

Get right next to him, put my voice in his ear and said, “Charlie, I think we ought to buy General Motors at 30. Do you agree?”

Charlie said, “For the third time, yes.” (Laughter)

So, Charlie, would you like to address that question? (Laughter)

CHARLIE MUNGER: Yes. The question addressed the problem of unfairness of executive compensation and the effects of that unfairness on investors. And now that you know the question, you can solve the problem. (Laughter)

WARREN BUFFETT: Well, Charlie and I have plenty to say about compensation, and some of it makes our stomach turn.

I will say this, though. There are more problems with having the wrong manager than with having the wrong compensation system.

I mean, it is enormously important who runs — you name the company — Proctor & Gamble, Coca-Cola, American Express — and any compensation sins are generally of minor importance compared to the sin of having somebody that’s mediocre running a huge company.

That said, Charlie and I think that compensation has — there’s a natural tendency — because of ratcheting, because of the publicity of what other people get, and because of the lack of intensity in the bargaining process.

I mean, you read about labor contracts, you know, where impasses go on for weeks and where they negotiate till 3 in the morning and, you know, both sides take their case to the press and everything.

I ask you, when have you heard of a comp committee, you know, working until 4 in the morning, declaring an impasse for a week, not being able to make a deal?

It just doesn’t happen because the CEO cares enormously how he or she is paid, and to the comp committee — and they’re doing, perhaps, a little better job now — but it’s basically play money.

And, of course, as I’ve pointed out in the past, I’ve been on 19 boards. They put me on one comp committee and they regretted it subsequently.

You know, they are looking for cocker spaniels with their tails wagging to put on comp committees and, you know, they're not looking for Dobermans.

And I try to pretend I'm a cocker spaniel just to get on one, but it doesn't work. (Laughter)

But it is not — there is not a parity of intensity in the bargaining process. One guy cares enormously and the others don't.

And as Charlie has pointed out in the past, what really drives a lot of this ratcheting impact is envy.

I saw that on Wall Street. You can talk about greed, but if you paid somebody $2 million, they might be quite happy until they found out the guy next to them made 2 million-one, and then they were miserable.

And Charlie has also pointed out that envy, of the seven deadly sins, is probably the dumbest, because if you're envious of somebody, you feel terrible and, you know, the other guy isn't bothered at all.

So all you get out of envy is this miserable grinding in your stomach and all that sort of thing.

You know, compare that to some of the other sins like gluttony, which we are about to engage in. (Laughter)

You know, there's some upside to gluttony. I'm told there's upside to lust, but I'll leave that to Charlie to explain. (Laughter)

But envy, where the hell is the upside, you know? But it does produce this ratcheting effect in pay.

The comp committee sits down. The human relations person comes in. The human relations person knows what the CEO thinks of them is going to determine their future, and the human relations department recommends some comp consultant. The comp consultant knows that his recommendation to other firms is dependent on what these people say about him.

So under those circumstances, you know, can you imagine that it's anything like a fair fight? It's a joke.

Charlie?

CHARLIE MUNGER: Yes. The process is contributed to by a wonderful bunch of people called compensation consultants.

And that reminds me of the old story where the mother asked the child why she told the census taker that the man of the house was in prison for embezzlement. And the child said, "I didn't want to admit he was a compensation consultant." (Laughter)

WARREN BUFFETT: We'll get around to the rest of you later on, too. Don't feel smug because we haven't attacked your —

I just had a note handed to me. We do have about 27,000 people here. The overflow rooms are full, and we will have a whole bunch in the exhibition hall as well. (Applause)

8. Corporate jets can be good

WARREN BUFFETT: Let's go to number 4.

AUDIENCE MEMBER: Yes. Good morning. I'm Rob (inaudible). I'm from the UK, and I traveled from Switzerland to be here today.

This is a question that Charlie will like. There's a study by David Yermack that companies with private jets underperform their peers by 4 percent.

What is the yardstick that you use to judge whether people are good stewards of money — management?

WARREN BUFFETT: Did he direct that to you, Charlie?

CHARLIE MUNGER: Well, he referred to private jets being a possible indication of executive excess.

I want to report that we're solidly in favor of private jets. (Laughter)

WARREN BUFFETT: We even pay for them ourselves. (Laughs)

Charlie used to only — he traveled on the bus, and only then when they offered a senior citizen's discount.

But in recent years I've shamed him into getting his own NetJets share — I have my own — I have two NetJets shares.

Actually, Berkshire is significantly better off in a number of its businesses, and including at the corporate level, because we use corporate jets.

I don't know which deals wouldn't have been made, but I do know that — excuse me — I would not have had the same enthusiasm for traveling thousands of miles to go after deal after deal and so on.

And I see what it produces at our — a number of our other businesses. So it has been a valuable business tool.

It can be misused like anything else. I remember many, many years ago, we owned stock in a public company, and the CEO stopped off in Omaha on the way to see me, and he explained that they use some grocery chain in Idaho or something to be sort of their test case on all new products.

And they would go visit it because they also had this lodge out there. I mean, you can abuse any system. But properly used, I would say that corporate jets have been a real asset to Berkshire.

I would go back to this comp question just one second, too.

I mean, comp is not rocket science. I mean, we have very simple systems that compensate those people whose pictures you saw during the movie.

They're terrific people. We compensate them based on things that are under their control and that we care about. And we don't make it complicated, and we don't pay them for things that are happening that they have nothing to do with.

I mean, we talked last year about what you do in a commodity business like copper, oil. I mean, if oil goes from $30 to $60 a barrel, there's no reason in the world why oil executives should get paid more for what's going on. They didn't get it to $60 a barrel.

If they have low finding costs, which is under their control, and which is important, I would pay like crazy for that, because a person who finds oil and develops reserves at $6 a barrel is worth a lot more than somebody that finds and develops them at $10 a barrel, assuming they're similar quality reserves.

That is the job that you hire the person for. But the price of oil, they've got nothing to do with it, and to hand them huge checks because oil goes up or to cut them back because it goes down — if oil went down and somebody had the lowest finding costs that was working for us, we would pay them like crazy.

Charlie?

CHARLIE MUNGER: Yeah. Well, I'd like to go back to that corporate jet thing.

If the trappings of power are greatly abused, I think you would find a correlation that some of those companies would be disappointing to investors.

And, you know, man has known for a long time that getting too enchanted with the trappings of power is counterproductive.

The Roman emperor that's most remembered as presiding over a period of great felicity was Marcus Aurelius, who was totally against the trappings of power even though he had them all — he had all the power.

So I think all these things can be abused, and I think the best way to tackle a subject is to provide examples of contrary behavior.

WARREN BUFFETT: Charlie, have a (inaudible) —

CHARLIE MUNGER: I think I'll go over here.

WARREN BUFFETT: This is our idea of corporate benefits up here, lots of fudge, lots of peanut brittle. I recommend the diet to everyone.

9. "Extraordinary" things can happen when people panic

WARREN BUFFETT: Let's go to number 5.

AUDIENCE MEMBER: David Winters, Mountain Lakes, New Jersey.

Could you please explain what you believe the impact and, hopefully benefit, of a credit contraction would be on Berkshire Hathaway, and maybe higher interest rates as well?

WARREN BUFFETT: Well, we do benefit when others suffer.

That doesn't mean we enjoy their suffering, but times of chaos in financial markets, the situation that existed in junk bonds in 2002, the situation that existed in equities, you know, back in 1974.

So I don't think you'll necessarily see a contraction in credit. That — I think most authorities are very reluctant to really step on the brakes. You know, it's too easy to figure out who did step on the brakes.

But you could very well see some exogenous event that starts feeding on itself in markets.

In fact, I think it's much more prone to feed on itself in markets than in most periods in the past, if you really got a shock to the system.

And that would result in a huge widening of credit spreads, cheaper equity prices, all kinds of things that actually are helpful to Berkshire because we usually have at least some money around to do something at times like that.

There will be periods like that. If you go back 30 or 40 years, when credit contracted, it just really wasn't available.

Charlie and I went through a couple periods like that. We were trying to buy a bank in Chicago 40 — 40 or so years ago, and the only people that would lend it to us in the world — because banks weren't lending for acquisitions — we found some people over in Kuwait who said they'd lend it to us in dinars.

And we thought, you know, it might be fine to borrow it, but when it came time to pay them back the dinars, they would probably be telling us what the dinar was worth, so we passed on that particular deal.

But you had real credit contractions then. And, of course, the whole reason — not — I would say the major reason the Federal Reserve was established was the huge contractions in credit that were felt, particularly here in places like the Midwest where they were dependent on correspondent banks in the larger cities, and when those banks had problems, the banks here got shut off.

And we really needed a system that would not have that happen except by design. And I would say the Fed, by design, is probably not going to produce any credit crunches.

Charlie?

CHARLIE MUNGER: Well, the last time we had that credit contraction, we made, what, a quick 3 or $4 billion? And we were acting with vigor.

The whole investment world is more and more competitive, and if you talk about a real credit contraction, which gums up the whole civilization, no one would welcome that.

And I would predict that if we ever had a really big credit contraction after a period like the one we're in with all this excess, which is causing so much envy and resentment, that we would get legislation that most of us wouldn't like.

WARREN BUFFETT: There's a book by Jonathan Alter that came out about a year ago that talks about the first hundred days after [President Franklin] Roosevelt took over [in 1933], and by the nature of the book it tells about some of the days before that, too.

But if you want to get an example of — I mean, this country was close to the brink at that point, and, basically, Roosevelt got anything passed he wanted, just as fast as they could write the bills there, initially. And that was a good thing, you know, with banks closing and people dealing in scrip and that sort of thing.

So nobody wants that to come back, and we've learned a lot more about that sort of thing since the Great Depression.

I don't think you'll see an orchestrated credit contraction.

Now, you had in 1998, in the fall, when Long-Term Capital Management got in trouble, you had a seize up of the credit markets.

It wasn't an orchestrated by the Fed-type contraction. You simply had people panicked about even the most — even the safest of instruments and credit spreads doing things that they'd never done before.

And that's rather an interesting example, because that was not a hundred years ago. It was less than ten years ago. You had all kinds of people with high IQs in Wall Street. You had all kinds of people with cash available.

And you had some really extraordinary things happen in credit markets simply because people panicked and they felt other people were going to panic. And you get these second- and third-degree type reactions in markets.

We will see that sort of thing again. It won't be the same but, you know, as Mark Twain said, history doesn't repeat itself but it rhymes. And we will have something that rhymes with 1998.

10. Munger reminds people "too much of John Adams"

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Hello. My name is Andrew Paullin (PH), a former Michigander now from Woburn, Massachusetts.

My question is for Charlie, though Warren, please add your thoughts as well.

Charlie, you were quoted in "Poor Charlie's Almanack" as saying, quote, "Ben Franklin was a very good ambassador and whatever was wrong with him from John Adams' point of view probably helped him with the French," end quote.

If you are willing, I'm curious to hear your additional thoughts regarding John Adams and his wife, Abigail Adams.

CHARLIE MUNGER: Well, of course, they were wonderful people, both of them. And —

WARREN BUFFETT: Did you know them personally, Charlie? (Laughter)

CHARLIE MUNGER: No. No.

But if you wanted to have a really jolly evening, I would have taken Franklin every time. And the French love Franklin.

I think I remind many people too much of John Adams and too little of Ben Franklin. (Laughter)

WARREN BUFFETT: He does pretty well in respect to Ben Franklin, too

11. Corporate profits can't stay at record highs

WARREN BUFFETT: Let's go to number 7.

AUDIENCE MEMBER: My name Takashi Ito (PH) from Japan.

In addition to the global excess liquidity, corporate profits are very high compared to the share of labor. Does that make it extra challenging for you to find investment opportunities? Thank you.

WARREN BUFFETT: Yes, corporate profits in the United States are — except for just a very few years — are record, in terms of GDP.

I've been amazed that after being in a range between 4 and 6 percent of GDP, they have jumped upward. And — (coughs) — you would not think this would be sustainable over time.

Excuse me just one second. Charlie, want to talk for a second? (Laughter)

You've just heard him on the subject.

But corporate profits, when they get up to 8 percent plus of GDP, you know, that is very high. And so far it has caused no reaction.

One reaction could be higher corporate taxes. You have lots and lots of businesses in this country earning 20 or 25 percent on tangible equity in a world where long-term bond rates are 4 3/4 percent — government bond rates.

That's extraordinary. If you'd read an economics book 40 years ago and it talked about that kind of a situation persisting, you wouldn't have found a book like that.

I mean, that does not make sense under pure economic theory, but it's been occurring for some period of time and, as a matter of fact, it's gotten more extreme.

Corporate profits continue to rise as a percentage of GDP. That means somebody else's share of GDP is going down.

And you're quite correct that the labor component of GDP has actually fallen fairly significantly.

Whether that becomes a political issue — maybe in the next campaign — whether it becomes something that Congress does something about — Congress has the power to change that ratio very quickly.

Corporate tax rates not that long ago were 52 percent and now they're 35 percent and a whole lot of companies get by with paying 20 percent or less.

So I would say that, at the moment, corporate America is kind of living in the best of all worlds, and history has shown that those conditions don't persist indefinitely.

What brings it to an end, when it happens, I don't know. But I would not expect corporate profits to be eight-and-a-fraction percent of GDP, on average, in the future.

Charlie?

CHARLIE MUNGER: Yeah. Of course, a lot of the profits are not in the manufacturing sector or the retailing sector, either. A lot of them are in this financial sector.

And so we've had a huge flow of profit to banks and investment banks and investment management groups of all kinds, including various kinds of private equity.

And that has, I think, no precedent. I don't think it's ever been as extreme as it is now. Do you agree with that?

WARREN BUFFETT: Yeah. And Charlie and I would have said 20 years ago — and we've done things in banking from time to time, including owning a bank.

But if you had said to us, in a world of 4 3/4 percent long-term governments, will one major bank after another be earning more than 20 percent on tangible equity, dealing in what is basically a commodity — money — we would have said that that condition just wouldn't persist.

Now, part of that is because the banks are geared up more. So if you earn 1 1/2 percent on deposits, you know, and you have — or 1 1/2 percent on assets — and you have assets of 15 times equity, you're going to be earning 22 1/2 percent on equity. And by gearing up more, it does improve the return on equity.

But you still would think that would be self-neutralizing. You'd think that after one guy did it, another guy would do it, and then instead of earning 1 1/2 percent on assets, you'd earn, you know, 9/10 of a percent or 1 percent on assets, but it hasn't happened. It's gone on for a long time.

And, you know, we are living — I'd have to look at a chart on it, but there may have been a year or two post-World War II, but I don't think that — I would bet there haven't been more than two or three years in the last 75 when corporate profits, as a percentage of GDP, have been this high.

CHARLIE MUNGER: Some of this has come from consumer credit, which I think has been pushed to extremes that we've never before seen in the history of this country.

Some other countries that pushed consumer credit very hard had enormous collapses. Korea had one, for instance, that caused chaos for, what, two or three years? Maybe longer. So I don't think this is a time to just swing for the fences.

WARREN BUFFETT: And the chaos in 1997 and 1998 when the IMF stepped in, I mean, it was bad in Korea for a while.

It produced some of the most ridiculously low stock prices that I've ever seen in my life.

In fact, I mean, you could go back to 1932 in this country and you wouldn't have seen things any cheaper. And in the meantime, the companies rebuilt their balance sheets and their earning power.

So things do turn around in financial markets. You will — if you're young enough, you will see everything and then some.

I mention in the annual report, in looking for an investment manager to succeed me, that we care enormously about finding somebody who's not cognizant of everything risky that's already happened, but that also can envision things that have not yet been experienced.

That's our job in the insurance business, and it's our job in the investment business.

And there are a lot of people that just don't seem to — they're not — they're very smart, but they just — they're just not wired to think about troubles that they haven't actually witnessed before.

But, you know, that's the problem Noah had. You know, the first 40 days, it was tough sledding for Noah, but he got revenge eventually.

12. We welcome short-sellers betting against us

WARREN BUFFETT: Let's go to number 8.

AUDIENCE MEMBER: Hello. My name is Brian Bowalk (PH), Fremont, Nebraska.

With the growing number of fail-to-deliver trades happening in our stock markets, including investors' cash accounts, Roth IRAs, and other retirement accounts, it seems like the problem is getting worse.

With some companies being on the Regulation SHO list for hundreds of days, what can be done to make Wall Street deliver stock that they have sold but never delivered? Thank you.

WARREN BUFFETT: Yeah. The so-called fail to deliver and naked shorting, I think is the question. I don't know exact — I've never been in a position where I've asked a broker from whom I bought stock to give me the certificate and have them decline it for any period of time.

I would think that you might have some action against them. But I've never — I do not see the problem at all with people shorting stocks.

I mean, I would welcome people shorting Berkshire Hathaway. I mean, it — if you own stock, and they need to borrow from you, you can get some extra income from your stock. And the one sure buyer of your stock eventually is somebody who shorted it. I mean, that guy is going to buy it someday.

And I have no problem with shorts. If there's some kind of a game that's played — and I've read about it — I've never seen it happen to anything that we've owned.

Like I say, if anybody wants to naked short Berkshire Hathaway, they can do it until the cows come home, and we'll be happy to. We'll have a special meeting for them.

But — and I would say this: the shorts generally have the tougher time of it in this world. I mean, there are more people bowling stocks for phony reasons than there are burying stocks for phony reasons.

So I do not see shorts as any great threat to the world. If enough people shorted Berkshire stock, they would have to borrow it and they would pay you to borrow your stock and that's found money.

We did that on USG. When USG got hammered after they went into bankruptcy — or maybe just before — one large brokerage firm came to us and they wanted us to lend them millions of shares and they paid us a lot of money.

And we happily lent them the stock. We wished they borrowed more. In fact, we insisted that they borrow it for a given length of time just so that we could collect a large premium.

And I don't know how many — I'd have to look it up but — I don't know whether it's in the hundred thousands or, maybe, low millions, but we were better off.

And they didn't do too well shorting USG at $4 a share either, but it was immaterial to us.

So I do not regard — I do not regard shorts as — it's a tough way to make a living.

It's very easy to spot phony stocks and promoted stocks, but it's very hard to tell when that will turn around.

And somebody that's promoted a stock to five times what it's worth, may very well promote it to ten times what it's worth, and if you're short, that can get very painful.

Charlie, do you have any thoughts on shorting?

CHARLIE MUNGER: Well, not on shorting. But those delays in delivering sometimes reflect a tremendous slop in the clearance process, and it is not good for a civilization to have huge slop in the clearance processes for its security trades.

That would be sort of like having a lot of slop in the management of your atomic power plants. It's not a good idea to have slop that causes a lot of financial exposure that people are ignoring.

WARREN BUFFETT: Charlie, reach back into your law practice. If I buy a thousand shares of General Motors, and my broker doesn't deliver it to me, and I ask him to deliver it and he doesn't deliver it to me after a week or two weeks or three weeks, what's the situation?

CHARLIE MUNGER: Well, if you're a private customer, you may wait a while. And a lot of the other trades — the clearance systems do cause people to put up collateral and so on.

But a lot of — take derivative trading. There's a lot of slop in derivative trading. And the clearance problem would be awful if a lot of people wanted to do something at once.

WARREN BUFFETT: But if I demand delivery after three weeks, can I walk into court and say I want my stock, I've given you the money?

CHARLIE MUNGER: I don't think there's any court that can issue you a stock certificate just because you want it.

No, the clearance system is failing you. Why, you can scream a lot, and you may have some ultimate remedy, but there's —

WARREN BUFFETT: I'll get somebody else to represent me. (Laughter)

13. "Gambling is a tax on ignorance"

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Hello, hello. My name is Johann Fortenberg (PH) from Hanover, Germany.

Do you think gambling companies will have a great future? Thank you.

WARREN BUFFETT: What kind of company?

CHARLIE MUNGER: Gambling companies.

WARREN BUFFETT: Gambling companies. Gambling companies will have a terrific future, if they're legal.

You know, which ones or anything, I don't know anything about that.

But the desire of people to gamble and to gamble in stocks, incidentally, too. Day trading, I would say, very often was — came very close to gambling as defined —.

But people like to gamble, you know. I mean, it's a — if the Super Bowl is on — better yet, if a terribly boring football game is on but you don't have anything to do, and you're sitting there with somebody else, you're probably going to enjoy the game more if you bet a few bucks on it one way or the other.

As you know, I mean, we insure hurricanes, so I watch the Weather Channel. But that's a — (Laughter)

It can be exciting. (Laughter)

But people — the human propensity to gamble is huge. Now, when it was legalized only in — pretty much in Nevada — you had to go to some distance, or break some laws, to do any serious gambling.

But as the states learned to — you know, what a great source of revenue it was, they gradually made it easier and easier and easier for people to gamble.

And, believe me, the easier it's made, the more people will gamble.

I mean, when I was — my children are here, and 40 years ago I bought a slot machine and I put it up on our third floor, and I could give me kids any allowance they wanted as long as it was in dimes. I mean, I had it all back by nightfall. (Laughter)

I thought it would be a good lesson for them. Now they weren't going to Las Vegas to do it, but believe me when it was on the third floor, they could find it, you know.

And my payout ratio was terrible, too, but that's the kind of father I was. (Laughter)

The — but gambling, you know, people are always going to want to do it.

And for that reason, I particularly think that access — you know, in terms of friendly gambling or anything like that, I'm not a prude about it, but I do think that to quite an extent, gambling is a tax on ignorance.

I mean, if you want to tax the ignorant, people who will do things with the odds against them, you know, you just put it in and guys like me don't have to pay taxes.

I really don't — I find that — I find it kind of socially revolting when a government preys on the weaknesses of its citizenry rather than acts to serve them. And, believe me, when a government — (Applause)

WARREN BUFFETT: When a government makes it easy for people to take their Social Security checks and start pulling handles or participating in lotteries or whatever it may be, it's a pretty cynical act.

It works. It's a pretty cynical act. And it relieves taxes on those, you know, who don't fall for those or who don't — who aren't dreaming about having a car instead of actually having a car or dreaming about a color TV instead of having one.

So it's not government at its best, and I think other things flow from that over time, too.

Charlie?

CHARLIE MUNGER: You know, I would argue that the gambling casinos use clever psychological tricks to cause people to hurt themselves.

There is undoubtedly a lot of harmless amusement in the casinos, but there's also a lot of grievous injury that is deliberately caused by the casinos.

It's a dirty business, and I don't think you'll find a casino soon in Berkshire Hathaway. (Applause)

14. How to be a better investor

WARREN BUFFETT: Number 10, please.

AUDIENCE MEMBER: Good morning. I'm Thomas Gamay (PH) from San Francisco. I'm 17-years-old and this is my tenth consecutive annual meeting. (Applause)

WARREN BUFFETT: You must be a Ph.D. by now at least.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, I'm curious about what you think is the best way to become a better investor.

Should I get an MBA? Get more work experience? Read more Charlie Munger almanacs or merely is it genetic and out of my hands?

WARREN BUFFETT: Well, I think you should read everything you can.

I can tell you in my own case, I think by the time I was — well, I know by the time I was ten — I'd read every book in the Omaha Public Library that had anything to do with investing, and many of them I'd read twice.

So I don't think there's anything like reading, and not just as limited to investing at all. But you've just got to fill up your mind with various competing thoughts and sort them out as to what really makes sense over time.

And then once you've done a lot of that, I think you have to jump in the water, because investing on paper and doing — you know, and investing with real money, you know, is like the difference between reading a romance novel and doing something else. (Laughter)

There is nothing like actually having a little experience in investing. And you soon find out whether you like it. If you like it, if it turns you on, you know, you're probably going to do well on it.

And the earlier you start, the better, in terms of reading. But, you know, I read a book at age 19 that formed my framework for thinking about investments ever since.

I mean, what I'm doing today at 76 is running things through the same thought pattern that I got from a book I read when I was 19.

And I read all the other books, too, but if you — and you have to read a lot of them to know which ones really do jump out at you and which ideas jump out at you over time.

So I would say that read and then, on a small scale in a way that can't hurt you financially, do some of it yourself.

Charlie?

CHARLIE MUNGER: Well, Sandy Gottesman, who is a Berkshire director, runs a large and successful investment operation, and you can tell what he thinks causes people to learn to be good investors by noticing his employment practices.

When a young man comes to Sandy, he asks a very simple question, no matter how young the man is. He says, "What do you own and why do you own it?" And if you haven't been interested enough in the subject to have that involvement already, why, he'd rather you go somewhere else.

WARREN BUFFETT: Yeah. It's very — that whole idea that you own a business, you know, is vital to the investment process.

If you were going to buy a farm, you'd say, I'm buying this 160-acre farm because I expect that the farm will produce 120 bushels an acre of corn or 45 bushels an acre of soybeans and I can buy — you know, you go through the whole process.

It'd be a quantitative decision and it would be based on pretty solid stuff. It would not be based on, you know, what you saw on television that day. It would not be based on, you know, what your neighbor said to you or anything of the sort.

It's the same thing with stocks. I used to always recommend to my students that they take a yellow pad like this and if they're buying a hundred shares of General Motors at 30 and General Motors has whatever it has out, 600 million shares or a little less, that they say, "I'm going to buy the General Motors company for $18 billion, and here's why."

And if they can't give a good essay on that subject, they've got no business buying 100 shares or ten shares or one share at $30 per share because they are not subjecting it to business tests.

And to get in the habit of thinking that way, you know, Sandy would have followed it up with the questions, based on how you answered the first two questions, that made you defend exactly why you thought that business was cheap at the price at which you are buying it. And any other answer, you'd flunk.

15. When you don't need a huge margin of safety

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, I'm Marc Rabinov from Melbourne, Australia.

I just wanted to ask you, how do you judge the right margin of safety to use when investing in various common stocks?

For example, in a dominant, long-standing, stable business, would you demand a 10 percent margin of safety and, if so, how would you increase this in a weaker business? Thank you.

WARREN BUFFETT: We favor the businesses where we really think we know the answer.

And, therefore, if a business gets to the point where we think the industry in which it operates, the competitive position or anything is so chancy that we can't really come up with a figure, we don't really try to compensate for that sort of thing by having some extra large margin of safety.

We really want to try to go on to something that we understand better. So if we buy something like — See's Candy as a business or Coca-Cola as a stock, we don't think we need a huge margin of safety because we don’t think we’re going to be wrong about our assumptions in any material way.

What we really want to do is buy a business that’s a great business, which means that business is going to earn a high return on capital employed for a very long period of time, and where we think the management will treat us right.

We don’t have to mark those down a lot when we find those factors. We’d love to find them when they’re selling at 40 cents on the dollar but we will buy those as much closer to a dollar on the dollar. We don’t like to pay a dollar on the dollar, but we’ll pay something close.

And if we really get to something — you know, when we see a great business, it’s like if you see some — somebody walk in the door, you don’t know whether they weigh 300 pounds or 325 pounds. You still know they’re fat, right, you know?

And so if we see something we know it’s fat, financially, we don’t worry about being precise. And if we can come in, in that particular example, at the equivalent of 270 pounds, we’ll feel good.

But if we find something where the competitive aspects are — it’s just the nature of the business that you really can’t see out five or 10 or 20 years because that’s what investing is, is seeing out.

You don’t get paid for what’s already happened. You only get paid for what’s going to happen in the future. The past is only useful to you in the extent to which it gives you insights into the future, and sometimes the past doesn’t give you any insights into the future.

And in other cases, like the stable business that you postulated, it probably does give you a pretty good guideline as to what’s going to happen in the future, and you don’t need a huge margin of safety.

You should have something that — you always should feel you’re getting a little more than what it’s worth, and there are times when we’ve been able to buy wonderful businesses at a quarter of what they’re worth, but we haven’t seen those — well, we saw it in Korea here recently — but you don’t see those sort of things very often.

And does that mean you should sit around and hope they come back for 10 or — you know, wait 10 or 15 years? That’s not the way we do it. If we can buy good businesses at a reasonable valuation, we’re going to keep doing it.

Charlie?

CHARLIE MUNGER: Yeah. You’re — that margin of safety concept boils down to getting more value than you’re paying. And that value can exist in a lot of different forms.

If you’re paid four-to-one on something that’s an even money proposition, why, that’s a value proposition, too.

It’s high school algebra. And people who don’t know how to use high school algebra should take up some other activity.

16. Health care is too tough for Berkshire

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: — morning. Good morning.

WARREN BUFFETT: Morning.

AUDIENCE MEMBER: My name is Mike Klein, and I’m a general surgeon from Salinas, California.

Given your resources and experience in underwriting insurance, do you have any thoughts of entering into, or helping to solve, our health care mess?

Time is right for a new approach with Berkshire’s clarity brought to the formula. Let’s acknowledge the stakes are huge with implication for our economy and our future as a country.

CHARLIE MUNGER: Let me try that one. It’s too tough.

WARREN BUFFETT: I would —

CHARLIE MUNGER: Warren and I can’t solve that.

WARREN BUFFETT: Yeah, we can’t solve that one.

We try to look for easy problems because those are the ones we find we have the answers for. And you can do that in investments. We don’t really try tough things.

Now, sometimes life hands you a problem, not in the financial area in our case, usually, but it will hand you a problem that is very tough and that you have to wrestle with.

But we don’t go around looking for tough problems. I would say this: we do very, very little in health insurance. You know, if we were to have — if we were looking for a solution through the private sector, we would be looking for something with very, very low distribution costs.

I mean, you do not want a lot of the revenue soaked up in frictional costs between the benefits paid and the premiums received.

I don't know how to do that, and I haven't seen anybody else that's very good at doing it, and you can say if you're paying close to 15 percent of GDP for health costs, you know, somebody ought to be able to figure out something, but I haven't heard it.

Maybe we'll hear it in the upcoming political campaign but Charlie's views reflect mine at the present.

17. Munger on what's driven Berkshire's "extreme" success

WARREN BUFFETT: Now we're going to go to the grand ballroom. We have these two overflow rooms that are full — or more or less full — and the grand ballroom is number. 13. Would they come in, please?

AUDIENCE MEMBER: This is Phil McCall (PH) from Connecticut.

I wondered if you could comment on a subject I don't think you like to talk about very much, which is intrinsic value, and the evolution over the past 10 or 12 years of going to — off and on — but giving us investments and then giving us the operating income and suggesting that might be a good guide to us.

I find it extremely helpful. I'm not sure other people do when looking out the 20 years you're talking about, looking ahead on both those two parts. Any comments you might have, I'd surely appreciate.

WARREN BUFFETT: Yeah. Well, the intrinsic value of Berkshire, like any other businesses, is based on the future amount of cash that can be expected to be delivered by the business between now and judgment day, discounted back at the proper rate.

Now, that's pretty nebulous. Another way of looking at it is to try and figure out the value of the businesses we own presently, and we try to give you the information that will enable you to make a reasonably close estimate at that.

We own lots of marketable securities. It's probably safe to say that they're worth more or less what they are carried for. And then we own a number of operating businesses, and we try to give you the figures on those businesses that are the figures that we use in making our own judgments about the value of those businesses.

Now, that tells you what we have today and more or less what it's worth. But since Berkshire retains all of its earnings, it becomes very important to evaluate what will be done with those earnings over time.

I mean, it is not only a question what the present businesses are worth. It's a judgment on the efficiency or the effectiveness with which retained earnings will be used.

If you had looked at the intrinsic value of Berkshire in 1965, we had a textile business that was probably worth about $12 a share. But that was not the only part of the equation, because we intended to use any cash generated to try and buy into better businesses than we had, and we were fortunate to be able to buy in the insurance business in 1967 and build on that.

So it was not only a combination of the business we had, but the skill with which retained earnings would be used, that determined what the present value actually should have been at Berkshire going back that far.

It's the same situation today. We will put to work billions and billions of dollars this year and next year and the year after. If we put that to work effectively, each dollar has a greater present value than a dollar has simply in cash or distributed. If we do ineffectively, it has a value of something less.

The businesses today, you know, we have whatever the figure is in the annual report — roughly $80,000 in marketable securities.

If our insurance business breaks even, that $80,000 is free to us, in terms of using it. And we have a group of operating businesses and we show their earnings in the report and we're going to try to add to those and they'll try to add to their earnings.

But if Charlie and I were each right now to write down on a piece of paper what we think the intrinsic value of Berkshire is, our figures would not be the same. They'd be reasonably close.

And I think with that, I'll turn it over to Charlie.

CHARLIE MUNGER: Yeah. What's hard to judge at Berkshire is the likelihood that you'll have anything like the past to look forward to in the future.

Berkshire has gotten very extreme, in terms of investment results. In fact, it's gotten so extreme that it's hard to think of another similar precedent in the history of the world.

And the balance sheet is gross, considering the small beginnings of the place. Now, what on earth has caused this extreme record to go on for such a very long time?

I would argue that the young man who was reading everything he could read when he was 10-years-old became a learning machine, and he got a lot of power early, and then he got a very long run when he kept learning.

If Warren had not been learning all the while, I'm telling you having watched the process closely, the record would be a pale shadow of what it is. And Warren has improved since he passed the retirement age of man.

In other words, in this field, at least, you can improve when you're old.

Now, most people don't even try and create that kind of a record. They pass power from one 65-year-old to one 59-year-old and then do it over and over again. But you get an enormous advantage from practice in this field.

And so what happened accidentally in the case of Warren has helped you shareholders greatly because you had this long run with power extremely concentrated, and with the man holding the power being a ferocious learner.

Our system ought to be more copied than it is. (Applause)

This idea of passing the power from one old codger to another, in a settled way, is not necessarily the right system at all.

WARREN BUFFETT: We have a very strong culture now of rationality, of being owner-oriented, that will go on long after I'm not around. And we have a talent on the operating side in place to do a lot of wonderful things over time.

We will need, in capital allocation, to keep doing intelligent things. We won't get to do brilliant things because you don't get to do brilliant things with the kind of sums we're talking about. Maybe once in a blue moon or something, you know, you'll get a chance.

But we will need somebody that never does — basically doesn't do any dumb things, and occasionally does something that's reasonably good. That can be done.

And we have — we're on that road already. It does not — fitting into this organization as an investment officer or a capital allocator, you're getting in the right vehicle. It has the right standards. It will reject ideas that really are irrational.

I've been on a lot of boards. Charlie's been on a lot of boards. You would be amazed at the number of things that are responding to "animal spirits" rather than to rationality that take place. And we have our animal spirits but we devote them to other areas.

18. "Deficient" auditing of derivatives will cause problems

WARREN BUFFETT: Let's go on to number 14. That's in — that's in the junior ballroom.

AUDIENCE MEMBER: Yes. Hi, Mr. Buffett and Mr. Munger. This is Whitney Tilson, a shareholder from New York.

For many years both of you have been warning about the dangers of derivatives, at one point calling them "financial weapons of mass destruction."

Yet every year, tens of trillions of dollars of derivatives are bought and sold. It just seems to be getting bigger and bigger and almost certainly improperly accounted for.

And so I was wondering if you could comment, and, specifically, if you have any thoughts on how much longer this might go on.

Do you see anything imminent that could derail this ever inflating bubble? What might trigger it? And who should be doing what to try and mitigate this looming danger?

WARREN BUFFETT: Well, we've tried to do a little to mitigate it ourselves by talking about it, but the — you're right, the — and it isn't the derivative itself. I mean, there's nothing evil about a derivative instrument.

As I mentioned, we have 60-some of them at Berkshire, and on Monday I'll go over with the directors — I'll go over all 60-some and, believe me, we'll make money out of those particular instruments.

But they — usage of them on an expanding basis, more and more imaginative ways of using them, introduces, essentially, more and more leverage into the system.

And it's an invisible — or largely invisible — sort of leverage. If you go back to the 1920s, after the crash, the United States government held hearings.

They decided that leverage — margin, in those days, as they called it — leverage contributed to, perhaps, the crash itself and certainly to the extent of the crash. And it was like pouring gasoline on a fire was — when people's holdings got tripped, you know, when stocks went down 10 percent people had to sell, another 10 percent, more people had to sell and so on.

Leverage was regarded as dangerous and the United States government empowered the Federal Reserve to regulate margin requirements, regulate leverage, and that was taken very seriously.

And for decades it was a source of real attention. I mean, if you went to a bank and tried to borrow money on a stock, they made you sign certain papers as to — that you weren't in violation of the margin requirements, and they policed it.

And it was taken quite seriously when the Fed increased or decreased margin requirements. It was a signal of how they felt about the level of speculation.

Well, the introduction of derivatives and index futures, all that sort of thing, has just totally made any regulation of margin requirements a joke.

They still exist and, you know, it's an anachronism.

So I believe — I think Charlie probably agrees with me — that we may not know where, exactly, the danger begins and where — and at what point it becomes a superdanger and so on.

We certainly don't know what will end it, precisely. We don't know when it will end, precisely.

But we probably — at least I believe — that it will go on and increase to the point where at some point there will be some very unpleasant things happen in markets because of it.

You saw one example of what can happen under forced sales back in October 19, 1987, when you had so-called portfolio insurance.

Now, portfolio insurance — and you ought to go back and read the literature for the couple years preceding that. I mean, this was something that came out of academia and it was regarded as a great advance in financial theories and everything.

It was a joke. It was a bunch of stop-loss orders which, you know, go back 150 years or something, except that they were done automatically and in large scale by institutions and they were merchandise.

People paid a lot of money to people to teach them how to put in a stop-loss order. And what happened, of course, was that if you have a whole series of stop-loss orders by very big institutions, you are pouring gasoline on fire.

And when October 19th came along, you had a 22 percent shrink in the value of American business, caused, essentially, by a doomsday machine. A dead hand was selling as each level got hit. And three weeks earlier, you know, people were proclaiming the beauty of this.

Well, that is nothing compared — it was a formal arrangement to have these — this dynamic hedging or portfolio insurance — sell things.

But you have the same thing existing when you have fund operators operating with billions in aggregate, trillions of dollars, leveraged, who will respond to the same stimulus.

They have what we would call a "crowded trade," but they don't know it. It's not a formal crowded trade.

It's just that they're all ready to sell if a certain given signal or a certain given activity occurs. And when you get that, coupled with extreme leverage which derivatives allow, you will someday get a very, very chaotic situation.

I have no idea when. I have no idea what the exogenous factor — I didn't know that shooting some archduke, you know, would start World War I, and I have no idea what will cause this kind of a thing, but it will happen.

Charlie?

CHARLIE MUNGER: Yeah. And, of course, the accounting being deficient enormously contributes to the risks.

If you get paid enormous bonuses based on reporting profits that don't exist, you're going to keep doing whatever causes those phony profits to keep appearing on the books.

And what makes that so difficult is that most of the accounting profession doesn't even recognize how stupidly it is behaving.

And one of the people in charge of accounting standards said to me, "Well, this is better, this derivative accounting, because it's mark-to-market, and don't we want current information?"

And I said, "Yes. But if you mark-to-model, and you create the models, and your accountants trust your models, and you can just report whatever profit you want as long as you keep expanding the positions bigger and bigger and bigger, the way human nature is, that will cause terrible results and terrible behavior."

And this person said to me, "Well, you just don't understand accounting." (Laughter.)

WARREN BUFFETT: If four years ago, or whenever it was, when we started to liquidate Gen Re's portfolio, we had reserves set up for in the hundreds and millions and all sorts of things.

And our auditor — and I emphasize any other of the Big Four auditors absolutely would have attested to the fact that our stuff was mark-to-market.

You know, I just wish I'd sold the portfolio to the auditors that day. (Laughs) I'd be 400 million better off.

So it's a real problem. Now there's one thing that's really quite interesting to me. If I owe you, on my dry cleaning bill or something, $15, and they're auditing the dry cleaners, they check with me and they find out that I owe you $15 and it's all fine.

If they're auditing me, they find out I owe the dry cleaner 15 bucks. There are only four big auditing firms, you know, basically in this country.

And I will — so in many cases, if they're auditing my side of the derivative transaction, you know, what I'm valuing it at, the same firm may often be valuing — or attesting to the value of the mark by the person on the other side of the contract.

I will guarantee you that if you add up the marks on both sides, they don't equate out to zero.

We have 60-some contracts, and I will bet that people are valuing them differently on the other side than we value themselves, and it won't be to the disadvantage of the trader on the other side.

I don't get paid based on how ours are valued, so I have no reason to want to game the system. But there are people out on the other side that do have reasons to game the system.

So if I'm valuing some contract at plus a million dollars for Berkshire, that contract on the other side, it's just one piece of paper, should be valued at a minus 1 million by somebody else.

But I think you probably have cases — and this is — I'm not talking about our auditors, I'm talking about all four of the firms — but they have many cases where they are attesting to values that — of the exact same piece of paper — where the numbers are widely different on both sides.

Do you have any thoughts on that, Charlie?

CHARLIE MUNGER: Well, I — as sure as God made little green apples, this is going to cause a lot of trouble in due course.

As long as it keeps expanding and ballooning and so on and the convulsions are minor, it can just go on and on. But eventually there will be a big denouement.

19. Dangers of short-term investing and advanced mathematics

WARREN BUFFETT: Let's go back to number one.

AUDIENCE MEMBER: Hi. I'm Stanley Ku from Hong Kong. My question is about a proliferation of short-term mindset to investing.

As more and more money is being placed under absolute return mandate, these managers, as you just said, responded the same response, and tried to trade issues.

So with credit spread on — I should say, risk premium — on various products declining across the board and correlation across markets increasing, can we read into it and say what is healthy or not healthy for the economy or the markets? And can we arguably say the portfolio insurance dynamics is already in place today?

WARREN BUFFETT: Well, I think you put your finger on it. And, you know, we do think it's unhealthy.

Obviously, if you take — and no way of precisely measuring this, but I'm quite certain I'm right — if you take the degree to which, say, either bonds or stocks, the percentage of them that are held by people who could change their minds tomorrow morning based on a given stimulus, whether it be something the Fed does or whether it be some kind of an accident in financial markets, the percentage is far higher.

There is an electronic herd of people around the world managing huge amounts of money who think that a decision on everything in their portfolio should be made, basically, daily or hourly or by the minute.

And that has increased turnover on the New York Stock Exchange — and I don't know the exact figures — but I think it was down around the 15 or 20 percent range 40 years ago and it's increased it to a hundred percent, I believe, plus, now.

So — and certainly in the bond market, the turnover of bonds has increased dramatically. People used to buy bonds to own them and they'd buy bonds to trade them.

And there's nothing evil about that, but it just means that the participants are playing a different game, and that different game can have different consequences than in a buy-and-hold environment.

And I do think it means that if you're trying to beat the other fellow on a day-to-day basis, you're watching news events very carefully or watching the other fellow very carefully.

If you think he's about to hit that key, you know, you're going to try to hit the key faster, if that's the game you're playing and if you're getting measured on results weekly.

So I think that you describe the conditions that will lead to a result that we've been talking about expecting at some point.

It's not new to markets, though. I mean, markets will do crazy things over time. Every time — when Charlie and I were at Salomon, they'd always talk to us about five sigma events or six sigma events, and that's fine if you're talking about flipping coins, but it doesn't mean anything when you get human behavior involved.

And people do things that — and intelligent people do things — very intelligent, educated people do things — that are totally irrational, and they do them en masse.

And you saw it in 1998. You saw it in 2002. And you'll see it again. And you'll see it — it's more likely to happen when you have people trying to beat currency, bond, stock markets, day by day.

It's — I think it's a fool's game. But — you know, it may be what's required to attract money.

When I set up my partnership, I told the partners, you know, you'll hear from me once a year.

And I even thought — in 1962 I put the partnerships together and in May of 1962 the market got terrible — and I actually thought of sending all my partners a letter, and then sending it down to Brazil to have it reshipped back up, just to sort of test them out, but — how they felt about things.

But, you know, I had a few with bad hearts. I decided it wasn't worthwhile.

Charlie?

CHARLIE MUNGER: Yeah. When people talk about sigmas, in terms of disaster potentialities in markets, they're all crazy.

They got the idea that bad results in markets would be predicted by Gaussian distributions. And the way they decided on that outcome was it made everything so easy to compute.

They don't follow Gaussian distributions. You have to believe in the Tooth Fairy to believe that.

And the disasters are bigger and more irritating than [German mathematician Carl Friedrich] Gauss would have predicted.

WARREN BUFFETT: It was easier to teach as well.

CHARLIE MUNGER: It's easier to teach, too.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I once asked a distinguished medical school professor why he was still doing an obsolete procedure, and he said, "It's so wonderful to teach." (Laughter)

WARREN BUFFETT: There's more of that in finance departments than you might think.

It's very discouraging to learn advanced mathematics and, you know, how to do things that none but the priesthood can do in your field, and then find out it doesn't have any meaning, you know.

And what you do when confronted with that knowledge, after you've invested these years to get your Ph.D., you know, and you've maybe written a textbook and a paper or two, having a revelation that that stuff has no utility at all, and really has counter-utility, I'm not sure, you know, too many people can handle it well. And I think they just generally keep on teaching.

20. Quantitative approach to intrinsic value and investments

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Hello. Burkhardt Whittick (PH) from Munich in Germany.

I would like to get some more transparency on how you make investment decisions, particularly how you determine intrinsic value.

You mentioned that the theoretically correct method is discounted cash flow, but at the same time you point out the inherent difficulties of the methodology.

From other books, I see that you use multiples on operating earnings, or (inaudible) multiples. Your [former] daughter [in law] Mary, in one of her books, describes another methodology where you apply compounding economics to the value of the equity.

Could you give us a bit more transparency which quantitative approach you use and how many years out you try to quantify the results of the investments you're interested in?

WARREN BUFFETT: I understand the question, but I'm going to pretend I don't and let Charlie answer first. (Laughs)

I really do.

CHARLIE MUNGER: Yeah. When you're trying to determine something like intrinsic value and margin of safety and so on, there's no one easy method that could be simply mechanically applied by, say, a computer and make anybody who could punch the buttons rich.

By definition, this is going to be a game which you play with multiple techniques and multiple models, and a lot of experience is very helpful.

I don't think you can become a great investor very rapidly any more than you could become a great bone tumor pathologist very rapidly. It takes some experience and that's why it's helpful to get a very early start.

WARREN BUFFETT: But if you're — let's just say that we all decided we're going to buy a — or think about — buying a farm.

And we go up 30-miles north of here and we find out that a farm up there can produce 120 bushels of corn, and it can produce 45 bushels of soybean per acre, and we know what fertilizer costs, and we know what the property taxes cost, and we know what we'll have to pay the farmer to actually do the work involved, and we'll get some number that we can make per acre, using fairly conservative assumptions.

And let's just assume that when you get through making those calculations that it turns out to be that you can make $70 an acre to the owner without working at it.

Then the question is how much do you pay for the $70? Do you assume that agriculture will get a little bit better over the years so that your yields will be a little higher?

Do you assume that prices will work a little higher over time? They haven't done much of that, although recently, it's been good with corn and soybeans. But over the years agriculture prices have not done too much. So you would be conservative in your assumptions, then.

And you might decide that for $70 an acre, you know, you would want a — if you decided you wanted a 7 percent return, you'd pay a thousand dollars an acre.

You know, if farmland is selling for 900, you know you're going to have a buy signal. And if it's selling for 1200, you're going to look at something else. That's what we do in businesses.

We are trying to figure out what those corporate farms that we're looking at are going to produce. And to do that we have to understand their competitive position. We have to understand the dynamics of the business.

We have to be able to look out in the future. And like I've said earlier, some businesses you can't look out very far at.

But the mathematics of investment were set out by Aesop in 600BC. And he said, "A bird in the hand is worth two in the bush."

Now our question is, when do we get the two? How long do we wait? How sure are we that there are two in the bush? Could there be more, you know? What's the right discount rate?

And we measure one against the other that way. I mean, we are looking at a whole bunch of businesses, how many birds are they going to give us, when are they going to give them to us, and we try to decide which ones — basically, which bushes — we want to buy out in the future.

It's all about evaluating future — the future ability — to distribute cash, or to reinvest cash at high rates if it isn't distributed.

Berkshire has never distributed any cash, but it's grown in its cash producing abilities, and we retain it because we think we can create more than a dollar present value by retaining it. But it's the ability to distribute cash that gives Berkshire its value.

And we try to increase that ability to distribute cash year by year by year and then we try to keep it and invest it in a way so that a dollar bill is worth more than a dollar.

You may have an insight into very few businesses. I mean, if we left here and walked by a McDonald's stand, you know, and you decided, would you pay a million dollars for that McDonald's stand, or a million-three, or 900,000, you'd think about how likely it was there would be more competition, whether McDonald's could change the franchise arrangement on you, whether people are going to keep eating hamburgers, you know, all kinds of things.

And you actually would say to yourself this McDonald's stand will make X — X plus 5 percent — maybe in a couple years because over time prices will increase a little.

And that's all investing is. But you have to know when you know what you're doing, and you have to know when you're getting outside of what I call your circle of competency, you don't have the faintest idea.

Charlie.

CHARLIE MUNGER: Yeah. The other thing, you've got to recognize that we've never had any system for being able to make correct judgments on the values of all businesses.

We throw almost all decisions into the too hard pile, and we just sift for a few decisions that we can make that are easy. And that's a comparative process.

And if you're looking for an ability to correctly value all investments at all times, we can't help you.

WARREN BUFFETT: No. We know how to step over one-foot bars. We don't know how to jump over seven-foot bars.

But we do know how to recognize, occasionally, what is a one-foot bar. And we know enough to stay away from the seven-foot bars, too.

21. What Buffett wants as he hires portfolio managers

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: John Stevo (PH), shareholder from Chicago. Mr. Buffett — Mr. Buffett, Mr. Munger, thank you for the great weekend.

In your annual shareholders letter, you stated that you're looking for someone younger to possibly work at Berkshire, and I was wondering if you could expand on that, and how would I apply for that job? (Laughter)

WARREN BUFFETT: I think you just did. (Laughter)

The — we're looking for one or more. I mean, I would — I don't think it's at all impossible we might even find three or four that we would decide to have run some money and to take a closer look.

We're not looking for someone to teach. I probably didn't make that clear enough in the annual report. We're not — we're not going to be mentors or teachers or anything of the sort.

We're looking for somebody that we think knows how to do it. And there are people like that out there. We've heard from 6- or 700.

I did hear — I heard from one that had a four-year-old son. I thought that was quite a compliment that — I mean, I knew a caveman could do my job, but a four-year-old? (Laughter)

The — but we're looking — and we've heard from a number of very intelligent people. We have heard from a number of people that have had good investment records for — in recent years, and in some cases some time.

The biggest problem we have is whether they would scale up, because it's a different job to run a hundred billion than it is to run a hundred million.

And incidentally — and you can't do as well running a hundred billion as a hundred million, in terms of returns. You can't come close to doing it. That doesn't bother us.

But we do want to find somebody that we think can run large sums of money mildly better than the general performance in securities. And I emphasize mildly.

There's no way in the world somebody's going to beat the S&P by 10 percentage points a year with a hundred billion dollars. It isn't going to happen.

But we think maybe we can find somebody or some group, several of them, that can maybe be a couple percentage points better, but we really are interested in being sure that we have somebody that, under conditions that people haven't even seen yet, will not blow it.

You know, anything times zero is zero. And I don't care how many wonderful figures are in between.

So we are looking for somebody that's wired in a way that they see risks that other people don't see that haven't occurred, and they're plenty cognizant of the risks that have occurred.

And those people are fairly rare. Charlie and I have seen a lot of very smart people go broke, or end up with very mediocre records where, you know, 99 out of the 100 things they did were intelligent but the hundredth did them in.

So our job is to filter through these hundreds and hundreds of applications, find a couple of them that we think can do the job who are much younger, perhaps give them a chunk — two, three, five billion — have them manage it for some time, have them manage it in the kind of securities that they would scale up to a larger portfolio because — and then either one or more of them will get the job turned over to them at some point.

Charlie?

CHARLIE MUNGER: Yeah. Our situation in looking for this help reminds me of an apocryphal tail about Mozart. And a young man of 25 or so once asked to see Mozart and he said, "I'm thinking of starting to write symphonies, and I'd like to get your advice."

And Mozart said, “Well, you’re too young to write symphonies.” And the guy says, “But you were writing them when you were ten-years-old.” And Mozart says, “Yes, but I wasn’t asking anybody else for advice how to do it.” (Laughter.)

CHARLIE MUNGER: And so if you remind yourself of young Mozart, why, you’re the man for us.

WARREN BUFFETT: We will come up with, probably, a couple of people. And, you know, it’s — I’ve known people over the years.

I’ve been in the job before. I mean, in 1969 I wound up my partnership, and I had a lot of people that trusted me, and I wasn’t going to just mail the money back to them and, you know, say good-bye, because they would have been sort of adrift, most of them.

And so I had the job of finding somebody to replace me. And there were three absolutely stand-out candidates. Any one of the three would have been a great choice.

Charlie was one of them. Sandy Gottesman was one of them. And Bill Ruane was one of them.

Charlie wasn’t interested in having more partners.

Sandy was interested in individual accounts and took on the accounts of some of my partners and they were very, very happy and they’re still happy that he did it.

And Bill Ruane set up a separate mutual fund called Sequoia Fund to take care of all of the partners, whether they had small amounts or not. And he did a sensational job.

So I really identified three people in 1969 that were not only superior money managers, but that were also the kind that could never get you a terrible result and that were terrific stewards of capital.

Now, they were about my age at the time so it was a universe that I was familiar with, and now I have the problem that at — the people I know that are even close to my age, we don’t want anyway, and besides, most of them are already rich. They don’t care about having a job.

So I have to look into an age cohort where I don’t really know lots of people, but it can be done.

And like I say, we did it successfully with three people in 1969. And it was done successfully in 1979 with Lou Simpson for GEICO.

And I never knew Lou Simpson before I met him down at the airport here, and I spent a few hours with him, and it was clear that he was a steward of capital. He was going to get an above-average result, and there was no chance he was going to get a bad result.

And he’s been managing money for GEICO now for 28 years, roughly.

So it's doable. It's a little more work than I like to do. I've been kind of spoiled. But I'll — I've got a job to do on it, and I'll do it.

22. Buffett and Munger differ on climate change

WARREN BUFFETT: Number 4?

AUDIENCE MEMBER: Good morning. I'm Glen Strong (PH) from Canton, Ohio.

Please tell us where you stand on the global warming debate or where your managers at General Re stand.

In particular, perhaps you can give us your thoughts on the science of global warming and how serious you believe it is, and whether warming is actually more harmful than helpful. Thank you.

WARREN BUFFETT: Yep. Well, I believe the odds are good that it is serious. I'm not enough of a — I can't say that with 100 percent certainty or 90 percent certainty, but I think that there's enough evidence that it would be very foolish to say that it's 100 percent certain or 90 percent certain that it isn't a problem.

And since it's — if it is a problem, it's a problem that once it manifests itself to a very significant degree, it's a little too late to do something about it.

In other words, you really have to build the ark before the rains come, in this case. I think if you make a mistake, in terms of a social decision, you should, what I call err, on the side of the planet.

In other words, you should build a margin of safety into your thinking about the future of the only planet we've got a hundred years from now.

So I think — I take it seriously. In terms of our own businesses, you mentioned General Re. Gen Re writes less — way less business — that would be subject to the annual increments in global warming that would have an effect on their results than the reinsurance division of National Indemnity, where we write far more of the catastrophe business.

It's not going to affect, you know, in any measurable degree at all, you know, excess casualty insurance, property insurance. You're thinking much more of whether it's going to produce atmospheric changes that change materially the probabilities of really — of catastrophes, both their frequency and their intensity.

In my own mind, and in the minds of the people that run National Indemnity's reinsurance division, we crank — we think the exposure goes up every year because of what's going on in the atmosphere, even though we don't understand very well what goes on in the atmosphere.

And the relationship between damage caused and the causal factors is not linear at all. I mean, it can be explosive.

So if temperatures in the waters of the Atlantic or something change by relatively small amounts, or what seem like small amounts, it could increase the expectable losses from a given hurricane season by a factor of two, three, four or five.

So we're plenty cautious about it. It's not something that keeps me up, in terms of our financial prospects, at all at Berkshire. But it's something that I think every citizen ought to be very cognizant of and make a decision on.

Charlie?

CHARLIE MUNGER: Well, of course carbon dioxide is what plants eat. And so — and generally speaking, I think it's a little more comfortable to have it a little warmer instead of a little colder. (Laughter)

WARREN BUFFETT: I hope you don't get a chance to test that after death, Charlie. (Laughs)

CHARLIE MUNGER: It isn't as though there's a vast flood of people trying to move to North Dakota from southern California.

And so you're talking about dislocation. It's not at all clear to me that, net, it would be worse for mankind in general to have the planet a little hotter.

But the dislocations would cause agonies for a great many places, particularly those that would soon find themselves underwater.

WARREN BUFFETT: Yeah. I was going to ask you. How do you feel about the sea level being 15 or 20 feet higher? (Laughs)

CHARLIE MUNGER: Well, that's very unfortunate, but — (Laughter)

Holland lives with what, 25 percent of the nation below sea level? With enough time and enough capital, why, these things can be adjusted, too.

I don't think it's an utter calamity for man that threatens the whole human race or anything like that. You know, you'd have to be a pot-smoking journalism student or something to — (Applause)

CHARLIE MUNGER: — believe that.

WARREN BUFFETT: We're finally unleashing him, folks. (Laughter)

Well, we'll continue to have people in charge of insurance who are plenty worried about global warming, I promise you.

But it — we don't know — we do know that 2004 and 2005, there was a frequency, and more particularly, there was an intensity of hurricanes that would not be expected at all by looking at the previous century.

And we were spared — even though we had Katrina — we were spared what could have been a far worse case by a couple of Category Fives that didn't hit the mainland.

So I do not regard Katrina as being anywhere near a worst-case scenario.

And, like I say, I don't know whether — how much of — I don't know whether the water is a half a degree or 1 degree Fahrenheit warmer than 30 years ago, but I don't know — and I don't know all the factors that go into hurricanes.

I mean, I know that, obviously, the water temperature, you know, contributes to energy and all that sort. But there could be 50 variables.

All I know is, on balance, I think they're probably getting more negative for us and I know we ought to be very careful about it. And I know that it would be crazy to write insurance in 2007 at the same rates that it was being written a few years ago, in relation to catastrophes.

And since we're in the catastrophe business, that is something I think about, and the people that actually write the policies think about it as well. So it's a factor with us.

23. Bank problems don't mean China will collapse

WARREN BUFFETT: Five.

AUDIENCE MEMBER: Hi. I'm John Golob from Kansas City.

I have a question about the Chinese economy. Some observers have suggested that the Chinese banking system looks a little like Japan back in the 1990s.

Are you concerned that China could experience similar disruptions as Japan in '90 or is China possibly — with different institutions — possibly more resistant to economic disruptions?

WARREN BUFFETT: I would have to say I don't know the answer to that. I mean, it's a very interesting question. It's a very important question.

But, you know, I didn't necessarily understand what was going to happen in Japan before it happened, and my insight into Chinese banks is about zero.

We’ve been offered chances to buy into various Chinese banks and, again, because I don’t know anything about them, I pass. It’s no judgment that there’s anything bad.

It just means that sitting in Omaha, Nebraska, not knowing what some item of loans and advances — what composes it or anything about the real operation of the place — that I can make a decision whether it’s worth X, half of X, 2X, a quarter of X, I just don’t know.

And I really don’t know — I just have no notion as to the answer to your question, but maybe Charlie does.

CHARLIE MUNGER: Well, if you stop to think about it, all of the remarkable economic progress that we’ve seen in China in the last 15 years has been accompanied by practices in their government banks that would make you shutter if you compared them to normal banking standards.

So everything you see in terms of progress has occurred despite — the banks were almost doling out money for aid as distinguished from doing normal banking.

So I’d be very leery of predicting that that’s sure to cause a huge economic collapse in Japan — in China.

They’ve been doing it for a long time, and they may actually be getting better now.

WARREN BUFFETT: Yeah. We’ve had our share of banking troubles in this country. I mean, it wasn’t that long ago in terms of the savings and loan crisis and all kinds of things.

And strong economies come through those things. So, you know, if ahead of time you’d seen all the problems with foreign loans that the commercial banks got into and all the problems with real estate loans that the savings and loans got into, you could have said, you know, it’s going to be terrible for the American economy, and it did produce a lot of dislocations and all of that.

But if you look at the regular American economy, it’s come through all kinds of financial crises with the real output per capita rising at a very substantial rate just decade after decade.

I don’t know what will happen in China, but I think it’s pretty amazing in terms of the gains that have been made.

And I think they’ll be — I think they’ll continue to be made, and I don’t know what will happen with the banking system, though.

24. Easy decision: stocks over bonds

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Good morning, Warren and Charlie. My name is Frank Martin from Elkhart, Indiana. I'm a shareholder.

WARREN BUFFETT: Yeah. You've written a good book too, Frank. (Laughs)

AUDIENCE MEMBER: Thanks, Warren. I'll do my best to be succinct with this question. As you know, my long suit is not brevity in the written word.

Recently, I sequentially read everything that you and Charlie have written, or that has been written about you, since 1999, including your help wanted ad in the annual report, which sought not a Ted Williams, but the consummate defensive player in your forcefully worded quotations in last Monday's Wall Street journal.

When contemplating the chronology, I sensed a gradual but unmistakable sea change in your perspective on the investment environment for marketable securities.

The intensification of your preoccupation with managing risk is conspicuous by its absence among the other biggest players at the margin — hedge funds, private equity, mutual funds — who are shamefully mute both about what are likely to be anemic prospective returns and the unconscionable risks assumed to achieve them, all the while charging a king's ransom for such low value-added services.

When I give free rein to my intuition, the post-1999 Warren Buffett reminds me of the Warren Buffett of post-1969.

Back then, when Berkshire was a small fraction of its current size, you spoke of the difficulty in playing a game you did not understand, that there was little margin of safety in the equity markets in general.

You weren't forecasting what in its own time became the bear market of '73-'74, but you were surely intuitively aware of what [former Federal Reserve Chairman Alan] Greenspan years later has repeatedly warned: the inevitable day of reckoning that follows long periods of low equity risk premium.

Imagine yourself, if you are willing, cast overnight into a new role with a clean slate as head of the investment committee of a $10 billion pension fund.

Today, would your decisions reflect the same risk-averse mindset that dominated your behavior in the post-1969 period? And might you anticipate that following all of this might appear opportunities that were as mouthwatering as appeared in '73-'74?

Please explain, and I hope Charlie will weigh in on the subject as well. Thank you.

WARREN BUFFETT: Yeah Frank, when I closed up to the partnership, if I'd had an endowment fund to run then, the prospective return — and actually, I wrote this in a letter to my partners that I'd be glad to send you a copy of — the prospective return — and I was looking at them as individuals on an after-tax basis — was about the same, I felt, from equities and from municipal bonds over the next decade, and it turned out to be more or less the case.

I would say that I do not regard that as being the same situation now. If I were managing a very large endowment fund, for one thing it would either be a hundred percent in stocks or a hundred percent in long bonds or a hundred percent in short-term bonds.

I mean, I don't believe in layering things and saying I'm going to have 60 percent of this and 30 percent of that. Why do I have the 30 percent if I think the 60 percent makes more sense?

So — and if you told me I had to invest a fund for 20 years and I had a choice between buying the index, the 500, or a 20-year bond, you know, I would buy stocks.

You know, that doesn't mean they won't go down a lot. But if you — I would rather a have an equity investment — I wouldn't rather have an equity investment where I paid a ton of money to somebody else that took my stock return down dramatically.

But simply buying an index fund for 20 years of equities or buying a 20-year bond, I would — it would not be a close decision with me.

I would buy the equities. I'd rather buy them cheaper, you know, but I'd rather buy the bond with a bigger yield, too. But in terms of what's offered to me today, that's the way I would come down.

Charlie?

CHARLIE MUNGER: Yeah. I don't think that was the answer that was expected, but that's the answer. (Laughter)

WARREN BUFFETT: It doesn't have a thing to do with what we think stocks — we don't think at all — but where stocks could be or bonds could be.

We don't have the faintest idea where the S&P will be in three years, or where the long-term bond will be in three years, but we do know which we would rather own on a 20-year basis.

CHARLIE MUNGER: Warren, we'd also expect that the current scene will cause some real disruption, not too many years ahead.

WARREN BUFFETT: That's true, but if you go back a hundred years, you could almost say that, you know, in almost any period, you will get disruptions from time to time, and it's very nice if you have a lot of cash then and you have the guts to do something with it.

But predicting them or waiting around for them, that sort of thing, is not our game. And I mean, we bought $5 billion worth of equities in the first quarter, something like that.

And, you know, we don't think they're anything like — well, they aren't — they're not — it would be a joke to even compare them to 1974 or a whole bunch of other periods. But we decided we would rather have them than cash, or we would rather have them than sit around and hope that things get a lot cheaper.

We don't spend a lot of time doing that. It — you can freeze yourself out indefinitely.

So any time we find something — what we think is intelligent to do, we just do it, and we hope we can do it big.

25. Buffett bought and sold silver early: "Other than that, a perfect trade"

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: My name is Nathan Narusis from Vancouver, Canada.

Mr. Buffett, Mr. Munger, my question concerns your previous silver bullion investment. I'm curious to hear more about why you sold when you did.

More specifically, whether you sold your bullion to the organizers of the silver exchange-traded fund in return for cash plus, perhaps, important noncash consideration in order to keep silver markets from either rising or falling sharply.

Thank you very much for anything you would care to share with us.

WARREN BUFFETT: I'm not sure who we sold it to, but whoever we sold it to was a lot smarter than I was. (Laughs)

I bought it too early. I sold it too early. Other than that, it was a perfect trade. (Laughter)

Charlie, do you have anything to add? Charlie had nothing to do with the silver decision, so that one falls entirely on me.

CHARLIE MUNGER: I think we demonstrated how much we know about silver.

WARREN BUFFETT: Yeah. (Laughter)

The very fact you asked us a question on silver flatters us because nobody asks us about silver anymore. (Laughs)

But we'll come up with something else at some point.

You know, the last part of your question, there was a small implication, I think, of perhaps a silver conspiracy.

We — as soon as we started — it got known that we bought silver, we started getting all these letters in the mail from people who had all these different theories about the fact that hedging was killing things or these kind of traders were doing something.

In the end, silver responds as supply and demand just like oil responds to supply and demand. Oil is — the price of oil at 60 or $65 is not a product of a bunch of oil executives conspiring or anything of the sort. It's supply and demand on a huge commodity.

Silver is a small commodity, but on any kind of commodity like that, supply and demand is what determines prices over time. Although the Hunt brothers, I must admit, for a short period there, in a few years, managed to change the equation and they forever wished they hadn't.

26. Why Buffett "outsourced" his philanthropy

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Hello, Mr. Buffett. Eben Pagan, Santa Monica, California.

You seem amazing at keeping your composure in tough situations. I would be very interested to know what your thought process was when you were in that incredibly stressful situation, you knew the world was watching, and you went head-to-head with LeBron James. (Laughter)

WARREN BUFFETT: The game was rigged. (Laughter)

He was the one that had a problem. (Laughs)

AUDIENCE MEMBER: What I'd really like to know is, I'm a real big fan of you and Mr. Gates and your philosophy of channeling all the value you've created back into the world.

And I have a successful business, and I'd like to do the same, but maybe in 20 or 30 or 40 years, and with a time horizon like that, I'd love to know what advice you'd give someone like me.

WARREN BUFFETT: Well, there's nothing wrong with your time horizon, in my view, as long as you're going — as long as you plan to give it back, I mean, A) the decision is yours entirely, anyway, whether you want to do it.

But assuming you want to give it back, or give it to society in some way, if you're compounding your money at a rate greater than people generally do, you are, in effect, an endowment fund for society.

And, you know, all kinds of organizations in the nonprofit area have endowment funds, and they think it's wise to have it, and they do that in order to get standard returns, usually.

And if you can compound it more and you're going to give it back later on, let someone else take care of current giving, and you can take care of giving in 20 or 30 years. But, you know, I regard that as a personal decision.

I always felt that I would compound money at a rate higher than average, and it would have been foolish to give away a significant portion of my capital to somebody who would spend it within, you know, months, when there could be a really much larger amount later on.

And, on the other hand, the time had come, I'd really thought my wife would be doing that, and when that didn't work out, the time had come to do something with it.

And, fortunately, I had some great options available, and I get to keep on doing what I love doing and I let some — I farm out all the work.

But, you know, when my wife had a baby, we hired an obstetrician. I didn't try and do it myself. I mean, when a tooth hurts, you know, I don't have Charlie fix it. I go to a dentist.

So when I have money to give away, I believe in turning it over to people who are — and I've got five different organizations, including my three kids — and I believe in turning it over to people who are energized, working hard at it, smart, you know, doing it with their own money, the whole thing.

And I get to keep doing what I like doing. So as far as I'm concerned, I haven't given away a penny.

Charlie?

CHARLIE MUNGER: Well, I think it's wonderful for the shareholders that somebody else is giving away the money. (Laughter)

I tell you, if all Warren wanted to talk about was interfacing with applicants for donations, we would have a different life. And we wouldn't be very well adapted to it, either.

WARREN BUFFETT: Yeah. You know, actually on the smaller ones I send them all to my sister Doris, and she does a great job with it, and enjoys it, spends lots of time on it, good at it, and I'm glad she does it and I don't.

You know, the truth is, I haven't given away anything in a practical matter. I have everything in life I want. You know, there's no way I can sleep better, I can eat better. Other people might think I could eat better. (Laughter)

I haven't given up anything.

Now, if you think about it, you know, somebody that gives up having an evening out, somebody that, you know, gives up their time working on something, somebody that doesn't take their kids to Disneyland this year because they've, you know, they've given the money instead to their church, I mean, those people are changing their lives in some way with what they give.

I haven't changed my life at all. I don't want to change my life. I'm having a lot of fun doing what I do. And, you know, it's just a bunch of stock certificates that one way or another they're going to go someplace.

And what I really want to do is keep doing what I enjoy doing, and feel that the claim checks that I accumulate that comes about for this, are going to get used effectively for the same general purposes that I would want to use them for if I really had the energy and the interest in doing the job myself.

But somebody else can keep doing the work.

27. You can always earn big returns with small amounts of money

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Hi. I'm Eric Schline (PH) from Larchmont, New York.

My question is directed at Mr. Buffett. Mr. Buffett, you claim you can do 50 percent a year.

If you had to start over with a small portfolio, would you still be doing buy and hold, buying quality companies at a good price, or would you be doing arbitrage and really getting down to the nitty-gritty Benjamin Graham cigar butts that you did in the Buffett Partnership?

WARREN BUFFETT: Yeah. If I were working with a very small sum — and you should all hope I'm not — (laughs) — if I were working with a very small sum, I would be doing entirely — almost entirely — different things than I do.

I mean, there's — your universe expands. I mean, if you're looking, there's thousands and thousands and thousands of times as many options to think about if you're investing $10,000 than if you're investing a hundred billion.

And, obviously, if you have that many — you've got all the options you got with a hundred billion, except buying entire businesses, and you've got all of these other options.

So you can earn very high returns with very small amounts of money, and it will always be such.

I don't mean that everybody can do it, but if you know something about values and investments, you will find opportunities with small sums, and it will not be with a portfolio that Berkshire itself owns.

We can't earn phenomenal returns putting 3 billion, 4 billion, 5 billion in a stock. It won't work that way. It won't even come close to working that way.

But if Charlie or I were in a position of working with a million dollars or $500,000 or 2 million, we would find little things here and there — and it wouldn't always be stocks — where we would earn very high returns on capital.

Charlie?

CHARLIE MUNGER: Yeah. But it's — there's no point our thinking about that now. (Laughter)

WARREN BUFFETT: But he's thinking about it, Charlie. (Laughter)

28. Subprime mortgage defaults won't be "huge anchor"

WARREN BUFFETT: OK. We'll take one more, and then we will go to lunch and then we'll — after that we'll come back. So we'll go to number 10 now.

Is the microphone open on 10?

AUDIENCE MEMBER: Hello? Hello?

WARREN BUFFETT: Do we have a problem here?

AUDIENCE MEMBER: Warren and Charlie, my question is, what's your opinion regarding the subprime market relative to the foreign national market?

CHARLIE MUNGER: We can't hear that.

WARREN BUFFETT: We can't hear that.

AUDIENCE MEMBER: What's your opinion regarding the subprime market relative to the foreign national market? Sorry. My name is Calvin Chong (PH). I'm from New York.

WARREN BUFFETT: Well, the subprime market, encouraged by both lenders, intermediaries, and borrowers themselves, resulted in a lot of people buying a lot of houses that they really didn't want to own or that they can't make payments on for once the normal payments were required.

And the people, the institutions, in some cases the intermediaries, are going to suffer in various degrees.

Now, the question is whether it spills over and starts affecting the general economy to a big degree, and I would — my guess would be — it's quite severe some places.

But my guess would be that if unemployment doesn't rise significantly, and interest rates don't move up dramatically, that it will be a — it will be a very big problem for those involved, and some people are very involved. Some institutions are very involved.

But I don't see it — I think it's unlikely that that factor alone triggers anything of a massive nature in the general economy.

I think it — you know, I've looked at several financial institutions. I've looked at their 10-Qs and 10-Ks, and I've seen that a very high percentage of the loans they made in the last few years allowed people to make very tiny payments on the mortgages, but, of course, those subnormal payments increased principal so that they had to make above average payments later on at some point.

And I think that's dumb lending, and I think it's dumb borrowing, because somebody that can only make 20 or 30 percent of their normal mortgage payments the first year is very unlikely to be able to make 110 percent of their normal mortgage payments a few years later.

Those people and those institutions were largely betting on the fact that house prices would just keep going up, and it really didn't make any difference whether they could make the payments.

And that worked for a while until it didn't work. And when it doesn't work, you have an abnormal supply of housing coming on the market, similar to what happened in manufactured housing, the business we're in, six or seven years ago, and that changes the whole equation.

From people on the demand side, you no longer have people thinking they're buying something that's bound to go up, and then you have the supply coming on from the people who were anticipating that before and really don't want to hold the asset unless it's going to go up.

So you'll see plenty of misery in that field. You've already seen some. And I don't think — I don't think it's going to be any huge anchor to the economy.

Charlie?

CHARLIE MUNGER: Yeah. A lot of what went on was a combination of sin and folly, and a lot of it happened because the accountants allowed the lending institutions to show profits on loans where nobody in his right mind would have showed any profit until the loan had matured into a better condition.

And, once again, if the accountants lay down on their basic job, why, huge excess and folly is going to come inevitably, and that happened here.

The national experience with low-interest starter home loans to what I would call the deserving poor, has been very good. But the minute you pay a bunch of people high commissions to make loans to the undeserving poor, or the overstretched rich, you can get loan losses that are staggering.

And I don't see how the people did it and still shaved in the morning, because looking back at them was a face that was evil and stupid.

WARREN BUFFETT: Yeah. (Applause)

WARREN BUFFETT: You've seen some very interesting figures in the last few months on the number — on the percentage — of loans where people didn't even make the first or second payment. And there's really — that shouldn't happen.

That happened, incidentally — you had a prelude to this in the manufactured housing industry.

I mean, in the late 1990s — and securitization accentuated the problem, because once you had somebody in Grand Island, Nebraska, selling a mobile home — or a manufactured home — to someone and they needed a $3,000 down payment and the salesman was going to get a $6,000 commission, believe me, you start getting some very strange things going on.

Now, if the person doing that had to borrow the money in Grand Island, the chances are the local banker would have seen what was happening and said, you know, we don't want any of this where the salesman fakes the down payment and all that.

But once you just package those things and securitize them so they get sold through major investment banking houses and sliced up in various tranches and so on, you know, the old — the discipline leaves the system.

And securitization really accentuates that, and we have had that in subprime loans, just as we had it in manufactured housing six or seven years ago.

And, like I say, that has not all worked its way through the system, but I don't think it's going to cause huge troubles.

Now, we do see certain areas of the country where it will be at least a couple of years before real estate recovers.

I mean, the overhang is huge compared to normal monthly volume in certain sections. And the people that were counting on flipping things there are going to get flipped, but in a different way.

Afternoon Session - 2007 Meeting

1. "Areas don't make opportunities, brains make opportunities"

WARREN BUFFETT: OK. If you're ready, we are.

We're going to keep going in the same order because there's people in the other rooms that have been waiting. So we will go to number 11.

AUDIENCE MEMBER: Hi. My name is Christian Baha from Superfund. I have a question for you, Mr. Buffett.

What do you think about managed futures funds?

WARREN BUFFETT: About which fund?

CHARLIE MUNGER: I didn't quite get that. What kind of fund?

AUDIENCE MEMBER: Managed futures funds.

CHARLIE MUNGER: Oh, managed —

AUDIENCE MEMBER: Like a very diversified portfolio in stocks and bonds going long and short, all the different markets, based on the most natural human behavior, trying following a herd behavior?

CHARLIE MUNGER: Managed futures funds.

WARREN BUFFETT: Well, I would say that we think the most logical fund is the one we have at Berkshire where, essentially, we can do anything that makes sense and are not compelled to do anything that we don't think makes sense.

So any entity that is devoted to a limited segment of the financial market we would regard as being at a disadvantage to one that has total authority if you have the right person in charge.

But you — that's an assumption you're going to make under any fund. So we would not want to devote our funds to something that was only going to buy bonds, something that was only going to buy futures, or anything of the sort.

We would — we buy futures at Berkshire. We buy bonds at Berkshire. We've bought — we buy currencies. We buy businesses.

So I think it's a mistake to shrink the universe of possibilities. Ours is shrunk simply by size, but we don't try to — we don't set out to circumscribe our actions in any way.

But in the end, there's no form that produces investment results.

Hedge funds don't produce investment results. Private equity doesn't produce investment results. Mutual funds don't produce it.

If it was simply a matter of form, we'd all call ourselves, you know, whatever that form happened to be.

What really makes the difference is whether the person that's running it knows what their limitations are, knows where their strengths are, plays when they have the opportunity to play advantageously, and stays out when they don't see any opportunities.

Charlie?

CHARLIE MUNGER: Yeah. I'd go further. I'd say averaged out, I would expect that the return per dollar per year in managed futures funds would be somewhere between lousy and negative. (Laughter)

WARREN BUFFETT: And I would agree with that. Yeah.

Usually those are sales tools. I mean, people find out something that will sell, and it can be — you know, it can be bond funds at some point, it could be — but when they find something to sell, it will get sold to the public. That will be — it will sell until it stops selling.

And that means lots of money comes in and lots of competition for a limited number of opportunities.

And I think it's a mistake to get sold something on the basis that here is a great area of opportunity.

Areas don't make opportunities; brains make opportunities, basically.

2. Read a lot, look for opportunities, avoid catastrophes

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: Matthew Monahan (PH) from Palo Alto, California.

Mr. Buffett, Mr. Munger, first of all, I want to thank both of you for so freely sharing your wisdom and knowledge over the years.

Even though we've never met in person, I consider you both to be close personal mentors and attribute your teachings and philosophies to any success I've had in business so far. So thank you.

Here's my question: for a 23-year-old with high ambitions, some initial working capital, and a genetic wiring, as you call it, for disciplines like investments, mathematics, and technology, what do you foresee as the significant areas of opportunity over the next 50, even 100, years?

And, if you were in my shoes, what would be your approach and methodology for really learning, tackling, and mastering these areas of opportunity for the purpose of massive value creation?

WARREN BUFFETT: Well, I remain very big on the idea of reading everything in sight.

And, frankly, when you get the chance to talk to somebody like Lorimer Davidson, as I did when I was 20 years old — I probably learned more from Lorimer Davidson in those four or five hours than I learned in college, with the exception of learning some accounting and one or two subjects like that.

So you just want to soak it up. If you have those qualities you talked about, you'll see the areas as you go along. I mean, we have — Charlie and I probably — you know, we've made money in a lot of different ways, some of which we didn't anticipate, you know, when we were — 30 or 40 years ago.

But we did have the ability to recognize some; we didn't have the ability to recognize others. But we did know when we knew what we were doing and when we didn't, and we just kept looking.

We had a curiosity about things. You would know at a time like the Long-Term Capital Management crisis, for example, that there were going to be ways to make money.

I mean, they were going to be out there, and all you had to do was just read and think eight or ten hours a day and you were going to cover a lot of possibilities, probably a very high percentage of them good, and some of them sensational.

So you can't really lay it out ahead of time. You can't have a defined roadmap. But you can have a reservoir of thinking, looking at different kinds of businesses, looking at different kinds of securities, looking at markets in different places, and you will then spot a reasonable number of things that come along.

You won't spot every one of them. We've missed all kinds of things.

But the biggest thing, too, is to have something in the way you're programmed so that you don't ever do anything where you can lose a lot.

I mean, we — our best ideas have not been better than other people's best ideas, but we've never had a lot of things that pulled us way back.

So we never went two steps forward and one step back. We probably went two steps forward and a fraction of a step back.

But avoiding the catastrophes is a very important thing, and it will be important in the future. I mean, you will have your chance to participate in catastrophes.

Charlie?

CHARLIE MUNGER: Yeah. And, of course, the place to look when you're young is in the inefficient markets.

You shouldn't be trying to guess whether, you know, one drug company has a better drug pipeline than another. You want to go, when you're young, someplace that's very inefficient.

WARREN BUFFETT: And you shouldn't be trying to guess whether the stock market is going to go up or whether long-term bonds are going to change in yield.

I mean, you don't have anything going in that kind of a game, but you can have a lot going in games that very few people are playing, and maybe where they've even got their heads screwed on wrong, in terms of how they're thinking about the subject.

The RTC was a great example of a chance to make a lot of money.

I mean, here was a seller of hundreds of billions of dollars' worth of real estate where the people that were selling it had no economic interest in it, were eager to wind up the thing, you know, and they were selling at a terrible time when the people who had been venturesome in lending were no longer lending, the people who had been venturesome in the equity end of real estate had gotten cleaned out.

So you had a great background of environment, and then you had an imbalance of intensity, in terms of analyzing situations between the seller, which was the government, with a bunch of people who had no economic interest in it and were probably eager to wind up the job, and buyers on the other side who were of the generally cautious type. Because the more venturesome type had taken themselves out of action. And there were huge amounts of property.

So you get these opportunities, and you'll get more. I mean, there won't be any scarcity of opportunities in your life, although there will be days when you feel that way.

3. Politics and catastrophe insurance

WARREN BUFFETT: OK. Let's go to the other rooms now. They've been waiting. Number 13.

AUDIENCE MEMBER: John Goss (PH), Key West, Florida.

Katrina created litigation that resulted in some rulings that combined flood damage and wind damage where the insurance companies thought they covered wind only.

As a result, some insurance companies are significantly reducing coverage in those states.

Florida recently empowered their insurance company called Citizens to be more aggressive not only with wind storms, but also with homeowners, while at the same time not allowing requested rate increases of other insurance companies.

The result is that some solid insurance companies have announced reducing their coverage or pulling out of Florida.

Is this type of government interference a random fluctuation in insurance or a major cause of concern for the future?

WARREN BUFFETT: Well, that’s an easy one to understand both sides of the question on.

I mean, the average homeowner is not going to sit there and read line-by-line what is in his insurance policy, and a lot of times the agent is not going to explain it carefully to them.

So when something comes along and he thinks it’s insured and it turns out that he bought a policy where it wasn’t insured, he’s going to feel very unhappy about it.

And when tens of thousands of people feel unhappy about it, you’re very likely to get some kind of governmental interference, and probably an inflation by judicial degree or by threats of the government to, in effect, extend the terms of the policy beyond what the insurance company thought it was insuring.

Now, an insurance company that’s had that kind of experience is going to be very reluctant to write insurance policies in the future, if they don’t think that the words will be adhered to.

And, on the other hand, I can fully understand some guy who’s had his house blown away in a storm and a lot of it was water damage and a lot of it was wind damage, thinking that, you know, he’s been wiped out and the insurance company comes around waving a policy that’s got a lot of small print in it, you know, he’s going to be unhappy.

So it’s a real tussle on that. And, you know, I guess I would — if I were writing policies, I would put the exclusions in very big type and very easy to understand.

But I still would expect that if thousands of people suffered losses, that courts and legislators would probably seek to stretch the terms, or even abrogate the terms of the contract, in order to take care of their own constituents and figure that guys like me or institutional investors who own insurance companies can afford it better than the homeowner.

When you get into the question of whether you should, in effect, have all of the people in the country pay premiums for, we'll say, hurricanes, in a way, subsidize it through policies in Nebraska or Minnesota or someplace, for hurricanes in Florida, that gets very tough.

I mean, it can be very expensive to insure against hurricanes if hurricanes become more frequent and more intense. In fact, it can become so expensive that people really will not want to bear the cost of insurance, and they'll want to socialize it some way.

And, of course, the guy in Nebraska says, "Look it. You went down there to live on the ocean and you thought it was wonderful, and we're back here with these terrible winters, but why should we pay a portion of your insurance?"

So you're going to have that tussle go on, and you'll really have that tussle go on if you get a hundred billion dollar or $150 billion insured loss in Florida.

Because that will mean a huge change in taxation if the State of Florida steps in to compensate people. There will be calls for Washington to pay for it.

But, you know, it's how much people who are not exposed to a risk should pay for the people who have elected to be exposed to the risk is — you know, it becomes a political question.

And my guess is that sometime in the next five or 10 years, you'll see a struggle on that subject that exceeds — far exceeds — what we saw on Katrina. Charlie?

CHARLIE MUNGER: I've got nothing to add.

4. We're still looking for a big acquisition

WARREN BUFFETT: Number 14?

AUDIENCE MEMBER: Hi. My name is Glenn Tongue, and I'm a shareholder from New York.

I'd like to congratulate you on Berkshire's newest director. Sue is a terrific addition. My question is —

WARREN BUFFETT: We agree with you.

AUDIENCE MEMBER: My question is, according to the 10-Q filed yesterday, you purchased about 5.3 billion in shares in the first quarter.

This acceleration in activity is occurring while the general market levels are getting more expensive.

Does this indicate some shift in your thinking about hurdle rates of return for your ever-growing asset base and/or your prospects for an elephant-sized acquisition?

WARREN BUFFETT: Well, that's a good question. I would — incidentally, I would say in the first quarter, actually, stocks didn't rise. But they've risen a lot in April.

But they didn't go down, either. I mean, they were pretty much flat. And we did invest 5 billion or so in equities.

Did we change our standards? You know, I don't think so. But, you know, you can't be a hundred percent sure that you have — you know, if you haven't had a date for a month, you know, you may say that was a girl you would have dated the first day, but who knows. (Laughter)

So, I don't know for sure the answer, but I think we would have dated that girl the first day.

And the second question, in terms — does it reflect giving up on finding an elephant to acquire in terms of a business? The answer to that is no. We've got plenty of money available.

And we would sell stocks if we really — I mean, that would not be a problem — if we really needed to, to buy a really big business.

So we're as prepared as we've ever been prepared to buy a big business outright. We hope we do. We hope we buy relatively small ones if they're attractive.

We bought a very attractive business, TTI, run by Paul Andrews — terrific business — in the first quarter.

And, you know, I wish it was five times the size, but maybe it will be some day. But we know that we're in with the kind of person we want and the kind of business we want. And if we find larger ones, one way or another, we'll swing them.

Charlie?

CHARLIE MUNGER: Yeah. The one thing I think we can promise you is that we won't make returns, on average, in the kind of stuff we're buying now like those that we made 10 or 15 years ago.

WARREN BUFFETT: Yeah. We won't come close, no.

CHARLIE MUNGER: No. It's a different world with more modest expectations.

WARREN BUFFETT: And we hope you share them.

5. Buffett defends Planned Parenthood

WARREN BUFFETT: Let's go to number 1.

AUDIENCE MEMBER: Hello, Charlie, Warren. Bill Paparella (PH) from St. James, New York.

Warren, I brought my ten-year-old daughter, Gina, with me. She asked me last summer, "How do I get rich?"

So I gave her your letters, writings, even gave her "Charlie's Almanack."

So she's been reading it ever since, asking me a lot of questions. So I said, "Maybe we'll go to our first meeting together."

WARREN BUFFETT: Is she married? I mean, she's the kind of girl I want my granddaughter — or grandson — to meet. (Laughs)

AUDIENCE MEMBER: So we're learning together.

Warren, my question for you is in regards to your recent charitable gifts. And if I could start by saying that I mean no disrespect. You're my hero. So — and nor is it political.

WARREN BUFFETT: You're doing fine so far. (Laughter)

AUDIENCE MEMBER: OK. I am, as a father of five daughters, perplexed and upset that one — or I've read — that one or more of these foundations is a big supporter of Planned Parenthood and abortion rights. (Scattered applause)

If you were to go on the Planned Parenthood website, you would see a website that promotes promiscuity, goes out of its way to support internet porn — (audience noises)

WARREN BUFFETT: Yeah. Let's get to the question, please. Do you have a question?

AUDIENCE MEMBER: The question is, Warren, I was hoping that you could speak to the billions of dollars that's been allocated with an agency as Planned Parenthood that is very well-funded.

It just doesn't seem to jive with the hero that I study, and I was hoping that you could speak to it.

WARREN BUFFETT: Yeah. Well, I'll be glad to speak to it. I think it's a terrific organization. (Applause with some boos)

And I really think it's too bad that for millennia, you know, women, not only in the United States, but all over the world, you know, have had involuntary bearing of babies forced upon them, and usually by a government run by men. (Applause)

So I don't think we want to get into a — we don't want to get into a cheering contest here — but, you know, I think that it's a very important issue.

I think it tends to have a small natural funding constituency because it isn't a popular-type thing where it's like sticking your name on a hospital or something like that.

But I would say that if we'd had a Supreme Court with nine women on it starting when the country became the United States, that by now I don't think a question like yours would even be being raised.

You know, men set the rules for a lot of years — (applause) — and I think it's wonderful that a woman can make reproductive choices.

But, you know, I've got a lot of people that disagree with me on that. I've got a lot of people that agree with me on it. And I hope you'll respect my opinion as I do yours. Thank you. (Applause)

6. "Volatility is not a measure of risk"

WARREN BUFFETT: Number 2, please.

AUDIENCE MEMBER: Hi. I'm Bob Kline (PH) from Los Angeles.

Pursuing your earlier comments on sigmas from a different angle, the conventional wisdom in the investment world is that an investment risk can be measured by the volatility of the price of the investment in the marketplace.

To me, this approach has it backwards. Since changes in price are determined by the changes in the opinions of investors in the marketplace, why would a rational investor substitute the opinions of the marketplace, as reflected in the volatility of the price, for his own assessment of the risk of the investment?

And consultants take this idea further by tracking the volatility of a portfolio manager's results in an attempt to measure risk. So could you guys expand on your thoughts on this?

WARREN BUFFETT: Yes. Volatility is not a measure of risk.

And the problem is that the people who have written and taught about volatility do not know how to measure — or, I mean, taught about risk — do not know how to measure risk.

And the nice thing about beta, which is a measure of volatility, is that it's nice and mathematical and wrong in terms of measuring risk. It's a measure of volatility, but past volatility does not determine the risk of investing.

I mean, actually, take it with farmland. Here in 1980, or in the early 1980s, farms that sold for $2,000 an acre went to $600 an acre. I bought one of them when the banking and farm crash took place.

And the beta of farms shot way up. And, according to standard economic theory or market theory, I was buying a much more risky asset at $600 an acre than the same farm was at 2,000 an acre.

Now, people, because farmland doesn't trade often and prices don't get recorded, you know, they would regard that as nonsense, that my purchase at $600 an acre of the same farm that sold for 2,000 an acre a few years ago was riskier.

But in stocks, because the prices jiggle around every minute, and because it lets the people who teach finance use the mathematics they've learned, they have — in effect, they would explain this a way a little more technically — but they have, in effect, translated volatility into all kinds of — past volatility — in terms of all kinds of measures of risk.

And it's nonsense. Risk comes from the nature of certain kinds of businesses. It can be risky to be in some businesses just by the simple economics of the type of business you're in, and it comes from not knowing what you're doing.

And, you know, if you understand the economics of the business in which you are engaged, and you know the people with whom you're doing business, and you know the price you pay is sensible, you don't run any real risk.

And I don't think Charlie and I — certainly Berkshire — I don't think we've ever had a permanent loss in marketable securities that was, what, 1 percent, maybe, half a percent of net worth.

I made a terrible mistake in buying Dexter Shoe, which cost us significantly more than 1 percent of net worth where I bought an entire business then.

But I was wrong about the business. It had nothing to do with the volatility of shoe prices or leather or anything else. It just was wrong.

But in terms of marketable securities, I cannot recall a case where we've lost that kind of — I mean, we've done a lot of things in things — in securities — that had a very high beta. We've dealt with a lot of things in securities that had a low beta.

It's just the whole development of volatility as a measure of risk, it has really occurred in my lifetime. And it's been very useful for people who wanted a career in teaching, but it is not — we've never found a way for it to be useful to us.

Charlie?

CHARLIE MUNGER: Well, it's been amazing that both corporate finance and investment management courses, as taught in the major universities — we would argue it's at least 50 percent twaddle, and yet these people have very high IQs.

One of the reasons we've been able to do pretty well is that we early recognized that very smart people do very dumb things, and we tried to figure out why, and also wanted to know, who so we could avoid them. And — (Laughter)

WARREN BUFFETT: We will not run big risks at Berkshire. Now, we will be willing to lose, as I put in the annual report, $6 billion in a given catastrophe, but our catastrophe business, run over many years, is not risky.

You know, a roulette wheel will occasionally pay off at 35-to-1, and that sounds like you're paying out an awful lot of money compared to the amount bet on one number, but I would love to own a lot of roulette wheels.

7. What an annual report tells you about the CEO

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Hi. My name is Stuart Kaye, and I'm from New York City.

Warren and Charlie, you spend a lot of time evaluating the management quality and integrity of the companies that you may invest in.

In my current job, I do not have the opportunity to do that. As I read through annual reports and financial statements, what do you suggest I focus on to help me to determine the quality and integrity of management?

WARREN BUFFETT: Well, you can — we've spent many, many years — and we've bought many things. I mean, I — without meeting managements at all, having any entree to them.

The stocks — the 5 billion of stocks — that we may have bought in the first quarter, most of those were companies I never met the management, never talked to them.

We read a lot. We read annual reports. We read about competitors. We read about the industries they're in.

In terms of sizing up managements — obviously if we're going to buy the whole business, that's a different question. Then you — because you — we're going to buy it, be in bed with them, they're going to run them, and we care very much about whether they're going to behave in the future as they have in the past once we own the business. And we've had very good luck on that.

But in terms of marketable securities, we read the reports. Now, Charlie and I were just talking about one the other day where we read an annual report of a large oil company.

And the company — you know, hundred pages, public relations people, lots of pictures — spent a fortune on it. And you can't find in that report what their finding cost per McF or per barrel of oil was last year. That's the most important figure in an oil and gas company over a period of years, but every year counts.

The fact it wouldn't even be discussed — the reason it wasn't discussed, it was absolutely terrible — but the fact it wouldn't even be discussed — and to the extent it was touched on, it was done in a dishonest manner.

When we read things where we basically are getting dishonest messages from the management, it makes a difference to us.

You know, like I say, in marketable securities we can solve that by selling the stock, and it's not the same thing as buying the entire business.

But I think you can learn a lot by reading the annual letters. I mean, for one thing, if it's clearly the product of some investor relations department or outside consultant or something of the sort, you know, that tells you something about the individual.

If he's not willing to talk once a year through a few pages to the people that gave him their money to invest, I mean, that — I've really got — I've got some questions about people like that.

So I like that feeling that I'm hearing directly from somebody who regards me as a partner.

And you may not get it all the way, but when I get it 0 percent of the way, I don't like it.

I've still bought — we've still bought into some — in marketable securities — we've bought into some extremely good businesses where we thought they were run by people we didn't really like very well, because we didn't feel they could screw them up.

Charlie?

CHARLIE MUNGER: Yeah. I think that's exactly right. There are two things: the quality of the business and the quality of the management.

And if the business is good enough, it will carry a lousy manager. And the converse case, where a really good manager gets in a really lousy business, he'll ordinarily have a very imperfect record.

In other words, it's a rare person that can take over a textile business, totally doomed, which is what Warren did in his youthful folly —

WARREN BUFFETT: Right.

CHARLIE MUNGER: — and turn it into what's happened here. You should not be looking for other Warrens on the theory they're under every bush.

WARREN BUFFETT: I figured it out in 20 years, though. I'll have to say that for myself. (Laughs)

Twenty years, and I finally figured out I was in the wrong business.

But there are businesses — if you gave me first draft pick of all the CEOs in America and said it's your job to run Ford Motor now or, you know, pick a company that's in a terribly tough business, you know, I wouldn't do it.

I mean, that it's just too tough. They may get it solved, you know, if they get cooperation from unions and a whole bunch of things, but it will not be solely in the control of the CEO who has that job.

He is dependent on too many good things happening outside to say that he alone can get the job, even if he's the best in the world.

8. Stocks over bonds, but with modest expectations

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. I'm Walter Chang (PH) from San Jose, California. My wife and I are expecting our first baby boy in July, and we're going to name him Warren after you. (Laughter)

WARREN BUFFETT: You're trying to get into my will again.

AUDIENCE MEMBER: Charlie, I'm rooting for you, for the next one.

WARREN BUFFETT: I'd move him further down the line, maybe to number five. (Laughter)

AUDIENCE MEMBER: Warren and Charlie — Warren, if you were writing a follow-up to the very prescient Fortune magazine article from November 1999 in which you were talking about the lean and fat 17-year periods, what would you be writing?

And since we're halfway through the third 17-year period, how is it turning out, based on your expectations from back in 1999?

WARREN BUFFETT: Yeah. The 17 years, of course, I had a little fun with because of the fact there were two 17-year periods and there are also 17-year locusts. So I stretched it a little from a literary standpoint.

But there's nothing magic about given spans of time. There was something very different between the first 17 years of that 34-year period and the second 17, and I used that for kind of a dramatic contrast.

If I were writing something now, I would say what I said just a little earlier in response to Frank Martin's question, that it is — if I had to own long bonds or long-term position equities, I'd rather have equities. But I would not have high expectations for them, but I would have expectations beyond 4 3/4 percent.

How much beyond, I'm not sure, but something enough beyond four 3/4 percent that I would rather own equities than bonds.

I did not feel — I felt, in 1999, that people were extrapolating the experience of the previous 17 years and assuming there was something magic about owning equities.

And expectations of the people were bound to be — that they were — people were bound to be disappointed. They simply had an unrealistic view by extrapolation, and that was the main purpose of that article.

But if I were writing something now, I would not have high expectations for equities, but I would have better expectations for equities than for bonds.

Charlie?

CHARLIE MUNGER: Yeah. And I would say that since that article was written, the results from owning equities have been pretty lean, at least compared to what happened in the glorious 17 years that preceded.

So Warren has been right so far, and he's probably right now when he says modest expectations.

WARREN BUFFETT: Yeah. You really don't have — in markets you can't say something terribly important or intelligent every day or every week or every month.

That's one of the problems of — if you went on television too often or had to write weekly letters or something of the sort.

Every now and then you get something extreme. I mean, I did close down the partnership in 1969, and an article appeared. I did give an interview in ’74. I gave another interview in ‘81 or ’2.

I mean, every now and then, things really get out of whack. But the gradations in between, they’re too tough.

But the nice thing about it is you don’t have to have an opinion every day or every week or every month. If you own some good businesses and you bought them at the right price, if they get to a silly price, you probably should sell them.

And if you find that everything is extremely cheap, like in ’74, you should put every available dime into equities. And that’s what we’ve tried to do.

9. PacifiCorp and the Klamath Dams controversy

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Yes. Thank you, gentlemen, for this opportunity to ask you a question. My name is Ronnie Pellagreen (PH), and this is my 14-year-old daughter, Mikayla (PH).

We are here representing hundreds of ocean, commercial, hook-and-line salmon fishermen, and their families from the West Coast. They are barely hanging on to their livelihoods because of the Klamath River crisis.

My husband is a fourth-generation hook-and-line commercial fisherman from Eureka, California. His family has fished for the last 100 years.

Last year, our commercial salmon season was completely shut down because of the crisis in the Klamath River. It is caused by the four lower hydroelectric dams owned by your subsidiary PacifiCorp.

We personally took a 95 percent hit in our income — excuse me — and we had no way to make up that loss. We have used our savings and were forced to take out a Small Business Administration disaster loan to meet our financial needs.

Our daughters were so upset after overhearing my husband and I last Christmas, they came to us wanting to give us all the money in their bank accounts.

I am telling you this, gentlemen and shareholders, because you and the shareholders can help.

Under Klamath Dam relicensing, it is shown that this dam removal makes economic sense for PacifiCorp and MidAmerican.

You are a great businessman who has built an incredible empire. We sure could use your creativity and expertise in solving this crisis situation so the Indian people along the river, and we, in the coastal communities, can continue our long and proud heritage.

People back home are eagerly waiting for me to bring a response back from you.

My question is, what can I tell them is your position on removing the outdated Klamath dams?

WARREN BUFFETT: Yes. Our position on it is quite simple.

The FERC and several of the regulatory commissions have before them 27 different proposals or positions by various interest groups.

Some want — some like hydropower, which is what comes from the dams, because it does not generate the emissions that come from coal or gas-fired generation.

Some like the fact that hydropower is cheaper, several hundred thousand consumers. Some people have been hurt by what you describe in terms of the fish.

And you have a public policy question which will not be determined by PacifiCorp. It will be determined by FERC because they are — they represent the public. In fact, the secretary of Interior has advised FERC that it's a very tough question.

FERC will be having hearings. They will listen to the positions. The Oregon and Utah, California, perhaps, public utility commissions will be listening to the arguments.

And, in the end, we are a public utility responding to public policy. Public policy, weighing both your interests and the interests of others in the matter, will come to a determination, and PacifiCorp will do exactly what they say.

We are responsive to the people that regulate us, just as people have been in that position since the first dam was put in in 1906. So that is entirely a question for FERC and the state commissions.

10. No opinion on NYSE and Euronext merger

WARREN BUFETT: Number 6.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. Thank you for taking my question.

This is my second time at the Berkshire Hathaway meeting that I have attended. My name is Cameron Sparrow (PH). I am 13-years-old and from Boulder, Colorado.

My question is for Mr. Buffett. Mr. Buffett, what is your opinion about the merger of the New York Stock Exchange with the Euronext?

Do you think that the merger will have a positive or negative effect on the market?

WARREN BUFFETT: Well, I really don't know the answer to that. My guess is that — I mean, both of those institutions were very large institutions beforehand, and we would judge a positive effect in terms of narrowness of spreads, as an investor, in terms of costs of execution and that sort of thing.

Both places have been very efficient in the past. I mean, we pay quite low payments. Although my broker is here. We probably should be paying even less.

But the New York Stock Exchange has gotten far more efficient in terms of costs from 30 or — from the days of fixed commissions back in the early '70s and before that. I mean, it's a fraction of the cost.

And the real test from our standpoint is, you know, do we get better executions and less costly executions. And, like I say, both institutions were big, effective institutions before.

And if they get a little more efficient, I hope it gets passed on to the customers, but it may just result in larger profit.

But we're pretty satisfied with — quite satisfied, actually — with the functioning of the New York Stock Exchange where we do most of our business.

But we've done business — we've been buying international stocks, and we've had generally good executions throughout the world. So it's not a source of either concern or enthusiasm to me.

Charlie?

CHARLIE MUNGER: I don't know anything about it. (Laughter)

WARREN BUFFETT: I don't either, but I took longer to say so. (Laughter)

11. Beware when someone says "it's so easy"

WARREN BUFFETT: Number 7, please.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, thanks for hosting this wonderful meeting. My name is Chander Chavla (PH), and I'm visiting from Seattle, Washington.

And I think Berkshire Hathaway can contribute to the reduction of global warming if, for next year shareholder's meeting, Mr. Gates and I fly on the same plane. (Laughter)

My question is, I have made a few mistakes in business by trusting the wrong people. So in — and I don't know where to learn how to trust the right people.

They don't teach you that in business school, and the people who are supposed to teach you in the corporate world sometimes betray you.

So how can I learn who to trust and who not to trust?

WARREN BUFFETT: Boy, that's a great question. But you probably have about as good a chance of getting a good answer from me on that as you have on getting on Bill Gates' plane next year. (Laughter)

I get letters all the time, and I hear from people who have been taken advantage of in financial transactions. And, you know, it really is — it's sad. And a lot of it isn't even — it's not fraud or anything.

For one thing, I mean, just the charges involved, the frictional costs and the baloney that is presented is tough.

Charlie and I have had very good luck in terms of buying businesses and putting our trust in people. It's been just overwhelmingly good.

But we filter out a lot of people. And then you say, "Well, how do you filter them out?"

I would say — I think Charlie will agree with this — people give themselves away fairly often. And maybe it does help to have been around as long as we have in seeing the various ways they give themselves away.

They — when somebody comes to me with a business — and I probably shouldn't tell this publicly because they'll probably tailor their approach subsequently — but when they come, just the very things they talk about, what they regard as important and not important, there are a lot of clues that come as to subsequent behavior.

And, like I say, we've really had a batting average I wouldn't have thought we would have had in the people that we've joined with.

But it hasn't been a hundred percent. It's been well above 90. And I get asked that, you know, I mean, "How do you make those judgments?" And I don't know.

Charlie, can you articulate the way we do it?

CHARLIE MUNGER: Well, partly we're deeply suspicious when the proposition is too good to be true.

Warren once introduced me to a gentleman promoter who wanted to inveigle us into an insurance program. And he said, "We only write fire insurance on concrete bridges that are covered by water." He says, "It's like taking candy from babies." We are able to filter out propositions like that.

WARREN BUFFETT: Yeah. Anybody that, implicit in their comments or what they kind of laugh about or — all kinds of things in terms of the fact — you know, it's so easy and — it ain't that easy, you know, and we get suspicious very quickly.

And the truth is, we rule out 90 percent of the times. And we may be wrong about a fair number that we're ruling out. The important thing is whether the ones we're ruling in we're right about.

And so we don't mind — we're looking for the obvious cases of people you can trust.

I mean, go back to 1969 again. When I was thinking about who to turn my partners over to, all kinds of people with great records. That was a hedge fund — that was the first hay-day of hedge funds. And there were books written about it, "New Breed on Wall Street" and some of those. You can look them up.

And dozens and dozens and dozens of people with good records. And when I sat down and thought about, I'm going to write my partners and tell them who to turn over all their money to — because most of them had a hundred percent or close to it with me — you know, Charlie, Sandy, Bill Ruane.

I couldn't have told you which of the three was going to do the best. And, you know, I couldn't even tell you those three would done better than five others that somebody else might pick.

But the one thing I was sure of is that they were going to be sensational stewards of money.

They were going to care more about those people — the people that were turned over to them — in getting the best result possible than they were going to care about, you know, whether they made X or 2X this year in terms of commissions or fees or any of that sort of thing.

Anytime I find somebody with a — what I regard as an unfair fee structure, and saying, "Well, I can get it," well, you know, I rule them out.

And I may rule out some of the wrong people. But the ones that are left in, I feel very good about. And I wish I could give you better advice than that, but that's all I can do.

12. Pay attention to opportunity costs

WARREN BUFFETT: Eight.

AUDIENCE MEMBER: Yes. Mr. Buffett, Mr. Munger, thank you again for being so generous with your time with us every year.

I'd like to follow up on the question from the gentleman from Australia and from Munich on valuation.

The gentleman from Australia asked about margin of safety, and you replied that a superior business may not require that much of a margin of safety.

And my follow-up would be, does that suggest market rate of returns going forward for superior businesses?

And then on the Munich valuation, in which you cited a farm example on discounted cash flows, I'm very curious how you come up with your discount rate and how you might adjust that discount rate based upon various businesses.

You might want to discuss your discount rates used for Coca-Cola, J&J, or some of your past investments. Thank you.

WARREN BUFFETT: Yeah. We don't formally have discount rates. I mean, every time I start talking about all this stuff, Charlie reminds me that I've never prepared a spreadsheet. But, in effect, in my mind I do.

But we are going to want to get a significantly higher return, obviously — in terms of cash produced relative to the amount we're outlaying now for a business — than we are from a government bond.

I mean, we — you know, we are going to — that has to be the yardstick at a base. And how much more do we want?

Well, if government bond rates were 2 percent, we're not going to buy a business to earn 3 or 3 1/2 percent expectancy over the years. We just don't want to commit our money that way. We'd rather sit around and wait a little while.

If they're 4 3/4 percent, you know, what do we hope to get over time? Well, we want to get a fair amount more than that.

But I can't tell you that we sit down every morning and I call Charlie in Los Angeles and say, "What's our hurdle rate today?" I mean, we've never used the term.

You know, it's a little bit of the — we want enough so that we feel very comfortable if they closed down on the stock market for a couple of years, if interest rates go up another hundred basis points or 200 basis points, we're still happy with what we've bought.

And above that, I really — I know it sounds kind of fuzzy, but it is fuzzy.

Charlie?

CHARLIE MUNGER: Yeah. The concept of a hurdle rate makes nothing but sense, and yet a lot of terrible errors are made by people who are talking about hurdle rates.

Just because you can measure something and guess it, doesn't mean that it's the controlling variable in what you're dealing with in a messy world.

And I don't think there's any substitute for thinking about a whole lot of investment options and thinking about why one is better than another and what the likely returns are from each, et cetera, et cetera.

And the trouble with the hurdle rate concept — not that we don't have one, in a sense — is it doesn't work as well as a system of comparing things.

In other words, if I have something available that I think will give me 8 percent for sure and I can buy all I want of it, and you've got a perfectly good investment that I think will earn 7, I don't have to waste 5 minutes with you.

You're like the mail order service offering the bride through the mail and she's got AIDS. You know, I can go on to some different subject.

And so this — the concept of opportunity cost is — it's so little taught in investment. They teach it in the freshman course in economics in all the major universities, but when you get to the corporate finance departments and so forth, it doesn't lend itself with the kind of mathematics they want to use, so they ignore it.

But in the real world, your opportunity costs are what you want to make your decisions based on.

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

CHARLIE MUNGER: Sure.

WARREN BUFFETT: As I mentioned, I've been on 19 corporate boards. I would say that of the presentations I've seen — and I've seen a lot of them — and every one of them had a calculation of internal rate of return, if they'd burned them all, the boards would have been better off.

I mean, there's so much nonsense presented, because the presenters, essentially, know what the listeners are desirous of hearing, and what is needed in order to get through something the CEO wants to do anyway — you just get nonsense figures.

And, you know, we may get nonsense figures, too, but they're ours, and we — (Laughs)

CHARLIE MUNGER: Let me give you an example of that. I have a young friend who sells private partnership interests to investors. And he's in a really tough field where it's hard to get decent returns.

And I said, "What return do you tell them you're aiming for?" And he said, "20 percent." And I said, "How did you pick that number?" And he said, "If I chose any lower number, they wouldn't give me the money." (Laughter)

WARREN BUFFETT: And there's no one in the world we think can earn 20 percent with big money. I mean, it just — so anybody making a promise like that, basically, we're going to write off immediately.

It's amazing to me what — you know, in a sense, how gullible big investors are, pension funds and so on, in that they have people come around and promise them the Holy Grail.

And they want it so badly, you know, that they're willing to believe things that just have to be nonsense.

13. Some problems are too important to be "too difficult"

WARREN BUFFETT: Let's go to number 9.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. My name is Robert Piton (PH), and I'm from Chicago, Illinois.

Over your careers, has there been any question, either personally or professionally, that you haven't been able to get a comfortable answer to that you cannot simply put in your "too difficult" pile? Thank you.

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Well, sure. You get —

WARREN BUFFETT: You may have just asked one. (Laughter)

CHARLIE MUNGER: Sure. If you've got a child dying of some horrible disease, you have a problem you can't just put in a "too difficult" pile.

So there are lots of things in life that come to you that you — where you have no option to not consider the issue.

But where it's voluntary, like choosing one investment from many, then the "too difficult" pile is a marvelous way of sifting your daily grist.

WARREN BUFFETT: Yeah. I have a file on my desk — Laura Graham gave it to me — that's entitled "too hard." And, as Charlie said, if something is optional and it's too hard, you just throw it in there.

If you've got the problems of weapons of mass destruction, it is too hard, but you have to keep wrestling with it. Because if you even reduce the probabilities a tiny bit, you know, you're doing something. But you're never going to solve it.

You just have to keep working at certain types of problems, and you hope you don't have too many like that.

14. We're thinking all the time

WARREN BUFFETT: Ten.

AUDIENCE MEMBER: Many greetings from Germany. I am Bernard Yaadan (PH) from (inaudible), a little town close to the Black Forest, and I'm the mayor of it.

My question to Mr. Buffett and Mr. Munger is, how often do you review each single position in your portfolio?

Some look at their stocks every day, sometimes more, some only once a year. What is your frequency? Thank you.

WARREN BUFFETT: Well, that sort of breaks down into two periods in my life. When I had more ideas than money, I was thinking about everyone all the time because I was thinking about buying the next one and which one I would have to sell in order to buy something even more attractive.

So my opportunity cost, as Charlie would put it, then, was the least attractive stock which I would give up to buy something more attractive.

So I — literally, if I had $100,000 and it was all invested and I wanted to put $10,000 or 20,000 into something I felt was more attractive, I would be thinking all the time of which one of these do I unload.

Now our situation is such that we have more money than ideas, and that means that we really aren't re-examining something every minute, because the option is cash and not doing something that we really are excited about.

We still think about the businesses we're in — whether they're wholly owned or whether they're partially owned through stocks — we think about them all the time.

I mean, we've got a lot of information filed away in our minds. And you keep getting little incremental bits about that company or the competition or other things going on.

So it's — you know, it is a continuous process, but it's not a continuous process with the idea that daily activity, or weekly activity, or monthly activity, is going to result.

It's just we want to just keep adding to our thinking and knowledge, refining it further about every business that we're in.

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

Charlie?

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

15. It's hard to buy billions of dollars of stock

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Good afternoon. Charles Fisher (PH) from New York.

In the last 18 months, the company has allocated at least $1 billion to four or five publicly traded companies.

Berkshire has an abundance of capital and a scarcity of ideas. Since these stocks investments were made in large cap companies in which we could have probably made $5 billion investments, have you thought about allocating more capital to each stock investment?

WARREN BUFFETT: Yeah, we do think about that, obviously. And there's certain ones that we have added billions of dollars to that we already had substantial positions in a couple years ago.

Obviously, when we add to the present list, we think we're adding to the ones either that look the most attractive to us, or to the ones that we can just buy. I mean, there's some things where we can't put that much money in, or where we will have reporting thresholds that will cause a problem.

If we own over 10 percent of a company, you know, we can't sell a share of it, then, for six months without it being — if there's a profit — it being recaptured pursuant to a short-swing rule.

So there's some technical things that enter into whether we cross certain thresholds of ownership size.

But if you look at — you know, if you look at the portfolio at the end of 2007, you're going to see that certain positions in there from 2006, there will probably be an increase by billions of dollars.

And that's always something that I'm considering and Charlie is considering.

We like to add to present positions. I mean, those are companies we know, understand, obviously like to some degree.

And if the price gets reasonably attractive and we've got money around, we will add. If we can find a good business to buy, you know, we will sell the least attractive.

Charlie?

CHARLIE MUNGER: Yeah. It isn't as easy as it looks to buy these big positions. When we were buying Coca-Cola, we were buying every share we could. We bought, what, 30 or 40 percent of the daily trading?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And it took us a long, long time to get our position. And so there are huge difficulties to managing great, big, common stock portfolios.

We like it way better when we have those problems now than we liked it when we didn't have them early, but it does make it much harder. We have no easy way of moving these elephants around.

WARREN BUFFETT: In general, we think we usually can buy something like 20 percent of the daily trading volume and feel that we're not causing the price to be violently different than it would have been if we hadn't been participating in the market.

So that means if we're going to buy $5 billion worth of something, $25 billion worth of it is going to have to trade, and that's a lot for many stocks.

So we are a big ocean liner, and that has its disadvantages compared to being a smaller boat.

16. Buffett responds to concerns about Klamath Dams

WARREN BUFFETT: Number 12?

AUDIENCE MEMBER: Heya hamalio (PH). My name is Wendy George, and I am from the Hoopa Indian Reservation in northern California. I'm here with the Yurok and Karuk indigenous people who live along —

WARREN BUFFETT: I don't know if the microphone isn't working or not, but we want to make sure it is working.

AUDIENCE MEMBER: — who live along the Klamath River. My people are river people. Our entire culture, religion, and subsistence is centered around the river.

Your subsidiary company PacifiCorp owns dams on our river. Mr. Buffett, I know you care very much about humanity and ethical business. We also understand that you cannot exercise direct control over PacifiCorp's operations.

However, there are things you can do to help us. So we are here to ask you if you would be willing to meet with the tribal representatives, learn more about our issues, and explore ways to help save our salmon?

WARREN BUFFETT: Are you complete? Just take your time here.

AUDIENCE MEMBER: Complete.

WARREN BUFFETT: OK. As I said earlier, we will not make the determination in the end. It will be made by FERC.

It's the same way as if we're going to put in a coal generation plant or a gas generation plant or more wind-powered.

For example, we put in a lot of wind power in Iowa, but that was decided, essentially, by the utility commission in Iowa, that they wished to make that decision.

And, incidentally, sometimes people are unhappy when we put in wind because they don't want the transmission lines that are going to be involved.

They're usually happy to give us the plots on which to put the wind turbines because they get paid very well for it, but they're not happy to have the transmission lines.

Anytime you get into the public utility field, there are people happy and unhappy with decisions. Nobody wants a generating plant built near them, and that's the nature of it.

The world does want electricity. And because it wants electricity, and it wants more electricity, it essentially has to decide the public policy issues through regulatory authorities.

And we will do exactly what FERC, finally — and with the consent of the state commissions — what they finally decide on it.

And all of the arguments will be presented to them. As I say, there are 27 groups, I believe. And then they go and then they get the opinion of the secretary of the interior and so on and a lot of other groups.

And somehow they come out with a decision on public policy, and we will follow it.

It takes a lot of time, too, I must say. Anytime you've got an issue that's got 27 different views and more than one authority, it's going to take significant time.

I'm in a peculiar position on this. Because when we bought PacifiCorp, we had to — Walter Scott and I both signed affidavits. As part of the acquisition of PacifiCorp, the Oregon Public Utility Commission required that we submit these affidavits.

And I'll read to you from this. I don't want you to think I'm ducking behind this, but this was executed several years ago.

And it says, "I agree I will not exercise any control, directly or indirectly, on matters that pertain to PacifiCorp, except for relating to PacifiCorp that are ministerial in nature."

And then, "I agree, as a MidAmerican Holding Company and Berkshire Hathaway director, I will recuse myself from voting on MidAmerican Holding Corp. or Berkshire Hathaway board of director matters concerning PacifiCorp activities or operations."

This is part of the order that came down that allowed MidAmerican to buy PacifiCorp.

I must say, too, that in terms of the Oregon Commission and the five other states, that our application went through in almost record time because MidAmerican does have such a good record in terms of being responsive to the public utility commissions under which it's operated, and we will continue to be responsive.

WARREN BUFFETT: But I appreciate your point. Thank you.

17. Florida's public-sector hurricane insurance

WARREN BUFFETT: Number 13, please.

AUDIENCE MEMBER: Peter Vanden Broeck (PH), Cleveland, Ohio. Mr. Buffett and Mr. Munger, thank you for so eloquently answering some of these tough questions. I know of no other public company that would allow a forum such as this. You're doing a great job. (Applause)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: My question is a follow-up question to the Katrina aftermath situation regarding policyholders with insurance companies and the tussle between coverage and what's the proper remedy for those that suffered after such a storm.

Part of that tussle, or one of the results of that tussle, was some legislation that was passed in the state of Florida.

Could you please explain that legislation, as you understand it, to shareholders? And what effect, if any, does that have on Berkshire's insurance subsidiaries? Thank you.

WARREN BUFFETT: Yeah. I can't tell you with precision what the Florida — I don't know whether Joe Brandon, or Ajit [Jain], or Tad Montross — if they're in the managers' group, if somebody could pass the microphone over to them.

Essentially — I should let them explain it — but the state of Florida has gotten more into the business of insuring the citizens by a considerable margin than it did before, but there are some significant limitations on that.

And I think, if we've got a microphone with one of the three of them, they could answer that question better than I.

Do we have somebody over there? Are they all out writing insurance, or — (Laughter)

CHARLIE MUNGER: More likely buying jewelry. (Laughter)

VOICE: Check, one, two.

WARREN BUFFETT: Who do we have?

It's impossible for me to see over there with the lights.

VOICE: I'm getting a mic.

WARREN BUFFETT: What are they yelling?

CHARLIE MUNGER: Seven.

JOE BRANDON: Hello.

WARREN BUFFETT: Ah.

JOE BRANDON: Warren, it's Joe.

WARREN BUFFETT: OK.

JOE BRANDON: Took me a little time to get here.

WARREN BUFFETT: OK. Fine.

JOE BRANDON: I was looking for Ajit. What was the specific question?

WARREN BUFFETT: I think the questioner wanted to know what has really happened in Florida in the last three or four months, in terms of the state getting involved in the homeowner's insurance business.

JOE BRANDON: Well, back in mid-January, the Florida legislature met in a special session and passed legislation, at the urging of the governor, that expanded the reinsurance fund and ultimately is moving a lot of risk, both personal lines and commercial lines, from the private market to the public market.

You know, this is going to, and has manifested itself, in lower prices for wind risks in Florida and has freed up capacity that was dedicated to Florida for other markets.

So ultimately it's going to have a depressing effect on the insurance industry.

Longer term, you know, there is no free lunch, and the state and the citizens of Florida are taking a tremendous amount of risk.

And it will all work out if the wind doesn't blow, but the odds are eventually it will, and Florida is going to have a large public policy issue to deal with.

WARREN BUFFETT: Are they — Joe, are they explicitly taking on about 30 billion and then sort of leaving it in the laps of the gods above that? I'm not sure myself, but —

JOE BRANDON: Yeah. I believe they take out about 30 billion. It's about — the increase was 12 to 16 billion. So they previously had taken about 18 billion out, and they took an additional 12 to 16.

WARREN BUFFETT: Yeah. The real problem will be if there turns out to be a $100 billion insured loss.

And then the — you know, the state may decide to issue 60 or 70 billion of bonds. They may decide to go to the federal government and say, “This really isn’t our fault, and therefore the entire country should pay, in some form.”

Who knows what will happen? And the truth is, you know, it’s very unlikely that a $100 billion storm occurs. The biggest one was Hurricane Andrew, which trended, through inflation to present day, probably wouldn’t quite hit 30 billion.

But if that same storm come through as a Category 5 about 20 miles north of where it came — where it hit — you would have — or you could easily have something like $100 billion storm.

So, you know, you’re going to have to stay tuned on that. And if they don’t have any hurricanes in the next couple of years, the whole matter will die down — big hurricanes.

And if they have a $100 billion storm, they will probably go to Washington, and we will find out whether the whole country has been insuring hurricanes in Florida or whether the federal government will throw it back to the State of Florida, and the State of Florida will, presumably, issue a lot of bonds, and taxes would go up.

And, in effect, you would distribute insurance — insured losses — in relation to the proportion people pay of the general tax revenues of a state like Florida.

It’s tough to be where the wind blows a lot, but it’s also a very nice place to live, apparently. So we will find out how it plays out.

18. “Associate with people who are better than you are”

WARREN BUFFETT: Number 14, please.

AUDIENCE MEMBER: Steve Rosenberg (PH), originally from Michigan. Thank you very much for continuing to serve as excellent role models and for the values that you continue to teach by example.

I’m curious to know who are your present-day role models. And I know that your prior heroes included your father, Ben Graham, and Davy [former GEICO CEO Lorimer Davidson], but would be curious to know who in addition to those three. Thank you.

WARREN BUFFETT: Well, I’ve had a number of them. And I’m not sure I want to name them because the ones you don’t name might feel a little left out.

But the one thing I've been very lucky on is that the ones I've had have never let me down. So I've never had that experience where you've looked up enormously to somebody and then had that person let you down in some way, which would be a terrible experience and very hard to get over it.

And, you know, I'm sure some people have had that in marriage, and they've had it in business.

And the worse situation, of course, is if you have it with your parents, but that did not happen.

In fact, the reverse happened with me. So I can just tell you that choosing your heroes is very important. I tell that to the students when they come. Because you are going to gravitate toward the behavior of those around you.

I tell people to be sure and associate with people who are better than you are. Marry up and hope you find somebody that doesn't mind marrying down. (Laughter)

And it will do wonders for you. It was a huge help to me. I can tell you that.

Charlie?

CHARLIE MUNGER: Yeah. I would say that you're not restricted to living people when picking your mentors. Some of the very best people are dead. (Laughter and applause)

19. "I have my resume screen-printed on my shirt"

WARREN BUFFETT: Well, with that, we better go to number 1. (Laughter)

AUDIENCE MEMBER: Hello, everyone. My name is Kendall Brubaker (PH). I'm a senior from Purdue University in West Lafayette, Indiana.

I have my resume screen-printed on my shirt. Charlie and Warren, I brought a shirt for each of you, as well as one for (inaudible), who is responsible for my presence today.

Additionally, I have a strong interest in social entrepreneurship and the Gates Foundation and would love to offer a shirt to Bill, if he is willing to accept.

Now, I had an overly technical question about the historic rate of economic growth and why it's 3 percent as opposed to 2 or 5.

However, given my circumstances, I feel it is more appropriate to ask if I made a sound economic decision to make this trip to Omaha to display my own intrinsic value, and to turn down the $500 that the man just offered me for my spot in line to 27,000 people and to learn from you, or if I would have been better off charging the equivalent amount to my American Express card on See's Candy and Coca-Cola?

Thank you. And, again, my name is Kendall Brubaker. (Applause)

WARREN BUFFETT: Thank you. I thought your question was going to be what shirt size we wore, but — (Laughter)

CHARLIE MUNGER: Mine is small. (Laughter)

20. Munger: Running cars on corn is "dumb"

WARREN BUFFETT: I think we'll move on to number 2. (Laughter)

AUDIENCE MEMBER: Tom Nelson (PH), North Oaks, Minnesota.

This one is for Charlie. What are your current views on the costs and benefits of ethanol production in this country?

CHARLIE MUNGER: Well, you know, even [Sen. John] McCain has had a counter revelation lately. He's decided that ethanol is wonderful now that he realizes that's the way they think in Iowa.

I'm somewhat in his position here, but I won't allow that to stop me. (Laughter)

I think the idea of running automobiles on corn is one of the dumbest ideas — (applause) — that has gotten widespread acceptance that I have ever seen.

But in a government with a lot of political pressures, weird decisions get made. But that has to be about as crazy a decision as was ever made.

You want a social safety net under people, and the most basic safety net of all is food. And you're going to raise the cost of food so you can run these automobiles around? And you use up just about as much hydrocarbons making the corn as you get out of the ethanol.

I would say that — and you don't count in the cost of the ethanol, the cost of the topsoil that goes away forever when you — it's a — I love Nebraska. I'm a Nebraskan to my core. But this was not my home state's finest moment.

WARREN BUFFETT: We're going to try to smuggle him out of town tonight. (Laughter)

21. "Supermoney" book available for purchase

WARREN BUFFETT: I should make one announcement.

In terms of the books at the Bookworm outside, Jerry Goodman, a friend of mine from way back, wrote a book many years ago called "Supermoney," which he just brought out a new addition.

They actually flew those in. They arrived here at the auditorium about 9 or 10 — 10 or 11 o'clock — I guess, this morning. And the new revised issue of "Supermoney" is now out there, in addition to all the other titles.

And I would feel remiss, after all the trouble they went to, if I didn't mention that to this group.

It's a very good book. Jerry was a great writer. He wrote "The Money Game," which was a classic. And "Supermoney" is a good book, too.

22. Best hedge against inflation

WARREN BUFFETT: Let's go to number three.

AUDIENCE MEMBER: Good afternoon, gentlemen. Paul Wigdor (PH) from Montclair, New Jersey.

What are you doing to protect our company's portfolio against the perils of inflation? Specifically, are you looking at further currency investing and metals investing?

WARREN BUFFETT: Well, we would not necessarily look at metals investing as being any protection against inflation at all.

But we are — the best protection for inflation is your own earning power. I mean, somebody that is a first-class surgeon, or lawyer, or teacher, or salesperson, or anything else, whether the currency is seashells, or paper money, or whatever, will do all right in terms of commanding the resources of other people.

So your own earning power is your best — is the best hedge against inflation.

The second best hedge is to own a wonderful business, not a metals business, necessarily, not a raw material business, not a minerals business, but a wonderful business.

And the truth is, if you own Coca-Cola, if you own Snickers bars, if you own Hershey bars, if you own anything that people are going to want to give a portion of their current income to keep getting, and it has relatively low capital investment attached to it so that you don't have to keep plowing tremendous amounts of money in just to meet inflationary demands, that's the best investment you can probably have in an inflationary world.

But inflation is bad news for investors under almost any circumstances.

You can argue that if you own some business that required very little capital investment and had real flexibility of price during an inflationary period so that people would continue to give up a half an hour of work — of their own work — every month to buy your product, and you leveraged it, then you might even beat inflation to some extent.

But leverage is not our game, but we try to own good businesses.

I think that the Berkshire would not do as well during high rates of inflation at all as it does — in real terms — as it does in periods of low inflation, but I think we would do better than a good many companies.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

23. Railroad business is better but won't be "sensational"

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hello, Warren and Charlie. My name is Felton Jenkins. I'm from Savannah, Georgia.

I've been a shareholder for a number of years. This is my third annual meeting. Thanks to you guys, and thanks to your managers and all your employees for the great job.

Just briefly follow up on one thing. It's been published in the Washington Post, LA Times, a number of media outlets, that the FERC, the California Regulatory Commission, the Department of Interior, have determined that it would save between 100 to $200 million to decommission the dams and find alternative power versus doing the capital retrofit.

But, anyway, my question is, what can you tell us about your views on the future profitability of the railroad industry? And what might make that more exciting going forward versus what it's done historically? Thank you.

WARREN BUFFETT: Yeah. Thank you.

I don't think it will be a lot more exciting. But the relative — the competitive position of the rails has improved somewhat from, really, not a very good competitive position 20 or 25 years ago.

There's been a lot of progress made on the labor front. They benefit in their competitive position vis-a-vis trucking as oil prices go up.

Higher diesel fuel, obviously, raises costs for rails, but it raises costs for their competitors, the truckers, by probably a factor of close to four compared to how it hurts them. And there isn't a whole lot of new capacity being created in the rail industry.

So what was a terrible business 30 years ago, and it was operating under regulation — it's still under — operates under the threat of reregulation, which has a tempering effect on their pricing power — but it's a better business now.

It will never be a sensational business. It's a very capital-intensive business. And when you put tons of capital out every year, it's very hard to earn really extraordinary returns on capital.

But if they earn a decent return on capital, it can be a good business over time, and it can be a lot better business than it was in the past.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that one, either.

24. Best ways a 10-year-old can earn money

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name is Marie Blevins, and I am from Bardstown, Kentucky. This is my first shareholder meeting.

My question is, what do you think are the best ways a 10-year-old can earn money? (Laughter and applause)

WARREN BUFFETT: Well, I must say that was a subject I gave a lot of thought to when I was 10 — (laughs) — more than I gave to school and some other things.

You know, you have to — you're probably a little young to deliver papers. That was always my favorite. And I got about half the capital I started with by delivering papers, and I always liked it because I could sort of do it by myself.

I don't know the situation and the town in which you live, but, like I say, 10 is probably a little young, but 12 or 13 would not be.

And almost any — there can be a lot of — I tried to — I must have tried 20 different businesses by the time I got out of high school.

The best one was a pinball machine business, but I'm not sure I want to recommend that you get into that.

When I did it, it was a much purer business where you put a nickel in, and that was about it.

But it is interesting — I read a study a long time ago — I wish I could get my hands on it because I've quoted it a lot but I never quoted it as authoritatively as I would be able to if I could actually find the damn thing that I read 30 years ago.

But it correlated business success with certain variables.

And, you know, they tried grades in school, and they tried what your parents did, and they tried whether you went to business school, all those kind of things.

And they found it correlated best with the age at which you started your first business, got into business, that the younger you were when you did your first piece of business seemed to correlate best with later business success.

And to some extent, that's sort of natural. It's probably true that — that when you see it in athletics, you see it in music and that sort of thing.

So whatever you can figure out that other people will pay you to do that they don't want to do themselves or that they'd like done for them — I advise you to look around the neighborhood and talk to your parents, talk to your friends, see what other people have done that have been 10 or 11 or 12 years old that's worked for them and copy it.

But if you can get a good paper route when you're 12 or 13, that's a sure way to save some money.

I've often wondered about people that are having trouble being in debt, you know, that have a normal eight-hour job.

If they added a route in the morning and just put that aside, you know, it could be the way out of being behind the game instead of being — and getting ahead of the game — and take another hour and a half out of their day, but not too many people seem to do it.

Charlie used to sell — didn't you used to sell yourself the best hour of the day or something, Charlie?

CHARLIE MUNGER: You bet.

WARREN BUFFETT: Yeah. Tell them what you did.

CHARLIE MUNGER: Well, when I was young, I read that savings bank thing, "The Richest Man in Babylon," which taught the joys of underspending your income and investing the difference and how wonderfully it would work over time.

And, lo and behold, I did exactly what this little pamphlet suggested, and it worked. And the other idea — and then so I got the idea that — I had a mental compound interest thing, too.

And so I finally decided I was going to give the best hour of the day to improving my own mind, and then the world could buy the rest of the time. And that may have been a very selfish thing to do, but it worked.

WARREN BUFFETT: Yeah. Charlie was selling his time — I don't know. What you were getting per hour as a lawyer?

CHARLIE MUNGER: Not much.

WARREN BUFFETT: Yeah. He just decided to sell himself the best hour, and not a crazy thing to do.

CHARLIE MUNGER: But I would tell that little girl if you make yourself a very reliable person and stay reliable all your life, faithfully doing whatever you engage to do, it will be very hard for you to fail at anything you want. (Applause)

25. Global competitors matter, not global trends

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: Good afternoon, everyone. My name is Dennis Batrowski (PH). My hometown is West Point, Nebraska, and I now live in Omaha with my family.

WARREN BUFFETT: As you may know, my mother came from West Point.

AUDIENCE MEMBER: Yes. Thank you, Warren and Charlie, for your incredible education, generosity in this great meeting. I've attended every meeting since 1994.

Warren and Charlie, assuming a necessary margin of safety in the future cash flow estimates and proper adjustments in discount rates, would you discuss which trends of global economic growth that you think will be sustainable, given our holdings in railroads, steel, materials, and energy, with our modest expectations, enormous trade deficit, tight credit spreads, low risk premiums, and explosive growth in emerging economies? Thank you.

WARREN BUFFETT: Yeah. We think we're — we think we're in a pretty good group of businesses for the world we face. You know, we don't know which ones will turn out to be the best. There's a few that we think are real superwinners, and we think a significant number of them will do OK.

And we don't try to buy our businesses with thoughts much of world trends. We certainly think in terms of international — foreign competition.

I mean, we do not want to buy into a business that has a very high labor content and that has a product that can be shipped in from abroad very easily.

Because, sooner or later, that will probably be trouble, just like Charlie and I — really, I bought into an airline — he came along and tried to rescue me — some years ago that had very high seat mile costs and it had protected routes — US Airways — so it was able to operate with 12 cents a seat mile of cost because Southwest hadn't gotten there yet with their 8 cent costs.

But they get there. And you do not want to have something whose competitive position is going to erode over time. But I think most of our businesses have got pretty strong competitive positions.

And, really, the variables you name don't bother us. You know, we will play the hand as well as we can, and we're playing it with terrific people in very good businesses, and we're dealing from strength all the time. You know, we've always got a loaded gun.

And we think we've got the right values with our managers, the people. Think we've got a culture that's owner-oriented.

We've got a lot of things going for us, and they won't produce huge returns, but they're likely to work OK.

Charlie?

CHARLIE MUNGER: Well, we learned about foreign labor competition in our shoe business. And in that, it reminds me of Will Rogers, who didn't think man should have to learn these easy lessons in such a hard fashion.

Will Rogers believed that you should learn not to pee on an electrified fence without actually trying it. (Laughter)

WARREN BUFFETT: Will told Charlie a lot of things he didn't tell me. (Laughter)

26. It's all relative with currencies

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. I'm Shinydaz Guynadewa (PH) from Fort Lauderdale, Florida.

First of all, I want to thank you for your efforts in making investors aware of the high transaction cost involved with several investments, and I got lot of personal benefit by reading your articles.

My question today is in reference to the declining value of dollars compared to all other major currencies. In last three years, dollar declined as high as 25 to 30 percent.

So I want to understand how it is going to impact individual investors and the how big is the threat? Thank you?

WARREN BUFFETT: The question is about the declining dollar but I didn’t get all the —

CHARLIE MUNGER: He asked you for — what do we think about it, what are we going to do about it.

WARREN BUFFETT: We think it — we think the dollar over time is — unless policies are changed in a major way — is likely to decline somewhat more against most major currencies.

And we originally backed that opinion up with transactions that got as high as 21 or -2 billion in the ownership of foreign currencies.

And then the carry on that, the difference between interest rates in the various countries, made that quite an expensive way to express that belief.

So we have focused much more on buying into companies that earn lots of money in other currencies, on the thought that they will be somewhat favored over companies earning just U.S.

But that’s not — as I mention in the report — that is not a huge determination of what we buy. It’s a factor, but it’s not — it’s not 50 percent of the decision or anything like that.

We are following policies in this country that are likely to cause the dollar to decline in value against many major currencies. And who knows what speed, whether it happens this year or next year. We don’t have any idea on that sort of thing.

But the fundamental forces are fairly strong.

We actually only own one currency now — trade — which would surprise you, actually. We’ll tell you about it next year.

Charlie?

CHARLIE MUNGER: Yeah. So far, something peculiar has happened. During this exact period of maximum dollar decline in value versus other currencies, the dollar prices at Costco have showed an inflation factor of approximately zero.

So what really matters, of course, is how things are working in your own country, and it’s been perfectly amazing how well we’ve gotten by so far with the decline of the dollar.

WARREN BUFFETT: Yeah. As Charlie says, you know, we reference everything in terms of our own country.

If you look at oil, for example, which we'll say has gone from roughly $30 a barrel to $60 a barrel over the last few years, you know, during that same time the euro has gone from, like, 83 cents to a $1.35.

So the price of oil, if you're a European, has gone up very little. I mean, we think oil has run wild. But in terms of anybody that's using the euro, the price of oil has gone up about 25 percent, and we feel the price has gone up a hundred percent.

So you do have this anchoring of thought to your own currency, which is understandable.

I do think you'll need to think about currency matters more than Americans traditionally have. I was struck 20, 30, 40 years ago, when I would travel elsewhere, how much more sophisticated most people in Europe and the UK, wherever, were about currency than the United States.

We never really had to think about it. Everything was dollar-based, and an American didn't have to be smart about currency or even think too much about it in terms of their business. But that world has changed.

27. Corporate directors aren't doing their job

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: John Norwood from Des Moines, Iowa. A quick question — a quick comment and then a question.

The comment, following on Charlie's comments on ethanol, I would ask him at least to look at the environmental benefits of ethanol as a fuel blend — octane boosters superior to other types of chemical additives, such as MTBE, which has been so damaging to groundwater.

My question is for Mr. Buffett. And I'm hoping you might be able to tell us a little bit more about your interactions with the board of directors and the types of ideas and idea exchange and, perhaps, a model for how you believe a board of directors is supposed to function with management. Thank you.

WARREN BUFFETT: Yeah. I would say that most writers and most shareholders probably have a little bit of a distorted version, at least, how most corporations — large corporations — have operated over the years.

Usually — for a long time I would say that directors, generally, were sort of potted plants. I mean, you sat there and the management had its agenda and didn't really want input on major matters.

And Charlie and I can certainly testify to the fact that we have had great lack of success, even when we were the largest shareholder of a company, in terms of talking about things that really count.

I mean, if somebody spends their whole lifetime— 25, 30 years — rising to the position of CEO, you know, they want to be boss, and you can't blame them, and the only thing in their way is the board of directors.

So they look for people who are big names and they look for ways to keep them happy, but they don't really want them getting into the business very much.

There's a lot more process now that's been imposed by the recent rules. But I would say still, in terms of the reality of the guts of business and the discussions that take place and all that, I think you might be surprised at the level overall of that throughout corporate America.

As I've written in the report, overwhelmingly, the job of the board of directors is to have the right CEO. I mean, if you've got the right CEO, 90 percent of it takes care of itself. If you were the director of Cap Cities and you had Tom Murphy as the CEO, you know, case closed. It was all you needed.

And if you have that CEO, I think you have an obligation on the board to make sure that there's not overreaching by the CEO, because the CEO can have different interests.

And I think the third thing that the board does — should do — is they really should bring some independent judgment in on major acquisitions. Because there is a natural tendency for people with, usually, big egos, big motors, who get to be CEOs that like to do big things and to become bigger spending other people's money.

And normally, when big deals come along, you know, the management — by the time it gets there, they've made the deal anyway. They have investment bankers there who go through a little ritual. I've never seen one come in and make a presentation that says it's a dumb idea. I mean, they know what the answer is supposed to be, and it just becomes kind of a little game.

So I think in those three respects, a good director will first make an affirmative decision. You've got a very good CEO — not the best in the whole world, not everybody can do that — but a very good CEO.

That that CEO is not overreaching.

And when significant deals come along, that they get a chance to weigh in, and that you really get a balanced discussion about the real economics of what you're doing.

And I would say in that latter point, what I've seen over the years has really been pretty bad. But I can understand it because the CEO wouldn't bring in the deal unless he wants it done.

And once he brings it in, he’s going to stack the deck and make the presentation in such a way that it’s almost impossible to exercise independent judgment.

Charlie, do you have any thoughts on —

CHARLIE MUNGER: I think big, big deals, on average, in America, are contrary to the shareholders’ interest. That’s the way to bet. On the acquirer’s side, usually the shareholders are worse off.

WARREN BUFFETT: Most stock deals, they think about what they’re getting and they don’t think about what they’re giving.

I mean, I have been involved time after time where people are giving a significant percentage of the business, which they wouldn’t sell at the current market price. If somebody came along with a tender offer 20 percent higher, they would say that’s inadequate.

But they hand away a piece of the business because they want to own something else. And there’s nothing wrong with that, but you just have to be sure that you’re getting as much as you’re giving.

I have very seldom heard a discussion — in fact, I don’t think I’ve virtually ever heard of a discussion — of weighing what you were actually giving away on a stock deal versus what you’re getting.

I’ve heard a lot of discussion about dilution and when dilution will be overcome and all that sort of thing, but that is not the question.

The real question is are you — if more value is being created, how is it being whacked up between the two companies?

And if not extra value is being created, are you getting more than you’re giving?

When I gave away 2 percent of Berkshire Hathaway to acquire Dexter Shoe, that was one of the dumbest deals in the history of the world.

And I did it all by myself. Charlie didn’t participate in that one. I wish he had.

But, you know, it was dumb. I mean, here’s — it wasn’t 2 percent of what I had then at Berkshire, it’s 2 percent of the present Berkshire Hathaway company.

You’d all be 2 percent richer — a little more than 2 percent richer — but you’d be a full 2 percent richer if I hadn’t done that.

CHARLIE MUNGER: Fortunately, you’ve made some better decisions.

WARREN BUFFETT: Yeah. Well, I have to, or we wouldn't be here. (Laughs)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: But, you know, the point is that doesn't show up under conventional accounting at all. You know, it gets brushed under the rug.

At Gillette, literally, we had ten deals in a row that never met — came close to meeting — the case that was presented at the time they were presented to the board. Was that ever mentioned to shareholders? Did it show up in our financial report?

Never. It never will. And that goes on all the time in corporate America.

And, unfortunately, shareholders, to the extent they get unhappy with managements, are complaining about whether they've got diversity on the board or something like that.

But when you're blowing away the company, I mean, that, to me, is a whole lot more important.

Charlie, you want to —

CHARLIE MUNGER: Yeah. The self-serving delusional nature of even some very good minds, in terms of IQ points, is amazing.

I had a friend who sold a business to a government-controlled business in a socialized Scandinavian country.

And my friend had a very nice business, and the people on the other side, after they had bought it for stock in their government corporations, said, "This was such a marvelous deal. We got your whole business, and we didn't have to give anything."

WARREN BUFFETT: Well, we owned stock in the Third National Bank one time down in Nashville. And they got the ability — and they're wonderful people — really wonderful people — but they got the ability to acquire other banks where they formerly had been limited in that ability.

And they went out to some very small bank, and the guy at the very small bank said, "I want stock." And he says, "My stock is worth private market value, and your stock is worth market price."

Well, market price happened to be half of — but he says, "All I'm getting is whatever the market is, so I want you to value your stock at market and value mine at this huge premium."

And he said, “And there’s one other condition.” He said, “Since I’m going to be putting my whole net worth in your stock,” he says, “I want you to promise you’ll never do a deal this dumb in the future.” (Laughter)

Do you remember that one, Charlie?

CHARLIE MUNGER: Yeah, I remember.

WARREN BUFFETT: Yeah. And that fellow was just being a little — was just getting a little more out in the open than is typically the case.

I’ve been on some terrific boards. There was a local one here called Data Documents that really functioned with everybody on the board thinking about the business, understanding the business, making decisions as owners.

Every one of them had a significant percentage of their net worth in the business, and probably the best board I’ve ever been on. I mean, every decision there was made for business reasons.

The worst decisions — at least they have the potential for being the worst — but it’s standard procedure now when an acquisition comes up to trot in the, you know, investment bankers and the lawyers, and the momentum is just totally to get the deal done. And, like I say, there will be a lot of slides presented.

And I can — I don’t need to look at the slides. I know what the answer is going to be. At the end they’re going to say it’s a great deal, you know, and there will be nobody arguing the other side.

They’re just — you know, it is not like something where you would make a decision and you’d have somebody give pro and con. It just doesn’t work that way. I don’t know how to improve that a lot.

I think we’ve got a sensational group at Berkshire. You have a group with almost everybody on the board having a significant percentage of their net worth — Bill’s is so big we can’t get him to a significant percentage, but that’s — he’s got hundreds of millions of dollars in it.

We’ve got a board that is in exactly the same position as the shareholders. They don’t have directors’ and officers’ insurance. They’ve got the downside as well as the upside. They bought their stock in the open market, so it hasn’t been given to them. It is a real owners’ board, and I like it that way.

I think it’s a terrific group, and I’m glad I can get them to work cheap. (Applause)

28. Why Berkshire avoids deals with partners

WARREN BUFFETT: Number 9, please.

AUDIENCE MEMBER: My name is Eid (PH) and I'm from Kuwait. In response to earlier comment about borrowing from Kuwait, I can tell you that after 40 years we now lend in dollars, and you are always welcome in Kuwait. (Laughter)

My question is, if you would pick your partners to invest with you in big deals, what would be your criteria for choosing partners?

WARREN BUFFETT: Yeah. We — is that — are you complete on that?

AUDIENCE MEMBER: I'm complete.

WARREN BUFFETT: Yeah. We normally don't want to do deals with partners. If we like a deal, we want to own it all.

And we usually have the money to do it all, so almost — in very few cases would there be a need for a money partner.

And then there's a question for a knowledge partner. And we really wouldn't want to be going into something, in most cases, where we were relying on somebody else to be the brains of the deal. We've made exceptions on that, but very seldom.

So we — by our nature, we would like to have a hundred percent of any deal for the benefit of our shareholders. If we're going to spend our time on it, we just as soon get a hundred percent of the rewards. We don't mind taking a hundred percent of the downside.

And we ought to understand it well enough so we don't need a partner.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that one, either.

WARREN BUFFETT: Number 10. Wait, I'm just trying to think. Have we done any big partnership deals?

CHARLIE MUNGER: Well, you made that partnership deal with Leucadia, but they brought you the deal.

WARREN BUFFETT: That is true. We made a very good partnership deal with Leucadia. They did way more than their share, but they brought us the deal. And so they asked us to participate in their deal.

Now, in effect, we own less than a hundred percent of some of our businesses, and we're in partnership with the management. But that's perfect. I mean, we've had some great experiences with that, and we'll continue to have great experiences.

But, you know, they came — they're in on the same terms we are, and they're owners.

All of our managers think like owners. But in certain cases, they are real owners directly in those businesses as well.

But just some outside party as a partner, we really haven't done, although I would do another deal with Leucadia if they came to me and I liked the deal. I mean, that was a very good experience.

29. No opinion on commodity prices

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Good afternoon, ladies and gentlemen. My name is Ari Jahja. I'm a junior from Baruch College, New York City.

And on behalf of the Portfolio Management Club, I would like to thank you, Mr. Buffett, for inviting us to this wonderful event.

And my question is that, first of all, speaking about Berkshire's portfolio, there's an increasing exposure of your investments toward commodities, such as to oil through PetroChina, to steel through POSCO, and to coal and agriculture through the rail stocks that you recently purchased.

So my question is that what is your long-term view on commodities, and how does it impact your view on the geopolitical state of the world in the future? Thank you.

WARREN BUFFETT: Yeah. I — and, to my knowledge, Charlie — we'll hear from him — but we have no opinion on commodities.

We — if we were in an oil stock, it's because we think it offers a lot of value at this price, but it does not mean that we think the price of oil is going up. If we thought oil was going up, we could buy oil futures, which we actually did once.

But very seldom — very, very seldom would we have any opinion on what any given commodity would do.

Owning POSCO, we just think it's one of the — well, it is probably the best steel company in the world and — remarkable record.

When we bought that stock, we were buying it at four or five times earnings, with a debt-free balance sheet, one of the lowest-cost producers around. I mean, it's a fabulous company.

And in addition, it was a play on the Korean won, and we made 20 percent on the won by being invested through a won-denominated security.

So we may occasionally be in those kind of businesses.

We, basically, like best the businesses that require very little capital, because they're the only ones that have a chance of earning really high returns on capital.

You can't have a business that has huge capital expenditures year after year, and end up with a high- return business. It just doesn't work in this world.

But you can find some businesses that really require relatively minimal capital investment.

Here's the case. This is a small one. But See's Candy is not going to require a huge capital investment.

It requires some capital investment, but it's a wonderful business. It's a small business, but it's a wonderful business. And it's far better business, relative to size — adjusted for size — it's a far better business than any steel business is going to be or any oil business is going to be.

It's just that it's not very big. We'd love to have it bigger. And we'll do our share in every way we can, as you may have noticed up here.

But we do not have any — we do not have a bias toward — at all — toward businesses involved in commodities. And if we had any bias, it would be against.

Charlie?

CHARLIE MUNGER: Yeah. We're going to be investors in businesses, not commodities, by and large. And that has to work better over time.

30. Dual class shares at the New York Times

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Good afternoon. My name is Andy Peake from Weston, Connecticut.

Recently the newspapers have been in the news: the [Rupert] Murdoch bid for Dow Jones, Morgan Stanley's Hassan Elmasry's push to eliminate the New York Times dual-class share.

Given you are both experts in the dual-class share and newspapers, what advice would you give to the long-suffering New York Times shareholders, and what advice do you have for Arthur Sulzberger, the besieged CEO of the New York Times and head of the family that owns the newspaper?

WARREN BUFFETT: Well, I think the "long suffering," as you put it, shareholder of the New York Times has probably made a mistake — I don't think I'd necessarily blame the Sulzbergers for the woes of the newspaper business.

I mean, we have said for a good many years that we thought — in effect, we thought newspapers were overpriced because they reflected a valuation based on looking in the rearview mirror rather than through the window.

And we — it's interesting. We have this dual-class structure at Berkshire. But because I converted a whole bunch of shares to B, I own about the same percentage of the B as the A, because I converted about six or seven times as much as I needed for present gifts.

I only go down to my safe deposit box when I have to, and I didn't want to go down every year to convert stocks, so I just converted a bunch of stock early on.

And now I own about 30 percent of each. So it has no effect, in terms of voting power at Berkshire.

But the woes of the newspaper business are not connected with the difference in voting structure at the Times or other places. The newspaper business has just gotten a lot tougher.

And if you think about it — I mean, let's assume that Mr. [Johannes] Gutenberg, back there in the 15th century, instead of wasting his time developing movable type and all of those kinds of things, decided to become a day trader or hedge fund operator and really made something of himself, so that we never had print.

But along came the internet, along came cable TV, all kinds of other things. And then now this year, you know, Johannes Gutenberg the 28th or something, came along and said, "I've got this wonderful idea. We're going to chop trees down. We're going to haul them great distances.

"And then we're going to put them through expensive newsprint machines. And then we're going to send them down to someplace where they've got expensive presses.

"And we'll run these things all night. And then we'll send delivery trucks out through the snow to get these little pieces of paper out to people where they can read about what happened yesterday."

Well, I don't think we would be backing him, you know.

Now, it happened, you know. The other one came along first, and people's habits don't change immediately, and, you know, the world doesn't turn over.

But, in effect, you know, the position of newspapers today still reflects the fact that they have inertia and momentum on their side from the past.

And I don't care how smart you are. You know, there was a fellow that came into the LA Times a few years back. He was going to take the circulation up to a million- five, as I remember, Charlie. And the circulation is now 800-and-some thousand of the LA Times, and it's gone down every week.

And I don't know that — you know, I don't know that Joseph Pulitzer or William Randolph Hearst or E.W. Scripps or anybody who were geniuses in their day, maybe, at building circulation, could do much about that.

The truth is that the world has changed in a significant way. We used to sell 300,000 World Books a year. It was a good value. You know, and we sell 22,000 sets or something like that now.

And it isn't because the World Book isn't worth what it sells for. It's just not worth what it sells to for most people who can go on the internet and get an awful lot of that information free.

So I don't think I would blame the dual-class structure on anybody's investment losses in the New York Times.

The companies that have not had dual-class structures — I mean, we own the Buffalo News. And the Buffalo News earnings have been — they're certainly down over 40 percent from the peak.

We have terrific management. We've got a paper that has among the highest penetration in circulation of any large metropolitan paper in the country. But we are — our earnings are going down, and it's a fact of life.

Charlie?

CHARLIE MUNGER: Yeah. He was talking about that dual-class structure as being intrinsically wrong, but I would argue that the Sulzbergers set it up that way when they went public, and so that was in the basic contract.

And once a contract has been made, the idea that you can just stamp your foot and take away the contract strikes me as a — kind of an immature idea.

WARREN BUFFETT: I would add, too, that the Sulzbergers from the start — anybody that bought the New York Times knew that they would not try to maximize earnings in a given quarter or try to minimize the downturn by slashing costs or something of the sort.

They didn't build the New York Times by doing that. It did not have a reputation which allows it, perhaps, to have a decent future on the internet. It did not get to where it is by a policy of, you know, Management 101 as taught as some business school.

And, yet, following that differing course, you know, I don't know how many papers in New York disappeared. But whether it's The Herald Tribune or The Sun or The World-Telegram or you name it, the world — they had a different management approach, and they all fell by the wayside, and the Times is still around.

So I — I'm not sure 10 years from now or 15 years from now that people will regard the Times' playing of their hand as being, necessarily, an inferior one.

They may have a better position going into the internet than almost any newspaper around. Certainly a lot better than, you know, the Philadelphia Inquirer or the LA Times has.

You know, the LA Times will have more trouble monetizing their reputation on the internet than the New York Times will, if there's a national game to be played in that. So we'll see how it plays out.

31. Annual meeting is running out of space

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: My name is Betty Stuart Rodgers Jeffreys, and I live in Barrington Hills, Illinois, 35 miles northwest of Chicago.

This is the first time I've ever been to your annual meeting, and I want to thank you both for giving us so much time to answer our questions and give us such words of wisdom.

I would also like to thank you for giving us a wonderful weekend of lunches, brunches, cocktail parties, time at Gorat's and Borsheims.

The problem is that when I told my two adult daughters that I was going to have such a wonderful weekend, they both made me promise to bring them next year.

And if 25,000 people bring two people next year, where are we going to meet?

WARREN BUFFETT: Well, I would — if you get the answer to that, I'm really waiting to hear it. Because we — it's about 27,000, and we are just about maxed out here. We're just about maxed out in terms of hotel rooms. I think we're going to have four new hotels in Omaha —

AUDIENCE MEMBER: Oh, good.

WARREN BUFFETT: — before next year. But, you know, that's a couple thousand people. And, you know, based on the growth, at some point we sort of hit the wall, and I haven't figured out how to handle that.

If anybody has any suggestions, I'll appreciate hearing about them.

But I'm delighted you're having a good time here. I hope you've all had a good time here.

AUDIENCE MEMBER: Thank you.

WARREN BUFFETT: We're now going to take a ten-minute recess, and then we'll reconvene. Thank you.

32. Formal business meeting begins

WARREN BUFFETT: OK.

If you'll please take your seats? We want to finish by 4, so we'd like to move quickly through the rest of the business, and we'll get on to the PetroChina question.

And let's see. Here we are. The meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company. I welcome you to this 2007 annual meeting of shareholders.

I will first introduce the Berkshire directors — I've already done that.

So, also today with us are partners in the firm of Deloitte & Touche, our auditors. They are available to respond to appropriate questions you might have concerning the firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at this meeting? Forrest?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 6, 2007, being the record date of this meeting, there were 1,113,240 shares of Class A Berkshire stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 12,888,424 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to one two-hundredth of one vote on motions considered at the meeting.

Of that number, 955,276 Class A shares, and enough — 11,301,274 Class B shares are represented at this meeting by proxies returned through Thursday, May 3rd.

WARREN BUFFETT: Thank you. That number represents a quorum, and we will therefore directly proceed with the meeting.

The first order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

I guess I heard a second.

The motion has been moved and seconded. Are there any comments or questions? We will vote on this question by voice vote. All those in favor say "aye."

VOICES: Aye.

WARREN BUFFETT: Opposed? The motion is carried.

33. Berkshire directors elected

WARREN BUFFETT: The first item of business is to elect directors.

If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles, and we'll furnish a ballot to you.

Would those persons desiring ballots please identify themselves so that we may distribute them.

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WARREN BUFFETT: I move that Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: Second.

WARREN BUFFETT: It's been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott be elected as directors.

Are there any other nominations? Is there any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors voting the proxies in accordance with the instructions they have received.

Miss Amick, when you are ready, you may give your report.

REBECCA AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 1,008,564 votes for each nominee.

That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as any cast in person at is this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott have been elected as directors.

34. Shareholder proposal to divest PetroChina shares

WARREN BUFFETT: Now, the next item of business we'll spend more time on, and that is a proposal put by — forth by Berkshire shareholder Judith Porter, the owner of ten Class B shares.

Miss Porter's motion, as set forth in the proxy statement, provides that Berkshire Hathaway not invest in the securities of any foreign corporation, or subsidiary thereof, that engages in activities that would be prohibited for U.S. corporations by executive order of the President of the United States.

The directors have recommended that the shareholders vote against the proposal.

The microphones at zone 1 and 7 are available for those wishing to speak for or against Miss Porter's motion.

These are the only microphone zones in operation; so I ask that you go to either 1 or 7 if you'd like to talk on this.

I ask that you confine your remarks solely to Miss Porter's motion.

Now, we have a number of shareholders who want to the talk about this, and we will let shareholders speak.

If there's sufficient time at the end of that — and we're willing to — certainly willing to — have them speak for half an hour, and Charlie and I will give them, maybe, a couple minutes' response after that.

But you've got a half an hour. Different shareholders can speak. I hope you tailor the length of your remarks, the early ones, so that it gives other people a chance.

And if we have time after the shareholders have spoken and there are other people that are in attendance as visitors that wish to speak, we'll have them also.

But if the shareholders use up the full time until almost 4 o'clock, then we'll have to finish at that time.

So, Miss Porter, if you're available — if we can turn the light on there at station 1 — to speak, you have the floor.

JUDITH PORTER: Thank you. Mr. Buffett, my name is Judith Porter, and I'm the shareholder who introduced the proxy resolution involving Berkshire Hathaway's divestment of PetroChina.

PetroChina is implicated in the genocide in Darfur, Sudan.

I want to thank you for allowing us to speak to this resolution. In many countries it would be impossible for us to do so, but we are indeed fortunate to live in a country where we can express our opinion without fear or without recrimination.

Before my husband formally presents the resolution, I want to explain to you why I have introduced it.

My family is no stranger to genocide. My grandparents were murdered in 1941 in the Nazi genocide, as were other members of my family.

I will never forget the despair my father expressed when my aunt, who was released from Bergen-Belsen concentration camp, sent him a letter telling him what happened to his family.

It deeply affected him for the rest of his life. And I was raised to believe that genocide should never, ever again happen, never again.

The world was silent when my grandparents were murdered. But genocide has continued.

In the genocide in Cambodia, the world was silent. In the genocide in Bosnia, the world was silent until late in the slaughter. The world was again silent in the horrible genocide in Rwanda.

How many times must we say, “Never again?”

Now, there’s the first genocide of the 21st century in Darfur. Two and a half million civilians have been driven from their homes. More than 400,000 have been killed, and 1,600 villages have been destroyed.

Berkshire Hathaway can play a role in ending this slaughter by divesting in PetroChina, as we’ll shortly describe. As an exemplar of both business ethics and personal integrity, your support of divestment will send a signal to China and to the Sudan that there are costs to continuing this destruction, and it will lead other corporations to follow your ethical actions.

Genocide is never a good investment. I can think of no greater tribute to my grandparents than introducing this resolution. As Elie Wiesel said in his Nobel Peace Prize speech, “We must take sides. Neutrality helps the oppressor, never the victim. Silence encourages the tormenter, never the tormented. Sometimes, sometimes we must interfere.”

My husband will now present the proxy resolution. He will be followed by Jason Miller, who will speak about the relationship between CNPC and PetroChina. Abdul Makjid (PH), who is from Sudan, will speak about the genocide taking place. And Bob Edgar, Secretary General of the National Council of Churches, will conclude our discussion of this resolution. Thank you.

GERALD PORTER: Thank you. Mr. Buffett. Since you’ve read the resolution, I will not repeat the resolution. I will speak about the resolution, though.

On November 3rd, 1997, President Bill Clinton issued Executive Order 13067, which imposed a trade embargo prohibiting most American businesses from operating in the Sudan.

This executive order was expanded on April 27th, 2006, by President George W. Bush. While it is true that American companies cannot do business in the Sudan, Americans can invest in Asian and European companies that do business in the Sudan.

Such investments do not violate the letter of this law, but they certainly do violate the spirit of the law and are counter to the stated policy of the United States.

We believe there is general agreement that the Chinese National Petroleum Company, CNPC, plays a major role in funding the genocide, in providing weapons to the Sudanese, in cooperating with the Sudanese military, in forcibly displacing local populations, and in myriad other ways, facilitating the killing of hundreds of thousands of Darfuris.

CNPC is the largest foreign investor in Sudan's oil industry, and fully 70 percent of the revenues Khartoum generates from CNPC's operations go to its military, which, in turn, conducts the genocide in Darfur.

We are here today because Berkshire Hathaway is the major non-Chinese investor in CNPC's subsidiary, PetroChina.

You, Mr. Buffett, have stated that you believe that we are wrong, both in our analysis of PetroChina's connection to the genocide and the belief that divesting the company's PetroChina holdings would in any way have a beneficial effect on Sudanese behavior.

We disagree. You are correct in stating that PetroChina does not do business in the Sudan. However, as you agree, its parent company, CNPC, is a major investor in the Sudan, and funds from that relationship help provide the instrumentalities of genocide.

Managements claim that the relationship between PetroChina and CNPC is similar to that between Fannie Mae and the U.S. government. That argument is fallacious.

The Harvard University Advisory Committee on Social Responsibility examined the management of the two companies. The results of that review were striking.

There was almost total management overlap between the two companies. Andrew Leonard, writing for Salon.com commented, "To declare that a subsidiary has no ability to control the policies of the parent when the two entities are run by exactly the same people is an exercise in specious obfuscation."

In short, PetroChina is an artifact created for the sole purpose of allowing some shareholders to distance themselves from the action of its parents, CNPC.

In China, the companies share the same brand name and the same logo. If you look at a coin, the images on the two sides are different, but the coin is a unity. You cannot spend one side of a dime or own one side of a quarter.

It's the same with PetroChina and with CNPC. They look different, but they are simply two faces of the same corporation.

Two U.S. presidents have stated clearly that it's against the national interests of the United States for U.S. companies to do business in Sudan.

It is the position of the U.S. government that a targeted economic boycott of the Sudan will help end the genocide in Darfur.

For a U.S. company to invest in a subsidiary of a foreign company, such as PetroChina, that engages in business in the Sudan is a circumvention of Executive Order 13067 and weakens the U.S. sanctions.

Economic sanctions against the Sudan have worked in the past. For example, Talisman Oil's sale of its assets in the Sudan helped bring about the end of the civil war in the Sudan.

Sudan's main protector in the United Nations is the government of China. China will be hosting the 2008 Olympics and is very sensitive about negative publicity that could be aimed at that event.

In response to the recent criticism of the Chinese support of Sudan by Mia Farrow and Steven Spielberg, a senior Chinese official traveled to Sudan to push the Sudanese government to accept a United Nations peacekeeping force.

You and the company are viewed as exemplars of ethical behavior. If Berkshire were to take the lead and divest, others would follow. If Mia Farrow can cause change to occur, then so, too, can Warren Buffett.

No one divestment in South Africa brought about the end of apartheid. But if we all act together, we have tremendous power to bring pressure on the Sudanese government to stop the killing of innocent people.

During the last two decades, beginning with the tearing down of the Berlin Wall in October 1989, we have seen events that no person could ever have anticipated: The breakup of the Soviet Union, the democratization of Eastern Europe, and an unbelievable transition in South Africa.

What we have learned is that all things are possible. There are important issues in our society that desperately need our attention. Remember the words of Hillel: "If I am not for myself, who will be for me? If I am for myself alone, what am I? If not now, when?"

Thank you. And I'm pleased to introduce Jason Miller. (Applause.)

JASON MILLER: I'm Jason Miller, the National Policy Director for the Sudan Divestment Task Force and also an owner of three shares of Berkshire Class B stock.

I'd like to echo the Porters' comments that CNPC is by far and away the most irresponsible and abusive oil operator in Sudan.

They've participated with the government in forced displacements and other human rights violations, and 70 percent of the revenue that they provide to Sudan gets funneled into the military that prosecutes the genocide at Darfur. But what does that have to do with PetroChina?

Currently, the chairman of PetroChina's board is the immediate past president of CNPC. The president of CNPC is the president of PetroChina and vice chair of the PetroChina board. The CFO of CNPC is the CFO of PetroChina. The chairman of the PetroChina supervisory board is the chief of discipline and inspection at CNPC.

Eight of the nine PetroChina directors have a current or immediate past connection to CNPC. Four of the five PetroChina supervisors have a current or immediate past connection to CNPC. All PetroChina senior executives are currently or formerly connected to CNPC.

We've also documented a slew of other management irregularities. Furthermore, asset transfers between the two are fluid and often cross-subsidized. After PetroChina's IPO, it took on $15 billion in debt from CNPC, which freed up cash flows for CNPC to spend on Sudan.

Ten percent of IPO revenue from PetroChina went to CNPC's operations in Sudan. Fifty percent of CNPC's profits come from PetroChina dividends.

PetroChina, in 2005, provided $3.15 billion in cash for CNPC's finance arm to provide to other CNPC subsidiaries like those in Sudan. And 64 percent of CNPC's assets are represented by PetroChina stock.

If this isn't management overlap and two manifestations of the same entity, I would challenge people to find one that is more overlapping.

As a result, and because of the huge magnitude of the atrocities in Darfur, even a whiff of this type of overlap between PetroChina and CNPC, and the lack of strong corporate governing structures there, would suggest that engagement with PetroChina by Berkshire Hathaway is a minimum requirement in order to investigate these connections and their potential contributions to the Darfur genocide.

I'd very quickly also like to mention the important question that Berkshire Hathaway was asked, which is what's next? If we engage PetroChina, ask them about these questions, what happens?

The answer by unanimous consent with all foreign policy experts we interact with and those international organizations working in Sudan is that China would change its behavior in Sudan.

Sudan is too important to China as an energy policy for China for it to abdicate those assets. And, as a result, we've already seen changes in China's behavior.

And taking leadership from the queues of Berkshire Hathaway would be one more in the line of Mia Farrows and Steven Spielbergs that could help catalyze the important sea change that's necessary to bring an end to the genocide. (Applause)

JASON MILLER: I'd now like to introduce a Darfurian who's from Des Moines and would like to speak —

WARREN BUFFETT: I would — I would —

Is he a shareholder or not? I want to be sure all the shareholders have a —

GERALD PORTER: He has the proxy of Etta and James Friend, who are the shareholders of three shares —

WARREN BUFFETT: I just want to make sure. Are there other shareholders at 7 that want to talk too or not? I want to make sure that all the time isn't taken.

AUDIENCE MEMBER: We will not take all the time.

WARREN BUFFETT: OK. That's fine. I just want to make sure that the shareholders aren't shut up.

AUDIENCE MEMBER: Good afternoon, and thank you for inviting me to speak about Darfur. My name is Abdamide Jusef (PH), and I am speaking today as a proxy of Etta, Freta, and James Friend, who are the holder of four shares of Class B stocks.

I am from western Darfur, and my parents still live in Darfur. I fled from Sudan to Egypt in September 2002 after being expelled from Sudan University in Khartoum for speaking out in (inaudible) of Darfur.

We are detained for a few week and we suffered from abuse physically and psychologically every day until they released and told us we are not allowed to go to any university and we had to stay away from any activity for that student association. I get refugee status in the United States, and I move to Des Moines, Iowa, on March 2005.

The Janjaweed attack my family — my family's home — in Darfur in January 8, 2007. Four Arab men from the Janjaweed attack our home in the early morning.

At that time, there was a guest in my family home. The Janjaweed left him without attention; so he run away to get help from our neighbors. The Janjaweed started by taking all the money and jewelry from my family.

When the Janjaweed found out that someone had run to get help, they left my family, but they promised them they were going to come back.

Even that my family escaped injury, my neighbor (inaudible) and his entire family of five were murdered by the Janjaweed. The Janjaweed also took their horses, and these activities were ongoing in my town for a while.

And everybody in my community or someone was murdered, have someone was murdered and raided by the Janjaweed. My mom told me everybody wake up every day, and the first thing they do is check their neighbor and their relative to see if they are alive or not, and so do I.

The Janjaweed are stealing my town. Now they work as gangs who kill and rape. Every family is affected, and nobody can stop them.

Even though I live in safety and peace there — here in United States, I still worry about my family back home in Darfur.

Please try to do anything to help my family and all people in Darfur. I need your help. If you do the simple thing like tell your friend about the genocide in Darfur or join an organization, or talk or send letters to your member of Congress, or don't invest in any companies that's helped genocide in Darfur.

Please, Mr. Buffett and Berkshire Hathaway shareholders, get involved to bring the hope and peace to the children and women and all of us in Darfur. Whatever you do to stop the genocide in Darfur is saving life of human being.

Thank you for listening, and now I would like to introduce Bob Edgar, the General Secretary of the National Council of the Church. Thank you.

BOB EDGAR: As we close, I'm Bob Edgar, General Secretary of the National Council of Churches and a former member of the United States Congress. I'm here in support of the resolution and a proxy for Doris Gluck, who holds ten shares in the company Class B stock.

In February of 1968, I had the privilege of meeting Dr. Martin Luther King five weeks before he was assassinated. Later, as a member of Congress, I served on the Select Committee on Assassinations, looking into both the death of Dr. King and John F. Kennedy. I come here today in honor of the kind of dream that Dr. King had.

He said this: "Our lives begin and end the day we have become silent about the things that matter. We will not be silent."

I am here today representing millions of faithful Americans — Christians, Jews, Muslims, and others — who have stood up and said no to this genocide. Just 11 or 12 or 13 years ago, 800,000 people were killed in Rwanda in 90 days, and we were silent. We will be silent no more.

Mr. Buffett, this morning you said a great thing, and I quote, “I find it reprehensible when a government preys on the weaknesses of its citizens rather than protecting them.” I wholeheartedly agree. You were talking about gambling. We urge you to think the same way about genocide.

On the document in opposition to this resolution, you said this: “Proponents of the Chinese government’s divesting should ask the most important question in economics, ‘And then what?’”

We are prepared to answer that question, “And then what? And then what?” Then the world will finally focus on the issue of genocide in Darfur.

Then the international investors all over the world in many companies would follow the ethical actions of Berkshire Hathaway’s moral leadership, moral leadership, and call for all governments of the world to stop the genocide.

“And then what?” Children would be saved, women would not be raped, fathers would not be killed, and we would find our way in this human family to care for one another.

Jesus said, “We should love our neighbors as ourselves.” I think he meant, “We should probably try every means available to stop those neighbors from being killed.” This is just one way we can follow those words of Jesus.

And, finally, the former pope, John Paul, said, “I dream of a world where none will be so poor they have nothing to give and none will be so rich they have nothing to receive.” I urge support of this resolution. (Applause.)

WARREN BUFFETT: Are there other shareholders that would like to talk before we respond?

AUDIENCE MEMBER: Mr. Buffett, my name is Aaron Frank. Thank you for hearing us on this matter. I’m from Atlanta, Georgia. And along with being a — along with being a Berkshire shareholder, I also independently own shares of PetroChina.

And this issue is something I’ve struggled with for years, in terms of whether to divest or not. What I’ve done personally is given the dividends that I receive from PetroChina to organizations that help in Darfur, but this is mostly symbolic.

What is clear to me is if I had the opportunity to engage the management of PetroChina in a meaningful way as I do with you here today, that I would be compelled to do so ethically.

As owners of Berkshire Hathaway, we have a unique opportunity to engage the management of PetroChina in a way that will be heard not only by the management of PetroChina but by CNPC, China, and the international community due to your standing.

That’s a unique opportunity, and this is an incredibly — this is an incredibly important matter. I think we have an ethical obligation to do so. Thank you for listening.

WARREN BUFFETT: OK. Thank you. (Applause.)

WARREN BUFFETT: Is there anyone —

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: My name is Bill Rosenfeld from Lexington, Massachusetts. In your web posting you claim that a subsidiary can’t control the actions of its parent, so actions against PetroChina will have no impact on CNPC.

Suppose that millions of Americans boycotted GEICO Insurance or other Berkshire companies because of a policy at Berkshire Hathaway. Wouldn’t that make you reconsider that policy even though your subsidiaries are voiceless in Berkshire Hathaway management?

How does targeting PetroChina to influence CNPC differ from this situation? (Applause.)

WARREN BUFFETT: Well, I actually would say it’s quite different. If a shareholder of Wesco — you might — Marc, you might put up the chart that shows the flow of ownership both with China and with —

MARK HAMBURG: It’s up.

WARREN BUFFETT: OK. Wesco does not control Berkshire Hathaway. We can have all the — we can have lots of overlap in management and everything.

Berkshire Hathaway controls Wesco. If a shareholder of Wesco were to complain to the management of Wesco, which is analogous to PetroChina, about the fact that, let’s say, that Berkshire bought ISCAR or any other activity or anything I was doing personally, they would have no ability to control me.

If somebody controlled — complained to Berkshire about something that was going on at Wesco, we could certainly introduce action. So the — it flows downward.

The overlap means nothing. I mean, obviously the Chinese government controls PetroChina. They own 88 percent of the stock. We control MiTek. We own 90 percent of the stock. We control Wesco. We own 80 percent of the stock. We can tell MiTek what to do. We can tell Wesco what to do. But MiTek and Wesco cannot tell Berkshire what to do.

I think there's a fundamental misunderstanding on that. The Chinese government controls 20 — 32 of the largest 33 publicly-owned companies in China. And the Chinese government, in effect, is in charge of all of those companies.

The Chinese government does business with the Sudan. PetroChina does not. PetroChina in no way tells the Chinese government what to do. And we've seen evidence of that in a lot of ways.

So it seems to me it's backwards. If it was PetroChina following a policy that the Chinese government disagreed with, believe me, there would be a change in a hurry.

We have no disagreement at all about what's going on in Darfur. There's two questions.

One is PetroChina influence the Chinese government. And, secondly, if we don't agree with what the Chinese government is doing, should we sell our stock in PetroChina?

The people here who are come, who own stock in Berkshire Hathaway, have obviously made the choice, even though they disagree with what our policy is, to continue as shareholders.

And I agree with them — with that — a hundred percent. And we, in turn, elect to continue to hold our shares in PetroChina because we have no disagreement with what PetroChina is doing.

If there's a disagreement, it may be with what the Chinese government is doing. Now, in terms of what the Chinese government is doing, you know, we've heard talk about divesture by China.

If the Chinese left the Sudan tomorrow, 400,000 barrels of oil would be being produced, a good bit with the money that China has invested in the Sudan.

You can't take the assets. You can't the refinery. You can't take pipelines. You can't take the oil out of it.

They can sell their interest. They can sell it to other people who are doing business in the Sudan. They can sell it to the Sudanese government.

But, believe me, they would probably sell it very cheap. The Sudanese government would get a bargain, or the Sudanese government might very well renegotiate terms in their favor, if they allowed a third party to buy.

Believe me, you know, they would be in a position if they — assuming they could affect the transfer — and I think there's a lack of understanding of what really would happen if China said tomorrow, "We're going to get — we're going to take our interest away from our activities in Sudan."

They would have to sell them or they'd have to give them up one way or the other. And, like I say, I think the Sudanese government would probably end up better off financially if they had a half-decent adviser in the question than they are presently.

I might mention one other thing which is kind of interesting in this. We buy about — currently about $250 billion worth more of goods from China than we sell to them, and we give them little pieces of paper in exchange.

And we say to them, "We want your goods, and you should work hard and send us your goods, and we'll send you these little piece of paper called American dollars."

Two years ago, China wanted to use some of those American dollar — we'd use their goods — to want to buy a company called Unocal. Unocal was a (inaudible) U.S. company.

The majority of their production of oil and gas came from outside the United States — a substantial majority — came from places like Thailand, Indonesia.

And the Chinese wanted to buy that company, and by a vote of 395 to 18, the U.S. House of Representatives sent their message to President Bush that it would be against the national interest to let this company be sold, which, as I say, produced very little oil and gas in the United States. Got most of it from the rest of the world.

So, in effect, we snubbed the Chinese in a big way on something important to them: energy.

And I might mention that we import perhaps four times as much energy from all the countries around the world as the Chinese do, even though they have four times the population.

So we have, in a sense, told the Chinese a couple of years ago "Don't even think about buying the small U.S. company with a lot of production — fair amount of production — abroad to satisfy your energy needs."

And I think it's understandable to some extent that the Chinese are looking for energy around the world just as we have for the last century. They are buying significant amounts of oil from Sudan. They put money in there, and the — they are going to buy four or — they are going to buy that 400,000 — they're not taking the whole 400,000 barrels a day from the Sudan, but they're taking significant amounts.

They're going to buy that oil in the world market. That oil is going to get produced. Revenue is going to flow to the Sudan. The question is how much the Sudanese keep themselves and how much gets disbursed to the Chinese because of the investment they've made.

So I see no effect whatsoever in Berkshire Hathaway trying to tell the Chinese government how to conduct their business.

I agree a hundred percent with the fact that what is happening in the Sudan should not be happening, and I — there are other parts of the world where say some — that same situation may exist, although not to the same degree.

But I don't think you can — I don't think it's proper for us to divest our shares in PetroChina. They would be sold to somebody else. I think the proponents of the motion probably would like the idea that the price of the stock would go down.

But we don't sell stocks, you know, basically to try and drive them down in price. We might sell PetroChina if it went up enough, but we would not be selling it to try and drive down the price, because all that would be doing is giving a bargain to somebody else who is buying the stock of PetroChina.

It doesn't change the funds available to them at all.

One of the speakers mentioned the amount of money that goes from PetroChina up to its parent. Well, money from Wesco comes up to Berkshire from our subsidiaries. You know, that's the nature of having a major ownership in a subsidiary is that you get money from MiTek, you get money from Nebraska Furniture Mart, which we own 80 percent of.

But that really has nothing to do — in my view, at least — it has nothing to do with the fact that it is China that has a policy in respect to being partners in Sudan, and it is not PetroChina at all. Selling our stock would not change one thing.

If we would have any communications, as a practical matter, the communications should be with Chinese government — and actually people here have had a chance because we have a lot of media here — they've had a chance to express their views to the Chinese government.

Believe me, unless the opinions get expressed to the Chinese government, expressing them to PetroChina means nothing.

I mean, PetroChina is controlled by the Chinese government, and they are not — if you were an official of PetroChina, you are not going to tell the Chinese government what to do. They are going to tell you what to do.

Charlie?

CHARLIE MUNGER: Well, the issue also is China is a rapidly rising nuclear power, and who should decide how the federal government — or how the Americans — should react to China?

There's a lot to be said for letting the policy flow through the U.S. government instead of sort of a vigilante effort of various citizens.

Now, I would also point out that there's a lot wrong all over the Earth, and there's a lot of cruelty and there always has been, and there will always be a lot of oil produced in a lot of lands with a lot of cruelty.

And nobody is in favor of cruelty, but there's a limit to how much you can fix. And so I'm very skeptical of the idea that Berkshire should become an instrument of telling — of setting United States policies vis-a-vis China. (Applause)

WARREN BUFFETT: Yeah. Charlie and I have our own views, for example, on reproductive freedom, but we don't have a Berkshire Hathaway policy on reproductive freedom nor do we finance from Berkshire Hathaway funds — the funds of our shareholders — we do not finance any activities that relate to our personal beliefs, although we may, obviously, fund them by ourselves or speak out on them by themselves, but we do not have a Berkshire Hathaway funding just because we believe that women should have the right to choose or questions of that sort.

CHARLIE MUNGER: I think reasonable minds can disagree on these subjects.

At Berkshire, there's all kinds of businesses we won't buy and control individually, but we're willing to own stock in the same businesses.

Is that the correct moral line to draw? I don't know. We do our best, and we make the decisions, and we make the calls.

WARREN BUFFETT: I would say — I wonder really whether when the Unocal question was being determined here, were the Chinese to whom we'd given lots of little tickets in exchange for taking their goods, and they came along with a perfectly decent offer to the shareholders of Unocal, 18 1/2 billion dollars.

They wanted to buy a little more oil and gas production around the world. And the U.S. Congress overwhelmingly said this is a terrible thing and we want the United States to oppose it and we want it sold to Chevron for less money.

And I really don't recall a lot of people speaking up on behalf of the Chinese right to buy oil companies over here, just like we've bought oil companies around the world for many decades.

So to the extent that they may feel themselves somewhat alienated from the rest of the world in this respect, I think we've actually contributed our share.

Charlie?

CHARLIE MUNGER: Another thing in the complexity of life, the woman who lost her family to the Holocaust, we clobbered the people that committed that genocide by joining genocidal Joe Stalin. These issues are complicated.

WARREN BUFFETT: OK. If there are any shareholders that want to vote in person in this — on this — matter or to change their proxies, we have monitors. If you just raise your hand.

And if there are none of those, Miss Amick, are you ready to give your report?

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast 15,740 votes for the motion and 830,598 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes related to all Class A and Class B shares outstanding, the motion has failed.

Certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick. The proposal fails.

35. Formal meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move this meeting be adjourned.

WARREN BUFFETT: Is there a second?

VOICE: Second.

WARREN BUFFETT: All those in favor say “aye.”

VOICES: Aye.

Morning Session - 2008 Meeting

1. TV soap star Susan Lucci trades jobs with Buffett

NEWS ANCHOR (CNBC's Becky Quick, on tape): Folks, this just in. It appears that Warren Buffett has struck a deal to trade jobs with daytime soap opera diva Susan Lucci.

Buffett has reportedly negotiated a permanent spot on the cast of All My Children. Apparently, Ms. Lucci is en route to Omaha as the new CEO of Berkshire. (Applause.)

CHARLIE MUNGER: Where could he be? (Laughter and applause as actress Susan Lucci comes on stage)

SUSAN LUCCI: Do you mean Warren, Charlie? He's been detained at the TV studio. (Laughter)

CHARLIE MUNGER: Really?

SUSAN LUCCI: Hi, Charlie. I'm Susan Lucci. Oh, haven't you heard about the deal between Warren and me? He's going to be a big star in All My Children, and I'm going to be taking over Berkshire Hathaway.

CHARLIE MUNGER: Well, you've certainly got some important qualities that Warren lacks. (Laughter)

SUSAN LUCCI: Well, thank you, Charlie. And you can relax now, you dear man. You just make yourself at home because I'll take it from here, thank you.

I've been wanting to talk to our shareholders for quite some time now. There's some changes I really think we need to make around here.

The first thing we need to look at is our dividend policy. (Laughter)

I have never heard of anything so cheap and so unfair to our wonderful shareholders. We need to change it. (Applause)

CHARLIE MUNGER: Sounds good to me. (Laughter)

SUSAN LUCCI: And, second, we need to look at giving guidance on earnings. And we need to do that every single week. (Laughter)

CHARLIE MUNGER: Sounds good to me. (Laughter)

SUSAN LUCCI: And, third, we need to pay our directors more than $900 a year. (Cheers and applause)

WARREN BUFFETT: Just one minute. (Applause.)

SUSAN LUCCI: Hi, Warren. Warren, I thought you were at the All My Children studio.

WARREN BUFFETT: What's that talk about dividends that I hear?

SUSAN LUCCI: Oh, nothing important, Warren. You just concentrate on your role on the show.

WARREN BUFFETT: Susan, my show is Berkshire Hathaway. And my role is to run it. (Takes paper out of jacket pocket and rips it up)

SUSAN LUCCI: Warren, you can't do that.

WARREN BUFFETT: I just did it. All My Children can't do without you, and I can't do without Berkshire. (Applause.)

SUSAN LUCCI: Oh, Warren. So you mean the deal is off?

WARREN BUFFETT: The deal is off. I really want to thank you. You've brought me to my senses. You can go back to All My Children. I'll stay here at Berkshire.

But I am so grateful to you Susan, that I want you to go out to Berkshire — not to Berkshire — to Borsheims and I want you to pick out anything you would like, and charge it to Charlie. (Laughter)

SUSAN LUCCI: Oh, Warren, you are darling. Thank you. (Applause.)

SUSAN LUCCI (to MUNGER): And you're a darling, too.

WARREN BUFFETT: Now, wait a second.

SUSAN LUCCI: Thank you. (Applause)

2. Welcome

WARREN BUFFETT: OK. Charlie, let's get this show on the road. (Laughter)

The — she spent more time with him than she did with me, but — (Laughter)

The — we're going to follow the usual procedure.

The business meeting will start at 3:15. But between now and then, with a break for lunch, we're going to answer your questions. We don't screen them ahead of time, as you know — based on who gets lined up at the microphone first.

And we'll go around from sections to sections and then go to the overflow rooms. My understanding is that our best estimate is that we have about 31,000 people here today. (Applause.)

WARREN BUFFETT: Somewhere I have a map here. Marc, do we have that?

Pardon me? Can't hear a thing up here. But in any event — on the yellow pad. OK. We'll just mark them off as we go along.

The — I would like, before we start — I heard Ron Olson laughing there. I think he made it. I'm glad to hear it.

Let me introduce our directors. I really wasn't sure whether to go through with this part of the show after they showed that rousing applause for things like dividends and raising their — but we have up here — we have Charlie Munger on my left. He's the one that can hear; I can see. We work together for that reason. (Applause.)

WARREN BUFFETT: And if the rest of you will just stand as I give your name. And if you'll hold your applause to the end — or even longer if you would like — (laughter) — I will introduce them.

It's Howard Buffett, Susan Decker, Bill Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott. The best directors in America. (Applause.)

WARREN BUFFETT: Charlie and I will take a break at noon because we will probably, by that time, have finished all of the things we have up here to eat, and we'll need to have lunch.

I'd appreciate it if you would limit your questions to one question, and that means not embodying a three-parter or a four-parter or something like that.

And there's no need to make a long introductory statement because we'll get more questions answered that way, and we want to cover as many people as we can.

3. How NOT to be a lemming

WARREN BUFFETT: So with that, we'll go right over to post number 1 and start in with the first question.

AUDIENCE MEMBER: Very good morning to Mr. Buffett and Mr. Munger. My name is Rajesh Furor (PH) from Bombay, India.

I have been learning a lot from letters of yours. It's been a great insight into investment philosophy that I haven't learned from anywhere else. Great job.

That’s on the mind side. But on the heart side, what touches me the most is what you have achieved all these years is through a hundred percent honesty, and I salute to that. Thanks.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Now, my question is on what key steps would you recommend to correct the mind set of typical investor like me, which is what you noted as lemmings-like, the crowd mindset?

WARREN BUFFETT: What would we recommend — we got the question being repeated here — about the mindset of an investor? Is that —?

CHARLIE MUNGER: He wants you to advise him as to how he can become less like a lemming. (Laughter)

WARREN BUFFETT: Well, since you repeated the question, I’m going to let you give the first answer to that, Charlie. (Laughter)

Until he eats about a thousand calories, it — (Laughter)

CHARLIE MUNGER: He wants to invest less like a lemming.

WARREN BUFFETT: Oh, I understand that. I was giving you the first shot at it. Well, I will tell you what changed my own life on investing.

I started investing when I was 11. I first started reading about it — I believe in reading everything in sight. And I first started reading about it when I was probably six or seven years old.

But for about eight years I wandered around with technical analysis and doing all kinds of things, and then I read a book called “The Intelligent Investor.” And I did that when I was 19 down at the University of Nebraska.

And I would say that if you absorb the lessons of “The Intelligent Investor”, mainly in — I wrote a forward and I recommended particularly Chapters 8 and 20 — that you will not behave like a lemming and you may do very well compared to the lemmings.

We have here in the Bookworm, copies of “The Intelligent Investor”, and I think it’s as great a book now as I did when I read it early, I guess, in 1950.

You will never — you can’t get a bad result if you follow the lessons of — Ben Graham taught in that book.

I should mention that there's a book out there also that I did not know it would be completed by this time.

My cousin, Bill Buffett, has written a book about our grandfather's grocery store called "Foods You Will Enjoy." And Bill will be out there. He's signing books.

I just got my first copy a couple days ago. Read it, and I enjoyed it a lot.

Charlie worked at the same grocery store — how many years ago? Probably a good 70 years ago in Charlie's case. Neither one of us was very good. (Laughter)

But my grandfather — you don't want to pay much attention to his advice on stocks. He wrote a lot of letters, and he was very negative on the stock market and big on hard work at the grocery store.

So we quit listening to him. (Laughter)

Instead, read The Intelligent Investor. That's the book that gave me the philosophy that has taken me now for a lot of years.

And there's three big lessons in there which relate to your attitude towards stocks generally, which is that you think of them as parts of a business; and your attitude toward the market, which is that you use it to serve you and not to instruct you; and then the idea of a margin of safety, of always leaving some extra room and things.

But the people in this room, I think, have learned that important first lesson. I mean, I think most people that own Berkshire do not see themselves as owning something with a little ticker symbol or something that may have a favorable or unfavorable earnings surprise or something of the sort, but they'd rather think of themselves as owning a group of those businesses that are out there in the other room.

And that's the way to look at stocks. You'll never be a lemming if you do that.

4. Buffett will handle Cologne Re's investment portfolio

WARREN BUFFETT: Let's go to Number two.

AUDIENCE MEMBER: Good morning, Warren. Good morning, Charlie. My name is George Iscis (PH) from Cologne, Germany.

My question: how is the operational integration of the Cologne Re progressing? Thank you very much.

WARREN BUFFETT: Cologne Re, for those of you who are not familiar with it, is a 95 percent-owned subsidiary of General Re, of which Berkshire Hathaway owns 100 percent.

And Cologne Re, I believe, is the oldest reinsurance company in the world. It's done a magnificent job for us as part of, first Gen Re, and then Berkshire Hathaway.

And we have a process in place that will, before too long, result in us owning a hundred percent of Cologne.

One difference, then — there won't be any difference in operation. It runs magnificently the way it's being run. But at that point — up until this point, they have run their own investment portfolio. That portfolio and the equity portfolio of GEICO are the only two that I don't run.

But when we own a hundred percent of Cologne, then I will take the responsibility for Cologne's investment portfolio. Otherwise it would be hard to improve on the operation of the management of Cologne.

So there will be — you will not see any other changes except we will consolidate in 100 percent of the earnings of Cologne rather than 95 percent.

5. "Forget about the word 'stock'"

WARREN BUFFETT: Area 3.

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger. My name is Sam Reiner (PH) from Fort Lee, New Jersey, and my question concerns your comment this week about the recession, and the stock market going up so significantly in April.

Can you expand on where the market is going from here? (Laughter)

WARREN BUFFETT: Hah. Well, I can expand, but I couldn't answer. (Laughter)

Charlie and I haven't the faintest idea where the stock market is going to go next week, next month, or next year. We never talk about it. You know, it never comes up.

Our directors will tell you that they've never been to a directors meeting where the subject of the direction of the stock market is — we are not in that business. We don't know how to be in that business.

Obviously, if we could guess successfully a high percentage of the time where the stock market was going to go, we would do nothing but play the S&P futures market. There wouldn't be any reason to look at businesses and stocks. So it's just not our game.

We don't think — what we see when we look at the stock market is we see thousands and thousands and thousands of companies priced every day, and we ignore 99.9 percent of what we see, although we run our eyes over them.

And then every now and then we see something that looks like it's attractively priced to us, as a business. Forget about the word "stock."

So when we buy a stock, we would be happy with that stock if they told us the market was going to close for a couple years. We look to the business.

It's exactly the same way as if you were going to buy a farm a few miles here outside of Omaha. You would not get a price on it every day, and you wouldn't ask, you know, whether the yield was a little above expectation this year or down a little bit.

You'd look at what the farm was going to produce over time. You'd look at expected yields. You'd look at expected prices, the taxes, the cost of fertilizer, and you would evaluate the intelligence of your purchase based on what the farm produced relative to your purchase price.

Quotes would have nothing to do with it. That's exactly the way we look at stocks. We look at them as businesses. We make judgments about what the future of those businesses will be. And if we're right about — in those judgments, the stocks will take care of themselves.

Charlie?

CHARLIE MUNGER: Nothing to add. (Laughter)

WARREN BUFFETT: He's been practicing for weeks. (Laughter)

6. We don't cultivate great managers, we keep them

WARREN BUFFETT: Let's go to area 4.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Chander Chavla (PH), and I am from Seattle, Washington.

Berkshire Hathaway has some of the best managers in the world, and I am very bad at hiring good managers. The — some of the decisions that I've made, which were without any phone calls from Jamie Lee Curtis, I look back and I see — you know, what was I thinking.

What can you advise on, how in one hour you can assess the capability of a person to be a good manager?

WARREN BUFFETT: Well, you have to understand that we cheat. (Laughs)

We buy businesses with good managers. So if you give me a hundred MBAs — and I have these classes come out all the time to Omaha. I've had about 30 schools this year, and usually there's 75 or a hundred men and women in the classes.

I no more could take those hundred and spend a few hours and rank them from number one to a hundred in terms of their future achievements as managers, you know, than I could pick them — you know, it would be impossible for me.

But what we do is we buy businesses with great managers in place. We've seen those people perform for, in many cases, decades. We've seen their record, and they come with the business.

Now, our job is not so much to select great managers, because we do have this proven record that they come with. Our job is to retain them.

And many of the managers — a majority of the managers that work at Berkshire — are independently wealthy. We hand them checks, sometimes, in the billions, often in the hundreds of millions. So they do not have a monetary reason to work, in many cases.

So our job — we are dependent on them, incidentally. I mean, we have 19 or so people at headquarters, and we have 250,000 working for Berkshire around the world, and we can't run their businesses.

And our job is to make sure that they have the same enthusiasm, excitement, passion, for their job after the stock certificate changes hands, than they had before.

Now, that requires some judgment on our part as to whether these people love the business or love the money. They all like money, but many of them — well, our managers in particular — they love their businesses. I mean, they've worked at them — they're a work of art to them, and they've been in the family sometimes as many as four generations.

So we have to see the passion in their eyes, and if we see that, then we have to behave in a way that that passion remains.

Can't be done by contract. We don't have contracts. It won't — that doesn't work.

But we can try to create an environment — and Berkshire, frankly, is the ideal environment — it's even an ideal environment because of events like this.

Our managers feel appreciated. And they are appreciated. They're not just appreciated by me and Charlie; they're appreciated by you. And we want to give you a chance to applaud them. (Applause.)

WARREN BUFFETT: So I can't be of enormous help. And if you're looking at a group of MBAs, you know, it's not easy. I mean, they know — they sort of learn by that point in life how to fool you, in terms of what answers you want to hear and all of that sort of thing.

I would look for the person with passion for the job. I mean, the person that is always doing more than their share. You look for people that are goods communicators and all of that sort of thing.

But I like my way better. It's a lot easier just to take somebody that's been batting .400 in baseball and say, "I think I'll stick them in the lineup."

And the nice thing about our game is that, you know, in baseball, unless you're Nolan Ryan or somebody, you have to hang up things at 40 or thereabouts, but in our game, they go on and on and on.

I mean, I use as an example — we had a famous Mrs. B from the Furniture Mart, and she worked for us until she was 103, and then she left and she died the next year. And that is a lesson to our managers that — (Laughter)

Charlie?

CHARLIE MUNGER: Well, that was very useful advice. It reminds me very much of the late Howard Ahmanson.

And a young and starving business student once asked him for advice as to how to get ahead, and Howard said, "Well, I always keep a few million dollars laying around in case a good opportunity suddenly turns up." (Laughter)

7. Teaching option pricing is "totally nonsense"

WARREN BUFFETT: Well, let's go to number 5. (Laughter)

AUDIENCE MEMBER: Good morning. I'm Joe Hutchin (PH), a shareholder from Culver, Indiana.

Could you please comment on how you use stock options when trying to enter or exit a position in a public company?

WARREN BUFFETT: Yeah. We've — I think there's one time we sold a put on Coca-Cola with the idea that, if it got exercised, we were very happy to own more Coca-Cola. It didn't get exercised. We would have been better off if we had just bought the stock.

Usually, if you want to buy or sell a stock, you should buy or sell the stock.

And using an option technique to buy a call on a stock instead of buying the stock outright with the idea that you get it a little cheaper that way means that about four times out of five you'll be right and the fifth time the stock will have moved earlier and you'll have missed, you know, the transaction you wanted to have.

And so we virtually have never used options as a way to enter a position or exit a position, and I would doubt very much if we do.

We've used — we've sold these equity — long-term equity put options that were described in the press release yesterday and were described in the annual report, but that's a different sort of thing.

If we want to buy something, we'll just start buying it. And if we want to get out of it, we'll start selling it. And we won't get involved in any fancy techniques.

Charlie?

CHARLIE MUNGER: Well, if I remember right, you wrote a letter when the public authorities were deciding whether we should have option exchanges for stocks. And Warren was all alone at that time, and he wrote a letter saying that he didn't think it would do any good at all for the country to throw out the margin rules in this fashion.

I've always thought that Warren was totally right. We — it's — the idea of turning financial markets into gambling parlors so the croupiers can make more money has never been very attractive to us.

WARREN BUFFETT: Yeah. (Applause.)

WARREN BUFFETT: Yeah. It's very interesting to me when I talk to these MBA students. One of them from the University of Chicago, the very first question I got a few years ago, he says, "What are we being taught that's wrong?"

I love questions like that. I have to plant them in the future.

The amount of time spent at business schools — maybe it's a little less now — but teaching things like option pricing and that sort of thing, it's totally nonsense.

I mean, you need two courses in a business school: one is how to value a business, and — from the standpoint of investments — how to value a business and how to think about stock market fluctuations.

But the idea that you would spend all of this time with formulas — but the problem, of course, is that the instructors know the formulas, and you don't when they come, and so they've got something to fill the time explaining to you.

And, you know, it is no fun if you — I mean, if you were teaching Biblical studies, you know, and you could read three or four of the most important religious tomes forward and backward in five different languages, you would hate to tell somebody that it comes down to the Ten Commandments. I mean, any damn fool can do that.

So there's a great desire of the priesthood in finance to want to teach the things that they know and you don't know and that they spent a long time learning and that maybe requires a fair amount of mathematics.

And it really has nothing to do with investment success. Investment success depends on buying into the right businesses at the right price. And you have to know how to value businesses, and you have to have an attitude that divorces you from being influenced by the market.

You want the market there, not to influence you, you want it there to serve you. And that requires a mindset, which goes back to an earlier question, and it's a mindset that's described quite well in Chapter 8 of "The Intelligent Investor."

8. Buffett praises sister Doris for her "retail" charity

WARREN BUFFETT: Let's go to number 6.

AUDIENCE MEMBER: Hi. I'm Irene from Bonn, Germany. Both of you are very generous person. What is your joy of giving, and what are the potential pits when donating money — pitfalls when donating money? I'm sorry.

WARREN BUFFETT: The joys and giving and the pitfalls of donating money, huh. The — I know personally I've never given up anything in my life that made a difference in my life.

I mean, there are people that will go to church this Sunday and they will drop money in a collection plate, and it will make the difference about where they take their family, or whether they take their family, in terms of where they eat, whether they go to a movie, whether they get an extra present at Christmas, whatever it may be.

I mean, they are giving some money that makes a difference in their lives. I've never given a penny that way, and I never will.

I mean, I get to do everything I want to do in life. But because I've lived a long time — which gives you an enormous advantage in terms of accumulating money — and most of the things I want in life don't come from the expenditure of money.

So it accumulates, and basically I'm giving away excess. I'm not giving away anything from necessity.

So I really — you know, I think what I'm doing is useful with the money, but I don't think it's on a par at all with the actions of somebody that's giving money that really makes a difference in how they or their children live.

Those are really charitable people. I think my sister Doris is here. She has given away money that made a difference in her life. She gives away time, too. She gives away eight or ten hours a day, in terms of actually looking into the real needs of people, and giving them things beyond the money — giving them help and advice and somebody to talk to.

And, you know, that's real giving. And I admire her for it. I'm not emulating her. I mean, she is in the retail business of giving; I like wholesale much better.

In terms of the pitfalls, you know, you can make mistakes in any area. But if you — you should give to things that you personally have an interest in and believe in, and that can be anything. I don't — I'm not going to prioritize what should be done with gifts.

Something you're involved in. Something you want to give your time to as well as money. But beyond that, I'll let Charlie carry on.

CHARLIE MUNGER: Yeah. Regarding pitfalls, I would predict that, if you have an extreme political ideology, whether of the left or the right, you're very likely to make a lot of dumb charitable gifts. (Laughter and applause)

WARREN BUFFETT: If you hang around Charlie like I do, you get the sunny side of life. I mean — (laughter)

We ought to have that playing, "The Sunny Side of the Street."

9. We don't "tell the world how to run their business"

WARREN BUFFETT: Let's go to number 7.

AUDIENCE MEMBER: Good morning. My name is Okosh Vajay (PH), and I'm from India. I worship Mr. Buffett for his philanthropy, and I do hope to serve the Gates Foundation someday.

My question to Mr. Buffett is, what's your level of involvement when one of your companies is faced with an ethical dilemma? For example, Fruit of the Loom's competitors have sweatshops in Central America. So what do you do to ensure that you don't fall into the same trap?

WARREN BUFFETT: Yeah. Well, we let our managers run their businesses. And we've got some terrific managers, not only in terms of ability, but I would say that what we have seen of the ethical standards of our managers has been extraordinary over the years.

That doesn't mean there isn't — there aren't slip ups here or there. But taken as a group, over decades, I think that I'm very happy, in effect, turning over the keys, not only to the financial performance of the business, but in terms of how they behave.

And I would say that I think you're quite wrong in terms of — Fruit of the Loom's operations are conducted in absolutely terrific standards. John Holland is here. I'd be glad to have you meet with him later.

But we — we're proud of our businesses and how they operate.

We do not give them elaborate guidelines. I write them a letter every two years, roughly, and I ask them to send me a letter telling who they think should be the successor if anything happened to them that night. I keep those letters around. Fortunately, they don't come into play very often.

But I also tell them we've got all the money we need. It's nice to have more money, but we're not going to lack for money at Berkshire Hathaway.

We don't have a shred of reputation more than we need, and we never want to trade away reputation for money.

So we give them that same message that was given in the movie, in terms of the Salomon situation, which is that not only do they behave in a way that conforms with the laws, but that they behave in a way where, if a story were written by an unfriendly but intelligent reporter, the next morning, in their local paper, they would have no problem with their neighbors, their family reading it.

And we run that in the movie every year, just because we like the managers to keep getting that message all of the time. There is no pressure from Berkshire's corporate office to report X dollars per — of earnings in any quarter. They don't give me budgets, so they don't — there's no feeling that they have to come through with given numbers or I'll be embarrassed in public in terms of publishing earnings or anything of the sort.

We have no incentives to cause people to do anything that would go against their conscience or play games or cut corners or anything of the sort.

And, overall, I think it's worked pretty well. It isn't perfect. You can't have 250,000 people in the city without having something going on at some point. And we do have 250,000 people working. But I'm not unhappy with our batting average.

Charlie?

CHARLIE MUNGER: Yeah. And, of course, Fruit of the Loom does have foreign plants, and we have no rule against that at all. We've got quite a few foreign plants now.

We don't favor foreign plants. We just do whatever makes sense under the circumstances.

WARREN BUFFETT: Yeah, we had a shoe business I've written about in Maine, and we had wonderful, wonderful workers there. They were more productive than workers around the world.

But the United States was producing, 20 years ago, roughly a billion pairs of shoes a year, and we were a nation of Imelda Marcoses. I mean, it was wild.

And Brockton, Massachusetts, and you name the towns, revolved around the shoe business, as did a town called Dexter, Maine.

And we bought that business. And we tried to compete. We had a good brand name. We had great workmanship. And we found out that it just plain wouldn't work against — competing against — shoes produced in China.

So now of the — it's over a billion pairs of shoes a year used in this country. Basically they all come from outside the borders. And you're going to see that.

And factories in China, factories in Central America — they do not have exactly the norms that we have in this country. And, you know, that's going to be the situation.

We are — we will not — we are not going to tell the world how to run their business in any great way.

We — obviously we have some standards that have to be met, but we are not — they are not exactly the situation you are going to find in the United States.

10. Buffett dismisses higher raw material costs

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Good morning. My name is Mike McGowan (PH). I'm from Pasadena, California. I'm a shareholder in both Berkshire and Wesco. I run a website called FinancialFoghorn.com, and I write about precious metals and things.

And I've asked you questions in the past about silver, and I didn't really get them answered. So I thought I'd ask about a different commodity this time.

I read about the Chinese raising the price of tungsten, and I think about your comment last year in buying ISCAR.

Will commodity price increases in things like tungsten affect the profitability of ISCAR? And would that be the reason you're locating a plant in China to build machine tools? Thanks.

WARREN BUFFETT: Yeah. The reason the plant was built in China was to serve the Chinese market, which is large and growing. And we opened in Dalian late last fall.

It's nicer to be closer to the raw material, but it really had nothing to do with changes in the price of tungsten.

Generally speaking, if you're creating a higher value-added product, as ISCAR is doing, from a raw material, there may be three months, six months, of adjustment to changes in raw material prices. And obviously, with some commodities, if it gets high enough you get into substitutes.

But there isn't going to be any substitute for tungsten in the cutting tools, and there won't be — you know, we tried some substitutes for crude oil in terms of gasoline or — not so — heating oil but then the substitutes like natural gas go up in price, too.

So I think largely, in our businesses, raw materials get passed through.

Now, we're having a tough time, for example, in the carpet business in passing through the cost increases that we experience in oil-based raw materials. But we would be having trouble — we probably would be having trouble in the carpet business regardless now because of the slowdown in residential housing. It does make it tougher.

But over a period of time, our businesses are going to reflect raw material costs. You know, the candy here I have, this fudge, which I can hardly wait to get into, you know, it's going to reflect sugar and cocoa and things like that over time.

And if you're running an airline, it's going to reflect the cost of fuel. So you can have little squeezes here and there, but it's not a big deal, and it certainly isn't the reason that we went to China to locate the ISCAR facility.

That facility — incidentally ISCAR — we have a number of people here from ISCAR, and families in some cases.

That is — I had very high expectations for that when we bought it. It's exceeded it in every way. It's exceeded in terms of financial performance. It's exceeded in terms of the human relations we've developed with the people.

I mean, it was — I told you it was a terrific acquisition a few years ago. It's been a dream acquisition, and I know Charlie wants to add to that. (Applause)

CHARLIE MUNGER: Yeah. I would say that the short answer is that, while we don't like inflation because it's bad for our country and our civilization, that we will probably make more money over time because there is inflation.

11. Lots of work to find a better buy than Berkshire

WARREN BUFFETT: Go to number 9.

AUDIENCE MEMBER: Good morning. My name is Marc Rabinov from Melbourne, Australia.

My question is, Berkshire has bought a lot of shares over the last 12 months in listed companies. Do you expect the return on these investments to be between 7 and 10 percent per annum over many years, which is, I would say, well below what Berkshire has achieved in the past?

WARREN BUFFETT: The answer to that is yes. (Laughs)

The — we would be very happy if we could buy common stocks where our expectation over a long period, pretax, from a combination of dividends and capital gains — we'd be very happy if we thought it was going to be 10 percent, and we would probably settle for a little less than that.

And there's no question — absolutely no question — that returns from owning Berkshire will be less in the future than they have been in the past.

There's no question that we will not do as well with the common stocks at Berkshire that we own in the future as we have over the last, really, 40 years or thereabouts.

We operate now in a universe of marketable stocks that — where we're talking about companies with market caps of at least 10 billion but really, in most cases, to have a meaningful impact on Berkshire, we're talking much bigger than that, maybe 50 billion and up.

Well, that universe is not as profitable a universe to operate in as if you have the entire universe of thousands and thousands of companies.

So we — if we — just take an example. If we find a company with a market cap of 10 billion and we can buy 5 percent of it — and usually that's what we can buy without disturbing things — we can have a $500 million investment.

Let's say it doubles over a period of time. That's 500 million. You pay a 35 percent tax. You have 325 million. That's less than two-tenths of 1 percent in terms of Berkshire performance.

So our universe has shrunk enormously, and we will not do as well in that universe — remotely as well — as we would if we were the operating in a much wider universe and could do all kinds of things.

We've found little things to do from time to time where we've made some money. I may refer to them a little later, a couple things. And they're nice, but they don't move the needle very much at Berkshire.

So anyone that expects us to come close to replicating the past should sell their stock. I mean, because it isn't — it isn't going to happen.

And, you know, I think we're going to get decent results over time, but we're not going to get indecent results. And in this field we prefer indecent, but we're not going to get them.

Charlie?

CHARLIE MUNGER: I think you can take Warren's promises to the bank.

We are very happy making money at a rate in the future that is way less than the rate at which we made money in the past. And I suggest that you adopt the same attitude. (Laughter)

WARREN BUFFETT: Well, I wouldn't condemn them to that. I think if you're working with small amounts of money — I've talked —

CHARLIE MUNGER: Oh, yeah.

WARREN BUFFETT: Yeah. Then you may have something very much better to do with your money than to buy Berkshire.

I mean, if you're working with small amounts of money, and you want to put in significant amounts of time, and examine thousands of securities, you will find things that are more intelligent to buy than Berkshire.

You know, we still think Berkshire is an attractive investment over a long period of time. We think that it stacks up reasonably well with other very large companies.

We don't think it's the most attractive investment in the world, in terms of what you can find if you're willing to go through those thousands of possibilities, which is what Charlie and I used to do many years ago. It's not feasible for us to do it now and wouldn't have any impact on Berkshire.

What we really like at Berkshire is buying good-sized to very large first-class businesses with first-class management and just sitting there. Because the nice thing about that is you don't have go from flower to flower. You can just sit there and watch them produce more and more every year and give you capital and you can buy more businesses.

That's a nice formula. It's a formula that will work, I think, for us. It won't produce returns like the past.

12. PacifiCorp will follow regulators on Klamath River dam

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: (Inaudible). My name is Chu Chu (Inaudible), and I come here from the Klamath River, and I come here with a heavy heart.

And I know this is a pretty light-hearted event, but I came here last year with a heavy heart, too. And I fasted for ten days driving over here to speak with you.

And, you know, we really were disrespected last year, because one of your subsidiaries, PacifiCorp, has dams on the Klamath River that are creating toxic algae blooms, along with multiple other things. I won't go into it too far.

But I just come here today with a principle agreement between you and I, that you will sit down at the table and help us figure this out, help us make PacifiCorp accountable.

And being that I'm an indigenous American, and you're a guest in my home as a European American, that you would do that in front of all your shareholders today in good faith, that you care, you know, as a philanthropist and you care about, you know, helping, you know, third-world countries, you know, fight poverty, disease, when you're helping create it right here in the United States.

WARREN BUFFETT: You may not — you may not — last year we read the order under which we acquired PacifiCorp.

And, actually, as you may know, I'm prohibited from actually making decisions in that — in the area of PacifiCorp. That was part of the public utility commission ruling when we bought it.

But we have Dave Sokol here who can speak to that. I think the first dam was built in 1907, and we bought PacifiCorp a couple of years ago.

But David — if Dave could go to a microphone, I think that — I think he could address the issues that you brought up. I don't think we meant in any way to be disrespectful last year.

Those of you who were here last year, we may have a difference of opinion on this, and incidentally there are strong differences of opinion, as I understand it, in your area about what should be done.

And — well, I think I should have Dave make the explanation on it. Dave? Somebody want to put a spotlight on the —

DAVE SOKOL: Thanks, Warren. As you stated first, it would be inappropriate for Mr. Buffett to respond in any detail on this issue, because it's part of the acquisition in 2006 of PacifiCorp.

He specifically agreed in writing not to interfere with any decisions of our regulated assets within PacifiCorp. So having said that, these four dams that we operate on the Klamath River were built over the last 100 years.

There are a whole series of issues in the Federal Energy Regulatory Commission relicensing process as to what should occur.

These decisions, through that regulatory process, have been ongoing for eight years, and they won't culminate for probably another six.

Having said that, there are 28 various parties from federal, state, and local agencies, Native Americans, fishery folks, local landowners, that are party to a discussion as to what should or should not happen with these assets — and I left out the irrigators.

Of those 28 parties, other than PacifiCorp, there are at least four different directions in which people think this process should go.

From our perspective, we will be pleased to find a resolution when the 28 parties agree as to how that resolution should go forward, how it would be funded, et cetera.

Fundamentally, it's up to the Federal Energy Regulatory Commission, state and federal regulators, in addition to them, and then our specific regulators in each of the six states that PacifiCorp operates in.

So if public policy moves in a direction of dam removal, fish ladders, or maintaining the existing status quo, that would be the process in which we would go forward.

We are working constructively with each of the various parties. We've met numerous times with each of the four tribes. And it's a complicated situation and one that hopefully, over time, a cooperative resolution can be met. (Applause.)

13. Eat what you want and love what you're doing

WARREN BUFFETT: Area 11, please.

AUDIENCE MEMBER: Good morning. I'm (inaudible) from Walnut Creek, California. Well, we learned something from the comic movie, but could you please expand on how do you maintain your good mental and physical health? (Laughter)

WARREN BUFFETT: Well, you start with a balanced diet. (Laughter)

Some Wrigley's, some Mars, some See's, some Coke.

Basically it — if Charlie and I can't have a decent mental attitude, who can? I mean, we get to do what we love doing every day. We do it with people that are not only cheerful about it and like us, but they do their jobs extraordinarily — they like their jobs too.

We're forced to do virtually nothing we don't want to. I have a trainer that comes three times a week. She — I think she's probably here. And she may think I'm a little begrudging in that particular activity, but that's only 45 minutes, three times a week.

The rest of the time I am doing almost — well, I'm doing whatever I love, you know, day by day by day by day. And I do it, you know, in air-conditioned offices and, you know, with all kinds of help and it — I mean, how could you be sour about life, you know, being blessed in so many ways?

And then the amazing thing is that Charlie is 84; I'm 77. And we've slowed down, I'm sure, in a lot of ways, but we pretend we haven't, and it doesn't seem to bother us. (Laughs) We get along fine.

Great partners, great managers, you know, great families. I — there's just no reason to look at any minuses in life and to focus on that. It would be crazy.

So we really do count our blessings because they've been many and they continue to come forth, and we'll enjoy it as long as we can. There's not much more to it than that.

Charlie?

CHARLIE MUNGER: Well, I wish we were poster boys for the benefits of running marathons and maintaining a very slim bodily state and so forth.

But as nearly as I can tell, neither of us pays much attention to any health habits or dietary rules — (laughter) — and it seems to have worked pretty well so far. I don't think we can recommend it to everybody, but I, for one, don't plan to change. (Laughter and applause)

WARREN BUFFETT: Really, from the moment we get up to when we go to bed at night, we get to do all kinds of things.

We get to — associating with wonderful people is about as good as it gets. And, you know, we live — we're biased, obviously — but we think we live in the best country in the world and have all kinds of good things. I mean, just imagine — (Applause.)

WARREN BUFFETT: We could have stayed in my grandfather's grocery store, and it would have been hell. (Laughter)

CHARLIE MUNGER: By the way, this relates to the subject of corporate compensation.

You're in a job which you would pay to have, if that were the only way to get it, and you're supposed to be an exemplar from other people — for other people. There's a lot to be said for not paying yourself very well. (Applause.)

WARREN BUFFETT: He points that out to me regularly. (Laughs)

Well, if you think about it, you know, the idea that CEO compensation represents a market system and that you have to pay some guy a $10 million retention bonus or something to stay around in the job that, you know, he's been fighting to keep and stacking the board and everything so they keep him around.

I mean, it's — I don't know of a CEO in America — I'm sure there are a few — but I don't know of any that wouldn't gladly do the job at half the price or a quarter of the price.

And I've seen some that have left jobs paying them eight figures and nobody's offered them anything, you know, a year later or two years later. I wonder where that wonderful market system is that is supposed to have all these bidders for their services. It's really sort of ridiculous, I think. (Applause.)

14. Follow your passion and marry the right spouse

WARREN BUFFETT: Let's go onto 12.

AUDIENCE MEMBER: Hi. I'm Richard Rentrop from Bonn, Germany.

At the moment I attend high school and would like your wisdom on how to approach the question of what to do with the rest of my life. So — (Laughter)

WARREN BUFFETT: We prefer things a little more difficult than that if you're got a — (Laughter)

AUDIENCE MEMBER: So, Mr. Buffett and Mr. Munger, if you were about to start all over again, what profession would you choose and why?

WARREN BUFFETT: Well, I would choose what I do because, A, I have fun at it. I'm reasonably good at it. You know, I meet a lot of interesting people through it. No heavy lifting. You know, it — it's — it fits me.

It doesn't — but that — that's not advice for you. I mean, you have to find out what really — what's your passion in life?

You know, it's a terrible mistake to kind of sleepwalk through your life, because unless Shirley MacLaine is right, you know, it's the only one you're going to have.

And the — so I've — I was very lucky in that I found my passion early. I mean, I — that's not easy. You know, that takes some luck.

It just so happened my dad was in a business at a very small office and he had a bunch of books down there. And when I would go down there on Saturday or after school, I would start reading those books, and it turned me on.

And this was before Playboy actually existed. (Laughter)

And so, you know, that was just plain lucky, you know. If he'd been a minister, I'm not so sure I would have been quite so enthused about visiting the office. (Laughter)

But that's the way to go. And I can't prescribe that for you. But I can tell you that if you're going through the motions in life, you're doing something — now, obviously, if you need the job you have and you can't make a change and your kids have to eat and all of that, you deal with realities like that.

But when you're in a position to make choices, you know, I always tell the kids that come visit me, I tell them, "Go to work for an organization you admire or an individual you admire."

That means many of them become self-employed, but they — (Laughter)

The idea — you know, you can't get a bad result. I went to work for Ben Graham when I was 24. I only worked for him for less than two years, but I jumped out of bed every day in the morning.

I was excited about what I was going to do. I was learning things. I was with a man I admired. I never asked my salary when I took that job. I moved to New York City and found out what my salary was when I got the check.

So just be sure you — and be sure and get the right spouse. That's enormously important.

You know, as Charlie says, the problem, you know, is that we talk about that fellow that spent 20 years looking for the perfect woman, and then he found her, and unfortunately she was looking for the perfect man. So you may have a problem in that respect. (Laughter)

But it's enormously important who you marry. I mean, it's a huge, huge, huge decision.

And, you know, if you're lucky in a couple things like that, you're going to have a happy life.

And you're going to behave better as you go along. I mean, it's a lot easier to behave well when things are going your way and you are enjoying your work and you like the — you're thinking about things every day that are the kind of things that you like to think about.

And Charlie has a lot better advice than I have about it. Go to it.

CHARLIE MUNGER: Well, of course, you'll do better if you develop a passion for something in which you have a considerable aptitude. I think if Warren had gone into the ballet — (laughter) - nobody would have ever heard of him.

WARREN BUFFETT: Oh, I think they'd have heard of me, just in a different way, Charlie. (Laughter)

Well, the chances are, if you find something that turns you on, you probably do have some talent for it. I mean, it — I never — I don't think I could have gotten turned on by ballet. (Laughs)

15. How Buffett overcame his fear of public speaking

WARREN BUFFETT: Let's go — we're going to go now to 13, which is in an adjacent ballroom.

We have multiple overflow rooms, which is how we're handling the 31,000. The grand ballroom is the only one we've got a microphone in. So let's go to number 13. Somebody there?

AUDIENCE MEMBER: I'm Nancy Ancowitz. I'm from New York City, and I teach at New York University.

Mr. Buffett, I'd love to get your advice on something that's a little off the investing path but that taps into your business experience and wisdom.

I'm writing a book to help people of a more introverted nature get the recognition they deserve.

What advice would you give to the quieter half of the population to help them raise their visibility in their careers?

WARREN BUFFETT: Well, that's a very good question. And I sort of faced that at one time.

I was absolutely, throughout high school and college, terrified of public speaking.

And I would have — I avoided any classes, signing up for them, that would require it. I would get physically ill if I even thought about having to do it, let alone doing it.

And I took a Dale — well, I've — first of all, I signed up — I went down to a Dale Carnegie course when I was at Columbia, and signed up for it, gave him a check for a hundred dollars, went back to my room and stopped payment on the check. (Laughter)

This is a real man of courage you're looking at up here. (Laughter)

And then I came out to Omaha, and I saw a similar ad. It was at the Rome Hotel, for you old-timers in Omaha, on 16th Street.

And I went down there, and this time I took a hundred dollars in cash and gave it to Wally Keenan, who some of you may know. He died some years ago. First time I'd met him.

And I took that course, and when I finished that course, I went right out to the University of Omaha and volunteered to start teaching, knowing that I had to get up in front of people.

I think the ability to communicate, both in writing and orally, is of enormous importance, under taught.

Most graduate business schools, they wouldn't find an instructor to do it because it would sort of be beneath them to do something so supposedly simple.

But if you can communicate well, you have an enormous advantage. And to you, who are talking to the group of introverted people — and, believe me, I was in certain ways quite introverted — it — you know, it's important to get out there and do it while you're young.

If you wait until you're 50 it's probably too late. But if you do it while you're young, just force yourself into situations where you have to develop those abilities.

And I think the best way to do that is to get in with a whole bunch of other people who are having equal problems, because then you find you're not alone, and you don't feel quite as silly.

And, of course, that's what they did at the Dale Carnegie course. I mean, we would get up in front of 30 other people who could hardly give their own name, and after a while we'd find that we could actually pronounce our own name in front of a group.

But we would stand on tables and do all kinds of silly things, just to get outside of ourselves.

You may have thought — by this point you may think it went too far in my particular case, but that's another problem. (Laughs)

But you're doing something very worthwhile if you're helping introverted people get outside of themselves. And working with them in groups, where they see other people have the same problem and they don't feel quite as silly themselves, I think is — I think you're doing a lot for some human beings when you help them do that.

Charlie?

CHARLIE MUNGER: Yeah. It's a real pleasure to have an educator come who is working to do something simple and important instead of something foolish and unimportant. (Applause)

WARREN BUFFETT: I hope he's not going to name names. (Laughter)

16. Klamath River dam economics

WARREN BUFFETT: OK. Let's go back to number 1.

AUDIENCE MEMBER: Hi, Mr. Buffett. My name is Regina Chichizola, and I'm the Klamath Riverkeeper.

I came here today with many of the other people from the Klamath that came here, and I thank you for having us, and I thank the shareholders for being a lot nicer to us this year than they were last year.

So my question is, I'm sure you're familiar with the severe pollution issues in the Klamath River, such as the toxic algae problem that is 4,000 times allowable recreation levels, and that the fish are also now toxic due to the Klamath dams.

I was wondering if you were familiar with the finances behind the Klamath dams? Many economic studies have shown that removing the Klamath dams would be up to hundreds of millions of dollars cheaper than relicensing them.

So my question is, what would you do if PacifiCorp decided to keep these dams, even though it would mean that your shareholders would lose money in the long run and that PacifiCorp's ratepayers would also be losing money?

WARREN BUFFETT: Well, I think the question about the ratepayers will be addressed by the public utility commissions.

I mean, it is their job to represent the citizens of Oregon, and weigh a number of different considerations — for example, clean energy. Do you want to replace hydro energy with a — what you're talking about — with coal, which emits carbons into the atmosphere? There are enormous tradeoffs.

Anytime the government gets involved in eminent domain — we have that with wind farms, for example, in Iowa — there's some people that are unhappy with us using the land for wind farms. But, on the other hand, you get clean energy that way.

There are tradeoffs involved in government policy. You get into that with the question of eminent domain, all of that sort of thing.

But I think I'm going to let Dave talk to the more technical questions you get into.

But I would say, overall, you have people with widely different interests. Obviously, a big interest is the cost of electricity.

And to some extent, every public utility commission that makes a decision on gas versus coal versus wind versus solar is making a decision based partly on the economics to their ratepayers, partly on their feelings about what is the best for society, and those commissions are appointed state by state to make those decisions.

Now, in addition, in this case we have the FERC as it's called, the Federal Energy Regulation Commission, that will also have to rule on it.

They will listen to everybody. They'll listen to you. They'll listen to the 28 others that Dave mentioned. In the end we will do exactly what they say.

I mean, as a public utility, if they tell us to put up — not put up coal, we will not put up coal. If they tell us to put up wind, assuming that there is a place where there is wind, we will put up wind. We follow the dictates of the regulatory bodies that tell us what to do.

And in the end they give us a fair return on the assets employed, and we will get that return whatever the assets may be. If they tell us to put in coal assets, we'll get a return out of that.

So from our standpoint, from the standpoint of profitability, it's neutral.

From the standpoint of society, weighing all these different things, that's a decision society will make.

But, Dave, let's — do you want to talk to the algae question?

DAVE SOKOL: Sure. First, it's important, the Karuk tribe did do a study and found bioaccumulation of microcystins, or blue-green algae, in the perch and the fresh water mussels in the Klamath River.

What's important to understand about that — and by the way, we disseminated that report immediately to state and federal health agencies because they should know about it.

Microcystin is not unique to the Klamath River. There are 27 other lakes in the state of Oregon that have blue-green algae, 70 different countries, every province in Canada, and 27 of the U.S. states have lakes that have blue-green algae.

It is created from lakes that have a high abundance of nutrients and naturally-forming algae. And at the head of the Klamath River is a lake known as Upper Klamath Lake, which is actually a Bureau of Reclamation reservoir — it's a shallow, large reservoir, that is known as being hypereutrophic, which means a great abundance of algaes and various nutrients.

Those nutrients then flow down the river and do pass through or, in cases, get backed up by the four reservoirs down below the Bureau of Reclamation-linked dam.

The important issue is those things are, in fact, taken into account by the Federal Energy Regulatory Commission. They issued their environmental impact statement last November, which endorsed various fish passage methods on the dams but do not call for removal of the dams.

But, again, those are decisions that all the state, federal, agencies, and the various involved parties will either have to come to agreement with or let them run their course through the FERC process.

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

WARREN BUFFETT: Thank you. Number 2.

AUDIENCE MEMBER: Hi. My name is Henry Pattener (PH). I'm hailing from Singapore, most recently.

In one of your older letters, you — your older partnership letters in 1964 — you introduced a fourth investment method called "Generals — Relatively Undervalued."

In your description you say, "We have recently begun to implement a technique which gives promise of very substantially reducing the risk from an overall change in valuation standards.

"We buy something at 12 times earnings when comparables or poor-quality companies sell at 20 times earnings, but then a major revaluation takes place so that the latter only sell at ten times."

Is this technique pair trading and, if so, how did you think about and calculate the ratio of longs to shorts?

WARREN BUFFETT: Yeah. I didn't remember we started as early as '64, but certainly in the '60s we did some of what, in a very general way, would be called pair trading now, which is a technique that's used by a number of hedge funds, and perhaps others, that go long one security and short another, and often they try to keep them in the same industry or something.

They say that British Petroleum is relatively attractive compared to Chevron or vice versa, so they long one and short the other.

And actually that technique was employed first by Ben Graham in the mid-1920s when he had a hedge fund, oftentimes — I read articles all the time that credit A.W. Jones with originating the hedge fund concept in the late '40s, but Ben Graham had one in the mid-1920s — and he actually engaged in pairs trading.

And he found out it worked modestly — very modestly — well because he was right about four times out of five but the time he was wrong tended to kill him on the other four.

We did — we shorted out the general market for about five years in the partnership, to a degree. We borrowed stocks directly from some major universities. I think we were probably quite early in that.

We went to Columbia and Harvard and Chicago and different places and actually arranged for direct borrowing. They weren't — it wasn't as easy to facilitate in those days as it is now.

And so we would take their portfolios and we would just say, "Give us any of the stocks you want, and then we'll return them to you after a while and we'll pay you a little fee."

And then we went long things that we thought were attractive. We did not go short things that we thought were unattractive; we just shorted out the market generally.

It was always kind of interesting to me, when I would visit the treasurer of Columbia or something like and I'd say, "We'd like to borrow your stocks to short," and, you know, he thought his stocks were pretty good at that point.

And he'd say, "Which ones do you want?" And I said, "Just give me any of them — (laughs) — I'm happy to short your whole damn portfolio." (Laughter)

I needed the Dale Carnegie course to get me through that kind of thing, you know.

We didn't have any specific ratios in mind. We were always limited by the number of institutions that would give us the stocks to short.

So it was not a big deal, but we probably made some extra money on it in the '60s. It's not something that would fit our — what we do these days at all.

And, generally speaking, I think if you've got some very good ideas on businesses that are undervalued, it's really unnecessary to do any shorting out of the market.

There's a — for those of you who are in the field — I mean, there's a — kind of a popular proposal — money managers always have some popular proposal that's being sold to the potential investors — and now there's something called 130-30, where you're long 130 percent long, short 30 percent.

That stuff is all basically a bunch of stuff just to try and sell you the idea of the day. It doesn't really have any great statistical merit.

But the fish bite, as Charlie says. Charlie can elaborate on that.

CHARLIE MUNGER: Yeah. We made our money by being long some wonderful businesses. We didn't make it by a long-short strategy.

18. Big opportunities often don't last long

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Dear Mr. Buffett, dear Mr. Munger. My name is Oliver Krautscheid from Frankfurt in Germany.

The subprime crisis has led to inconsistent pricing in capital markets. Credits are trading at large discounts, and at the same time, the equities do not reflect this.

My question is, when will this be over, and how do you take advantage of market dislocations?

WARREN BUFFETT: Well, when there are market dislocations, there are always ways to take advantage of it, but we'll leave for you the joy of searching for those.

But there have been some really important dislocations. And I brought along, just for your amusement, a few figures on something that we've done recently. But it doesn't have any big significance for Berkshire. I mean, Berkshire will make some extra money out of this.

It doesn't take any time to think about. But it does illustrate just how dramatic the changes were. And the ones I brought along relate to the tax-exempt money market funds.

There were 330 billion of these. That's a lot of money — 330 billion. And they relied on repricing of — really, in almost all cases — first-grade municipal bonds.

Every seven days they have these auctions, and it was all set up very elaborately so that people could have their money, more or less, in their minds, instantly available and something that was tax exempt, and they were marketed extensively.

And I brought along — for example, here's one that related to the — they were backed by various municipal issues. This one happens to be one by the LA County Museum of Art. Just pulled that out.

And on January 24, it was marketed at 3.15 percent; January 31, 4.0; February 7, 3.5; February 14, 8 percent.

Now, how can a tax-exempt bond of short-term nature be selling at a 3 1/2 percent rate one week, and one week later on Valentine's Day be at 8 percent, and one week after that be at 10 percent?

It's now back to 4.2 percent. Now, those are huge dislocations in markets. That's crazy.

It would be one thing to be some little obscure item, but this happened with billions and billions and billions of dollars of securities.

It even happened — we get these bid sheets every day, and this happens to be a bid sheet, I think, from Citigroup. And they were repricing these every seven days.

And what you would find on these — you'll see there's lots of issues involved — the same issue would appear on several different pages, because it would represent some different auction, although handled by the same broker at the same time.

On one page you would find an issue — we would bid all these — we happened to bid these at 11.3 percent.

On one page, we bought them at 11.3 percent. On another page, the same issue, we bid the 11.3 percent and somebody else bid 6 percent.

So you have the same issue with the same broker at the same time being sold at 11.3 percent and 6 percent. Those are marks of extreme dislocation, and you find those occasionally.

You found that after the Long-Term Capital Management crisis is 1998. You found the equivalent of it in the stock market in 1974, and so on.

And those are great times to make unusual amounts of money. And if you — there's certain things we can't figure out.

I see — in the Wall Street Journal — I see advertisements these days of auctions taking place in some esoteric mortgage securities. If you had enough time, you could probably figure out some of those that were very mispriced. We don't fool around with that. We just don't have the time.

We were able to do four — we have about 4 billion in this right now. When we get all through, we'll have made some extra money for a couple of months.

It won't be significant, in relation to Berkshire's size, but it's something that's very easy to do.

You may be able to find — by working very, very hard on some smaller issues — you might be able to find in this mess in mortgages — and it's gone beyond subprime. It's gone into Alt-As and it's gone into Option ARMs and that sort of thing.

There very well could be some great opportunities out there that Charlie and I will no longer spot because we just can't be looking at that many things.

Charlie?

CHARLIE MUNGER: Yeah. What is interesting is that — how brief these opportunities to take advantage of dislocations frequently are.

Some idiot hedge fund bought unlimited municipal bonds at, you know, incredible margins. I think they bought 20 times more municipal bonds than they could afford with their own money, borrowing all the rest.

And when those things were dumped on margin calls, municipal bonds suddenly got mispriced in America. But the dislocation was very brief. So you —

WARREN BUFFETT: But very extreme.

CHARLIE MUNGER: But very extreme.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: So if you can't think fast and act resolutely, it does you no good.

So you're like a man standing by a stream trying to spear a fish and the fish just comes by once a week or once a month or once every ten years. And you've got to be there to throw that spear fast before the fish swims on. It's a pretty demanding business if you do it right.

WARREN BUFFETT: But there have been times. I mean, in the junk bond market, there was a three- or four-month period in 2002 where some really incredible things happened and they happened on a large scale. So —

CHARLIE MUNGER: Yeah. It happens about twice a century.

WARREN BUFFETT: Yeah. (Laughter)

Which means he and I have only had four or five times when we could do it. (Laughter)

19. "Automatic formula for getting ahead"

WARREN BUFFETT: Let's go to number 4.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name is Svinneyvaz Canadival (PH). I'm from Fort Lauderdale, Florida.

I read all your letters and annual reports multiple times, and every time I get a different insight. So thanks for doing it.

My question is about converting the successful small businesses into large enterprise. I have a good and successful small business from the last few years, and I'm unable to grow it to the next level. It seems like there are some components are missing, so I wanted to take your advice on it.

WARREN BUFFETT: Well, Berkshire was a small business at one time. I mean, it just takes time. I mean, it's the nature of compound interest. You know, you can't build it in one day or one week.

So Charlie and I — you know, we've never tried to do in some master stroke — convert Berkshire into something four times as large. People have done that sometimes in business.

But we've sort of felt that if we kept doing what we understood, and did it consistently, and had fun while we were doing it, that it would be something quite large at some point.

But there's nothing magic — it would be nice to attract a whole bunch of money into some great idea and have it — you know, multiply it manyfold in a few weeks or something of the sort. But that has really not been our approach.

We have just — we have done — in a general way, we've done the same thing. Now, we do little variations of it, but we kept doing the same thing for years and we'll keep doing it.

You know, we will have more businesses a few years from now than we have now. And we'll have all the ones we have presently. Most of them will do better. Some won't. And we will have added something.

And that's an automatic formula for getting ahead, but it's not an automatic formula for galloping ahead.

But we don't really feel — we're not unhappy because we're not galloping. We're not happy if we're not moving at all.

But, you know, we've got 76 or so, in most cases, pretty darn wonderful businesses. And, like I say, we'll have more as we go along. So it's a very simple formula.

Gypsy Rose Lee said once — she said, "I have everything I had five years ago. It's all that it's 2-inches lower," you know.

Well, what we want to have five years from now is a whole bunch of businesses we had before that are 2-inches higher, plus some more businesses. And that's the formula.

Charlie?

CHARLIE MUNGER: Yeah. You've got to remember that it's the nature of things that most small businesses will never be big businesses.

It's also in the nature of things that most small — most big businesses — eventually fall into mediocrity or worse. So it's a tough game out there.

In addition, the players of the game all have to die, and that is — those are just the rule of the game, and you have to get used to it.

We've only created from scratch one small business that became a huge business that I can think of, and that's the reinsurance department.

And there, Warren and Ajit and others have created a great and valuable business out of air. But can you think of anything other that's large that we've done in all these decades?

WARREN BUFFETT: No. No.

CHARLIE MUNGER: We've only done it once, so we're a one-trick pony.

WARREN BUFFETT: Yeah. We were lucky on that one, too. (Laughter)

Yeah, and incidentally, without Ajit we wouldn't have done it at all.

CHARLIE MUNGER: Right, right.

WARREN BUFFETT: It isn't that we did it. Ajit did it. We just sat there cheering.

CHARLIE MUNGER: Somebody asked us once what was the best investment we ever made, and I answered the fee we paid to the executive recruiter to find Ajit Jain. (Applause.)

20. Bond insurance business off to strong start

WARREN BUFFETT: In that connection, I'd like to give you a little report.

We went into the municipal bond insurance business a few months ago, and naturally, we did it through Ajit. And he got our companies up, licensed, and running.

And in the first quarter of 2008 — I don't have the figures for all the other people — but our premium volume came to over $400 million.

And I think — now, that was overwhelmingly written in the secondary market, but I think our premium volume was not only larger than any other municipal bond insurer in the United States, I wouldn't be surprised if it's as large as all of the rest of them combined.

And this was from a standing start that Ajit accomplished this. And I have here a list of, what, 300 and — this is the end of the quarter — 278, I believe it is, transactions.

Now, that's all done out of an office with 29 or 30 people who are doing a lot of other things, too. I mean, it's a remarkable, remarkable place.

One of the interesting things about this is that almost all of this business — although not all the premium volume — all of — almost all of this business was — came from people who came to us with municipal bonds asking us to insure them, and in every case, except two or three, they already had insurance from the other bond insurance, most of whom are rated triple-A.

So they were paying us a fee which was higher to write insurance which would only be paid, not only if the municipality didn't pay, but the original bond insurer didn't pay.

So we were writing business at an average rate of two and a fraction percent for the quarter, and the original insurer had charged, perhaps, an average of 1 percent. And they had to pay and they — in fact, the only way we're going to pay is if they went broke.

So it tells you something about the meaning of triple-A in the reinsurance — in the bond insurance — field in the first quarter of 2008.

Ajit has done a remarkable job in this arena. And Berkshire wrote a couple of primary policies for the Detroit Sewer District and the Detroit Water District that — each about 370 or 380 million — and people have found our insured bonds trading in the secondary market at a more attractive yield to the issuer. In other words, at lower yields than from any other bond insurer.

So this whole company has been built, just in a matter of a couple of months, by Ajit in his small office in Connecticut. It's pretty remarkable, and I congratulate him for it. (Applause.)

21. We prefer "the business which drowns in cash"

WARREN BUFFETT: Let's go to area 5, please.

AUDIENCE MEMBER: Hello. My name is Stuart Kaye, and I'm from New York City.

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

WARREN BUFFETT: Well, what we're doing in investment, and what everybody is doing in investment, is they're laying out money now to get more money back later on.

Now, let's leave the market aspect of the asset out. I mean, when you buy a farm, you really aren't thinking about what the market on it's going to be tomorrow or next week or next month.

You're thinking about how many — what the — how many bushels of beans per acre can you get or corn per acre and what the price is likely to be. You're looking to the asset itself.

In the case you lay out, the first question you'd have to make is do I understand enough about this business so that the financial statements will tell me the information that's useful to me in making a judgment about what the future financial statements are going to look like.

And in many cases, the answer would be no. Probably in a great majority of the cases it would be no.

But I've actually bought stocks the way you're describing many times, and they were in businesses that I thought I understood where, if I knew enough about the financial past, it would tell me enough about the financial future that I could buy.

Now, I couldn't say the stock was worth X or 105 percent of X or 95 percent of X, but if I could buy it at 40 percent of X, I would feel that I had this margin of safety that Graham would talk about, and I could make a decision.

Most times I wouldn't be able to make it. I wouldn't know — if you hand me a bunch of financial statements and you don't tell me what the business is, there's no way I could make a judgment as to what's going to happen. It could have been a hula hoop business; it could have been a pet rock business. You know, on the other hand it could have been Microsoft early on.

So unless I know the nature of the business, the financial statements aren't going to tell me much, you know. If I know the nature of the business and I see the financial statements, you know, if I see the financial statements on Wrigley, I know something about the business. Now I have to know something about the product before I can make that judgment.

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

Charlie?

CHARLIE MUNGER: Yeah. I think there's one metric that catches a lot of people. We tend to prefer the business which drowns in cash. It just makes so much money that the main — one of the main — principles of owning it is you have all this cash coming in.

There are other businesses, like the construction equipment business of my old friend John Anderson. And he used to say about his business "You work hard all year, and at the end of the year there's your profit sitting in the yard."

There was never any cash. Just more used construction equipment.

We tend to hate businesses like that.

WARREN BUFFETT: Yeah. It's a lot easier to understand a business that's mailing you a check every month. But that's what an apartment house — you know, if you own — you can probably value an apartment property pretty well if you know anything about, you know, the city in which it's in.

And if you have the financial statements, you could make a reasonable guess as to what the future earnings are likely to be. But that's because it is a business that gives you cash. Now, you can — there can be surprises in that arena as well.

But I've bought a lot of things off financial statements. There are a lot of things that I wouldn't buy, you know, if I knew the — actually, there are a lot of businesses I wouldn't buy if I thought the management was the most wonderful in the world because, if they were in the wrong business, it really doesn't make much difference.

22. Pollution in Klamath River

WARREN BUFFETT: Number six?

AUDIENCE MEMBER: Good morning. My name is Mike Palmateer (PH), fisheries supervisor for Karuk Fisheries.

Mr. Buffett, you grew up and still live in the banks of the Missouri River. I, too, live on a river called the Klamath. My family has lived there since time immemorial.

In 2002, 68,000 fish died at the mouth of the Klamath River due to disease and bad water quality. These fish are also my relations.

If another company polluted your river and killed all the fish and made the river unswimable and unfishable, how would you approach this problem? Thank you.

WARREN BUFFETT: Well, I think society would — as a whole — should approach that problem by looking at the net benefits from whatever is taking place in that situation and what the costs of electricity would be and what the farmer's situation would be if he went to a different form of water distribution.

I mean, there are a lot of competing ideas and desires in a large society, and it's up to government, basically, to sort out those.

We're sorting it out — right now, we're building coal plants in the country. We're building gas plants. We're doing various things.

People are coming to different conclusions about what kind of tradeoffs they want to make, and generally these are being made at the state level, although you could have a national energy policy that would override individual states' decisions.

We're responsive to national policy on that. We're responsive to local policy. The Oregon Public Utility Commission, I'm sure, is aware of exactly what you've discussed and they have to consider that, but they have to consider a lot of other things in determining what is the best way to generate the electricity required for the citizens of Oregon.

And, Dave, would you want to add anything to that?

DAVE SOKOL: Warren, just one comment. And not in any way to be disrespectful of the fishermen, but it — we are not polluting the river.

We're not doing — adding — anything to the water that isn't coming out of Upper Klamath River, and we do recognize the different views as to whether the irrigation is a good thing or a bad thing, whether renewable power such as hydro is better than returning the river to its prior 1907 date.

But the one thing that — just to be clear — is that PacifiCorp is not adding anything. The water is flowing through penstocks, creating electricity, and coming out the rear end, and it did so under a 50-year FERC license.

Again, we understand the varying concerns, and hopefully, over the next six years a societal answer that balances all those concerns will be reached.

WARREN BUFFETT: Thank you. (Applause.)

CHARLIE MUNGER: I'd like to — I'd like to point out how refreshing it is to have people addressing a pollution problem which has nothing to do with burning carbon. (Applause.)

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

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Hey. I'm Jack Range (PH). I'm from Philadelphia. I'm in seventh grade, and I'm 12-years-old.

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

WARREN BUFFETT: Well, I would get in the habit, if you don't have it already — but you sound like you very well may — of reading a daily newspaper, which is not the most popular thing in the world among younger people these days.

But you want to learn as much as you can about the world around you. And Bill Gates, I think, quit at the letter P in the World Book. Doesn't seem to have hurt him too much to quit there.

But you can have a set of World Books. You can read the newspapers. You should just sop it up. And you'll find out what's the most interesting to you.

I mean, you know, there's a certain point where the sports pages were most interesting to me, then the finance pages. I happen to be a political junkie. But you just can't learn enough in life.

And I think the fact — what you'll find is the more you learn, the more you want to learn. I mean, it is fun, and — but you sound to me like a young person that's going to do a lot of that on their own.

Do you have any suggestions, Charlie? You'd probably suggest reading Ben Franklin.

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

24. "We never urge people to sell good businesses"

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Greetings to all of you from the Midwest of Europe, from Bonn, Germany, on the Rhine River. I'm Norman Rentrop. I'm a shareholder in Berkshire, Wesco, and Cologne Re.

I want to thank you and Eitan Wertheimer to take the initiative and the time to come to four cities in Europe, and potentially throughout the world, to tell owners of family businesses what great alternative Berkshire Hathaway is to selling their businesses to buyout funds.

Now, my question regarding the chocolate industry. I'm challenged since I cannot buy See's Candy in my hometown, Bonn, Germany. You gave that great example of the great business, the good business, and the gruesome business.

See's Candy, you cited, having sent, like, $1.3 billion in cash profits to Omaha. There's another company called Lindt and Sprungli.

Now, while See's Candy achieves more than 20 percent profit on sales, you describe that their growth has been "OK." Lindt and Sprungli does only 14 percent on sales, but they did go almost global.

WARREN BUFFETT: Yeah. Could you get to the question, please, on this? (Laughs)

AUDIENCE MEMBER: Yeah. The question is in — whether you want to have a company with high profitability but OK growth versus a company going global but lower profits? What are your considerations?

WARREN BUFFETT: It really makes no difference to us. We evaluate all kinds of businesses.

And what we do want is we want a business with a durable competitive advantage, which both of the companies you named do.

And we want something we understand. And we want a management that we like and trust. And then we want a price that makes sense.

And we try to look at — we probably looked at every confectionary business, you know, for 20 years that was publicly owned where we got the figures. And sometimes we find something where we can take action, and most of the time we don't.

When they're private businesses, we don't determine — a really good private business — I always tell the manager, the best thing to do if you've got a wonderful private business is just keep it. It's going to be worth more next year and the year after.

So there's no reason to sell a wonderful business except for kind of extraneous factors. It may be family situations. It may be taxes. It may be that there isn't another potential heir or whatever it may be.

But there's no need — if you've got a business worth a billion dollars, you don't need the billion dollars — you've got a business that's worth a billion dollars — any more than if you've got a farm that's worth a million dollars. You've already got the million dollars. You just happen to have it in the farm. And if you like farming, you keep it.

So we never urge people to sell good businesses. We urge them to keep them.

But there comes times when they do want to sell for one reason or another — maybe once every 20 or 50 years — and we do think if they have a business that they're enormously proud of — it's a really fine business — that they can keep more of the attributes that they love in that business by selling it to Berkshire than they can, by far, selling it to anyone else.

So we are the logical buyer. As you mention, I'm going to Europe — Eitan, who's been wonderful about setting this up — and we're going to make presentations, not to try to get anybody to sell us their business now, because most people shouldn't sell us their business now.

But we do want them to think of us when the time comes when an event occurs that does cause them to think about selling. And we want to be on their radar screen.

And we're more on the radar screen in the United States than we are in Europe, and we're going to try to correct that.

But if you take a firm like you name, a Lindt, you know, there's a price at which we would buy stock in Lindt. There's a price at which we'd buy the whole business. But it's unlikely to be selling there.

You know, the — if you think about hundreds and hundreds of wonderful companies — I get all these managers that — just got a CEO yesterday who called me — and they want to tell me about their business, and they imply their businesses — or they think — their business is the most attractive investment in the world.

It isn't the most attractive investment in the world. There are thousands of possible investments. And, you know, the idea that all these managers are saying "Our stock is the most wonderful in the world" is crazy.

But it's our job to look at hundreds of things and, in terms of marketable securities, buy what we think are the most attractive ones, among the ones we understand and like as a businesses.

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

We love building Berkshire with a bunch of businesses with favorable long-term economic characteristics.

But the chance that any one of them — you know, we aren't going to look for a given confectionary company and say, "Regardless of price, we're going to do this," because we don't do anything when the phrase "regardless of price" enters into the sentence.

Charlie?

CHARLIE MUNGER: Yeah. I watched a man build up a business in southern California, which was a wonderful business. And the time came to sell it — and he devoted his whole life to creating it — he sold it to a known crook who was obviously going to ruin the business just because he could get a slightly higher price.

I think that's an insane way to live a life if you own a prosperous business. I think the better course is to sell to somebody you know is going to be a good steward of what you've created. (Applause.)

25. Dollar will probably weaken over time

WARREN BUFFETT: Let's go to number 9, please.

AUDIENCE MEMBER: Hi. My name is Johann Freudenberg (Ph) from Germany.

How would you, as a European investor that invests in U.S. equities, hedge the U.S. dollar risk? Thank you.

WARREN BUFFETT: How would I what?

CHARLIE MUNGER: How do you hedge the U.S. dollar?

WARREN BUFFETT: Oh. Well, whether you're thinking about starting in Germany and hedging the dollar risk of investing here or vice versa, we are happy to invest in businesses that earn their money in euros in Germany, or whether it's there, or France, or Italy, or earn their money in sterling in the UK, because we do not have a feeling — at least I don't have a feeling — that those currencies are likely to depreciate in a big way against the U.S. dollar.

That would be how we would get hurt. We could offset that by borrowing the money in those countries and borrowing in their currency to make the purchases.

But, overall, I think that the U.S. is going to continue to follow some policies that have made the dollar weaker in recent years.

So if I had to bet my life one way or another over 10 years, I would probably bet that the dollar would weaken against other major currencies, and, therefore, I feel no need — if we buy companies whose earnings primarily arise elsewhere in major countries — I feel no need to try and hedge those purchases.

I mean, if I landed from Mars today with a billion of Mars dollars or whatever they call them on Mars, and I was thinking about where to put my money, you know, I went to the local — wherever my UFO landed — and went to the bank and said, "I've got this billion of Mars currency," and they said, "Well, what would you like to exchange here?" I don't think I'd put all the billion in U.S. dollars.

So it doesn't bother me to buy businesses around the world, unhedged in terms of their currency, and have a fair amount of our earnings coming from earnings that originate in other currencies and which I will convert at current rates to dollars at some time in the future.

If you take Coca-Cola — we own 200 million shares of Coca-Cola. And if their earnings are roughly $3 a share, that means our share of the earnings of Coca-Cola are $600 million a year.

And of those earnings of 600 million, you know, maybe close to 500 million will be from around the world — all different kinds of currencies.

Basically I like that. I think that that will be a net plus to us over time, and it certainly has been a net plus to us in recent years.

So we are not in the business of hedging currencies, basically. We do not have a lot of hedges set up.

Charlie?

CHARLIE MUNGER: Nothing to add.

26. Small stocks and mispriced bonds offer opportunities

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Hey. How you doing? I'm Eric Schline (PH) from Larchmont, New York.

This is actually a follow-up question from a question that I asked last year at the meeting. I'd asked you guys, you know, what you would do with small sums of money since — you know, I run a small portfolio, under a million dollars.

And I asked you if you'd be doing things, you know, like the net-nets that Benjamin Graham used to talk about and, you know, liquidation arbitrage. You know, a lot of things you used to do at the Buffett Partnership.

And you acknowledged that you wouldn't be just a buy-and-hold investor, that you — as you are today — but we would be doing a lot of those transactions.

And, Mr. Buffett, you also talked about how a lot of the investments you would do with under a million dollars would have nothing to do with stocks and would be with other types of securities, and you really don't elaborate — neither of you really elaborated any more than that.

So I guess I was wondering if you could elaborate a little bit more on how your investment strategy, you know, back then, you know, in reference to non-stock investments, would be different than your buy- and-hold strategy today?

So what kind of stuff would you be doing? Maybe you could give me a past example that you did in the '50s and the '60s. That would be great. Thank you. Appreciate it.

WARREN BUFFETT: Well, if I work with small sums of money — and I'd be happy doing that — it would just open up thousands of possibilities to me.

And you might very well — certainly we found very mispriced bonds, where we could come nowhere near buying a position of enough size in Berkshire to make a difference, but where it would have made a difference if you were working with a million dollars.

But it would be bonds. It would be stocks of both in the United States and elsewhere. We found them in Korea a few years ago that were ridiculously cheap.

You know, you basically had to make very significant returns, but you couldn't put big money on it.

So it could be in stocks. It could be in bonds. It wouldn't be in currencies with small amounts.

But, you know, I had a friend who used to buy tax liens — you know, Tom Knapp, he's got some relatives here. An enterprising person can find a lot of different ways to make money.

You'll find most of them will be in small stocks. If you're working with small money, they'll be in small stocks or in some specialized bond situations. Wouldn't you say that, Charlie?

CHARLIE MUNGER: Sure. (Laughter)

27. Pandering politicians behave better in office

WARREN BUFFETT: Number 11, please.

AUDIENCE MEMBER: Hi. I'm Dr. Silber from the Infertility Center of St. Louis. And we feel that by making many, many babies, we're doing the best we can to help salvage the solvency of Social Security. (Laughs)

WARREN BUFFETT: We won't pursue the logic of that too far. (Laughter)

AUDIENCE MEMBER: We need someone to pay into the system, and with the demographic implosion that we're facing and the current anti-immigration feeling, that this is the real cause of the Social Security dilemma that we're facing. And it's true in most of the developed world.

But my question is, everybody is looking very closely at what you and Charlie are going to say at this meeting because there's just a huge amount of confusion since the credit crisis, and I guess you've been through many, many years and decades of confusion.

But everybody really wants to know what you think, because we have three candidates, one of whom I like, which I won't mention, but all three of whom seem to be pandering to voters and not really demonstrating a profound understanding of economics.

And we're going to decrease interest rates to help the credit crisis, and we're going to inject $180 billion as free gifts into the economy, and yet our dollar is down 50 percent, and we certainly don't want a recession and all the misery that would bring.

But aren't we going to eventually have a gigantic inflation here in the U.S.?

And so — in China, which is our major partner in this, the stock market has gone down and people are losing money because they're worried about the U.S.

So I'm wondering if you could just shed some words of wisdom on, if you were the presidential candidate — which I would like to see happen — what would be your position or your policy?

WARREN BUFFETT: Well, I think it was Bill Buckley that ran for mayor of New York, you know, 40 years ago or something like that, and they asked him what the first thing he would do if he were elected. He said, "I'd ask for a recount." (Laughter)

It's not an easy game. I think we have — just personally— I think we have three pretty good candidates this time — quite good candidates.

But I think that your comments about the pandering and all that, I'm afraid that's just part of — if you have a very long political process, and you have people only generally willing to listen to ideas in fairly short form, and you're trying to make the other candidates look bad one way or another — I think that the truth is you do get a lot of pandering in the policies that are proposed.

I think you have candidates that are pretty smart about economics. I happen to think two of the three are maybe a little smarter about economics than the third, but the third may be just as smart, too. They may just be forced into a different position.

You know, a political process is something that doesn't lend itself to Douglas-Lincoln debates on the fine points of policy, and it's a tough game.

And I don't — the one thing I think is I think they will behave better in office than on the stump. I think that's true of all three of them, and I think — but I think that's just built into the system.

We — you know, we have a country that works awfully well. You know, whether Warren Harding is in office or Franklin Pierce, or whatever it may be over the years.

And it gets back to that saying I've said many times that you want to buy stock in a business that's so good that an idiot can run it because sooner or later one will. (Laughter)

And we live in a country, frankly, that is so good that your children and grandchildren will live a lot better than you live, even though an idiot or two runs it from time to time in between.

But we've got a lot better than idiots running. Believe me. I think we've got three very good candidates, and I wish — whichever one of them wins, I wish them well.

You know, it's the toughest job in the world, the most important job in the world, and I think the motivations of the people running it are a lot better sometimes than their proclamations as they go along in the political process.

I think it's very hard to run in Iowa without being for ethanol. You know, it may be — you may win some badge for courage or something in the end, but you won't win the presidency.

Charlie?

CHARLIE MUNGER: Well, I'd like to address the recent turmoil and its relation to politics.

After Enron totally shocked the nation with the gross amount of folly and misbehavior, our politicians passed Sarbanes-Oxley, and it has now turned out that they were shooting at an elephant with a pea shooter.

And low and behold, we have a convulsion that makes Enron look like a tea party.

And I confidently predict that we will have changes in regulation and that they won't work perfectly. (Laughter)

Human nature always has these incentives to rationalize and misbehave, and the learned professions very often fail in their basic responsibility to be learned. And we're going to have this turmoil as far ahead as you can see.

WARREN BUFFETT: But look at it this way: I have a job here I love. You know, I'd gladly pay to have this job.

Now, I have enough stock so that I'm reasonably assured of keeping the job, but let's just assume for the moment that there are three other candidates out there, and none of us had any stock, and we were all up here making a pitch to you.

My answers might have been a little different today, you know, in terms of what Berkshire's prospects would be under me and all that sort of thing going forward. It's a corrupting process.

Now, you know, it works pretty well, but the process itself has to be corrupting.

Just take the boom in commodity prices we've had. We've had a boom in the price of oil, but we've had a boom in the price of corn and soybeans.

Now, I've heard no political candidate say you've had this huge increase in the price of corn and soybeans. That means all these poor people throughout the country, they'll be paying more for food, so we ought to put an excess profits tax on farmers. That is not something you're going to hear.

On the other hand, when it happens in oil and it happens to be Exxon, you know, people will propose occasionally we ought to put a terrible tax on Exxon because the price of oil has gone up.

There's a lot of situational ethics, or situational policymaking, that depends on how many voters there are in any given category and what state you happen to be in and all that. But I don't think I'd behave any better.

If my ambition were to be President of the United States, you know, I would — I'm sure it would affect my — what I talked about and my behavior. You know, we're all human beings.

So I don't condemn the people for the fact that when they, you know, are working 18 hours a day and the other guy is shooting at them and they start exaggerating things a little, I just don't think you should expect more of human beings than — and I think that they will tend — I think any one of the three candidates — will tend to behave quite well in the White House.

They'll succumb to all the things that presidents do in terms of having to — certain groups that helped them get there and all that sort of thing. But I think, on balance, they will end up doing what they think is best for the country, and I think they're all smart people.

28. "There will be no gap after my death"

WARREN BUFFETT: Number 12?

AUDIENCE MEMBER: My name is John Ebert (PH). I'm from Bremerton, Washington. I'm very pleased to see that both you and Charlie look so healthy, and I'm also glad to know that your goal is to work to at least 102 before you retire.

I think your secret must be the Cherry Coke and the See's Candy by evidence of what you're doing on the screen there.

My question, obviously, deals with succession. At last year's meeting, you spoke about your plan for your chief financial officer. Could you please update us on where you stand on succession?

WARREN BUFFETT: Yeah. And we've said, on the CEO front, we have three that any one of which could step in and do a better job than I do in many respects.

And the board is unanimous, I believe, in terms of knowing which one it would be if it were tomorrow morning, but that might be different two or three years from now.

I think in any event, when the time comes, they'll want to pick somebody reasonably young, because I think, on balance, it's good idea to have a long run at this job, and I think it aids in acquisition and being able to make promises to people about how their businesses will be treated and so on.

In terms of the investment officer, the board has four names. We've discussed the four. Any one or all of the four would be good at doing my job, probably better in some ways, and — but they all have good jobs now. They're happy where they are now.

They would — I think any one of the four would be here tomorrow if I died tonight and they were offered the job by the board. They're all reasonably young. They're all very well to do or rich, and compensation would not be a major factor with them.

I think any of the four would take the job at less money than they're making now, but there's no reason for them to come now.

I would still end up making the decisions, and they would probably chafe at the idea of not being able to make the decisions.

I actually worked for Ben Graham for a few years. And I loved the man enormously. I learned an amount from him. I named my older son, middle name, is after him.

But in the end, I wanted to make decisions, and I — if Ben Graham made them differently — you know, I actually prefer to make my own decisions. And anybody that manages money well is going to feel that way.

So it's just better in this case. It can happen tomorrow. It could happen five years from now. But whenever I'm not around to make the decisions, the board will decide whether to have one, two, three, or four of these people.

They'll decide — you know, they may decide to have four and divide it up four ways. They may decide to have only one. They will probably be heavily influenced by how the incoming CEO feels about exactly how he wants to work with a group or with one.

And they'll come. So there will not — there will be no — there will be no gap after my death in terms of having somebody managing the money, and they'll probably be a lot more energetic than I am now.

And they'll — they could very easily have a much better record. Some of them have a much better recent record than I do.

Charlie?

CHARLIE MUNGER: Well, you know, we still have a rising young man here named Warren Buffett. And having — (Applause)

WARREN BUFFETT: That's the advantage of working with a guy 84. You always look young. (Laughter)

CHARLIE MUNGER: And I think we want to encourage this rising young man to reach his full potential. (Laughter and applause)

WARREN BUFFETT: One thing I should point out, with our average age being 80, people talk about aging managements. We haven't found a management that isn't aging. If we ever find them, we want to start eating what they eat.

And what I can point out about your management, since our average age is 80, we're only aging at the age of 1 1/4 percent a year, and that is the lowest rate of aging that I know of in corporate America.

I mean, some of these companies have 50-year-olds, and they're aging at 2 percent a year, and just think how much riskier that is. (Laughter)

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

WARREN BUFFETT: Let's go to 13.

AUDIENCE MEMBER: I'm Isaac Dimitrovski (PH) from New York City. Mr. Buffett, it's great to be here.

I've read that there were several times in your investing career when you were confident enough in one idea to put a lot of your money into it — say, 25 percent or more.

I believe a couple of those cases were American Express and the Washington Post in the '70s. And I've heard you discuss your thinking on those.

But could you talk about any of the other times you've been confident enough to make such a big investment and what your thinking was in those cases?

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

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

WARREN BUFFETT: No. Well, I'm going back — let's just assume it was. (Laughter)

Let's just assume you didn't have Berkshire in the picture. There have been times — I mean, we've seen all kinds of ideas we would have put 75 percent of our net worth in.

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

WARREN BUFFETT: That's because you had a friendly banker; I didn't. (Laughter)

That — there have been times — well, initially, I had 70 — several times I had 75 percent of my net worth in one situation.

There are situations you will see over a long period of time. I mean, you will see things that it would be a mistake — if you're working with smaller sums — it would be a mistake not to have half your net worth in.

I mean, there — you really do, sometimes in securities, see things that are lead-pipe cinches. And you're not going to see them often and they're not going to be talking about them on television or anything of the sort, but there will be some extraordinary things happen in a lifetime where you can put 75 percent of your net worth or something like that in a given situation.

The problem has been the guys that have put 500 percent of their net worth in. You know, I mean, if you look at — just take LTCM. Very smart guys. Very decent guys. Some friends of mine. High grade. Knew their business.

But they put, you know, maybe 25 times their net worth into things that were a cinch, if they hadn't have gone in that heavily. I mean, they were in things that had to converge, but they didn't get to play out the hand.

But if they'd have had a hundred percent of their net worth in them, it would have worked out fine. If they would have had 200 percent of their net worth in it, it would have worked out fine. But they instead went to, you know, maybe 2500 percent or something like that.

So there are stocks — I mean, actually, there's quite a few people in this room that have close to a hundred percent of their net worth in Berkshire, and some of them have had it for 40 or more years.

Berkshire was not in a cinch category. It was in the strong probability category, I think.

But I saw things in 2002 in the junk bond field. I saw things in the equity markets.

If you could have bought Cap Cities with Tom Murphy running it in the early — in 1974, it was selling at a third or a fourth what the properties were worth and you had the best manager in the world running the place and you had a business that was pretty damn good even if the manager wasn't.

You could have put a hundred percent of your net worth in there and not worry. You could put a hundred percent of your net worth in Coca-Cola, earlier than when we bought it, but certainly around the time we bought it, and that would not have been a dangerous position.

It would be far more dangerous to do a whole bunch of other things that brokers were recommending to people.

Charlie, do you want to —?

CHARLIE MUNGER: Yeah. If you — students of America go to these elite business schools and law schools and they learn corporate finance the way it's now taught and investment management the way it's now taught.

And some of these people write articles in the newspaper and other places and they say, "Well, the whole secret of investment is diversification." That's the mantra.

They've got it exactly back-ass-ward. The whole secret of investment is to find places where it's safe and wise to non-diversify. It's just that simple.

Diversification is for the know-nothing investor; it's not for the professional.

WARREN BUFFETT: And there's nothing wrong with the know-nothing investor practicing it. It's exactly what they should practice. It's exactly what a good professional investor should not practice. But that's — you know, there's no contradiction in that.

It — a know-nothing investor will get decent results as long as they know they're a know-nothing investor, diversify as to time they purchase their equities, and as to the equities they purchase. That's crazy for somebody that really knows what they're doing.

And you will find opportunities that, if you put 20 percent of your net worth in it, you'll have wasted the opportunity of a lifetime, you know, in terms of not really loading up.

And we've had the chance to do that, way, way in our past, when we were working with small sums of money. We'll never get a chance to do that working with the kinds of money that Berkshire does.

We try to load up on things. And there will be markets when we get a chance to from time to time, but very seldom do we get to buy as much of any good idea as we would like to.

30. Parents Television Council and appropriate ads

WARREN BUFFETT: Go to number 1.

AUDIENCE MEMBER: Good morning, Mr. Chairman and Charlie. I'm Father Val Peter.

For 25 years I was lucky to be head of Boys Town. Expanded across the whole country. Warren was very kind to me, very helpful, over long periods of time.

What I represent today is Parents Television Council, where 1.2 million folks across the country, and our concern is to help keep toxicity off television programs — excessive violence, et cetera.

And I was very surprised, being on a parents television council board, when I read a report — I hope it's not true, but it might be — that says that of the best and most troublesome advertisers, Berkshire Hathaway, is near the bottom at 444 out of 452. I hope that's not true.

But my point is this: when I was head of Boys Town and somebody said something like that, I'd say, "Go find out. Correct it." My question is would you be kind enough to say, "Go find out," if it's necessary, "Correct it." Thank you.

WARREN BUFFETT: Yeah. I would say this: I don't know where the rankings come from. I mean, I see the — certainly by far our biggest advertiser would be GEICO.

We spend over $700 million a year on advertising. I see their ads all over the place, and, you know, I don't regard them as offensive or inducing antisocial behavior or anything like that.

But I would be glad for you to contact Tony Nicely because I can't think of any other company at Berkshire that does, remotely, the amount of advertising. And Tony is an easy fellow — he's here now, actually, but you could write him at GEICO or you could find him at the GEICO booth, probably, later in the day and just talk to him about that. I'd be glad to have you do that, Father Peter.

31. Diversification, IRAs, and brokerage accounts

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Good morning Mr. Buffett, Mr. Munger. My name is Deb Caviello, (PH) and I'm from Windsor, New Jersey.

I'm 45-years-old and have achieved financial independence in that I'm able to manage the money of my spouse and myself full time. And that goes to marrying well, part of that. I was —

WARREN BUFFETT: That can be a big part of it. (Laughter)

AUDIENCE MEMBER: Marrying well in the sense that I received the encouragement and the confidence to pursue that.

WARREN BUFFETT: That's terrific.

AUDIENCE MEMBER: I was going to ask you a question more along the lines of diversification, but I think I will put it this way. I'll skew it a little differently.

Each of us has a traditional IRA, a Roth IRA, and together we have a brokerage account. Should the assets in those accounts be separated or better managed as a whole pile?

In other words, have overlapping securities in each account or different types of securities relegated to a specific account?

WARREN BUFFETT: Yeah. Well, I would say your marriage sounds like it's going to last, so I think you should think of yourself and your husband as a unit.

And I would — you should — in my view, you should look at your overall financial condition and not worry about where the location of the assets will be.

So if you have a net worth of X and you have 20 percent of it in a 401(k) and 30 percent outright and so on like that, just look at the whole picture and decide what mix of assets, what type of assets you want, and don't treat them as being in separate pots.

I mean, at Berkshire, you know, we own stocks in a whole bunch of different — our insurance companies own stocks in separate portfolios and we even have a portfolio in Cologne as mentioned earlier.

I don't even think about what entity anything is in. You know, it's all working for Berkshire, and I think you should — the way to think about your situation is to think about it all working for your family.

Now, if you're — you strike me as having a very solid marriage, and I think your husband would be crazy if he split with you. But the — if you're just starting out, you may want to keep your money separate for a while until you see how it plays out, because a significant percentage do end up in divorce.

Listen, I don't get into marriage counseling very often. (Laughter)

But I can feel the ground sort of disappearing between my feet here. But I will turn it over, therefore, to our marital expert, Charlie Munger. (Laughter)

CHARLIE MUNGER: Yeah. Occasionally, you'll find an investment that is going to produce a huge amount of taxable income. It's a junk bond paying a high yield that's taxable or something.

So some items are more suitable for those retirement accounts that get tax-deferral benefits. But apart from that, it's all one pot. Sure.

32. Eventually power will have to come from the sun

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Hi, Warren. I'm Doug Hicks (PH) from Akron, Ohio. And you hear on the news lately a lot of people say that oil will run out during this century.

Considering the U.S. policy is to do nothing until the very last second, how do you think the end of oil will play out?

For example, do you think that this would, unfortunately, result in World War III? Or do you think alternative energy will be available, the day that oil runs out, to take its place?

And maybe, do you think these oil companies' value will go to zero when oil runs out?

WARREN BUFFETT: Yeah. Oil won't run out. It doesn't work that way.

What oil will do at some point — who knows when — people predict a lot of different things — oil at some point, daily productive capacity throughout the world will first level off and then start declining very gradually.

The nature of oil extraction is such that wells don't — with rare exceptions — they don't go to a given point producing a hundred barrels a day and then all of a sudden quit or anything like that. So you run into this depletion aspect and get into decline curves and that sort of thing.

So we won't — we're producing in the world, 86 or 87 million barrels a day of oil, which is more than we've ever produced before.

We are closer — by at least my calculations — we are very much closer to producing almost as much as our productive ability is in the world, with fields in their current stage of development, than we've ever been.

I mean, our surplus capacity, I think, is less than, well, any time I can remember. And it's quite a bit less than most periods.

So we don't have the ability to crank up, in any short period of time, the 86 or 7 to a hundred million barrels a day.

But whatever that peak will be, and whether we hit it five years from now or 50 years from now, and then it will just gradually taper down, and the world will adjust to it, and hopefully we'll be thinking about it, you know, well before it happens, and various adjustments will be made in the world that will cause the demand to somewhat taper down as the available supply.

But we will be producing oil far beyond this century. It's just — the question is whether we're producing 50 million barrels a day, or 75 million, or 25 million barrels a day. I don't know the answer to that.

There's a lot of oil in place in the world. We've messed up the recovery of a lot of the oil. I mean, we never recovered the, you know, the total potential of fields. And some fields we've mis-engineered in ways so that we will recover a very small percentage. Now, maybe there will be better engineering, tertiary recovery, and that sort of thing in the future.

It's nothing like an on and off switch, though, in terms of the world producing oil or adjusting to reduced capacity or anything like that.

You may still have enormous political considerations to — access to the available oil — because it's going to be so darn important to our society for so long.

There's nothing we can do, in any short period of time, that will wean the world off of oil. You know, that is a fact of life.

Charlie?

CHARLIE MUNGER: Well, if we get another 200 years of economic growth pretty well disbursed over the world, while the population of the world also goes up, all of the oil, coal, natural gas, and uranium reserves of the world are like nothing.

So eventually, of course, you have to use the sun. There is no other alternative. And I think we can confidently predict that there will be some pain in this process of adjusting to a different world.

Personally, I think it's extremely stupid to use up the hydrocarbon reserves of the world as fast as we are.

I don't think we've got any good substitutes for those things as chemical feed stocks, and I think it's perfectly crazy to use up something so precious for which you have no alternative that's sure to be available.

And if you look at it backwards, what should we have done? Hell, we should have bought all the oil in the '30s in the Middle East and take it over here by tankers and put it in our own ground.

I mean, it's obvious to see what should have been done in the past.

Even though that's obvious, are we doing the equivalent of that now? And the answer is, basically, no.

So I think the governmental policy tends to be way behind in terms of rationality. And I think we'll just have to soldier through. But eventually the — if we're going to have a prosperous civilization — we have no other alternative than the sun.

WARREN BUFFETT: What's your over-under figure for 25 years from now, world production oil per day?

CHARLIE MUNGER: Down.

WARREN BUFFETT: Yeah. (Laughter)

That's not an insignificant prediction. I mean, it — believe me. If oil production is down 25 years from now, it will be a different world.

I mean, you — China's going to sell over 10 million cars this year. I mean, the demand is going to keep — even at these prices — it's hard for me to imagine demand falling off a lot. So if production falls off, you'll have some interesting consequences.

33. Higher taxes for the superrich under Pres. Buffett

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my name is Guy Pope, and I'm from Portland, Oregon.

I enjoyed the cartoon this morning, and I'd like to expand on that.

I, too, like the idea of both of you serving as a single term as the President of the United States. During — hypothetically, let's say, Mr. Buffett, you served the first term; Mr. Munger, you served a second term.

WARREN BUFFETT: I think the other way around is better, but go ahead. (Laughter)

AUDIENCE MEMBER: Each of you please name three difficult policy decisions you would implement during your term to better the country.

WARREN BUFFETT: Well, Charlie is going to serve the first term, so I'm going to let him name his three.

CHARLIE MUNGER: I think that one takes us so far afield that I think it's asking too much. Three perfect solutions to the major problem of mankind from each of us in a few minutes?

We've just barely managed to stagger through life as well as we have, and I don't think we're quite up to it. (Laughter)

WARREN BUFFETT: We'd probably have a massive federal program for retirement homes, actually. (Laughter)

I would probably do something about the tax system that would change things so that the superrich paid a little more and the middle class paid a little less, but — (Applause.)

WARREN BUFFETT: That might be why you'd prefer to have Charlie serve first.

34. Munger: Ethanol is "monstrously dumb"

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Hi. I'm Ryan Johnson (PH) from Arizona, and I wanted to ask what you think about the food shortages in the world and what trends you see in the next decade or two?

WARREN BUFFETT: Well, again, I'm no expert on that. Charlie?

CHARLIE MUNGER: Well, I said last year that I thought that the policy of turning American corn into motor fuel was one of the dumbest ideas, in terms of the future of the world — (applause) — that I'd ever seen.

I came out here with the head of an academic institution, and he called the idea stunningly stupid.

Now, I'm here in Nebraska where I like Nebraskans to prosper. But this idea was so monstrously dumb that I think it's probably on its way out.

35. Amateurs should stick with low-cost index funds

WARREN BUFFETT: We've now — oh, no. We've got time for a couple more. Let's go to number 6.

AUDIENCE MEMBER: Hi. My name is Timothy Ferriss. I am a guest lecturer at Princeton University twice a year. And I'd like to touch on an earlier question about investing with small sums of money.

I'd like to ask both of you, if you were 30-years-old again and had your first million in the bank, how would you invest it, assuming you're not a full-time investor, you have another full-time job, you can cover your expenses with other savings for about 18 months, no dependents, and it would be really helpful for my students, for myself and others here, if you could be as specific as possible about asset classes, percentages, whatever you're willing to offer. (Crowd noises)

WARREN BUFFETT: Well, I'll be very simple: I — under the conditions you name, I'd probably have it all in a very low-cost index fund, and it would probably be — you know might be Vanguard — somebody I knew was reliable, somebody where the cost was low.

And because you postulated that you're not going to become a professional investor, I would recognize the fact that I'm an amateur investor, and I would feel that a — unless bought during a strong bull market, which this hasn't been — I would feel that that was going to outperform, to a degree, bonds, under current conditions over a long period of time, and then I'd forget it and go back to work.

Charlie?

CHARLIE MUNGER: Yeah. It's in the nature of things that you aren't going to have a whole lot of screamingly successful professional investors.

You've got a great horde of professionals taking croupiers profits out of the system, most of them by pretending to be professional investors, and that is in the nature of things, too.

But if you don't have any rational prospects of being a very skilled professional investor, of course you should compromise on some simple thing like an index fund.

WARREN BUFFETT: Yeah. And that — you will not get that advice from anybody because nobody gets paid to give you that advice.

So you will have all kinds of people telling you how much better they can do for you than that, and how if you just give them a wrap fee, or give them commissions, or whatever it may be, that they will do better, but they won't do better.

On average, you know, if a thousand other people like you do the same thing, that group of a thousand will do worse if they listen to the people that make pitches at them.

And in the end, why should you expect — I mean, you've got a very perfectly decent return over a 30- or 40-year period by doing what I suggest.

And why should you expect more than that when you don't bring anything to the party? The salesman will tell you that you'll get it, but you won't.

CHARLIE MUNGER: I would give you another word of warning: do not judge stockbrokers generally by the ones you meet at this meeting. We attract some of the most honorable, intelligent stockbrokers in the world. They are not representative of the class.

WARREN BUFFETT: (Laughs) The politician in him just came out

36. No "extreme frugality" but don't spend more than you make

WARREN BUFFETT: OK. We'll do one more, and then we'll break for lunch. Number 7.

AUDIENCE MEMBER: Good morning. My name is Tim Fam (PH). I'm from Austin, Texas.

For my children, I would like to hear from both of you as far as the temptation to keeping up with the Joneses.

And can you give them advice that they can live by with respect to frugality, debt, and work ethic?

WARREN BUFFETT: Yeah. Just tell them to keep up with the Buffetts. (Laughter)

Well, Charlie and I have always been big fans of living within your income, and if you do that, you'll have a whole lot more income later on.

And, you know, it — I think they will, to a considerable extent, not a perfect extent, they will follow the example of their parents.

I mean, if their parents are coveting, you know, every possession of their neighbor, you know, or trying to figure out ways to increase their cost of living without necessarily their standard of living, the kids are likely to pick up on it.

But now you can get the reverse effect. If you get too tough with them, they go crazy later on. (Laughs)

But the — it's — people make that election.

Incidentally, there are people — there are plenty of people that I don't advise to save.

I mean, the real — if you're struggling along and making a reasonable income and you have a job with a 401(k) being put aside for you, and you have Social Security, who's to say whether it's better to defer a dollar of expenditure on your family on a trip to Disneyland or something that they'll get enormous enjoyment out of so that when you're 75 you can have a, you know, 30-foot boat instead of a 20-foot boat?

I mean, there are choices and there are advantages to spending money in various forms for your family when it's young, and giving them various forms of enjoyment or education or whatever it may be.

So I don't — I don't advocate — I may practice — but I don't advocate extreme frugality.

The — and I don't say that it's always better to be saving 10 percent of your income instead of 5 percent of your income.

I think it's crazy to be spending 105 percent of your income, and I think that leads to all kinds of problems, and I get letters from people every day that have experienced those problems.

But, you know, in the end you want to have an internal score card. I mean, you are not a better person or a worse person because you live a different kind of life than your neighbor. Live a life that, you know, is true to yourself.

Charlie?

CHARLIE MUNGER: Yeah. It’s obviously the best method to train your children to provide the proper example.

(A person in the audience is shouting)

WARREN BUFFETT: I think we’re hearing a child that didn’t get that advice. (Laughter)

CHARLIE MUNGER: But of course, even if you do provide the proper example, it’s likely not to work —

WARREN BUFFETT: It’s noon.

CHARLIE MUNGER: — some of the time anyway.

WARREN BUFFETT: It’s noon now. We’ll take about a 30 to 40-minute break. We’ll come back. Some of those who are in the other room — we always have some openings here after lunch so you might be able to move into the main room.

We’ll reconvene, we’ll say, at 12:45. We’ll go to 3 o’clock.

Afternoon Session - 2008 Meeting

1. No more Klamath Dam questions

WARREN BUFFETT: OK. We're going to go back to work here. We broke off at area seven last time.

I have asked — just so everybody's aware of it — we've had three questions relating to the Klamath situation, and I think that's more than proportional to the interest of the crowd. (Applause)

So we'll skip any more like that. I think the position is known.

2. "Too big to fail" banks can't have "too much risk to manage"

WARREN BUFFETT: And we'll go onto number 8.

AUDIENCE MEMBER: My name is Ola Larson (PH). I live in Salt Lake City. And I think — on Lou Rukeyser, Wall Street Week, 1981 or something. So you must really have impressed me, Warren.

What I'd like to ask you is that looking at the future, have the business practices of the investment banks become so complex that it is not possible for the head of the investment bank to be aware of the exposures to financial risks day-to-day or week-to-week?

WARREN BUFFETT: Yeah. That's an exceptionally good question, and I think the answer, probably, is yes, at least in some places, although there's a few investment bank heads I've got enormous respect for their ability to sort of get their minds around risk.

But I decided, for example, when we bought Gen Re, it had about 23,000 derivative contracts, and I think I could have spent full time on that and not really been able to get my mind around how much risk we could — we were running — under some fairly extreme conditions that I did not think were impossible, but that the people who were running the operation might have thought were impossible, or that might not have cared about it that much because their own incentive compensation was such that if they made a lot of money one year on something, it would work 99 years out of a hundred, they would feel the chances of something going wrong big were very slim.

But I don't want to have it slim. I want to have it none. So I regard myself as the Chief Risk Officer at Berkshire.

If something goes wrong at Berkshire because of — in terms of risk — of the way we run the place, there's no way I can assign that to a risk committee or have some mathematicians come in and make a bunch of calculations and tell me I'm only running a risk that will happen once in the history of the universe or something of the sort.

I think the big investment banks, a number of them — and big commercial banks — I think they're almost too big to manage effectively from a risk standpoint in the way they've elected to conduct their business.

And it's going to work most of the time. So you don't see the risk in a way that — I mean, you don't — if you have a 1 in 50-year risk that a place will go broke, it may not be in the interest of a 62-year-old executive that's going to retire at 65 to worry too much about that.

I worry about everything at Berkshire. So I would say they're too — they're very hard to manage, very hard to have your mind around. I mean, clearly, you've seen cases in the last year where very big institutions, if the CEO knew what was going on, he certainly hasn't admitted it subsequent to what's happened.

It's embarrassing either way, but it's less embarrassing to say I didn't know what was going on than to acknowledge that you knew these kind of activities were going on and you let them go on.

It's — I've been asked for advice on regulation sometimes, and we've seen an extraordinary example, which somehow the press really hasn't picked up on much.

But you had an organization called OFHEO whose sole job was to supervise two big companies, and these big companies were Fannie Mae and Freddie Mac.

And they had a large element of public purpose in them, and they were chartered by the federal government, and they had — their activities had overtones for the whole mortgage and securities markets.

So Congress said, "If we're going to give you all this 'too big to fail'-type protection, in terms of the federal government stepping in and giving you special privileges, we want to keep an eye on you."

So they formed OFHEO and they had 200 people going to work, I presume at 9 o'clock every morning, and going home at 5, and their sole job was to see what these two places were doing. And they turned out to be two of the biggest accounting misrepresentations in the history of the world.

So they were two for two with the only things they had to examine. And I fear that if you tried to do the same thing with the biggest commercial banks or the biggest investment banks, I'm not sure you can keep track of it.

What you need is somebody at the top whose DNA is very, very much programmed against risk. And he is going to have to resist the entreaties of those who work beneath him who say everybody else is doing it, and if they can do it over there and make all this money doing it, why can't we be doing it here?

And that’s not easy to do. When you’ve got a bunch of high-powered people who are used to making in seven figures every year, and they want to do things and they say, “If you don’t do them here, we’re going to go elsewhere,” it’s a very tough system to be.

So I would say that, in many ways, there are firms that, in terms of risk, are simply — they are conducting themselves in a way that they’re too big to manage.

And if at the same time the government says they’re too big to fail, that has some very interesting policy implications.

Charlie?

CHARLIE MUNGER: Well, I would argue that you say that very well. It does have interesting policy implications.

It’s crazy to have people get so big and so important that you can’t allow them to fail, and allow them to be run with as much knavery and stupidity as permeated the major investment banks.

It’s not that Berkshire hasn’t had wonderful service from investment banking all these years, because we have. It’s just that, as an industry, this crazy culture of greed and overreaching and overconfidence in trading algorithms and so on creeps in.

I would argue it’s quite counterproductive for the country, and it ought to be reigned way back.

These institutions are too big to fail, and it was demented to allow derivative trading to end up the way it’s ended up and with the current risks that are embedded in the present system.

And it’s amazing how few people spoke against it as it was happening. There was just so much easy money to be reported.

A lot of the money that was reported as being earned wasn’t really being earned. It was in that wonderful category of assets that I call “good until reached for.”

They sit there on the balance sheet, and when you reach for it, it just fades away like — (laughter)

WARREN BUFFETT: He’s not kidding.

CHARLIE MUNGER: — mist.

WARREN BUFFETT: He’s not kidding.

CHARLIE MUNGER: We had 400 million of that “good until reached for” assets we got with General Re.

WARREN BUFFETT: And they were behaving honorably.

CHARLIE MUNGER: Yes. But at any rate, people pushed it way too far.

In the drug business, they say, "Prove that this works" before they certify the drug.

On Wall Street, they start believing in the tooth fairy, and if one guy is reporting a lot of money, why, everybody else is asking, "Why aren't we betting on the tooth fairy?"

It's a crazy culture, and to some extent it's an evil culture, and it needs a huge reigning in.

And the accounting profession utterly failed us. The worst behaving were the people who set the accounting practice standards. And they're very bureaucratic and take forever, and they don't want to do anything real difficult that displeases people.

This is not a combination of wonderful qualities when your job is to set accounting standards, which ought to be dealt with sort of like engineering standards. And they don't even have the right approach. So there's a lot wrong.

WARREN BUFFETT: When Charlie and I first got to Salomon, we noticed that they were trading with Marc Rich, who had fled the country. And we suggest — well, we told them — we wanted to quit trading with Marc.

And they said, well, they were making money doing it one way or another, and they said, what the hell did we know about crude oil trading, and they wanted to keep trading with him.

And only by just total directive could we stop our own employees from trading with Marc Rich.

Now, if you can't stop your people trading with Marc Rich, you know, when you're focusing on it, just imagine what goes on, you know, in those trading rooms elsewhere.

It's — if Bear Stearns — I think the Fed did the right thing by stepping in on Bear Stearns.

If Bear Stearns had failed on Sunday night — and it would have — they would have walked over to a federal judge and handed him a bankruptcy petition, I guess, a little after 6 o'clock Midwest time, because that's when Tokyo opened.

If they had failed, the next day, as I understand it, they had about 14 1/2 trillion — which isn't as bad as it sounds — but 14 1/2 trillion of derivative contracts.

Now, the parties that had those contracts that had a claim against Bear Stearns would have been required, I think, almost by the contracts they signed, but they would have been required to undo those contracts very promptly to establish the damages they would have against the bankrupt estate.

Just imagine thousands of counterparties around the world, you know, trying to undo contracts, everybody knowing they had to undo contracts in a very, very short period of time.

The 400 million we tried to reach for and didn't find — we had the luxury of spending about four or five years unwinding those contracts. These people would have had four or five hours to do the same thing with everybody else doing it simultaneously.

It would have been a spectacle that would have been of, I think, of unprecedented proportions, and, of course, it would have resulted, in my view, of another investment bank or two going down, you know, within a matter of days.

Because nobody has to lend you money. In fact, that was one of the interesting things that was said at the testimony when they called them down to the Senate Finance Committee.

They — I think two of the witnesses said, we didn't understand — we understood we couldn't borrow money unsecured, if people started looking at us with askance, but they said, we didn't dream we couldn't borrow money secured.

Well, we'd found that out at Salomon that we were having money borrowing money secured 17 years earlier.

When the world doesn't want to lend you money, ten basis points doesn't do much, you know, or 20 basis points, or 50 basis points much, or a bigger haircut on collateral.

If they (don't) want to lend you money, they don't want to lend you money. And if your dependent on borrowed money every day, you have to wake up in the morning hoping the world thinks well of you.

And there was a period there a few months ago when I think every investment bank in the United States was plenty worried about whether people were going to think well of them the next morning.

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

WARREN BUFFETT: Well, let's go on to number 9.

AUDIENCE MEMBER: Harry Beguy (PH), San Francisco.

Mr. Buffett, I was reading recently in Fortune magazine that when you invested $500 million in PetroChina back in 2001 or 2002, all you did was read the annual report.

Now, I was thinking that most professional investors with the kind of resources that you have would have liked to have done a lot more research and talked to management, maybe regulators, et cetera, et cetera.

The question I have is, how — what is it that you look for when you're reading an annual report like that? How is it that you were able to, and did, make an investment purely on the back of reading that report?

WARREN BUFFETT: Yeah. Well, it was in 2002 and 2003, and the report came out in the spring, and I read it. And that's the only thing I ever did. I never contacted any management. I never got a brokerage report. I never asked for anybody's opinion.

But what I did do is I came to the conclusion that the company — and it's not hard to understand crude oil production and refining and marketing and the chemical operation they have. I mean, you can do the same thing with Exxon or BP or any of them, and I do that with all — I look at them.

And I came to the conclusion it was worth a hundred billion, and then I checked the price and it was selling for 35 billion, roughly.

What's the sense of talking to management? I mean, basically, if you talk to management of almost every company, they'll say they think their stock is a wonderful buy, and they'll give you all the good stuff and skip over things that — it just doesn't make any difference.

Now, if I thought the company was worth 40 billion and had been selling for 35 billion, then at that point you have to start trying to refine your analysis more. But there's no reason to refine your analysis.

I mean, I didn't need to know whether it was worth 97 billion or 103 billion if I was buying it at 35 billion.

So any further refining of analysis would be a waste of time when what I should be doing is buying the stock.

So we really like things that you don't have to carry out to three decimal places, you know.

If you have to carry it out to three decimal places, it's not a good idea. And, you know, it — with something like PetroChina — it's like if somebody walked in the door here and they weighed somewhere between 300 and 350 pounds. I might not know how much they weigh, but I would know they were fat. (Laughter)

That's all I'm looking for, is something that's financially fat. And whether PetroChina weighed 95 billion dollars or 105 billion didn't make much difference. It was selling for 35 billion. If it had been selling for 90, it would have made a difference.

So if you can't make a decision on something like PetroChina off the figures, forget about going further, and that's basically what we did. It's a straightforward report, just like reading another — just like reading Chevron's or ConocoPhillips or something like that. Just as informative.

And you weren't going to learn more, you know, by going out and deciding whether you thought — they've got one huge field in China where the life of it was 13 years or 14 years or something of the sort. They should hit you between the eyes.

Charlie?

CHARLIE MUNGER: Yeah. I would argue that we have lower due diligence expenses than anybody else in America — (laughter) — and that we have had less trouble because we had less expense.

I know of an investment operation in America that pays over $200 billion a year that —

WARREN BUFFETT: Two-hundred million.

CHARLIE MUNGER: 200.

WARREN BUFFETT: Million.

CHARLIE MUNGER: Yes. 200 million. Pardon me.

WARREN BUFFETT: Uh-huh.

CHARLIE MUNGER: — every year to its accountants, a lot to help them with due diligence.

And I think our operation is safer because we think like engineers. We want these margins of reliability. And they're trying to do something really difficult, which is to have fine-grain judgments in very complex areas, and rely on other people to do it who are getting paid fees.

It's a very dicey process to do that. I think it's much safer to do our way.

WARREN BUFFETT: If you think the auditors know more about making an acquisition than you do, you ought to take up auditing and let them run the business, as far as we are concerned.

We are not — I mean, when we get a call on something like the Mars-Wrigley situation, if we don't know enough about Mars and Wrigley by this point so that we have to go out — I still like to go out, of course, and sample all the bars.

So we have a 15 — I mean, I feel I owe that to the Berkshire shareholders (Laughter)

But I'm not going to look at their labor contracts or their leases or anything like that.

If the value of Wrigley depends on a specific lease someplace or a specific commitment to this or that, you know, or a given environmental problem, forget it, you know.

The — there are these overriding considerations that are enormously important, and then there's a whole lot of trivia that doesn't mean anything.

We have never made a — we've made plenty of big investment — I've made plenty of big investment mistakes. I've never made one, in my view, that would have been avoided by conventional due diligence.

And we would have spent a lot of money, and we would have wasted a lot of time and, in some cases, we would have missed deals, simply because we wouldn't have committed fast enough.

We have a significant advantage, and it gets bigger as we get bigger, because, in terms of big deals, people rely more and more often on process, in that when people want to get a deal done, they want to know it's going to be done, they will come to us.

I mean, the Mars people wanted to deal — in terms of this financing aspect of the Wrigley situation — they only wanted to deal with Berkshire because they knew we didn't have any lawyers involved. I'll admit to this group we didn't even have any directors involved.

We just — you know, we got a call, it made sense, and we said yes. And when we say yes, we don't say yes with a material adverse change clause. We don't say yes, if financing is available. We just say yes.

So I can tell people when we make a deal that, if we're going to have 6 1/2 billion available, it's going to be available, you know, whether there's a nuclear bomb goes off in New York City, or whether there's a flu epidemic, or whether Ben Bernanke runs off to South America with Paris Hilton. (Laughter)

The check is going to clear.

And if you're making a deal, you know, the guy that wants the 6 1/2 billion, that assurance is worth something. And you really can't get anyplace — they say, "Well, I'll do it, but I've got to have a due diligence team check this out and do all of that." So it's a real advantage to us, and I don't think there's any disadvantage to us.

4. Buffett on religion: "I'm a true agnostic"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Hi, Mr. Buffett. My name is Matthew Millard (PH). I'm from Norman, Oklahoma, and —

WARREN BUFFETT: We'll forgive that as Nebraskans. (Laughter)

AUDIENCE MEMBER: That's OK. Thank you.

I've been a long-time Berkshire shareholder since I was 16. Really like the company. Really like your investment style, buy and hold forever, kind of beyond the grave.

But my question actually had to do with, do you know and believe in Jesus Christ and have a personal relationship with him.

WARREN BUFFETT: No. I'm an agnostic. And I grew up in a religious household. And if you'd have asked that question of my mother and father, you'd have gotten a different answer.

And I'm a true agnostic. I'm not closer to either a theist or an atheist. I simply don't know, and maybe someday I'll know and maybe someday I won't, but that's the nature of being an agnostic.

Charlie?

CHARLIE MUNGER: I don't want to talk about my religion.

WARREN BUFFETT: OK. Well — (Applause.)

WARREN BUFFETT: Being an agnostic, I don't have to talk about religion. It's very simple. (Laughter)

I don't — obviously I have no opinion on anybody else's religion because that's the nature of being an agnostic.

I wish everybody well on their own.

5. Berkshire takeover after Buffett dies is "very unlikely"

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Hello. Good afternoon, Warren and Charlie. I want to thank you for hosting this annual meeting.

My name is James (inaudible) from East Brunswick, New Jersey.

I don't want to sound morbid, but my question is, once you two are gone and Warren's stock is placed in trust and slowly forced to be sold over the years, what safeguards are in place to prevent a hedge fund or LBO shops from joining together and acquiring Berkshire Hathaway, and putting in play and breaking up this wonderful company and endangering the culture of this company?

WARREN BUFFETT: Well, my stock would be sold over about a 12-year period after my death.

During the time of settling the estate, it gets disposed of in the same manner as presently, and then it gets on a time clock.

So that takes a lot of time. I may live a little longer, even, than now, but even if that started now, you would be dealing, I hope, with a company that had a market value much larger than even we presently have, and you'd still have large blocks of stocks held by institutions or people that certainly had a similar philosophy.

There's no guarantee that if somebody wanted to try a 6- or $700 billion takeover — and it might be, you know, a lot larger than that if you go out a ways — that it can't be done.

But I think it would be about as unlikely to happen in the case of Berkshire as any company I can think of in the world.

It can't happen at all, in effect, until sometime after I die. There will be a lot of votes concentrated until that period.

And like Charlie says, I've told — there's this period after I die before this 10-year distribution period kicks in — so I've told my lawyer to make sure that my estate lasts for quite a while. And he says that's like telling your teenage son to have a normal sex life, when you tell a lawyer that.

But it will be a long time. And like I say, if we do anything in the way of decent rates of compounding, you really are talking, you know, one of the very largest companies in the United States.

And I don't think anybody's going — I don't think there's going to be an LBO of General Electric or Exxon, and I think it would be equally difficult with Berkshire. There's no 100 percent guarantee, however.

Charlie?

CHARLIE MUNGER: Yeah. And, besides, Warren doesn't plan to leave very early.

I've heard him say several times when people ask him what he wants said at his funeral. And he always gives the same answer. He says he wants people to say, "That's the oldest-looking corpse I ever saw." (Laughter)

WARREN BUFFETT: And I'm unlikely to change my views on that subject. (Laughs)

But thanks for asking. (Laughs)

6. It's hard to challenge a well-established, popular brand

WARREN BUFFETT: Number 12?

AUDIENCE MEMBER: Hello. My name is Harold Yulean (PH). I'm from Chicago, Illinois.

I'd like you to describe the economic characteristics of the Kraft Corporation, why you feel this is a good business.

WARREN BUFFETT: Well, I would say most of the big food companies are good businesses in that they earn good returns on tangible assets.

And I don't want to get into — particularly into specifics on Kraft — but if you own important, branded products in this country, whether it's Wrigley's or Mars or Coca-Cola, or a number of the Kraft brands, or See's Candy, you have good assets.

It's not easy to take on those products. Just imagine, you know, taking on — Coca-Cola will sell a billion and a half eight-ounce servings of its product around the world today.

There's something in everybody person's mind virtually in the globe about Coca-Cola. It's a product of — since 1886 has been associated with happiness and good value in terms of refreshment and all that.

It's just about impossible, you know, to, in my mind, anyway, to take on a product like that. It's clearly satisfies people in a huge way, you know, everywhere on the globe.

And, you know, it may not be the same — Kraft, for example, has Kool-Aid in the powdered soft drink business. You know, I don't think I'd want to take on Kool-Aid. I'd rather have Coca-Cola. But it's a tough product.

And to get implanted — just think of — to get implanted in people's mind RC Cola around the world. And RC Cola has been around a long, long time. You know, it isn't going to go anyplace. I mean, that is very, very difficult.

And actually, Richard Branson came over to this country — you know, they say that a brand is a promise. I mean, there's a promise involved in picking up a Milky Way, or picking up a Coca-Cola, as to what it's going to deliver to you.

Richard Branson came over seven or eight years ago, 10 years ago, you know, a fellow with a famous airline and all of that, and he came out with something called Virgin Cola. And I thought that was kind of an unusual promise to have in a product. (Laughter)

Never could quite figure that one out, what the promise was. But whatever it was, it didn't work.

And there have been — I don't know how many — Don Keough would know — but there have been hundreds of colas over the years. But in the end, who is going to, you know, buy some substitute cola for a penny a can less, or two cents a can less, than Coca-Cola, or the same thing with See's Candy, or the same thing with Kool-Aid, or whatever it may be.

So we feel pretty good about branded products when they're runaway leaders in their field. And there's nothing unusual about Kraft in their position versus Kellogg or some other people like that.

So there's — the specifics of which one we buy may depend a little bit how we feel about the price. It certainly will make a difference how we feel about the price, the management, and some other factors.

But if you buy in with good branded products and you don't pay too much, you're probably going to do OK.

On the other hand, you're not going to get super rich because the attributes that I've just laid out are pretty well recognized.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: OK.

7. Avoid low-probability problems that could destroy the company

WARREN BUFFETT: I don't — do we need to go to the other room or not? Well, let's just go to number 1. If I'm skipping the other room and there are still people in there, somebody can let me know, and we'll go back for them. Number 1.

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger. My name is Kevin Truitt (PH) from Chicago, Illinois.

My question is this: you have identified four investment professionals who will at some point in time be running the portfolio for Berkshire Hathaway.

What was the criteria that you used to select the four people and what will be the criteria for evaluating them going forward?

WARREN BUFFETT: Yeah. The criteria for selecting, I think, we laid out pretty well in the 2006 annual report.

We obviously look for people that have had pretty good records, but that criteria alone is nowhere near sufficient to come up with the candidates we want.

I mean, we care enormously about human qualities, and we think we can make that judgment in some cases, and in some cases we can't.

I mean — and it's no negative vote on people we skipped over. We just decided we didn't know whether they would be the right kind of person.

We made an affirmative judgment on four, as to both their ability and their integrity.

And I would like to — there was one other item in here, I believe, which I think achieved a little added relevance in the last year. I said, "We therefore need someone genetically programmed to recognize and avoid serious risks," and then I put in italics, "including those never before experienced."

And then I said, "Certain perils that lurk in investment strategies cannot be spotted by one of the models — by use of the models — commonly employed today by financial institutions."

Well, I think that proved to be somewhat prophetic of what happened last year. All of these places had models. I mean, the major banks, the major investment banks.

They would meet weekly at a risk committee, probably, and go over their models, and all of the statistics would be printed in nice columns and everything. And they didn't have the faintest idea what risk they were involved.

You really need, in the investment world, someone very solid, someone you trust, reasonable analytical skills.

But you also need someone that actually can contemplate problems that haven't popped up yet but which are starting to become possibilities, in terms of new financial instruments or new behaviors in markets and that sort of thing.

And that's a rare quality. I mean, that inability to envision something that doesn't show up in your past model, you know, can be fatal.

And Charlie and I spend a lot of time thinking about things that could hit us out of the blue that other people don't include in their thinking.

And we may miss some opportunities because of that, but we feel it's essential when managing other people's money or, for that matter, managing our own money.

So I would say that you might go back and read the 2006 annual report again, but those are the criteria we're looking for and we have identified as being met by the four people we're thinking about.

Charlie?

CHARLIE MUNGER: Yeah. You can see how risk averse Berkshire is. In the first place, we try and behave in a way so that no rational person is going to worry about our credit.

And after we've done that, and done it for many years, we also behave in a way that, if the world suddenly didn't like our credit, we wouldn't even notice it for months, because we have such liquidity and are so unlikely to be — unable to be — pressured by anybody.

That double layering of protection against risk is like breathing around Berkshire. It's just part of the culture.

And the alternative culture is just the opposite. You call a man the Chief Risk Officer, but often he is functioning as a guy that makes you feel good while you do dumb things. (Laughter)

So he's like the Delphic oracle that convinced the Persian king to attack somebody or other. I mean, it's — he's just a dumb soothsayer.

And how can a guy be dumb when he's got a Ph.D. and he can do all this advanced math?

WARREN BUFFETT: Easy.

CHARLIE MUNGER: You can — (laughter) — but you can. It's very — all you've got to do is crave system and computation so much that you torture reality into fitting some model — mathematical model — which really doesn't match, particularly, under extreme conditions.

And then, because of this work that you're putting into everything and these computations about daily trading, risk, and so forth, you feel confident that you've clobbered the risk, but you haven't. You're just clobbered up your own head. (Laughter)

WARREN BUFFETT: Yeah. We really want to run Berkshire, you know — (Applause.)

WARREN BUFFETT: I'll even applaud that one. (Laughs)

We really want to run Berkshire so that if the world isn't working tomorrow the way it's working today and it's working in a way nobody expected, that we don't have a problem.

We do not want to be dependent on anybody or anything else. And yet we want to keep doing things.

So, we've found a way to do it — we think we found a way — to do that. It may give up some of the — well, obviously gives up earning higher returns 99 percent of the time, and maybe 99.9 percent of the time.

Obviously, we could have run Berkshire with more leverage over the years than we have. But we wouldn't have slept as well, and we wouldn't feel comfortable — we'd have a lot of people in this room that have almost all their net worth in Berkshire, including me — and we wouldn't feel comfortable running a business that way.

Why do it? I mean, it doesn't — it just doesn't make any sense to us to be exposed to ruin and disgrace and embarrassment and — for something that's not that meaningful.

If we can earn a decent return on capital, you know, what's an extra percentage point? It just isn't that important.

So we will always try to behave in a way that, A, is not dependent on anybody else evaluating the risk except for us. It cannot be farmed out.

And you've seen what happened to some institutions where the management thought they were farming it out. And, you know, if that means a reasonable return instead of a slightly unreasonable return, we just accept it.

8. "If we can't make a decision in five minutes, we can't make it in five months"

WARREN BUFFETT: Number 2. (Applause)

AUDIENCE MEMBER: Hello, Mr. Buffett. Hello, Mr. Munger. My name is (inaudible) (PH), and I'm from Munich, Germany.

I would like to get back to your point that, as a professional investor, one should be able to act quickly and decisively. That means being able to know what the intrinsic value is and to act within a day or within an hour if the market offers an opportunity.

My question is, how large is the universe of companies which you have in your head whose intrinsic value you know, where you would be able to act within a day or two if the market offered an attractive price to you?

And, secondly, how come you suddenly invest in southern Korea or China?

WARREN BUFFETT: Yeah. We can act — our immediate decision is whether we can figure the — what's being offered out to us or not. I mean, there's a go/no-go signal.

And Charlie and I are often thought to be rude when we think we're just being polite and not wasting the other person's time. So as they start mid-sentence in their first conversation with us, we just say, "Forget it." And Charlie is pretty good at that, and I'm picking it up. (Laughter)

It's — we know very, very, very early in a conversation whether somebody's talking about something that there's any chance is actionable by us.

And we don't worry about the ones we miss. We want to make sure that we don't waste any time thinking about things that, when we get all through thinking about them, we're not going to know enough to make the decision on. So we just rule those out. And that rules a lot of things out.

But then, if it gets through a couple of these filters and makes it into an area where it says this is something that we know enough about to make a decision on, we're ready to move right then.

So we make decisions — we can make a decision in five minutes very easily. I mean, it just is not that complicated.

Now, we know about a number of businesses and industries, and there's a lot of businesses and industries we don't know anything about.

We know a lot of things about certain kinds of bonds, and we know — there's a variety of things we know about, and it's nice if we can expand that universe of knowledge. But the most important thing is that anything that gets through is in an area of knowledge.

And the truth is, if we can't make a decision in five minutes, we can't make it in five months. You know, we're not going to learn enough in the followings five months to make up for the fact that we went in deficient in the first place.

So it's just not a problem around Berkshire. If we get a call and somebody says either they've got a business for sale or — that's what we're going to get on the calls — or if I'm reading a paper, or a magazine, or an annual report, or a 10-K, and I look at a price and there's a significant differential between price and value, we move right then.

And Charlie and I don't need to talk to each other about it. I mean, we both think the same way, and we have generally similar spheres of knowledge.

Charlie?

CHARLIE MUNGER: It's — the answer to your question is, we could make a lot of decisions about a lot of things very fast and very easily.

And the — and we're unusual in that respect. And the reason we're able to do that is there's such an enormous other lot of things that we won't allow ourselves to think about at all.

It's just that simple. I mean, I have a little phrase when people make pitches to me, and about halfway through the first sentence, I say, "We don't do startups." They don't exist.

Well, if you blot out startups, there's a whole layer of complexity that goes out of your life. And we've got other little blotter-out systems. And using those, we finally find out that what remains is still a pretty large territory that we can handle. You think that's fair, Warren?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: And an awful lot of giveaways that people, in the first sentence or two, throw out that, you know, we just know we aren't — you know, it isn't going to work. (Laughs)

And we waste very — I would say — we waste a lot of time, but we waste it on things we want to waste our time on. (Laughs)

We're very selective about that, and then we're good at it. We waste a lot of time. But we're not going to waste it on things we don't want to waste it on.

9. No thoughts on Mexican billionaire Carlos Slim

WARREN BUFFETT: Number 3.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, thank you very much for this wonderful rite. Coming — my name is Jorge Garza (PH), and I'm coming from Mexico City.

Coming from there, you have been occasionally compared to — or rather Carlos Slim has been occasionally compared to you, for other reasons than your love of the game of baseball. Can you please share your thoughts on him?

WARREN BUFFETT: Well, I — he came up once with two of his boys, and we had lunch. But that was probably 15 years ago. So I really have no special — I mean, you probably know a lot more about Carlos Slim than what I do.

I read the news stories and all of that. And we had a perfectly pleasant lunch. But that was a long time ago.

And, Charlie, do you have anything?

CHARLIE MUNGER: No. I think you speak for the total knowledge of both of us about Carlos Slim. (Laughter)

WARREN BUFFETT: We'll go down the rest of the Forbes 400 for you, too, if you would like. (Laughter)

10. Human rights issues shouldn't keep a country out of the Olympics

WARREN BUFFETT: OK. Number 4.

AUDIENCE MEMBER: Hello. My name is Andre Stalty (PH). I come from New York City, and I'm thrilled to be here. I'm greatly inspired by you. We follow you in our analyze business class in New York City, a small group of small investors. And my —

VOICE SHOTING: There are human rights violations in the Klamath.

AUDIENCE MEMBER: My question is, would you, or have you, considered asking Coca-Cola to withdraw sponsorship from the Beijing Olympics in light of the immense human rights violations in Tibet, possibly inspiring a new business model that would value humanitarian interest as well as monetary interest?

WARREN BUFFETT: Yeah. I personally — you know, I personally think that the Olympics — and I hope they are — you know, conducted forever with everybody participating.

I think that, personally, it's a mistake to start deciding whether this country should be allowed and this country shouldn't be allowed. (Applause.)

WARREN BUFFETT: I think it's very hard to grade a couple hundred countries that might be participating, according to how their behavior was.

I mean, we didn't let women vote in the United States, you know, until 1920. So we went 140 or so, 130 years, and I would say that was a great human rights violation, but I would have hated to see the United States banned from the Olympics, you know, in the years prior to that because of that.

So I just think it's a terrible mistake to try to get into — the Olympics have a wonderful event. I think the more people participate in them, the better. And I think that, on balance, they contribute to a better world over time.

So I would not start getting punitive about it. But I understand your motives on it. Thank you.

Charlie?

CHARLIE MUNGER: Well, Warren understates my position. (Laughter)

WARREN BUFFETT: I usually understate his position. This is a man of strong opinion.

CHARLIE MUNGER: And I would say to you people who are distressed by imperfections in China, ask yourself your question — the question — is China more, or less, imperfect as the decades have gone by?

And the answer is China is moving in the right direction. And as long as that's happening, I think it's a grave mistake to just pick the worst thing about somebody you don't like and obsess about it.

WARREN BUFFETT: Yeah. The U.S. has moved in the right direction over years. (Applause.)

WARREN BUFFETT: Our Constitution said blacks were three-fifths of a person, you know. We've moved a long way, and we're far from perfection.

But I think you do better with people that you're working with to — if they're going in the right direction, largely, to encourage them.

You may want to nudge them a bit, but I don't think the Olympics is the right way to do it.

11. We'll reduce our reliance on coal, but not soon

WARREN BUFFETT: Let's go to number 5.

AUDIENCE MEMBER: Hi. My name is Jessica Helmers (PH), and I'm from Scottsdale, Arizona.

My question is, what future trends do you see in the coal industry? Do you think its cost advantage will outweigh its environmental impact?

WARREN BUFFETT: Well, I think in the short-term the world is going to use more coal, you know, and I think that there's no question that there's an environmental disadvantage to it.

And as the — I think the world will slowly — maybe more rapidly than that — but we will figure out better ways to do the things that coal does, that will be more environmentally friendly over time, but it isn't going to happen fast.

I mean, if you shut down the coal-generated utilities in the United States, you know, this — we would not be able to hold this meeting in a room with the lights on.

So it's a very tough problem to solve, or to even make big inroads on in a short period of time.

Now, we — at MidAmerican — we've put in a lot of wind capacity in the last five years or so — probably about as much as anybody has.

But we are dependent a lot on coal. It's cleaner coal than it was 20 years ago, but — and we will be dependent on it for a long time.

And, you know, it's a worldwide problem, obviously. The Chinese are building coal plants at a very rapid rate.

It's going to require cooperation and leadership on a worldwide scale. And, frankly, the United States is not in a great position in terms of leadership because, you know, per capita, we've done as much to this planet of a negative nature as any country in the world.

So we — it's a little tough for us to go around preaching to people, but we will need a leader, in my view, that can sort of transcend our record of the past and get cooperation from major countries around the world.

I don't think it's going to be — but I don't think it's going to be fast. Charlie is less pessimistic on this than I am.

Charlie?

CHARLIE MUNGER: Well, I think the people who are very against the use of coal should reflect: which one they'd rather use up fast — the hydrocarbons, the oil and natural gas, or the coal?

I would rather use up the coal because it's less desirable as a chemical feed stock for what we need to feed the world.

And so I would argue that there's an environmental reason, in terms of human kind, for being very pro-coal use.

Most people don't think that way, but I do. (Laughter)

WARREN BUFFETT: Charlie does not find comfort in numbers.

CHARLIE MUNGER: No.

12. Don't lump regional banks together

WARREN BUFFETT: Number 6.

AUDIENCE MEMBER: My name is Rosat Bastar (PH). I live in Sacramento, California.

The stock prices of most small, regional banks have become more attractive in the past one year. Do you have any opinions about regional banks as investments? And if you were going to purchase shares, what are the areas that you would carefully examine?

WARREN BUFFETT: Yeah. I don't think you should make a categorical decision about something like — however you define them — small, mid cap, whatever, regional, or national banks for that matter.

So much depends on the character of the institution, which will probably be a reflection, to a great degree, of the type of CEO you have.

And I — a bank can mean anything. It can — you know, it can mean an institution that's doing all kinds of crazy things.

It can — there was one called the Bank of the Commonwealth up in Detroit many years ago that went to extremes, and it was very popular on Wall Street for a while.

It could mean the soundest of institutions. We had one — we owned a bank — the only bank Berkshire's ever owned in its entirety — in Rockford, Illinois, run by a fellow named Gene Abegg.

And, you know, it wouldn't make any difference whether it was a super-regional or a regional or a small or a mid-cap bank, there's no way Gene Abegg could run anything other than a super-sound bank.

So I don't think you should — I think you should know something about the culture of the management and the institution to make a firm buy decision on a bank, and that's hard to do for 99 percent of the banks.

We own stock, as you know — it's in our report — Wells Fargo and U.S. Bank and M&T up in Buffalo. And in all three cases, I think I understand quite well the DNA of the institution, in terms of how it behaves.

That doesn't mean those places are immune from problems, because they'll have problems. But it means — but it does mean — they're immune, in my view, from what I would call institutional stupidity. And I would not say that all banks are immune from that.

As a matter of fact, there was a very wise man named — I think it was Morris Cohen (Morris Schapiro) — that said, "There are more banks than bankers," and if you think about that awhile, you'll get my point. (Laughs)

Charlie?

CHARLIE MUNGER: Well, I think the questioner is onto something.

So many of our very large banks, both here and in Europe, have sort of cast a pall of disgrace over the whole industry, and that is undoubtedly pounded down the stocks of some small banks that there's nothing at all wrong with.

So I think you're prospecting in a likely territory.

WARREN BUFFETT: Yeah, but you can find a few big banks —

CHARLIE MUNGER: Yes. (Crosstalk)

WARREN BUFFETT: And it — I don't know if you took the 20 smallest banks in Florida and the 20 largest banks in Florida which group would be in better shape, in terms of the Florida real estate situation.

CHARLIE MUNGER: It's a territory that has some promise. (Laughter)

WARREN BUFFETT: That is a wildly bullish statement from Charlie. (Laughter)

13. Nuclear proliferation is the "primary problem of mankind"

WARREN BUFFETT: Number 7. I'm going to go out and buy that stuff as soon as we get out of here. (Laughter)

AUDIENCE MEMBER: Good afternoon. My name is Matt Thurman (PH), Chicago, Illinois.

Mr. Buffett, Mr. Munger, what are your thoughts on preventing further nuclear proliferation, given recent events in Syria, Iran, North Korea, and other countries? Thank you.

WARREN BUFFETT: Yeah. Well, it's the great problem of mankind, along with proliferation or the spread of other weapons of mass destruction in the chemical and biological field.

The genie is out of the bottle on nuclear knowledge, and more and more people are going to know how to do enormous damage to the rest of the human race as the years go by.

You'll have a given percentage of the population that are psychotics or megalomaniacs or religious fanatics or whatever, and will wish ill on their neighbors.

And the choke point will be — presumably — will be materials, and to a degree, deliverability.

I think there — people generally associate weapons of mass destruction threats these days with terrorists and rogue organizations of some sort and not so much with nations.

But I regard both as being enormous threats to the future of mankind, and we have not made much progress in that respect to — we should be doing everything possible to reduce access to materials — and I've even had a few thoughts on that which you can look up on the Nuclear Threat Initiative, probably on the website.

And we've got a proposal, actually, that might reduce by a tiny bit the rationale, at least, for all kinds of nations having highly-enriched uranium and that sort of thing.

But it's the — it is the primary problem of mankind. If you've got 6 1/2 billion people, you're probably going to have — in the world — you're probably going to have close to twice the number of people who wish ill on their neighbor than you had when you had 3 billion people.

And for a long time, if you were a psychotic or something, you could pick up a stone and throw it at the guy in the next cave, and you moved onto bows and arrows and rifles and cannon. But for millennia, the ability to inflict massive damage was quite limited, no matter how crazy you were.

And since 1945, when Einstein said that the atomic bomb, as they called it then, "has changed everything in the world except how men think." That was a comment made shortly after Hiroshima.

We live in a world where exponentially — has experienced exponential growth — in the ability to inflict harm on somebody else, and we haven't gotten rid of the nuts or the people who want to do it.

And it is — whether it's, you know, Iran or you name it, or whether it's terrorist organizations or whatever, you know, we live in a very, very, very dangerous world on that that is getting more dangerous as we go along.

And we've been very lucky since 1945, you know, when the Cuban missile crisis came along in the '60s, you know, it might have been 50-50, and I think we were lucky we were dealing with Khrushchev and we were lucky that Kennedy behaved the way he did. But we were lucky, and Charlie and I talked a lot about it in the '60s at the time.

But it won't go away. And you would hope, at least in the United States, that we have an administration, whether it's Republican or Democrat, where that's at the top of the agenda, trying to figure out a way to minimize that risk.

You can't eliminate it. It is out of the bottle. But we've got to — it should be paramount to minimize the risk that we really get into something that involves, you know, deaths on a scale that nobody's ever contemplated before.

Charlie?

CHARLIE MUNGER: Yeah. Well, you talk about deaths on a scale that people have never contemplated before.

People have recently figured out that the population of Mexico probably had a population decline of 95 percent caused by European man bringing in his pathogens. And it was a pretty big civilization that went through that little knothole.

These things can happen and have happened. And look at Mexico today. I don't think it's going to wipe out the species.

WARREN BUFFETT: Well, that's —

CHARLIE MUNGER: I hope that cheers you up. (Laughter)

WARREN BUFFETT: The cockroaches will survive.

It's a very good question. I wish I knew a better answer.

14. Buffett's advice for young people

WARREN BUFFETT: Number 8.

AUDIENCE MEMBER: Good afternoon. I'm (inaudible) from Apopka, Florida. I would like to thank you for this wonderful opportunity to learn so much more about finances and, at the same time, have a wonderful time. It's been fun.

WARREN BUFFETT: That's great.

AUDIENCE MEMBER: I teach at Valencia Community College in Orlando, Florida. I teach office administration and business.

I applaud my students for investing in themselves by enrolling in college. I also want to stress financial independence and financial freedom. I do this by telling them that slow and steady wins the race; also, good, sound financial management; and then the law of reciprocity.

I have them track every expense over a period of time. Also they buy, theoretically, one stock and track that, too, over a period of time. We keep track of the current financial news, current news, and also they have research papers. (Applause.)

AUDIENCE MEMBER: Thank you. (Laughter)

They research FICO scores, the credit reports, Clark Howard, Suze Orman, the top ten billionaires, not because — (Applause)

WARREN BUFFETT: I think —

Could you move onto your question, then, please? (Laughter)

AUDIENCE MEMBER: Yes.

WARREN BUFFETT: But thank you.

AUDIENCE MEMBER: OK. What else should I be doing to lead them — (laughter) — to make sound financial decisions and to have happy, sound financial life?

WARREN BUFFETT: I'm ready to hire your entire class right now. (Laughter)

Well, I think you're telling — you're giving them some very good advice. I think that the most important investment you can make is in yourself.

I mean, very, very, very few people get anything like their potential horsepower translated into the actual horsepower of their output in life.

And potential exceeds realization to just an enormous factor with so many people.

And I — one illustration you might try with your class — I tell them this when I talk to high school groups — just imagine that you're 16 and I was going to give you a car of your choice today, any car you wanted to pick, and — but there was one catch attached to it — it was the only car you were going to get in the rest of your life, so you had to make it last there. You can pick out the fanciest you want, a Maserati, whatever it might be.

How would you treat it? Well, of course you would read the owner's manual about five times before you turn the key in the ignition. You'd keep it garaged. Any little rust, you would get taken care of immediately. You'd change the oil twice as often as you were supposed to, because you know it has to last a lifetime.

And then I tell the students, you get one body and one mind, and it's going to have to last you a lifetime, and you better treat it the same way, and you better start treating it right now, because it doesn't do you any good to start worrying about that when you're 50 or 60 and the rust — that little speck of rust — has turned into something big.

So anything your students do to invest in their mind and body — particularly your mind — we didn't work too hard on the bodies around here, but — (laughter) — you know, it pays off. It pays off in an extraordinary way.

Your best asset is your own self. And you can become, to an enormous degree, the person you want to be.

When I get classes in universities, I just ask them to imagine they were going to buy one of their classmates to own 10 percent of for the rest of their life. Which one would they pick?

They wouldn't pick the one with the highest IQ, or necessarily the one with the highest grades. They'd pick the person that's going to be effective.

And the reason people are effective is because other people want to work with them. They want to be around them. And other people they don't want to be around.

And those are qualities than an individual picks up — being generous, being humorous, being on time, not claiming credit for more than you do but rather less than you do, helping out other people — all kinds of human qualities that turn other people on, and then there's things that turn other people off.

And those are habits, and they're the habits that you pick up when they're the age of your students. The habits they have today will follow them throughout life, so why not have good ones? So that's the only message I would give your students. (Applause)

CHARLIE MUNGER: Well, I've got a specific suggestion that answers your specific question. I would add to that extensive repertoire of yours by teaching them to avoid being manipulated to their disadvantage by vendors and by lenders using the standard tricks of the vendor and lender trade.

And you couldn't start with a better book than Cialdini's "Influence," and I think Bob Cialdini, who is a shareholder, is here somewhere in this audience.

And so I have a new textbook to — I suggest you add to your class — which is Cialdini's "Influence." And he's just got a new book that's coming out and for sale in Omaha today, I think, for the first time, and that's called "Yes."

So here's two books that I suggest you add to your class.

WARREN BUFFETT: OK. (Applause.)

15. Buffett on owning sports teams

WARREN BUFFETT: Let's go to number 9.

AUDIENCE MEMBER: I'm Andrew (inaudible) from Chicago, Illinois, and I'm nine years old, and I'm a big baseball fan. I know you like baseball, and my favorite team is the Chicago Cubs.

Would you like to buy the Chicago Cubs from Sam Zell? (Laughter)

And my question is, do you think buying baseball teams is a good investment? (Applause)

WARREN BUFFETT: Well, it's been a good investment. It's been a good investment. It's not been a good investment necessarily because the earnings have gone up so much, although cable television multiplied the value in a big way.

In effect, television expanded the stadium. Wrigley Field, I think, probably seats less than 40,000, maybe.

So you had 40,000 seats available when I went there for my first major league baseball game in 1939. But then along came television, and then cable television, and pay — in effect, pay-cable television for baseball or sports networks, and that multiplied the seats in a huge way.

Now, a lot of that went to the players, but some of it stuck to the owners.

I am not a — when I was your age, I would have thought if I made a lot of money, I would have bought a team.

But there were a lot of things I thought I would do then — (laughter) — I haven't done subsequently.

So, I don't think — if the Cubs sell for 700 million, and you've got a percentage of that in your bank account — now, I don't think I would buy in at that price.

There's a psychic income to many people in owning sports teams. I mean, it makes them famous. Maybe not in the way they anticipated when they bought the team, but the — you know, it is a way to instant celebrity and recognition and all that.

And as long as we live in a society where people have loads and loads of money, a certain percentage of people are going to want to become known for the fact that they have done very well in life, and a sports team is certainly one way of doing it. That isn't the only reason people buy them, obviously.

But I will say this, you are not the first one that's asked me about buying the Cubs. (Laughs)

I've had calls — not from Sam — but from other people, and it's — I think I'll leave that to you.

Charlie? You know anything about buying a sports team? He would be a tougher sell than I would. I might do something kind of stupid like that, but —

CHARLIE MUNGER: Well, you've already done it once.

WARREN BUFFETT: Yeah. (Laughter) Touche.

16. U.S. may be so rich it doesn't need to save

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Mr. Chairman, Mr. Vice Chairman, my name is Andy Peake (PH), and I'm from Weston, Connecticut.

Americans at the individual, municipal, state, and federal levels, historically, do not save.

On the other hand, Asians save approximately 40 percent of their income. Living beyond one's means is an American way that obviously cannot continue.

First, why is it that Americans do not save, and, secondly, what can we do to correct this long-term problem? Thank you.

WARREN BUFFETT: Yeah, well certainly the savings rate in this country is — has fallen significantly and may even be negative, although it does seem to me that the value of the country, in real terms, I think, does increase quite significantly decade to decade.

So I'm not sure exactly how it happens without savings, but it does seem to me that this country, as a whole, is worth considerably more than it was 10 or 20 or 30 or 40 years ago, in real terms. So something good has happened.

But the propensity to save, that almost seems innate, in at least the great majority of cases. I mean, we've got our friend from Florida teaching children to save, and I think that has some impact.

And I should have thanked Andy Heyward for that terrific cartoon this morning, and he's got a program that I'm participating in that we think — in cartoon form — might influence a few younger people towards saving.

If you own Berkshire stock, you're automatically saving, because we retain earnings, and you're indirect interest in those retained earnings is a form of saving.

So you can spend every dollar of your income that comes in the other way, and if you own Berkshire, you are, net, saving, which is a practice I have now been following for 40 years. Sometimes to my family's consternation.

I don't know that the — you know, the savings rate is based on calculations made on consumption and imports and so on. We are importing $700 billion more of goods and services than we're exporting. And that means that somebody else is doing our savings for us, basically, as we export ownership and claims against America.

I think that's going to have consequences over time, but we are so rich that it may not be really apparent.

I think the average American's standard of living is going to improve, in real terms, although I think it may be very, very, very disproportionate, the extent to which the — particularly the super-rich — benefit compared to those in the middle class.

But, net, I think the country will be — even with our present policies, the net — in net real terms, the value on a per capita basis of the country will increase from decade to decade.

But nothing like it will, in places like a China or Korea percentage-wise, where the savings rate is very high.

This country may not save very much because it may not need to save very much. We have $47,000 of GDP per capita. It may not be distributed very well, but we are one very, very, very rich country.

And a very rich country may not need to save as much as a country that's trying to reach its potential.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that.

17. Why Buffett is going to Germany

WARREN BUFFETT: OK. Number 11.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger —

WARREN BUFFETT: This sounds serious.

AUDIENCE MEMBER: My name is — (Laughter)

I'm used to that. My name is Uta Bauda (PH) from Munich. Again, a guy from Germany.

We're going to meet in around about 14 days' time again in Germany, in Frankfurt at the Union Club. May I ask you a little bit ahead of the others, what your reasons for coming to Germany? Thank you.

WARREN BUFFETT: Yeah. It's very simple. We want more — not that there have been hardly any so far — but we would like more family owners of German businesses — in some cases in the family, maybe a hundred years, maybe 20 years, whatever it might be — we want more owners who, when they feel some need to monetize their business, think of Berkshire Hathaway.

We want to be on their radar screen. We want to be in the same position — we want them to be in the same position that the Wertheimer family was or Paul Andrews' family was here not so long ago, or the Pritzker family was.

When they have some reason — could be a variety of them — that they wanted to convert a — the ownership of a good — very good — company about which they care a great deal — translated into money, to think about calling us. And if they care about their business, we are their best call.

And I don't think we're anywhere near as prominent on the radar screen in Germany as we are in the United States, and it's something I probably should have done more about earlier, but now I'm going to hit four countries in Europe in a few weeks.

And when we leave, I think we'll be somewhat better known — what we're looking for, what we can do for those companies, why they should give us a call — I think we'll be better known a month from now than we are now.

Charlie?

CHARLIE MUNGER: Yeah. And Germany is a particularly advanced civilization, in terms of inventiveness and engineering.

You go into an American printing plant now, and the names on the machines are all German — not all, but mostly.

Now, some of the German names are Germans that came over here to America and formed printing equipment businesses. But it's just amazing the influence that the Germans have had on field after field in America. It's a very logical place for us to be looking.

WARREN BUFFETT: Sounds like maybe Charlie should go. (Laughter)

18. Munger on housing: A "particularly foolish mess"

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: My name is Len Yaffe. My wife, Ruth, and I live in Tiburon, California.

I was wondering if the current economic stresses remind you of any prior period in U.S., or any other nation's, history, and, if so, is there anything we can learn from the prior period that might help us manage the current period better?

WARREN BUFFETT: Well, they're all a little different and they all have similarities. But this one, obviously, had more of its origins in the mortgage field and in terms of the residential real estate bubble.

But the troubles that begin in one area have a way of spreading to other areas.

But I would say that, in my lifetime, it's been — I can't remember one where this particular residential real estate bubble has sent out the shock waves and the exposure of other practices elsewhere to — as to their weaknesses — like this one.

But I don't think there's any magic to the analysis or anything like that. I think that some stupid things were done that won't be done soon again, and they won't be done exactly the same again, but variations of them will pop up at some point.

Because humans are what lead to stupidity in behavior, and there are these sort of primal urges that — in terms of getting rich and using leverage and all of that sort of thing, and wanting to believe in the tooth fairy — that pop up from time to time in human behavior, and sometimes they pop up on a very big scale.

The — in terms of having any great insights on solutions or anything of the sort, I don't have them.

Charlie?

CHARLIE MUNGER: No. It was a particularly foolish mess. Now, at earlier meetings we talked about some idiot that decided that a credit delivery grocery business, like the old Buffett store —

WARREN BUFFETT: Webvan.

CHARLIE MUNGER: Yeah, Webvan. You know, internet-based delivery service for groceries. A really asinine idea. (Laughter)

And, of course, it met an ignominious failure.

That was smarter than what the people did in this mortgage field. (Laughter)

It was a lot smarter. I just wish we had those brilliant people back that gave us Webvan. (Laughter)

Which, by the way, reminds me of my general attitude toward political developments.

I have a rule and it's as follows: the politicians are never so bad you don't live to want them back. (Laughter)

WARREN BUFFETT: Pollyanna. (Laughs)

19. Financial crisis-era assets should be valued at market

WARREN BUFFETT: Number 1.

AUDIENCE MEMBER: I'm Bob Kline (PH) from Los Angeles.

Following up on the last question, can you speak to the accuracy of the financial statements of the world's major financial institutions?

What should be done to properly value their assets, like mortgages, leverage loans, CDOs, and other assets that are, as Charlie says, as good until reached for?

Since the leverage at these banks and brokerage firms is generally 15 to 20 times their tangible net worth, there isn't much margin for error. So what can be done to improve the integrity of financial statements?

WARREN BUFFETT: Well, it's a very tough thing.

I still lean strongly — there's a lot of controversy now about whether you should use fair value, however that may be determined. In many cases, it's very hard to determine.

But whether you should use that or some other figure like cost because people say that the present values are unrepresentative and so on.

I think that you get into more troubles as a society when you start openly valuing things at prices that make no sense in terms of what's going on, than whether you do your best to estimate them, even though those estimates may prove, many cases, optimistic later on, and certainly inaccurate in some respects.

So I would stick with financial institutions at least having to attempt to report their assets on a fair value basis.

But when you get into instruments — I've used this illustration before — but when you get into a CDO-Squared, if you read a standard mortgage — residential mortgage-backed certificate — security — it may consist of thousands of mortgages backing up this instrument.

And then that instrument may be traunched into 30 or so different traunches where each party has a different claim on the waterfall of funds received.

Now, that instrument itself can be kind of difficult to understand. But then you take that and you create a CDO by taking some of the lower junior tranches of a bunch of these RMBSs, maybe 50 of them, and then you create a CDO out of this.

So now you create, out of a whole bunch of junior — and perhaps — and very correlated — and perhaps kind of lousy instruments — and then you put them in a CDO and say that because you put them all together and diversified, in theory, you've got a lot of triple-A traunches of that — was a big error to start with.

And then when you took the lower tranches of a bunch of CDOs and stuck them into a CDO-Squared, that was nuttiness squared.

And if a residential mortgage-backed security had a 300 page prospectus and you had to read 50 of those to understand a CDO, you're up to 15,000 pages.

And if you had to read 50 more CDO prospectuses, and the material behind that, to evaluate a CDO-Squared, you had to read 750,000 pages, presumably, to evaluate one security, and that was madness.

To let people value that sort of thing, because they say the market at ten cents on the dollar is unrepresentative, so instead of using that, I'll use the hundred cents I paid, I think would be an abomination.

And I think that the discipline, mild as it may be, of telling managements that you're going to have to value this stuff at market may keep them from doing things that they would otherwise do that would be very stupid if they think they can get away with valuing them at some fictitious — or at cost — which would be fictitious, in terms of markets.

I lean toward the market value approach. I don't know — when you get into really complex instruments — I just don't know how you value them.

Charlie was on the audit committee at Salomon, and they would spend hours and hours and hours — and I think you found one that was mismarked by 20 million or something like that, back when 20 million was real money.

CHARLIE MUNGER: It was a floating plug.

WARREN BUFFETT: Well, we had the floating plug, too, yeah.

CHARLIE MUNGER: No. I — there's a lot that goes on in the bowels of American industry that is not pretty. (Laughter)

WARREN BUFFETT: So you can add sausage and laws — maybe you should add accounting practices to the things that people shouldn't have to witness the making of. (Laughs)

CHARLIE MUNGER: I think that part of the trouble comes from some prominent members of my own Republican Party.

Some of these people overdosed on Ayn Rand and what they learned in Economics 101, and they sort of got to thinking that if anything happened as a natural response of human nature in a free market system, even if it was an ax murder, it was a desirable development and part of a wise distribution of risk.

I don't know why grown-ups get these silly ideas, but they do. And one of them headed the Federal Reserve. I think Alan Greenspan did a very good job, averaged out, but he did overdose a little on Ayn Rand, and he had this tendency to believe that, if it happened in a free market, it had to be all right.

I think there's some things that should be forbidden. And I think that the world would have worked better if a lot of things that were described as follows: this is a financial innovation which will diversify risk — if that phrase had been banned from all discourse, the country would have worked better. (Applause.)

20. Plea from audience to read the U.S. Constitution

WARREN BUFFETT: Area 2.

AUDIENCE MEMBER: I'm Larry Tidrick (PH) from Elk Grove Village, Illinois.

My question is really more a plea. Get out your copies of the U.S. Constitution, read over Article 1, Section 8, the enumerated powers; the Ninth Amendment; the Tenth Amendment; and give Roger Pilon a call at the Cato Institute.

I think everything that's gone on today, regarding finance and economics, has to do with our Constitution, which was really based upon property rights and contract rights.

WARREN BUFFETT: Do you have a question, though, or not?

AUDIENCE MEMBER: Yes, sir.

WARREN BUFFETT: OK.

AUDIENCE MEMBER: Well, no, I don't. (Laughter)

WARREN BUFFETT: I sort of suspected that.

AUDIENCE MEMBER: I made — yeah. I made the plea and —

WARREN BUFFETT: OK.

AUDIENCE MEMBER: — that's really it.

WARREN BUFFETT: OK. Well, thank you.

21. American's distaste for mass transit won't change soon

WARREN BUFFETT: We'll go on to number 3.

AUDIENCE MEMBER: Yes. My name is Dan Schmidt (PH) from Burnsville, Minnesota.

And I'd like your opinion on the future of mass transit and how it relates to railroads, and will these transit systems and railroads be expanding in the future?

WARREN BUFFETT: In terms of passenger traffic?

AUDIENCE MEMBER: Correct.

WARREN BUFFETT: Yeah. The American public, basically, doesn't like mass transit. I mean, it endures it when it needs to, but there — the American love affair with the car, which translates to aversion to mass transit, is sort of overwhelming.

I used to be involved in bus companies. And, you know, you can make all kinds of rational arguments to people about the use of mass transit, but one person to a car seems to be an enormously popular method of moving around.

And I think it's unlikely that we see a large expansion in mass transit in this country. I think the American public is, for one reason or another, whether they're trained to it or whether it's just something in their genetic makeup, they do not like going out and waiting for buses or whatever it may be or trams.

And they want to get in their car. And even with gas at close to $4 a gallon, they want to go someplace and pay a lot of money to park, and they don't want to double up in the cars very much.

And that just seems to be human nature. Maybe it will change, but I never like to bet on something that has gone in one direction for a long time reversing unless the evidence is pretty strong.

Charlie?

CHARLIE MUNGER: You have a more optimistic view of it than I have. (Laughter)

22. Munger's in "awkward position of agreeing with Al Gore"

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: Hi. I'm Tom Nelson (PH) from North Oaks, Minnesota.

My question is for Charlie. If you were in charge of this country, how would you handle Al Gore's alleged climate crisis?

CHARLIE MUNGER: Well, of course, I'm in the awkward position of agreeing with Al Gore that we shouldn't be burning up so many hydrocarbons. (Applause)

I've just got a different reason. His brain doesn't work the way mine does, and you'll have to judge for yourself which you prefer. (Laughter)

WARREN BUFFETT: We'll have a vote a little later. (Laughter)

23. Disagreement on danger of CDOs

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: Good afternoon, Warren and Charlie. This is Frank Martin from Elkhart, Indiana.

WARREN BUFFETT: Nice to have you here, Frank.

AUDIENCE MEMBER: Thanks, Warren. One of my favorite aphorisms from you is, "To win, first you must not lose." The excerpt that you read a few moments ago from the 2006 annual report contemporized that aphorism, and I think was both prescient and prophetic. Notice I said "prophetic" and not "pathetic."

WARREN BUFFETT: I noticed.

AUDIENCE MEMBER: Yeah, thank you. (Laughter)

On several of occasions disagreeing with Alan Greenspan, you have called derivatives "weapons of financial mass destruction." We both have our own record as believing the country is currently in recession.

If corporate default rates, which are currently benign, escalate — should the recession deepen and we get back to default rates common in 2002 or back in the early 1990s — will the credit default swap problem materialize as a serious threat to financial stability?

I respect you as one of the all-time great pricers of risk. You and Charlie must consider selling insurance without reserves, without really understanding pricing risk, to be an abomination.

Is there a chance, in your judgment, that the CDS market may eclipse the subprime mortgage market as the next element of the financial meltdown?

WARREN BUFFETT: The credit default swap market — you can see these figures — and I'm repeating them, but I'm not validating them — but the last number that came out was over 60 trillion.

Now, there's lots of double counting in these things and all that sort of thing. But there's no question there's a lot of money on both sides of the credit default market. They call them credit default swaps.

You can think of it as insurance against a company going bankrupt. And actually, we have written two types of derivatives on a big scale. We explained them in the annual report. We explained them again in the press release that was issued yesterday.

And we have insured in the — we've written insurance that pays off to somebody else in the event of default by companies listed on given indices.

There's a high-yield two, a high-yield three, and so on, through high-yield nine. And we've written various traunches of risk on those things, and I think we're going to make significant money, although we could lose money, too. It will depend on credit experience in the next few years.

I think there's no question that the corporate default rate will rise. That's been cranked into the calculations I make in writing this insurance.

The question of whether the credit default swap — the size of that market — will lead to any kind of chaos in the financial markets, I think probably not.

Although if a Bear Stearns had failed, for example, you would have had a huge unwinding of contracts by counterparties who had to establish their claims and all that.

So you would have had rather chaotic conditions. Any time — a credit default swap is merely a payment by one party to another. So it's a negative-sum item. When somebody loses money on a subprime loan, on a mortgage loan, they've lost real money.

Now, somebody may be buying the house later on cheaper than they would have bought it earlier on, but there is not an equivalent swap of dollars at the time that a subprime loan goes bad.

With the credit default swaps, there is a swap of dollars. So as long as the counterparties pay, if A is up a million dollars, B is down a million dollars.

And the question is, is if you get a Bear Stearns-type situation that didn't get interrupted by the Fed, whether counterparties would fail and you get a lot of trip hammer effects, I don't think that's going to happen, and I think the chances of it happening were reduced significantly by what happened — by the fact that the Fed stepped in at Bear Stearns.

We’ve had enormous payments from one party to another, in terms of credit default swaps. Just — there’s a firm called Fairfax Financial that made — a relatively small firm — that made, as I remember, well over a billion dollars in credit default swaps.

Well, somebody else lost the billion, but it didn’t pose a threat to the system. It posed a threat to the guy that lost the billion, but he had to keep up putting up collateral, presumably, as he went along. So it wasn’t like he was called overnight for the billion.

So even though credit defaults — they’ve been the most volatile of instruments in the last 18 months. There’s been nothing that’s swung as much — maybe there’s some subprime index that has — but virtually it’s credit default swaps.

And that really hasn’t created a problem in the system. So I do not think — particularly if the Fed is going to step in when they see investment banks that they regard as too big to fail, or banks too big to fail — I don’t think that that will probably be the cause of the problem.

It may be a cause of enormous losses to some institutions, but those will be matched by enormous gains by other institutions.

I do think there’s that — the problem of the overnight disruption in the system, which Bear Stearns, I think, would have produced.

But maybe something else could produce it — a nuclear bomb going off in Manhattan, you know, or something of the sort. That kind of thing — where there’s a discontinuity, where the collateral posted the previous day was totally inadequate in terms of the kind of movement that occurred — certainly at that time something like having a large amount of CDSs out there, it could cause a — it could exacerbate — the chaos to a considerable degree.

Charlie?

CHARLIE MUNGER: Well, I think the answer to your question is — could we have a big-time mess out of credit default swaps — is yes, we certainly could.

I think the stupidity, while it’s extreme, is not as bad as sweeping bums off skid row to give them mortgages to buy houses, but it’s pretty bad.

One of the things that’s interesting about credit default swaps, which isn’t much commented on, is, let’s say you’re insuring against the outcome that people will lose money on a hundred million dollar bond issue.

And the credit default swaps, instead of amounting to a hundred million, amount to 3 billion. Now you’ve got people with $3 billion worth of contracts that really have a big incentive in having somebody fail.

And, of course, they may manipulate, in some fraudulent or extreme way, with the little loss in order to make the big collection.

It was insane for the regulators to allow this outcome to occur in America. It used to be illegal for people who had no insurable interest just to buy life insurance on people they didn't know, because society was afraid that people would do that and then kill the person.

And that happened in Los Angeles. We had sweet, little, old ladies that got bums off skid row. They'd take out life insurance on them. And when two years went past, they murdered them with fake hit-run accidents.

So human nature is up to this kind of venality where you have big payoffs. And why we wanted these enormous bets to be made, in relatively unregulated markets, where the bets are 10, 20 times the size of the original bond issue, it's crazy.

If I did this as a satire, you'd say I was overstating. I'm understating. We have a major nut case bunch of regulators and proprietors in this field. (Applause.)

WARREN BUFFETT: Charlie, one; invisible hand, zero.

24. Buffett's test on when to pay a dividend

WARREN BUFFETT: Let's go to number 6.

AUDIENCE MEMBER: Hi, Mr. Buffett and Mr. Munger. My name is Neharick Aneela (PH), and I'm from Houston, Texas. I'm a seventh grader, and I'm 12 years old.

I was wondering why you do not believe in dividends, Mr. Buffett, when your mentor, Ben Graham, believed in dividends?

He influenced you in so many ways, but why weren't you influenced into believing in dividends? Thank you.

WARREN BUFFETT: Well, I had to show a little individuality in some respect. (Laughter)

Well, the answer is I do believe in dividends in a great many situations, including many of the ones at companies in which we own stock.

The test about whether to pay dividends is whether you can continue to create more than one dollar of value for every dollar you retain.

And there are many businesses — take See's Candy, which we own. See's Candy has paid everything, virtually, out to us that they earn because they do not have the ability within See's Candy to use large sums, which they earn, intelligently in their business.

So it would be an enormous mistake for See's Candy to retain money. So they distribute to Berkshire, and we hope that we move that around in some other area where that dollar becomes worth $1.10, or $2.10, in terms of present value terms.

If we do that, the shareholder — whether they're taxable or whether they're not taxable, whether they're a foundation or whether they're living on income, even — they are better off if we retain the money.

Because if they were going to get a dollar in dividends and it became worth $1.10 or $1.20 in market value immediately on a present value basis, they're better off selling a small percentage of their stock and realizing the required amount that way, and they will have more money when they get all through doing that than if we paid it in dividends.

But if the time comes — and it will come someday — when the — if the time comes when we don't think we can use the money effectively to create more than a dollar of market value per dollar retained, then it should be paid out.

And, like I say, we do that individually within Berkshire. But because we have this ability to redistribute money in a tax-efficient way within the company, we probably had more — we had more reason — to retain all of our earnings.

If See's Candy were a standalone company, we would simply pay out a lot of the earnings, practically all of the earnings, in dividends. Just like we do now, except it goes to Berkshire.

We like our — we like the companies in which we have investments to pay to us the money they can't use efficiently in their own business.

In some cases that's a hundred percent of what they earn; in some cases it's 0 percent of what they earn. We own some stocks that don't pay any dividends.

Costco paid a very small — did they pay any dividend for a while, Charlie, or —?

CHARLIE MUNGER: They — while they were growing very rapidly, they paid no dividend. And finally they are paying one.

Berkshire's policy is much the same. Warren has always planned on paying large dividends out of Berkshire, and he does it in the mode of Saint Augustine when he said, "God give me chastity, but not yet."

WARREN BUFFETT: Right. I've always admired that.

25. Electricity in the Southwest

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good afternoon, Mr. Warren Buffett, Charlie Munger, shareholders. My name is Richard Meyers (PH). I'm from (inaudible), California.

In respect to your opinion earlier, I will go down to southern California, Arizona, and ask a question: if you have knowledge or interest of the corridor for electricity coming in from Arizona into California, or is it going from California back into Arizona?

As California is known as a sunny state, we should be able to have our own solar systems.

I have one more. I have saved $20 by staying in line since 2:30 this morning, and I would like to know which one of these books that I could buy that would do me the most good and my tribe. Thank you.

WARREN BUFFETT: Well, tell us about the books. You mean the whole list?

AUDIENCE MEMBER: Which one I can buy for $20. (Laughter)

WARREN BUFFETT: Probably the ones that haven't sold very well today. (Laughter)

Yeah, I'm not that familiar with the prices of the books. We try to have a good selection in there.

I'm a little partial to Larry Cunningham's books because — Larry Cunningham's book — because it consists of a rewriting of all my own stuff. (Laughs)

But, no, we — I think the whole collection is fine. I wouldn't want to recommend one over the other.

And I know nothing about that first subject. Charlie, do you?

CHARLIE MUNGER: Well, I know a little. You know, California did cause coal plants to be built near the Grand Canyon because California didn't want the pollution and it needed the electricity and they were nearer the coal mines.

And eventually that caused huge uproar, a lot like we heard about the Klamath River. And the Grand Canyon, that started having some visibility problems.

And I think those things are, maybe, decommissioned, or about to be decommissioned, so it's a very complicated subject. And I'm glad to (inaudible) it back to you.

26. Berkshire's international ambitions

WARREN BUFFETT: OK. Number 8.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Argin Row (PH).

I am in the eighth grade and live in Pearland, Texas. I ask everybody to call me Tony after reading your 2006 annual report. (Buffett laughs)

My question is, do you foresee Berkshire buying any businesses in either India or China in the near future?

WARREN BUFFETT: Well, Tony, I — (laughter) — we would like to. The odds are somewhat against us buying in any major country except the United States, if you'd name any specific one.

I would hope in the next three years that we might get a chance to buy one or two companies of size. We're always buying little companies that fit in with our present operations.

Right now, MiTek has several possibilities outside the United States. But in terms of major businesses that Berkshire would buy, you know, if we get lucky, we'll buy one or two in the next three or four years that's based outside the United States. We're trying to increase our chances of doing that.

Whether it turns out to be China or India or Germany or the UK or Japan, who knows? There's a lot of luck in that, just in terms of specific families thinking of us specifically. But we certainly wouldn't rule it out.

We've looked into developing an insurance company in some countries. Both India and China restrict the percentage ownership that Berkshire could have in any domestic insurance company.

They both have laws that would keep us — I know it's 25 percent in China, and I think it's 25 percent, but it may have been changed in the last year or so, in India.

We do not probably want to go into a country to own 25 percent of a company like that. We would want the laws to allow us to do more than that to make it worth our while.

But I hope we own something. You know, certainly at your age, you will see the day that Berkshire owns businesses — in my view, you'll see the day — that they own — we own — businesses in both countries.

Charlie?

CHARLIE MUNGER: Nothing to add.

27. Parents, spouses, and books are the best teachers

WARREN BUFFETT: OK. Number 9.

AUDIENCE MEMBER: Gentlemen, my name is Jim James (PH) from Minnesota, actually Minneapolis.

And clearly you've inspired 38,000 people here today. Books have been written about you, not solely for your financial prowess, but because of the people you are.

Could you share two or three influences on you — those kinds of people, educators, who have shaped your thinking on life and on investing? Thank you.

WARREN BUFFETT: Well, I think the biggest educator — certainly in my case — initially was my father. I think probably Charlie would say the same thing.

And I think— it's very, very, very important who you marry, and I've been lucky there, and those are great teachers.

And, of course, I had Ben Graham. I had Dave Dodd. I've learned from all kinds of people who have written books over the years. I've just devoured those and picking up things here and there.

Charlie learned a lot from Ben Franklin, obviously. (Laughter)

Many people think Ben Franklin learned a lot from Charlie but — (laughter) — we both learned a few things from my grandfather at the grocery store.

But your parents — I tell the students, you know, the most important job you have, you know, is being the teacher to your children.

I mean, you're the ultimate teacher. You're this big — great big thing. You provide warmth and food and everything else, and they're learning about the world, and they're not going to change a lot of that when they get into graduate school or sometime.

So it's — and you don't get any rewind button. You don't get to do it twice. So you have to do your best as a teacher, and you teach by what you do, not by what you say, with these young things.

And by the time they've got to a place where they're entering a formal school, they probably learned more from you than they're ever going to learn from anybody else.

Charlie?

CHARLIE MUNGER: Well, I would argue that differing people learn in differing ways.

With me, I was put together by nature to learn from reading. If some guy's talking to me, he's telling me something I don't know, I don't want to know, I already know, or he's doing it too slow or too fast.

In reading, I can learn what I want at the speed that works. So, to me, reading is the — is what works for my nature. And to all of you who are at all like me, I say welcome. It's a nice fraternity.

WARREN BUFFETT: You probably learn more from your father than you learned from all the reading you did, don't you think? In terms of actually forming you?

CHARLIE MUNGER: Well, yes. And my father was the type that always did more than his share of the work and took more of his share of the risk.

All that kind of example was, of course, very helpful, and you learn it better from a person close to you.

But in terms of the conceptual stuff, I'd say I learned it from books.

Now, those are fathers in a difference sense.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: The people who wrote the books.

WARREN BUFFETT: Yeah, well, one book, obviously, changed my whole financial life when I — you know, by happenstance, probably, I picked it up. I can't even remember why I bought it back when I was in school.

But if you just keep picking up enough books, you'll find some — you'll learn a lot. And I used to go through the Omaha Public Library and just go down the shelves.

It's kind of an inefficient way, maybe, of doing it, but I — if you read 20 books on a subject you've got an interest in, you're going to learn one hell of a lot. You don't know which one you're going to learn it in, though.

So I would take having — if you get the right parents, you're very, very lucky, and it's better than going to the right school or anything of the sort. And to get the right spouse, you've just doubled down.

28. Big institutional shareholders should take stand on CEO pay

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Gentlemen, my name is Mark Slaybe (PH). I'm from Chicago. I probably am going to be one of the last guys speaking today or asking a question, so on behalf of 31,000 people, I'm going to thank you —

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: — for the respect and the common courtesy that you've exhibited to the shareholders today.

WARREN BUFFETT: Thank you. (Applause.)

AUDIENCE MEMBER: My question is this: I work for a fairly large computer company that's a competitor of Mr. Gates up there.

And I'm curious. As a common, ordinary person and a common shareholder, what can we do, 31,000-some odd folks here do, about the outrageous salaries, bonuses, perks, of these enormous corporations that we will never have a chance at, a shot at, you know, working with them and that amount of wealth?

What would you advise us as common shareholders that we can do to get this country going the right way and get this issue going the right way? (Scattered applause)

WARREN BUFFETT: Well, I would say that, particularly on the compensation part, you can't do much. But there are a relatively few people that could do a lot.

If the half a dozen or so largest institutional owners took a position on extreme cases — I don't advise them trying to go after each one — but when they see something egregious, if they would simply withhold their votes and issue a short statement as to why they're doing it, that has an effect on — particularly on boards of directors.

Big shots don't like to be embarrassed. You know, they don't — that gets their attention.

The press is an enormous factor. Press is more of a factor in changing corporate behavior than regulations or Sarbanes-Oxley or that sort of thing.

You want a good press. But the press needs the material, and material — the raw material — for that could be — I won't name the organizations — but if you take the half a dozen largest investment organizations, I think it would have a lot of impact if they would — if they could get together on short statements when they felt pay was really egregious.

And I don't know what you individually can do about that, and I don't know how you create the incentives for the big institutions to do that. I mean, it doesn't really do that much for them personally.

I don't think — I think the — a lot of the checklists that institutions use as determining whether they approve of corporate practices are asinine. I mean, they — you know, they get sort of the "issue du jure" and they get — and they get people recommending how they vote their proxies, which is kind of silly. I don't know why they can't make up their minds themselves as to what they think is proper or not proper.

And Ben Graham, many years ago, bemoaned investors as a bunch of sheep. And with big institutions, I haven't seen much difference.

But it wouldn't take many of them. It would take — just take a few of the biggest ones and the willingness to speak out. And the press would do the rest and boards would respond to that. But they're not going to respond to you. I mean, I have to be, you know, totally candid about that.

A small shareholder can write the most persuasive arguments in the world, and I've been on the board where they've received those kind of letters. And basically they turn them over to the corporate secretary and say, "Take care of this," or something of the sort.

It takes real effective pressure to change behavior where the behavior is in the self-interest of that person. People do not give up self-interest easily.

Charlie?

CHARLIE MUNGER: It's an old question. In England, where they had a lot of class warfare, they at one time got the income taxes up to, like, 90 percent, so there just wasn't any possibility of having a large earned income except, you know, by not reporting it. The tax rate got that high.

That was quite counterproductive for England. And so you can get a politics of envy that sort of ruins the economic system because of the natural resentments and jealousies and so forth involved in excessive compensation.

I think the people taking the compensation have a moral duty not to take it. I would argue that, when you rise high enough in American business, you get a moral duty to be underpaid, not to get all you can, but to actually be underpaid.

If people are going to be generals and archbishops and everything else at low pay, I don't see why leaders of great big enterprise can't take less than the last dollar. (Applause.)

WARREN BUFFETT: Do you have any suggestions on how to implement those sentiments? (Laughs)

CHARLIE MUNGER: It's very difficult.

WARREN BUFFETT: Yeah. Charlie has always said that envy is — strikes him — as the silliest of the seven deadly sins, because when you're envious of somebody, you feel worse, and they don't feel any — they feel fine. In fact, maybe they even feel better because you're envious.

So it's such a counterproductive type of thing. So we — rule out as envy as part of your repertoire. And gluttony — (laughs) — I mean, that has some upside to it. (Laughter)

Maybe temporary, may have some side effects, but, you know, there's something to gluttony. And so lust, of course, I'll let Charlie speak to. (Laughter)

29. It's OK to buy pharmaceuticals as a group

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Hello. I'm Clemmon Low (PH) from Toronto, Canada. I want to thank you for the wonderful meeting, and I think I've learned a lot more here in a few hours than many, many more hours during university days.

My question is, you have invested in drug companies such as Johnson & Johnson and Sanofi. How do you evaluate the pipeline of these companies and know if their competitive advantage is, indeed, enduring?

WARREN BUFFETT: Well, that's a good question. And unlike many businesses, when we invest in something like pharma, we don't know the answer on the pipeline. It will be a different pipeline anyway five years from now.

So we don't know whether Pfizer or Merck, you know, or you name it — Johnson & Johnson — we don't know which of those will come up with a blockbuster commercial drug three or four years from now, and we don't try to assess it.

What we do feel is, if we have a group of those companies bought at reasonable prices, that, overall, pharma will do well. Maybe not quite as well as they have in the past, but they're doing something enormously important. They're doing something that should offer chances for decent profits over time.

And we do not pick one by one. I could not tell you what's the number one potential in the pipeline of a J&J or Sanofi — whatever which one you want to name.

So I think in that area, actually, a group approach makes sense, which is not the way we would go at the banks or something of that sort.

I do think if you buy pharma stocks at a reasonable multiple, a group of them, you know, you'll probably do OK five or 10 years from now. I would not know how to pick the specific winner.

Charlie?

CHARLIE MUNGER: Well, you speak from a position where you have a monopoly of our joint knowledge about pharmacology. (Laughter)

30. Why Berkshire sold PetroChina

WARREN BUFFETT: We will move on to number 12. (Laughter)

He gets cranky later in the day. (Laughter)

And we're just about to the end, but we can take a couple more.

AUDIENCE MEMBER: Thank you. My name is Chow (PH). I'm coming from Woshi, China. Thank you, Mr. Buffett and Mr. Munger, for your unbiased opinion on China and Olympics.

To support your (inaudible), we have a group of chairmen and CEOs from Chinese public companies to come to Omaha and try to learn from the best of how public companies should be run. (Applause.)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Quick question. We observed that you made a quick trade on PetroChina, not a typical buy and hold approach you do on investment.

Our question is, when it's come to selling PetroChina, what comes to your mind, and what suggestions you may have to these group of executives?

There are positive forces in China, and we welcome everyone to our Olympics.

WARREN BUFFETT: Thank you. (Applause.)

And I met Dr. Guo from the China Investment Corp here a few months ago. Was very impressed by him, had lunch with him here in Omaha.

The PetroChina decision, just as we made it to buy it at a valuation overall of 35 to 40 billion when we thought it was worth a hundred billion, when oil was at $70 a barrel, roughly, 75, I figured the value was about 275 or 300 billion and we could sell it at that price.

And we no longer felt it was undervalued compared to other oil companies, so we sold our stock. Now, incidentally, right after we sold it, it went up dramatically because, as you know, they issued A shares in in China, and it became very popular.

And at one time, PetroChina became the most valuable company in the world, measured by market value, which would have come as enormous surprise to investors seven or eight years earlier. So they've done a terrific job.

And if it went down to a price that we thought was a discount — a significant discount — to its valuation, we would buy PetroChina again. The — in terms of — I'm not so sure we don't have a lot to learn from the Chinese in terms of business currently, more than they have to learn from us. I'm not sure we would want some of our practices to spread to China.

It's a remarkable society, what's going on there now. And I did go to Dalian not long ago, and I must have traveled for 45 minutes from the center of town out to our plant there. And I just saw, really, hundreds of plants that — factories that had developed in recent years.

The economy is — the Chinese people are starting to realize their potential. I mean, what it amounted to is you had — for centuries — you had people of lots of ability but a system that did not unleash their potential.

And now it's starting to be unleashed, and that's why you're getting very substantial GDP growth per capita, and I think it will continue.

I would just look for the best practices in American industry as you see them and copy them, and I would discard the rest. And I think it's — you know, it's how you learn about human behavior. You try to — if you look at an effective individual, you try to figure out why they're effective.

You know, why is Don Keough, why are Tom Murphy — why are they so effective? Why do people want to be around them? Why are they leaders? Why do people love them? And you see certain human qualities, and you should copy those qualities.

And when you see some guy that should have everything going for him and everybody in town hates him, you know, you want to make sure you don't have any of those qualities.

Well, I would do the same thing in terms of looking at businesses in this country, and try to look for what I admire and emulate it, and make sure that — try very hard — not to let the things that you find over here that are distasteful to you creep into your own system.

Charlie?

CHARLIE MUNGER: Well, I hope you'll go back to China and tell them that you met at least one fellow that really approves the Confucius emphasis on reverence for elderly males. (Laughter)

WARREN BUFFETT: I think you should dig yourself out of that by including females too, Charlie. (Laughs)

CHARLIE MUNGER: That wasn't Confucius's idea.

WARREN BUFFETT: Oh, OK. No reason why you can't modify it. (Laughs)

31. Future hopes for Berkshire

WARREN BUFFETT: OK. We'll have one more, and then we'll take a break and come back for the business meeting in a few minutes. Number 1.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my name is Cynthia Beeman (PH), and I'm from Atherton, California.

This is my question: what is your fondest hope for Berkshire Hathaway moving forward in time?

WARREN BUFFETT: Well, in a general way, I hope for two things — obviously, I hope for decent performance, and I hope that the culture we have is maintained, which is both shareholder-oriented and manager-oriented, and that we are regarding as the best home in the world for large, wonderful, family businesses.

And I think the performance and those two goals will be intertwined, in a way.

And I not only hope, but I fully expect, that what we've tried to build into Berkshire lives far beyond, you know, my tenure as CEO. And I think it will because, A, we've got the right candidates to succeed me.

And, beyond that, we have a board, we have a bunch of managers, that have all seen how well the system works. So I think that we have about as strong a culture as you could find in this country among American businesses.

And if that's continued, as I'm really sure it will be for a long, long, long time, I think we will get decent results. We won't get great results, because you can't get them from our size base.

But that's my hope — that people 20 years from now, if they have a fine business they've spent a couple of generations building, and they immediately think — if they have to sell it for some reason — they think Berkshire Hathaway is the place where we want the ownership of this business and we want — as managers, we want to continue working at that company for the rest of their lives.

And if we can achieve that, we'll have something fine for shareholders, and we'll have something fine for managers and owners of those businesses we buy.

Charlie?

CHARLIE MUNGER: Yeah. I would say that I would like to see Berkshire even more deserved to be an exemplar, and I would like to see it have more actual influence on changes in other corporations.

I think there are things that have happened here that will be useful to others.

WARREN BUFFETT: We'd also like it to have the oldest living managers, but that's a minor point. (Applause.)

WARREN BUFFETT: Thank you. Thank you. Thank you. Thanks.

32. Break before formal business meeting

WARREN BUFFETT: The — now what we'll do is we'll just break for five or so minutes, and then we'll reconvene and have the formal business meeting.

After that, at 4 o'clock, for the international visitors, those from outside of North America, we will — Charlie and I — will meet with them personally.

And I thank you all for coming. I hope you come back next year and bring your friends. Thank you. (Applause)

33. Formal business meeting

WARREN BUFFETT (in progress): — appropriate questions you may have concerning their firm's audit or the accounts at Berkshire.

Mr. Forrest Krutter, our secretary at Berkshire, he will make a written record of the proceedings.

Miss Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and representative at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 5, 2008, being the record date for this meeting, there 1,081,013 shares of Class A Berkshire Hathaway common stock outstanding with each share entitled to one vote on motions considered at the meeting, and 14,033,343 shares of Class B Berkshire Hathaway common stock outstanding with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 883,428 Class A shares and 10,921,716 Class B shares are represented at this meeting by proxies returned through Thursday evening, May 1.

WARREN BUFFETT: Thank you. That number represents a quorum, and we'll therefore directly proceed with the meeting.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

Barely, I hear a second. The motion has been moved and seconded. Are there any comments or questions? We will vote on this motion by voice vote. All those in favor say "aye."

VOICES: Aye.

WARREN BUFFETT: Opposed? The motion is carried.

34. Election of board of directors

WARREN BUFFETT: First item of business is to elect directors.

If a shareholder is present and wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholders are present who not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you. Would those persons desiring ballots please identify themselves so that we may distribute them.

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second to the motion? Somebody second the motion.

VOICE: Second.

WARREN BUFFETT: OK. It has been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Thomas Murphy, Ronald Olson, Walter Scott be elected as directors.

Are there any other nomination? Is there any discussion? The nominations are ready to be voted upon.

If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Would the proxy holders please also submit to the inspector of elections a ballot on the election of directors voting the proxies in accordance with the instructions they've received.

Miss Amick, when you're ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 935,155 votes for each nominee.

That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keogh, Tom Murphy, Ronald Olson, Walter Scott have been elected as directors.

35. Formal business meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move this meeting be adjourned.

WARREN BUFFETT: Is there a second?

VOICES: Second.

WARREN BUFFETT: A motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor, say “aye.”

VOICES: Aye.

Morning Session - 2009 Meeting

1. Q&A sessions starts

WARREN BUFFETT: Good morning. I'm Warren. The hyperkinetic fellow here is Charlie. (Laughter)

And we're going to go in just a minute to a question and answer section, at least a question section, that will be a little different than last year.

We have a panel — I can't see very well here — over to the right, of journalists who will ask questions and alternate with the people in the audience.

And we'll go back and forth. Got a little checklist here that we'll use as we go back and forth. Here we are. And we should have a pen here someplace to check things off.

2. Board of directors introduced

WARREN BUFFETT: But first, even though we'll have the formal meeting later on, I would like to introduce our directors. And if they would stand as I announce them and then remain standing until the end.

And if you'll just hold your applause until the end or even later if you wish — (laughter) — we'll recognize them. We'll have a meeting later on to elect them. But if you'll stand up. And like I say, you can't see very well here with the lights, but —

There's me and Charlie, we start off. And then Howard Buffett, Susan Decker, Bill Gates, Sandy Gottesman, Charlotte Guyman , Don Keough, Tom Murphy, Ron Olson, and Walter Scott. Those are the directors of Berkshire Hathaway. (Applause)

3. Money under your mattress beats Treasurys

WARREN BUFFETT: Now, we only have one slide, which actually is more than we would usually have. (Laughs)

And — but it does tell you something about what happened last year.

And it also acts as a commercial for our Nervous Nellie mattress with the famous night depository feature. (Laughter)

Last year — and have we got that up on the slide?

Last year, we wrote a ticket on December 19th. And we sold 5 million of Treasury bills. I hope you can see that. It's — we've got the December 19th circled up there.

And those Treasury bills came due, or were to come due, on April 29th of this year. So they were going to come due over four months later.

And the remarkable thing is, and this tells you about what an extraordinary year it was, is that we sold those $5 million of Treasury bills, which were going to pay off at $5 million on April 29th of 2009, in December of 2008 we sold them for five million and ninety dollars and seven cents.

In other words, if the person who bought those from us and paid us five million and ninety dollars, instead had bought the Nervous Nellie mattress and had put their money under the mattress, they would've been $90 better off at the end of four months, than by buying Treasury bills.

If the U.S. Treasury had just sold 5 trillion of these, they could've made an easy $90 million and Tim Geithner could've put the money under a Nervous Nellie mattress and we all would've been better off.

Negative yields on U.S. Treasury bills are really an extraordinary thing. You've got less on — less for your money from the U.S. Treasury than you got from sticking it under a mattress.

I'm not sure you'll see that again in your lifetime. But it's been a very extraordinary year.

4. Panel of journalists introduced

WARREN BUFFETT: We have with us, the journalists. We have Carol Loomis of Fortune. We have Becky Quick of CNBC. And we have Andrew Ross Sorkin of the New York Times.

They have received questions from shareholders all over the country. Andrew told me that he received a couple hundred just this morning.

And they have selected what they think are — they're all Berkshire Hathaway-related questions.

We were having a problem in recent annual meetings where we sort of drifted away from Berkshire, into the realm of what people's children had done in school recently and that sort of thing. (Laughter)

So we wanted to bring it back a little bit to Berkshire.

So they have selected among the best of the Berkshire-related questions that they've received. And we will go from — we will start with Carol Loomis. And we will go then to the audience.

We have 13 sections, 12 in this room, one in an overflow room. And we have selected the people in each of the audience sections by a raffle system, half an hour to an hour ago. And we'll go back and forth. And with that, we'll start it off with Carol.

5. Carol Loomis comments

CAROL LOOMIS: Good morning. I come first because Loomis outrakes — outranks — the others alphabetically. But this gives me a chance to just have a few sentences to tell you that — about the questions that we received.

We conferred this morning. Andrew definitely got more than any, either Becky or me. We got almost 5,000 questions, which I think even will surprise Warren. Because I don't think he knew that it'd run that high.

And the main thing I wanted to say is that an awfully lot of them were very good. And we had a real problem trying to get them down to the number that we're probably going to be able to ask. We don't even know what that is for sure.

But we want to apologize to anybody who sent us a Berkshire-related question, because we did have to cut out some because they weren't that, and whose question we didn't get asked. And maybe in another year, it will work.

6. Our stock index derivatives aren't dangerous

CAROL LOOMIS: So, my first question, "Warren and Charlie, Warren particularly.

"You have referred to derivatives, this is famous, as weapons — financial weapons — of mass destruction.

"In the 1964 movie, 'Dr. Strangelove,' Major T.J. Kong, nicknamed 'King' Kong and played by Slim Pickens, rides a weapon of mass destruction out of the bomb bay of his B-52.

"As a long-term Berkshire shareholder, I'm feeling a little like Slim today. I understand that despite the dramatic decline in the stock market, there is a good probability we could make money on our derivatives, taking into account the return on our premiums.

"But given the amount of accounting equity and statutory capital, and, I would argue, market value —" this is the questioner saying this — "that these derivatives have destroyed, at least temporarily, do you think these large derivative positions are appropriate for a highly-rated insurance company?

"And if so, you do you think you will be adding to these positions?"

WARREN BUFFETT: Yeah. I would say this. The questioner to some extent answers his own question.

I don't know whether he anticipates as strongly as I do that, net, these positions will make money.

But over — you know, our job is to make money over time at Berkshire Hathaway. It does not impinge on capital. We have arranged them so that the collateral posting requirements, which are one of the big dangers in the derivatives field, that we have very, very minimal exposure to that.

Even on March 31st, at a time when the market was down very substantially from when we entered into these transactions, we had posted collateral of a little less than 1 percent of our total marketable securities.

So they have no — they pose no — they pose problems to the world, generally. And that's why I referred to them on a macro basis, in the 2002 report, as being financial weapons of mass destruction.

But I also said in that report, that we use them in our own business regularly when we think they're mispriced.

And we think our shareholders are intelligent enough that if we explain the transactions, as we try to do in the annual report, and explain why we think we will make money — there's no guarantee we'll make money, but our expectancy is that we will make money — we think that as long as we explain them, that the financial consequences to our shareholders far outweigh any accounting consequences.

We explained in earlier reports that because of mark-to-market, that these things can swing billions of dollars as an accounting liability.

But the only cash that has taken place, for example, in our equity put options, we have received $4.9 billion roughly. And we hold that money. Originally, the terms of these were 15 to 20 years. So we have the use of $4.9 billion for 15 to 20 years.

And then markets have to be lower at that time than they were at the time of inception. So I personally think that the odds are extremely good that on the equity put options, we will make money.

I think on the high-yield index, credit default swaps we've written, I think that we will probably lose money before figuring the value of the money we've held.

Now, I told you a year ago, I thought we would make money on those. But we have run into far more bankruptcies in the last year than is normal.

We've, in effect, had a financial hurricane. We insure against natural hurricanes. And we insure against a financial hurricane. And we have been in a bit of a financial hurricane.

So I would expect those contracts, before investment income, would show a loss, and perhaps, after investment income. The bigger contracts are the equity put contracts. And I think the odds are very high that we make money on those.

Now, it would be nice if we were writing with current prices. But we probably couldn't write them without getting into collateral posting requirements now. So we have a very favorable position on those.

In fact, in the last week, we modified two equity put contracts, one that had a strike price of 1514. That has been reduced to 994 on the S&P 500. Now, we shortened it up eight years. But it still has about 10 years to run.

So merely for reducing the term from 18 years to about 10 years, we still have the use of the money for 10 years, we reduced the strike price from 1514 to 994.

So I think those are going to be very advantageous contracts. I think our shareholders are intelligent enough to, if they're explained properly, to realize how advantageous they are. And we'll continue to hold them. And we'll continue to explain them.

And they have no impact on our financial flexibility. And we are far more than an insurance company. I mean, we have earnings coming in from many areas. We have lots of cash sitting at the parent company. We have lots of cash in the subsidiaries. We have no significant debt maturities of any kind.

So we're ideally suited to hold this sort of instrument.

And Charlie, what would you say?

CHARLIE MUNGER: Well, I would agree with the questioner that there is some limit to the amount of those things we should do. But I think we stayed well short of the limit.

7. Financial literacy problem could help Berkshire

WARREN BUFFETT: OK, we'll go to zone 1.

AUDIENCE MEMBER: Hi. My name's Scott Slaybee (PH). I'm from Denver, Colorado.

First off, I'd like to thank Mr. Buffett and Mr. Munger for having us out here today. I appreciate you bringing us out here so thank you very much.

WARREN BUFFETT: And thank you.

AUDIENCE MEMBER: And it's great that you answer our questions.

I'm a former teacher. Or I'm a teacher. I shouldn't say former. Being a former teacher yourself, I see a problem with financial literacy with our future generations.

And I'm curious what you think future generations should know and if there's anything that needs to be in school curriculums to teach younger people financial literacy as we move forward?

WARREN BUFFETT: Yeah. I think there's a problem with financial literacy with our current generation. (Laughter)

There's a — Andy Heyward, who has helped us with the cartoon, has a — will have a — he sold his company last year, but he has a new company.

And he will have a program coming out that works on that question. And that I play a very small part in.

ABC has a program coming up with a number of well-known personalities in it that will deal with the question of financial literacy.

And it's, you know, it is a tough sell in a world of credit cards and, you know, a world that depends on calculators rather than people sitting down and doing actual arithmetic and all of that, to teach people. But in the end, I think we make progress over time. I mean, I hope our annual reports contribute to that sort of thing.

But you're going to have people doing very foolish things with money.

I remember on my honeymoon. I was 21 and my wife was 19. And we drove west. I'd never been west. And we went through Las Vegas. And it was 1952. And we stopped at the Flamingo. And people were better dressed in the casinos then.

And there were a bunch of Omaha fellows that actually owned part of the Flamingo at that time, terribly nice to us.

But I looked around at that casino and I saw all kinds of well-dressed people who had traveled thousands of miles to do something very dumb. And I thought this is a country where you're going to get very rich. (Laughter)

If people are going to get on a plane in New York and fly a couple thousand miles to stand there and do things with a mathematical expectation that's negative on every action they take, that is a world of opportunity. So — (Laughter)

I, you know, I recommend that you and — you work with your students. I started teaching at the University of Omaha, you know, when I was 21. And you work with your students to make them literate. And they will have a terrific advantage.

Charlie?

CHARLIE MUNGER: Well, a world where legalized gambling is now conducted by a great many states in the form of lotteries where people are encouraged to bet against the odds and a world where we have a vast overuse of high-cost credit card debt, it needs a lot more financial litery. I would argue — literacy.

I think we've been going in the wrong direction. So I don't think you can teach people high finance who can't use a credit card — (laughter) — intelligently.

WARREN BUFFETT: Yeah. If you're — I talk to students about that. If you're willing to pay 18 or 21 percent on a credit card —

And the credit cards companies need it, incidentally, currently, because you have losses running close to 10 percent. So with expenses, they may need that.

But there's no way that you're going to financially come out borrowing money at those kind of rates. And I wouldn't know how to do it. And it's too bad. On the other hand, it's probably good for our business.

I mean, one of — you know — we are looking for things that are mispriced. And the more people think that borrowing money on credit cards is intelligent, they probably will not think that doing long-term equity put contracts is intelligent. And we'll go our way and they'll go their way.

8. Buffett "commends" DC's response to credit crisis

WARREN BUFFETT: Becky?

BECKY QUICK: Warren, first of all, we've been asked to pass on a message that the attendance today is 35,000.

WARREN BUFFETT: Good. (Applause) Now —

BECKY QUICK: This —

WARREN BUFFETT: Now if they all just spend appropriately, it'll be a big day. (Laughter)

BECKY QUICK: This question comes from James Lewis (PH) from Logan, Ohio, who said it was OK to use his name and city.

He says, "One of the substantial investments of Berkshire is Wells Fargo. The chairman of Wells Fargo supposedly indicated that he did not want to take TARP funds from the federal government.

"He, furthermore, recently said that some of the programs of the federal government to reinvigorate the banks were asinine.

"Mr. Munger, do you agree with the chairman of Wells Fargo? And please explain why you do or do not agree. And Mr. Buffett, do you agree with Mr. Munger?" (Laughter)

WARREN BUFFETT: Yes. (Laughter)

CHARLIE MUNGER: When a government is reacting to the biggest financial crisis in 70 years, which threatens important values in the whole world, and the decisions are being made hurriedly and under pressure and with good faith, I think it's unreasonable to expect perfect agreement with all of one's own ideas.

I think the government is entitled to be judged more leniently when it's doing the best it can under trouble.

Of course, there's going to be some reactions that are foolish. And I happen to share one of the troubles of some of the Wells Fargo executives, in that I'm pretty blunt.

I happen to think that the accounting principle that says your earnings go up as your credit is destroyed — because if you had any money left, you could buy your own debt back at a discount — I happen to think that's insane accounting.

And I think the people who voted it into effect ought to be removed from the accounting board. So a man who talks like that has to have some sympathy with the people at Wells Fargo.

WARREN BUFFETT: He usually gets to hang them by their thumbs, but he held back this morning.

The government, in mid-September last year, really did — they were facing a situation that was as close to a total meltdown throughout the financial system as I think you can imagine.

You had a couple hundred billion dollars move out of money market funds in a couple of days. You had the commercial paper market freeze up, which meant that companies all over the country that had nothing to do with the financial world, basically, were going to have trouble meeting payrolls.

We were — we really were looking into the abyss at that time. And a lot of action was taken very promptly. And overall, I commend the actions that were taken.

So as Charlie says, to expect perfection out of people that are working 20-hour days and are getting hit from all sides by new information, bad information, that one weekend with Lehman going, AIG going, Merrill would've gone, in my view, unless the BofA had bought it.

I mean it was — when you're getting punched from all sides and you have to make policy and you have to think about congressional reaction and the American people's reaction, you know, you're not going to do everything perfectly.

But I think overall, they did a very, very good job.

I'm sympathetic — that remark was made by Dick Kovacevich, who came in second last year to Charlie in the plain speaking contest around the world. (Laughter)

And it's true that Dick Kovacevich was called on a Sunday at a little after noon, as I understand it, and told would be in Washington the next day at 1- or 2 o'clock, without being told what it was about.

And there were 11 bankers there and some officials. And they were told that they were going to take TARP money. And they were going to take loans from the government and preferred stock. And that they only had an hour or two to sign it and they didn't get to consult with boards.

But that's the nature of an emergency. You know, it — I think you — well, you're going to have some decisions that later can be looked back at and somebody will say, "I could've done it a little bit better." But, by and large, the authorities, in my view, did a very good job.

And all banks aren't alike by a long shot. And in our opinion, Wells Fargo is a — among the large banks particularly — it's a fabulous bank and has some advantages that the other banks don't have.

But in a time like that, you're not dealing in nuances.

Incidentally, I would recommend to all of you, that you go to the internet and read Jamie Dimon's letter to his shareholders. Jamie Dimon of JPMorgan Chase. It's a fabulous letter. It talks about a point that Charlie made there.

But it — Jamie did a great job of writing about what caused this and what might be done in the future. It's as good a shareholders letter that I've ever seen. So by all means, look it up. It's long, but it's worth reading.

9. Higher mathematics can be dangerous for investing

WARREN BUFFETT: OK, we'll go to area 2.

AUDIENCE MEMBER: Yeah, thank you, Mr. Buffett and Mr. Munger. My name's Rick Franklin (PH). I'm from St. Louis, Missouri. I'd like to follow up on the microphone 1's question on financial literacy. And my own question from two years ago on your discount rate.

But before I do that, I hope you'll indulge me. Torstol's (PH) wife, Rosemary Coons (PH), if you could come to section 222. I found your husband. (Laughter)

You can come to microphone 2, if that's easier.

WARREN BUFFETT: You get a little of everything here. (Laughter)

AUDIENCE MEMBER: So my question is, free cash flow: sell-side analysts like to do a 10-year discounted cash flow analysis with a terminal value.

Even some of the books written about your style — "The Warren Buffett Way", "Buffettology" — imply that you go through that exercise.

But I know you're famous for not using computers or calculators. I'm wondering if those type of exercises fall into the "too hard" file, and you just do a simple free cash flow — normalized free cash flow — over a discount rate?

And if you care to augment the answer with your numerical analysis of Coke, I'd appreciate that. (Laughter)

WARREN BUFFETT: Well, the answer is that investing — all investing is, is laying out cash now to get more cash back at a later date. Now, the question is how much do you get back, how sure are you of getting it, when do you get it? It goes back to Aesop's fables. You know, "A bird in the hand is worth two in the bush."

Now, that was said by Aesop in 600 B.C. He was a very smart man. He didn't know it was 600 B.C. But I mean, he couldn't know everything. (Laughter)

But the — but that's what's being taught in the finance — you got a Ph.D. now and you do it more complicated, and you don't say, "A bird in the hand is worth two in the bush," because you can't really impress the laity with that sort of thing.

But the real question is, how many birds are in the bush? You know you're laying out a bird today, the dollar. And then how many birds are in the bush? How sure are you they're in the bush? How many birds are in other bushes? What's the discount rate?

In other words, if interest rates are 20 percent, you got to get those two birds faster than if interest rates are 5 percent and so on.

That's what we do. I mean, we are looking at putting out cash now to get back more cash later on.

You mentioned that I don't use a computer or a calculator. If you need to use a computer or a calculator to make the calculation, you shouldn't buy it.

I mean, it should be so obvious that you don't have to carry it out to tenths of a percent or hundredths of the percent. It should scream at you.

So if you really need a calculator to figure out that it's — the discount rate is 9.6 percent instead of 9.8 percent — forget about the whole exercise. Just go onto something that shouts at you. And essentially, we look at every business that way.

But you're right, we do not make — we do not sit down with spreadsheets and do all that sort of thing. We just see something that obviously is better than anything else around, that we understand. And then we act.

And Charlie, do you want to add to that?

CHARLIE MUNGER: Well, I'd go further. I'd say some of the worst business decisions I've ever seen are those that are done with a lot of formal projections and discounts back.

Shell Oil Company did that when they bought the Belridge Oil Company. And they had all these engineers make all these elaborate figures.

And the trouble is you get to believe the figures. And it seems that the higher mathematics, with more false precision, should help you. But it doesn't.

The effects, averaged out, are negative when you try and formalize it to the degree you're talking about. They do that in business schools because, well, they got to do something. (Laughter and applause)

WARREN BUFFETT: There's a lot of truth to that. I mean, if you stand up in front of a class and you say, "A bird in the hand is worth two in the bush," you know, you're not going to get tenure. (Laughter)

It's very important if you're in the priesthood to look, at least, like you know a whole more lot more than the people you're preaching to.

And if you come down and just — if you're a priest, and you just hand down the 10 Commandments and you say, "This is it," and we'll all go home, you know, it just isn't the way to progress in the world.

So, the false precision that goes into saying that this is a two standard deviation event or this is a three standard deviation event, and therefore we can afford to take this much risk and all that, it's totally crazy.

I mean, you saw it with Long-Term Capital Management in 1998. You've seen it time and time and time again.

And it only happens to people with high IQs. You know, those of you who are — have 120 IQs are all safe. (Laughter)

But if you have a very high IQ, and you've learned all this stuff, you know, you feel you have to use it. And the markets are not that way.

The markets of mid-September last year, when people who ran huge institutions were wondering how they were going to get funding the next week, you know, that doesn't appear on a — you can't calculate the standard deviation with — that that arises at.

It's going to arise much more often than people think, in markets that are made by people that get scared and get greedy. And they don't observe the laws of flipping coins, it's — in terms of the distribution of results.

And it's a terrible mistake to think that mathematics will take you a long place in investing. You have to understand certain aspects of mathematics. But you don't have to understand higher mathematics.

And higher mathematics may actually be dangerous and it will lead you down pathways that are better left untrod.

10. Moody's wasn't alone in making mistakes

WARREN BUFFETT: OK. Andrew, one of those 200 questions from this morning? Or what are —

ANDREW ROSS SORKIN: This one's not from this morning, but it relates to Moody's. And we've probably received about 300 questions, at least, on this topic.

This question, which is representative of many, comes from Aaron Goldsmeizer (PH). And the question is the following:

"Given the role of rating agencies in the current economic crisis — their conflict of interest, their reliance on, quote, 'flawed history-based models,' as you described in this year's letter to shareholders, and the likelihood that a loss of credibility and/or regulatory reforms could force drastic changes in their business models or earning streams — why do you retain such a large holding in Moody's?

"And more important, why didn't you use your stake to try to do something to prevent conflicts of interest and reliance on these flawed history-based models?"

WARREN BUFFETT: Yeah, I don't think the conflict of interest question was the — was the biggest —by anywhere close to the major cause of the shortcomings of the rating agencies in foreseeing what would happen with CDOs and CNBSs and all sorts of instruments like that.

Basically, five years ago, virtually everybody in the country had this model in their mind, formal or otherwise, that house prices could not fall significantly.

They were wrong. Congress was wrong. Bankers were wrong. People that bought the instruments were wrong. Lenders — the borrowers were wrong.

But people thought that if they were going to buy a house next year, they better buy it this year because it was going to be selling for more money the following year.

And people who lent them money said it doesn't make any difference if they're lying on their application or they don't have the income because houses go up, and if we have to foreclose we won't lose that much money. And besides, they can probably refinance next year and pay.

So there was an almost total belief — and there was always a few people that disagreed — but there was almost a total belief throughout the country that house prices would certainly not fall significantly, and that they would probably keep rising.

And the people at the rating agencies, one way or another, built that into their system.

And I don't — I really don't I think it was primarily the payment system that created the problem. I think they just didn't understand the various possibilities of what could happen in a market— or in a bubble, really — where people leveraged up enormously on the biggest asset that most Americans possess, their house.

And so you had a $20 trillion asset class in a $50 trillion of total assets of American families that got leveraged up very high. And then once it started melting down, it had self-reinforcing aspects on the downside.

So I say that they made a major mistake in terms of analyzing the instruments. But they made a mistake that a great, great, great many people made.

And that probably if they had taken a different view of residential mortgages four or five years ago, they would've been answering to Congressional committees that would be saying, "How can you be so un-American as to deny all these people the right to buy houses simply because you won't rate these securities higher?"

So I — they made a huge mistake. But the American people made a huge mistake. Congress made a huge mistake.

Congress presided over the two largest mortgage companies. And they were their creatures. And they were supervised by them. And, you know, they're both in conservatorship now.

So I don't think they were unique in their inability to spot what was coming.

In terms of us influencing their behavior, I don't think I've ever made a call to Moody's.

But it's also true that I haven't made it to, or made — maybe made one or two — to other companies in which we're involved.

I mean, we don't tell, you know, the Burlington Northern what safety procedures to put in.

We don't tell American Express who to cut off on credit cards and, you know, what they're — who they should lend to and who they shouldn't.

We are — when we own stock, we are not there to try and change people.

Our luck in changing them is very low, anyway. In fact, Charlie and I have been on boards of directors where we're the largest shareholders. And we've had very little luck in changing behavior.

So, we think that if you buy stock in a company, you know, you better not count on the fact that you're going to change their course of action.

And in terms of selling the stock, the odds are that the rating agency business is probably still a good business. It is subject to attack. And who knows where that leads? And who knows what Congress does about it?

But it's a business with very few people in it. It's a business that affects a large segment of the economy. I mean, the capital markets are huge. I think there will probably be rating agencies in the future. And I think that it's a business that doesn't require capital. So it has the fundamentals of a pretty good business.

It won't be doing the volume in the next — probably for a long time in certain areas of the capital markets. But capital markets are going to grow over time.

We have said in this meeting in the past, many times, that Charlie and I don't pay any attention to ratings. I mean, we don't believe in outsourcing investment decisions.

So we — if we buy a bond, the rating is immaterial to us, except to the extent if we think it's rated more poorly than it should, it may help us buy it at an attractive price.

But we do not think that the people at Moody's, or Standard and Poor's, or Fitch, or anyplace else, should be telling us the credit rating of a company. We figure that out for ourselves. And sometimes we disagree with the market in a major way. And we've made some money that way.

Charlie?

CHARLIE MUNGER: Yeah, I think the rating agencies, being good at doing mathematical calculations, eagerly sought stupid assumptions that enabled them to do clever mathematics. It's an example of being too smart for your own good.

There's an old saying, "To a man with hammer, every problem looks pretty much like a nail." And that's — (laughter) — what happened in the rating agencies.

WARREN BUFFETT: Yeah, the interesting things about all those triple-As, is the people that created them ended up owning a lot of them. So they believed their own baloney, themselves. Every — the belief was enormous.

So you had these people stirring up the Kool-Aid and then they drank it themselves. And they — (laughter) — you know, they paid a big penalty for it. But I don't think it was — I think it was stupidity and the fact that everybody else was doing it.

I send out a letter to our managers, only every couple of years. But the one reason you can't give at Berkshire, as far as I'm concerned, for any action, is that everybody else is doing it.

You know, and just — if that's the best you can come with, you know, something's wrong. But that happens in security markets all the time.

And of course, it's — when Charlie and I were at Salomon or someplace like that, it's very difficult to tell a huge organization that you shouldn't be doing something that people, well-regarded competitors, are doing. And particularly when there's a lot of money in it.

And so it's very hard to stop these things once you get sort of a industry acceptance of behavior. And you know, we were very unsuccessful, Charlie and I, at Salomon at saying, "Well, we just don't want to do this sort of thing."

We couldn't even get them — initially, when we got in there at first, they were doing business with Marc Rich. And we said, "Let's stop doing business with Marc Rich."

You know, that's like saying in the '30s, "Let's stop doing business with Al Capone," or something. And they said, "But it's good business. If he doesn't do it with us, he'll do it with somebody else." And they felt that way. And I think we won that one. But it wasn't easy.

You remember that, Charlie?

CHARLIE MUNGER: I certainly do.

11. Housing markets are beginning to improve

WARREN BUFFETT: OK, we'll go to area 3. (Laughter)

OK, zone 3, are we on?

AUDIENCE MEMBER: I'm Laurie Gould (PH) from Berkeley, California.

Where do you see the residential real estate market headed nationally, particularly in California, over the next year or two?

WARREN BUFFETT: Well, we don't know what real estate is going to do. We didn't know what it was going to do a few years ago. We thought it was getting kind of dangerous in certain ways. But it's very hard to tell.

I would say this. From what we're — from what I'm seeing, and I do see a lot of data — there's — and California, incidentally, is a very big — I mean, there are many markets within California. Stockton is going to be different than San Francisco and so on.

But, in the last few months, you've seen a real pickup in activity, although at much lower prices. But you've seen — I think you've seen something in the medium- to lower-priced houses. And medium means a different thing in California than it does in Nebraska.

But you've seen, in maybe $750,000 and under houses, you've seen a real pickup in activity, many more bidders. You haven't seen it bounce back in price. Prices are down significantly and it varies by the area.

But it looks as if — you know, you had a foreclosure moratorium for a while. And so get into distortions because of that.

But what it looks like, looking at our real estate brokerage data — and we have the largest real estate brokerage firm in Southern California, in Orange County, Los Angeles County, and San Diego in Prudential of California that's owned by MidAmerican — we see something close, I would say, to stability at these much-reduced prices in the medium to lower group.

If you've got a $5 million or $3 million house, that still looks like a very — erratic — it's a market in which there still isn't a lot of activity.

But in the lower levels, there's plenty of activity now. Houses are moving. Interest rates, of course, are down so it's much easier to make the payments.

The mortgages being put on the books every day in California, are much better than, you know, the mix that you had a few years earlier.

So it's improving. And I don't know what it'll do next month or three months from now.

The housing situation is pretty much this way. You can look at it this way.

We create about 1,300,000 or so households a year. It bounces around some. But — and it tends to — in a recession, it tends to be fewer because people postpone matrimony and so on to some extent.

But if there's 1,300,000 households created in a year and you create two million housing starts annually, you are going to run into trouble. And that's what we did. We just created more houses than the demand was — the fundamental demand — was going to absorb.

So we created an excess of houses. How much excess is there now? Perhaps a million and a half units. We were building two million units a year. That's down to 500,000 units a year.

Now, if you create 500,000 units a year and you have a 1,300,000 households created, you are going to absorb the excess supply.

It will be very uneven around the country. South Florida's going to be tough for a long, long time. So it isn't like you can move a house from one place to another if there's demand in one place and not another.

But we are eating up an excess inventory now. And we're probably eating it up at the rate of 7- or 800,000 units a year. And if we have a million and a half excess, that takes a couple of years. There's no getting away from it.

You have three choices. You could blow up a million and a half houses, you know. And if they do that, I hope they blow up yours and not mine, but that's a — (Laughter)

We could get rid of it. We could try to create more households. We could have 14-year-olds start getting married and having kids, and — (Laughter)

Or we can produce less than the natural demand increase. And that's what we're doing now.

And we're going to eat up the inventory. And you can't do it in a day. And you can't do it in a week. But it will get done.

And when it gets done, then you'll have a stabilization in pricings. And then you will create the demand for more housing starts. And then you go back up to a million and a quarter, and then our insulation business and our carpet business and our brick business will all get better.

Exactly when that happens nobody knows. But it will happen.

Charlie?

CHARLIE MUNGER: Oh, I think in a place like Omaha, which never had a really crazy boom in terms of housing prices, with interest rates so low if you've got good credit, that if I were a young person wanting a house in Omaha, I would buy it tomorrow. (Applause)

WARREN BUFFETT: We own the largest real estate brokerage firm in Omaha. So — (laughter) — Charlie will be — if he qualifies, we will give him a mortgage application.

If is true that 4 1/2 million houses will change hands. There's about 80 million houses in the country. Twenty-five million of those do not have a mortgage. About a third of the houses in the country do not have a mortgage. You've got about 55 million, or a little less, that have a mortgage. And five or six million of those are in trouble one way or another.

But we're selling 4 1/2 million houses every day. And by and large, they're going into stronger hands. The mortgages are more affordable. The down payments are higher. We're — the situation is getting corrected.

But it wasn't created in a day or a week or a month. And it's not going to get solved in a day or a week or a month. We are on the road to solution.

12. 2008 wasn't great for investment manager candidates

WARREN BUFFETT: OK, Carol?

CAROL LOOMIS: Perhaps I should have said one other thing at the beginning. Those of you who read the annual report carefully know that Charlie and Warren were to be given no clue as to what any of the three of us were going to ask. So don't think that they have gotten a little list. They have seen nothing.

This question, I got many versions of this question. This one happened to come from Jonathan Grant of New York City. It concerns the four investment managers you have said are in the wings as possible successors to you.

"Can you please tell us, without naming names, but preferably in both quantitative and qualitative terms, how each of the four did in 2008 with the money they are managing — they were managing — for their clients.

"You said you hoped to pick people who would be able to anticipate things that had never occurred before. While the world has seen credit crises before, there were a lot of things that happened in 2008, especially in the last few months of the year, that few were predicting and that you, yourself, have described as almost unprecedented.

"How would you rate the way that these managers — these four managers — did in managing against these low-probability risks? Are all four still on the list?

WARREN BUFFETT: Well, the answer is all four are still on the list. Let me just make one point first, though, because it got misreported a little bit.

We have three candidates for the CEO position. And this is always a major subject of discussion at our director's meetings. All of them are internal candidates. You should know that.

That's been said before. But it got misreported here once or twice. And it got confused, I think, because of the four possibilities for the investment job. And you could have all four come to work for us in that case.

We won't have three CEOs or two CEOs. But we might have multiple investment managers after I'm not around. Or we might just have one. That would be up to the board at that time.

They are both inside and outside the organization. And we don't preclude anything in terms of where they come from. So we could have a whole big list from outside the organization.

That will not be true about the CEO position. The person that follows me will come from within Berkshire Hathaway.

The four, I don't have precise figures from them, although I've got a fair amount of information on some of them. I would say they did no better than match the S&P last year, which was minus 37 after adding back dividends.

So I would say that in terms of 2008, by itself, you would not say that they covered themselves with glory. But I didn't cover myself with glory, either. So I'm very tolerant of that in 2008. (Laughter) They —

Charlie, you know some of the records pretty well. Wouldn't you say that's true?

CHARLIE MUNGER: Yeah. What's interesting to me is that practically every investment manager that I know of in America, and regard as intelligent and disciplined and with a unusual record of past success, they all got creamed last year. (Scattered laughter)

WARREN BUFFETT: The group — I don't hear a lot of laughter about that. (Laughter)

I think you're hitting a nerve out there, Charlie.

The four have a better-than-average record over time. If you'd asked me at the start of the year, if you'd said, "There's going to be a minus 37 percent year, will this group do better than average?" I would've said yes.

But I think I would've been wrong. And like I said, I haven't got audit returns from every one of them. But I would say I would be wrong.

I would say that their record over 10 years has been, in each case, has been anywhere from modestly to significantly better than average. And I'd be willing to be that would be the case over the next 10 years.

But certainly, last year, you know, there were a lot of things that didn't work. And our group was not exempt from them.

I have not changed the list. That doesn't mean that we're always looking with the idea of finding more people to add to it.

And as opposed to the CEO job, you know, if I dropped dead tonight, the board needs to put somebody in as a CEO tomorrow morning. And they will do so. And they know who it is. And they feel very good about it.

Not too good, I hope, but — (Laughter)

But on the investment officers — one or more, and it could easily be more — they don't need to do something the next day or the next week.

I mean, the portfolio isn't — everything doesn't stop because of that. So that can be a somewhat more leisurely decision they'll have. And it will be made, in an important way, in consultation and agreement with the new CEO.

So that is something that you shouldn't expect the next day to hear an announcement on the investment managers. But you should expect to hear, you know, within a month or something like that.

CHARLIE MUNGER: I don't think we would want a manager who thought he could just go to cash based on macroeconomic notions and then hop back in when it was no longer advantageous to be in cash. Since we can't do that ourselves —

WARREN BUFFETT: Yeah, we think it's impossible if we can't do it ourselves.

CHARLIE MUNGER: Yeah, right. (Laughs)

So we're not looking for a type who went to cash totally.

WARREN BUFFETT: Yeah, that would — in fact, we would leave out anybody that did that.

CHARLIE MUNGER: Yeah, we would exclude them.

WARREN BUFFETT: Yeah. That —

CHARLIE MUNGER: They're not dumb enough for us. (Laughter)

13. Munger expects public/private hybrid health care system

WARREN BUFFETT: OK, let's go to zone 4.

AUDIENCE MEMBER: Hi, Mr. Buffett, Mr. Munger. My name is Vern Cushenbery. I'm from Overland Park, Kansas.

I wonder if you might share your thoughts on the likelihood of a nationalized health care system, what that might look like and the effects on your portfolio?

WARREN BUFFETT: Well, I'm going to let Charlie answer that one since I don't know how to. (Laughs)

CHARLIE MUNGER: Personally, I think something more like Europe will come to the United States in due course. And I think it'll be supplemented by a private system, which is the equivalent of private school competition for public education.

And, although I'm a Republican, I'm not horrified by that probable development. Personally, I wish they'd put it off for a year while we solve the economic problems. (Applause)

WARREN BUFFETT: And I would say that in terms of its impact on Berkshire, you know, we have a broad cross section of companies — we have 246,000 people working for us — that we will adjust, like American business generally will adjust, to any developments along that line.

It won't pose special problems for us. It won't offer us special opportunities. We'll see what the national sentiment is, as expressed through Congress. And we'll behave accordingly.

14. Why we're not training or naming our next CEO

WARREN BUFFETT: Becky?

BECKY QUICK: This is a question that follows up on the succession question. This one is a, in particularly, though, addressed to the three candidates for CEO. It comes from Irving Fenster who writes:

"Running Berkshire is very complex and complicated. Give us some insight for your reluctance to bring in your replacement to give him the benefit of your training, instead of his having to tackle the myriad of problems of the transition on his own.

“The benefits for Berkshire, your replacement, and you, are so compelling your reluctance is puzzling. Having him on board may relieve some of the stress on you and help add many, many more years of good health for you.”

WARREN BUFFETT: Irving is a friend of mine in Oklahoma. Went in in my partnership 40 years ago, Irving and Irene. And he’s been writing me on this for 30 or 40 years. And he’s had — (laughter) — he’s had no luck with me. So he decided to write Becky, apparently. (Laughter)

If we had a good way to inject somebody into some role that was — would make them a better CEO of Berkshire, we would try it.

But the truth is that the candidates we have are running businesses. They’re making capital allocation decisions. They’re doing things every day of an operating nature. And these are major businesses.

And to sit around headquarters while I’m sitting in there reading and on the phone and, you know, who knows what else, they — it — there just is — there wouldn’t be anything to do.

I mean, we could meet every hour. You know, I could say, “Here’s what I’m thinking about now. What do you think about this?” and — (Laughter)

It’d be a waste of talent. It’d be ridiculous.

And Irving has this notion that somehow, that they would be absorbing all these things that I’m doing. I just throw The Wall Street Journal to him after I’m done reading it, and I’d throw him The New York Times and I’d throw him the FT. (Laughs)

And these are people that know how to run big businesses. They run businesses that make many, many, many millions, or even billions, of dollars.

So, they are ready for the job right now. I wouldn’t be happy unless we have — they are 100 percent ready. They know how to allocate capital.

The biggest job they’ll have is the fact that they will have to develop relationships with potential sellers of businesses, with the world, generally, with you, the shareholders, with other managers. That takes some time, not an extraordinary time.

But that — you know, they will have to become acquainted with people. But — different constituencies. But that — there’s, you know, that is nothing that really needs to be hastened along. It’s nothing terribly important.

I mean, they know how to run businesses. And they would do many things much better than I would. The biggest — probably the biggest challenge, because we have all of those talented managers that you saw during the movie.

And those people have different styles. And they have different needs to some degree. They have different ways of operating. They're all successes.

But you know, some of them bat left-handed. Some of them bat right-handed. Some of them stand deep in the box. You know, some of them crowd the plate. I mean, they all have a little bit of variation. But they all hit terrifically.

And for the CEO of Berkshire, it does require some knowledge of the individual personalities. And which ones like to run by themselves totally and which ones like to check in occasionally and all that.

But that is no reason to take a talent that's now running a business very successfully and building value and to have them sit in an office next to me and have us chew over the day's events.

I mean, Charlie and I worked together now for decades. And I've learned a lot from Charlie. But I haven't done it by, you know, having him sit next door and have hourly meetings or anything of the sort.

What do you think, Charlie?

CHARLIE MUNGER: Well, I think, averaged out, you're more likely to be qualified to be a CEO by running a subsidiary with an enormous amount of discretion than you are to being around headquarters watching somebody else do it his way.

A lot of the models that have worked well in the world, like Johnson & Johnson, are quite Berkshire-like, in that they're decentralized and they let these people pop up from the subsidiaries. They don't try and just create CEOs in a hothouse in headquarters.

WARREN BUFFETT: We have an unusual situation at Berkshire that most of the people at the top, virtually all of them, are doing what they want to do. I mean, they like running their businesses.

That's what they came in expecting to do. And that's what they're doing, and we're letting them do it the way they like to do it.

And so we don't have 50 people that all think they're on some pyramid to get to the top. And Irving would like me to name — he's talked to me about it. He would like to me name who it would be. But that could change in the future. It could create some possible —

Well, we saw it at General Electric, I mean, when Jeff Immelt got appointed from among three, the other two left. And I don't really see any advantage in having some crowned prince around. But Irving will keep writing me, I can promise you that. (Laughter)

15. Buffett's business school: only two courses

WARREN BUFFETT: OK, zone 5.

AUDIENCE MEMBER: Hi, Warren. That's a little loud, sorry. Hi. My name's Sarah. And I'm from Omaha, Nebraska.

I'd like to know if you could explain your strategies, namely value investing, in regards to cultivating the next generation of investors. How will you teach this young group?

WARREN BUFFETT: Well, I had 49 — mostly universities, a few colleges — that came to Omaha this year. We do them in clumps of six. And then the last one, we had an added university. So we had eight sessions, full-day sessions.

And they asked me what — sometimes they asked me what I'd do if I was running a business school, teaching investments.

And I'd tell them I'd only have two courses. One would be how to value a business, and the second would be how to think about markets.

And there wouldn't be anything about modern portfolio theory or beta or efficient markets or anything like that. We'd get rid of that in the first 10 minutes. The —

But if you know how to value a business — and you don't have to know how to value all businesses. On the New York Stock Exchange, I don't know, there's 4- or 5,000, probably, businesses and a whole lot more on NASDAQ.

You don't have to be right on 4,000 or 5,000. You don't have to be right on 400. You don't have to be right on 40.

You just have to stay within the circle of competence, the things that you can understand. And look for things that are selling for less than they're worth, of the ones you can value.

And you can start out with a fairly small circle of competence and learn more about businesses as you go along.

But you'll learn that there are a whole bunch of them that simply don't lend themselves to valuations and you forget about those.

And I think if — accounting helps you in that, you need to understand accounting to know the language of business, but accounting also has enormous limitations. And you have to learn enough to know what accounting is meaningful and when you have to ignore certain aspects of accounting.

You have to understand when competitive advantages are durable and when they're fleeting.

I mean, you have to learn the difference between a hula hoop company, you know, and Coca-Cola. But that isn't too hard to do.

And then you have to know how to think about market fluctuations and really learn that the market is there to serve you rather than to instruct you.

And to a great extent, that is not a matter of IQ. If you have — if you're in the investment business and you have a IQ of 150, sell 30 points to somebody else, 'cause you don't need it.

I mean, it — (laughter) — you need to be reasonably intelligent. But you do not need to be a genius, you know. At all. In fact, it can hurt.

But you do have to have an emotional stability. You have to have sort of an inner peace about your decisions. Because it is a game where you get subjected to minute-by-minute stimuli, where people are offering opinions all the time.

You have to be able to think for yourself. And, I don't know whether — I don't know how much of that's innate and how much can be taught.

But if you have that quality, you'll do very well in investing if you spend some time at it. Learn something about valuing businesses.

It's not a complicated game. As I say — said many times — it's simple, but not easy.

It is not a complicated game. You don't have to understand higher math. You don't — you know, you don't have to understand law. There's all kinds of things that you don't have to be good at. There's all kinds of jobs in this world that are much tougher.

But you do have to have sort of an emotional stability that will take you through almost anything. And then you'll make good investment decisions over time.

Charlie?

CHARLIE MUNGER: Yeah, you do have the basic problem that exactly half of the future investors of the world are going to be in the bottom 50 percent.

In other words — (laughter) — you're always going to have more skill at the top than you have at the bottom. And you're never going to be able to homogenize the investment expertise of the world.

There is so much that's false and nutty in modern investment practice, and in modern investment banking, and in modern academia in the business schools, even in the Economics departments, that if you just reduce the nonsense, that's all I think you should reasonably hope for.

WARREN BUFFETT: Beyond a certain basic level, though, of skill, wouldn't you say your emotional make-up's more important than the — than some super high degree of skill?

CHARLIE MUNGER: Absolutely. And if you think your talent — if you think your IQ is 160 and it's 150, you're a disaster. (Laughter)

You know, much better a guy with a 130 that's operating well within himself.

WARREN BUFFETT: I get to see the students that come by. I loved a fellow from the University of Chicago, one of the students. And the first question that was asked of me was, "What are we learning that's most wrong?" That's the kind of — I mean, I wish they'd ask that sort of thing of the panel here.

CHARLIE MUNGER: How do you handle that in one session?

WARREN BUFFETT: Yeah. (Laughter)

But it was holy writ 25 years ago, efficient market theory. You know, I never understood how you could even teach it.

I mean, if you walked in in the first five minutes, you said to the students, "Everything is priced properly," I mean, how do you kill the rest of the hour?

But — (Laughter) — they did it. And they got Ph.D.s for doing it well. You know, and the more Greek symbols they could work into their, you know, their writings, you know, the more they were revered.

It's astounding to me and I — that may have even given me a jaundiced view of academia generally — is the degree to which ideas that are nutty take hold and get propagated.

And then I read a quote the other day that may have partially explained it. Max Planck was talking, the famous physicist.

Max Planck was talking about the resistance of the human mind, even the bright human mind, to new ideas. And particularly the ones that had been developed carefully over many years, and were blessed by others of stature, and so on.

And he said, "Science advances one funeral at a time." And I think there's a lot of truth to that. Certainly been true in the world of finance.

16. Ajit Jain's successor won't have the same broad authority

WARREN BUFFETT: OK, Andrew?

ANDREW ROSS SORKIN: OK. We have a succession question. However, this one has a twist, coming from Ben Knoll.

“You famously said, quote, ‘You should invest in businesses that a fool can run, because someday a fool will.’ (Laughter)

“Given your reinsurance company’s capacity and inclination for big financial bets, can you provide us more reassurance about the risk once Ajit is gone?

“Do you have a succession plan for him?”

Ben says, “The Titanic-like ending at AIG, once Greenberg was gone, has me spooked.”

WARREN BUFFETT: Yeah, I would say that it would be impossible to replace Ajit. And we wouldn’t try. And, therefore, we wouldn’t give the latitude, in terms of size of risk or that sort of thing, that we give to Ajit.

No, we’ve got a unique talent, in my view there, and I think in Charlie’s. And so, when you get somebody like that, you give enormous authority to them after you firmly establish in your mind that that’s who you’re dealing with.

But that doesn’t mean that the authority goes with the position. The authority goes with the individual. And we would not — giving your pen away in insurance, as they say, is extraordinary dangerous.

And we have in this town, we have Mutual of Omaha, which in the 1980s, had been built up carefully over, probably, 75 years by that time, and become the largest health and accident association in the world, I believe.

And they got the idea that they should be writing property-casualty reinsurance. So they gave a pen to somebody within the place. And probably nobody had even heard the guy’s name, you know.

And in just signing a few contracts, they lost half their net worth in a very short period of time. And they were worried that they might have lost more than that.

So you can do enormous damage in the insurance business with a pen. And you’d better — have to be very careful about who you give your pen to. And we’ve given our pen to Ajit in a way that we wouldn’t give it to anyone else.

Now, it just so happens that I enjoy hearing about the kind of things he does. So we talk daily. But we don't talk daily because he needs my approval on anything. We talk daily because I find it very interesting.

When he says, "How much should we charge to insure Mike Tyson's life for a couple of years?" I mean, that's the kind of thing I can get kind of interested in. I — (Laughter)

I asked him whether there was an exclusion in case he got shot by a woman that felt unhappy about her treatment or something, but —

And it makes a difference in the price, but —

I enjoy that sort of thing. But I'm not needed. And Ajit is needed. And we won't find a substitute for him. And you know, there's some things that have to be faced that way.

Charlie?

CHARLIE MUNGER: Yeah. What that quotation indicates is sometimes, stated differently, you say if it won't stand a little mismanagement it's not much of a business. Of course, you prefer a business that will prosper pretty well, even if it's not managed very well.

But that doesn't mean you don't like even better when you get such a business that's managed magnificently. And both factors are quite important.

We're not looking for mismanagement. We like the capacity to stand it, if we stumble into it. But we're not looking for it.

WARREN BUFFETT: Yeah, we will not do things that we think are — we will not assign tasks to people that we think are beyond their capabilities. And it just so happens that Ajit has enormous capabilities.

So he gets assigned some very unusual things. But you don't see that prevailing throughout our insurance operation. And our managers don't expect to operate that way.

That's a one-off situation with Ajit. And he's in good health. And, you know, we send him all the Cherry Coke or fudge that he wants. (Laughter)

17. Berkshire was "cheaper" at the end of 2008

WARREN BUFFETT: OK, area 6. I recommend this fudge, incidentally. It's terrific. I'm having a good time. (Laughter)

AUDIENCE MEMBER: Good morning. I'm Steve Fulton (PH) from Louisville, Kentucky. I gave up box tickets to the Kentucky Derby this afternoon to come out and ask you this question. Thank you for this opportunity.

My question relates to how you view, or what your view is of the market's valuation of Berkshire's shares.

You commonly comment that Berkshire has two primary components of value: the investments that they own — the stocks, the bonds, and similar — and the earnings from the non-insurance operating companies that you've got.

And when you compare 2007 to 2008, the investments were down about 13 percent. And the earnings were down about 4 percent. But the value that the market was placing on the shares was down about 31 percent. And I was curious as to your comments on that valuation.

WARREN BUFFETT: Yeah, well, I think you put your finger on something.

We do think that the — we think, obviously, the investments are worth what they're carried for, or we wouldn't own them.

In fact, we think they're worth more money than they're carried for at any given time because we think, on balance, they're underpriced. So we have no problem with that number.

We define our earning power — we leave out insurance underwriting profit or loss, on the theory that insurance is — if it breaks even — will give us float, which we will invest. And on balance, I actually think that insurance probably will produce some underwriting profit. So I think we even understate it a little bit in that respect.

But we think the earning power of those businesses was not as good last year as normal. It won't be as good this year as normal.

But we think those are pretty good businesses overall. A few of them have got problems. And — but most of them will do well. And I think a few of them will do sensationally.

So, I think it's perfectly reasonable to look at Berkshire as the sum of two parts. A lot of liquid marketable securities — or maybe not so liquid, but at least fairly priced, or maybe even undervalued, securities — and a lot of earning power, which we are going to try and increase over time.

And if you look at it that way, you would come to the conclusion that Berkshire was cheaper in relation to its intrinsic value at the end of 2008 than it was at the end of 2007. But you would also come to the conclusion that was true of most securities. In other words, the whole level of securities.

And every stock is affected by what every other stock sells for. I mean, if the value of ABC stock goes down, XYZ, absent any other variables, but XYZ is worth less.

If you can buy stocks at eight times earnings, good companies, you know, or nine times earnings, you know, they — it reduces the value of Berkshire, as opposed to when stocks were selling, well, at 18 or 20 times earnings. I'm pulling those numbers out of the air.

But everything is affected by everything else in the financial world.

When you say a bird in the hand is worth two in the bush, you're comparing it — you've got to compare that to every other bush that's available.

So, you're correct that Berkshire was cheaper in relation to intrinsic value at the end of 2008, than 2007, at least in my opinion.

And that that those two variables will count. We'll report them to you regularly. And over time, we would hope that both increase.

And we particularly hope the operating earnings aspect increases, because that's our major focus. We would like to move money into good operating businesses over time and build that number a lot.

Charlie?

CHARLIE MUNGER: Well, I would argue that last year was a bad year for a float business. It was naturally going to make the owner of the float appear, briefly, to be at a disadvantage.

But long-term, having a large float, which you're getting at a cost of less than zero, is going to be a big advantage. And I wouldn't get too excited about the fact that the stock goes down.

I happen to know that there was one buyer there who rather inartistically bought about 10,000 shares when Berkshire was driven to its absolute peak. And how much significance does that have in the big scheme of things over the long term?

What matters are things like this: our casualty insurance business is probably the best big casualty business in the world — our utility subsidiary, well, if there's a better one, I don't know it — and if I had to bet on one carbide cutting tool business in the world, I'd bet on ISCAR against any other comer.

And I could go down the list a long way. I think those things are going to matter greatly over the long term. And if you think that it's easy to get in that kind of a position, the kind of position that Berkshire occupies, you are living in a different world from the one I inhabit. (Applause)

WARREN BUFFETT: Yeah, our insurance business now, it is a remarkable business. And it's got some remarkable managers.

18. How GEICO benefited from the financial crisis

WARREN BUFFETT: There's one interesting thing that's happened. In September, when we had a financial meltdown and, really, almost the ultimate — it was almost the China Syndrome-type thing — Americans started behaving differently.

Probably people around the world, but I certainly know in terms of our businesses, it was like a bell had been rung. And one manifestation of it was kind of interesting.

Whereas it hurt very much our jewelry business, our carpet business, it hurt NetJets, it hurt all the businesses. Hurt American Express, for example. You know, the average ticket went down almost 10 percent.

I mean, it just was like that, that people's behavior changed. But one of the things it did, was it also caused the phones to start ringing even more at GEICO.

And we didn't change our advertising, particularly. Our price advantage, relative to other companies, didn't change that much. But all of a sudden, just — it was remarkable. Thousands and thousands and thousands of more people came to our website or phoned us every week.

So, it — all of a sudden, saving $100 or $150 or whatever it might be, became important. Not only the people who were watching our ads that day, but just with the people that it was lurking in the back of their minds. They went to geico.com.

So in the first four months of this year — last year, we added about 665,000 policy holders. That's a lot of people. It made us, by far, the fastest growing auto insurer among the big companies.

First four months of this year, we've added 505,000 in four months. It's the behavioral changes. And that franchise, that competitive advantage, has been built up over decades.

And Tony Nicely has nurtured it like nobody else could, just day after day, office after office, associate after associate. But then it just pays off huge when the time comes.

Because we can — we are the low-cost producer among big auto insurance companies. That means we can offer the best value. And now people are value conscious.

So these things are going on all the time with our subsidiaries, with those managers. And it's — it builds a lot of value over time.

I mean, every GEICO policy holder is a real asset to the company. I could give you an estimated value. But I don't think it'd necessarily be smart. But they're worth real money.

And, we are now the third largest auto insurer in the country. I think we'll end up the year maybe at 8 1/2 percent of the market.

And it was 2 and a small fraction percent back in 1993 when Tony took charge of the business. And the fundamentals are in place — (applause) — to take us much higher.

19. 2008 was tough, but still no plans for dividend

WARREN BUFFETT: Carol?

CHARLIE MUNGER: (Quietly) Can you reach that peanut brittle?

CAROL LOOMIS: I promise you, this question did not come from Susan Lucci. However, it does concern dividend policy. It came from Peter Sargent of Yardley, Pennsylvania.

And to ask that, he quotes from principle number 9 of the "Owner's Manual." And Warren wrote there, quote:

"We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention over time delivers shareholders at least $1 of market value for each $1 retained. To date, this test has been met." Now, this was written some time ago.

"We will continue to apply it on a 5-year rolling basis. As our net worth grows, it more difficult to use retained earnings wisely."

So I'm now quoting the questioner here:

"The recent annual report made me think about the performance of both the company and the stock price. Berkshire seems to have done quite well in the past few years. But the stock price seems to have not quite kept pace.

"So I looked at the last five years of earnings per share. They're on page 26 of the annual report. And they add up, in total, to $29,207.

"As you probably know, the closing price of Berkshire on December 31st, 2008 was 84,250. If you add the 29,207 per share of retained earnings to this, you come up with a, quote, 'minimum market value of 113,457.'

"Since Berkshire closed on 12/31/2008 at 96,600" — oh, wait, I have read something wrong here.

“The closing price of Berkshire on 12/31/2003 was 84,250.

“And since Berkshire closed on 12/31/2008 at 96,600, and it’s been lower than that since, and is now around that now, it would seem that the market value has not increased for each $1 retained.

“Assuming my analysis is correct, it raises the question of whether or not Berkshire will pay a dividend in the coming year or not.”

WARREN BUFFETT: Well, we’ll now have a short quiz on that program — (laughter) — on the question.

The earnings, incidentally, of the 5-year period would include gains from things that were listed in unrealized appreciation at the end of the period.

In other words, some of those were actually built into the asset value at the time, but then become realized.

But the truth is if you take all of the money we earned in the five years, and the stocks, bonds, businesses purchased, and you sold them for cash on December 31st, 2008, we would not have — we would’ve had a loss on that, I mean, under the conditions that existed on December 31st, 2008.

I think that’s probably true of almost all capital programs that were (inaudible) — if you really measured it by what you could’ve sold, the businesses we bought — we love those businesses.

But there was no market to speak of for many businesses at that time. And security values were down significantly.

So I would say that he’s absolutely right, that measured on the value on December 31st, 2008, that the reinvested earnings had not produced a dollar market value at that particular market point.

Now, I would say this, that we also say we measure our business performance against the S&P. And we use book value as a conservative proxy for intrinsic business value.

We think intrinsic business value is higher, but we use that as a proxy. And we’ve done that consistently throughout the history of Berkshire.

And during that 5-year period — or during any — we’ve never had a 5-year period when we’ve under-performed the S&P, in terms of the — what I would call the intrinsic value measure of Berkshire.

And, as I said a few years ago, it's — as we get larger, it's much harder to do that, and we'll settle for a couple of points better.

But so far, that test has been made — been met. And it's been met while we reinvested all earnings.

So I think that we still have got the burden of — we still should have to prove by the fact that Berkshire will sell above the earnings we've retained. Berkshire sells above it — every dollar that's been retained at Berkshire translates even today into more than a dollar of market value.

But I would certainly say that if you took the five years and just sold all the things we bought during that period at that price, that there would be a loss.

Charlie?

CHARLIE MUNGER: Yeah, I don't get too excited about these oddball things that happen once every 50 years.

If you're reasonably prepared for them and you're dented a little on the bottom tick, and other people are suffering a lot more, and unusual opportunities are coming to you that you don't see under other conditions, I don't think we deserve any salt tears.

20. Wells Fargo's stock price plunge shouldn't spark selling

CHARLIE MUNGER: Take Wells Fargo. I think Wells Fargo's going to come out of this mess way stronger. The fact that the stock at the bottom tick scared a lot of people, I think will prove to be a very temporary phenomenon.

WARREN BUFFETT: Yeah. Wells Fargo got down below — actually, ticked below $9 a share at a time when spreads on business were never better, when depositing flows were never better, when their advantage in relation of costs of funds versus other large banks had never been better.

But you know, in a market that was terrified, it — literally, I had a class meeting that day, and it was the only time any of those classes have ever got me to name a stock. But they actually pushed me.

And somebody there with a BlackBerry, or whatever those instruments are that they carry around these days, checked the price and it was below $9. And I said, if I had to put all my net worth in one stock, that would've been the stock.

The — their business is — you know, the business model is fabulous.

And it, you know, when would you get a chance to buy something like Wachovia, which had the fourth largest deposit base in the United States, and bring that in? And then start getting the spread on assets versus liabilities that Wells gets and build the relationships they have. It's a great business opportunity.

Wells Fargo will be better off — unless they have to issue a lot of shares, which they shouldn't — Wells Fargo will be a lot better off a couple of years from now, than if none of this had happened.

And I think that's true of some of other businesses as well. But you — you know, you have to be prepared. You can't let somebody else get you in a position where you have to sell out your position.

Leverage is what causes people trouble in this world. So you don't — you never want to be in a position where somebody can pull the rug out from under you. And you also never want to be emotionally in a position where you pull the rug out from under yourself.

I mean, you don't want to have other people force you to sell and you don't want to let your own fears or emotions to cause you to sell at the wrong time.

I mean, why anybody sells Wells Fargo at $9 a share when they owned it at $25 and the business is better off, is one of the strange things about the way markets behave. But people do it. And they get very affected by looking at prices.

If they own a farm like I do, you know, 30 miles from here, they don't get a price on it every day. You know, they —

I bought that farm 25 years ago. And you look to the production of corn. You look to the production of soy beans and prices and cost of fertilizer and a few things. And you look to the asset itself to determine whether you made an intelligent investment. You have your expectations about what the asset will produce.

But people in stocks tend to look at the price. So they let the price tell them how they should feel or — that's kind of crazy in our view.

We think you should look at the business just like you'd look at the apartment house that you bought or the farm you want. They let the fact that a quote is available every day turn into a liability rather than an asset.

And all I would say there is you better go back and read chapter 8 of "The Intelligent Investor," where it tells you how to think about the market. And it will do you more good than learning what modern portfolio theory is all about.

21. Big stimulus spending bound to have some "slop"

WARREN BUFFETT: OK, number 7.

AUDIENCE MEMBER: My name is Jim Powers (PH). I'm from West Newton, Massachusetts. My question has to do with this stimulus bill by the federal government.

I've read that only 8 percent of the money is intended to go to infrastructure. When you invest money, you normally look at the asset you're getting for the money.

With the country going into so much debt, don't you think it would be better if a great percentage of the money invested by the federal government go to solid assets, as it did during the Great Depression with the Tennessee Valley Authority, Hoover Dam, other facilities, that are still making money today, and paying back the original investment by the government many times over, while putting numerous people to work?

CHARLIE MUNGER: Let me answer that one. Yes. (Laughter and applause)

WARREN BUFFETT: I would certainly agree. I mean the '30s — a lot of really wonderful things were done with the money that was used to then to stimulate the economy. And that should be the goal and a model.

I can't evaluate perfectly what the current stimulus bill will do. I know that I — I did get a notice the other day from the Social Security Administration telling me I'm getting $250 more. That ought to last me 6 or 7 months. (Laughter)

Charlie will make his last longer, I'm sure. (Laughter)

But you know, that's the stimulus that the Buffett household has received at the present time.

Obviously, you want to use the money as intelligently as possible.

Obviously, also, anytime the federal government does anything on a massive scale — any time any big organization, a church or a business or anything, you know, throws all kinds of resources at something, usually there's a fair amount of slop.

I think that the intent — but by the time it gets through Congress and everything, I can't guarantee how the result comes out — but I think the intent is to get the money into action quickly and to end up having it utilized in intelligent ways.

But if the day after Pearl Harbor happened, you know, if you'd attached 5 or 6 thousand earmarks to the declaration of war, you know, it would not have been a pretty sight.

I mean, it — we have a system now where — that doesn't seem to be perfectly effective, I would say, in detaching the interests of particular legislators away from the common goal.

I mean, I get distressed when I look at what gets attached to some of these bills. And that certainly was a case in point. So I'll go along with Charlie on the answer.

But I think the intent of the administration is the right thing. When the American public pulls back like they have, government does need to step in.

It will have consequences. We are doing things on a scale — we're doing the conventional things, but we're doing them in unconventional amounts.

And we will see consequences from what we are doing now. I think we should be doing it. But I don't think we should think it's a free ride.

CHARLIE MUNGER: Yeah, we have one big no-brainer on the list of infrastructure investments that can be made. And that is a hugely improved nationwide electricity grid. The chances that that won't help us are zero.

And that, when it happens, will enormously benefit Berkshire's utility subsidiary. But that isn't the reason I'm raising it. I would be making this argument if we didn't have a utilities subsidiary.

WARREN BUFFETT: We might make it a little more strongly if we had the utilities subsidiary, however. (Laughter)

22. Hard to compete with government-guaranteed debt

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Rita Addison (PH), who says, "How does Berkshire's strong balance sheet and credit rating help take advantage of buying opportunities when even weak financial companies can now borrow more cheaply than Berkshire by using U.S. government guarantees of their debt?"

WARREN BUFFETT: Yeah, well, as I pointed out in the annual report, we are at a significant disadvantage in any financing-type business where we are competing against people who are getting their funding and their financing with a government guarantee.

Our raw material costs us a lot more money. And that's particularly applicable at Clayton where we have 10- or $11 billion of, really, mortgage paper on mostly manufactured homes.

And it's exceptionally good quality portfolio. Kevin Clayton and the people at Clayton Homes have done a great job in terms of lending responsibly. Our borrowers have behaved very well.

But the raw material to fund that portfolio — money — costs us a whole lot more than some bank that's in trouble.

And that's a real problem for us. And it's forcing us to try to come up with various other sources of funding that portfolio where, one way or another, we get people with government guarantees involved in the program.

That's just a fact of life with us now. There are the blessed who have government guarantees. And there're the ones that aren't.

And of course, you see that dramatically, in the case of some companies that have a government guarantee for part of their money and then sell other money — and then sell other bonds — that aren't guaranteed.

I mean, just the other day, as I remember, I may be wrong on this, but I think Goldman Sachs sold something with a 400 basis point spread that wasn't guaranteed. Whereas their guaranteed paper would be hundreds of basis points underneath that.

General Electric sold something earlier this year that wasn't guaranteed. And the spread between the guaranteed and the un-guaranteed was huge.

We don't have anything guaranteed to sell, so we are not in that favored class in any way. And we can't become a bank holding company. So as long as the situation goes on, we have to figure out ways that we adjust.

We only really use borrowed money — we use it in our utility business. But other utilities are not in this favored class. I mean, the utility industry generally.

So our utility borrows money quite well, compared to most utilities. MidAmerican's credit is regarded as very good.

And generally speaking, we've raised our money at a lower rate, which benefits our customers in the utility business.

We don't use much money in the rest of our businesses, except for the financing at Clayton. And we won't use much money.

So we get our money by float, basically. And our float is — it was $58 billion. I mentioned a little while ago, that Wells Fargo raises its money in the first quarter at, I think, 1.12 percent — 112 basis points — which is very cheap.

But our money's cheaper. We can't get as much of it as Wells does. But we do have 58 billion — in fact, we have more now — that you would think will cost us less than zero over time, although there will be given periods when we have a cost to it.

But we don't have an answer for going head-to-head against a government-sponsored business that gets — can raise money with a government guarantee. We do not have a way of going head-to-head with them at any business, no matter how prudently we conduct our operations.

Charlie?

CHARLIE MUNGER: Well, of course we're at a funding disadvantage. But on the other hand, we aren't regulated like a bank or a bank holding company.

I think we'd be pretty ungrateful if we took this one disadvantage that has come to us and obsessed on it.

WARREN BUFFETT: I get those kind of lectures all the time. (Laughter)

23. Graham would probably agree with us on derivatives

WARREN BUFFETT: OK, number 8.

AUDIENCE MEMBER: Hi, Mr. Buffett. Hi, Mr. Munger. My name is Mary Kimble (PH) from New York City.

In getting back to basics, what do you think Ben Graham would have said about derivatives?

WARREN BUFFETT: He would not have liked them. I think he probably would've said pretty much what I said back in 2002, that they pose a real risk to the system.

They cause leverage to run wild. They cause counterparties to sign up for things that may be difficult to achieve under certain circumstances. That they place an already fragile economic system — added strains on them — which can pop up in unpredictable ways.

But he would probably also say if he saw some that were mispriced, he would act accordingly. But he wouldn't get himself in a position where the problems of the people who didn't act prudently could cause him any problems. And I think that probably would be the answer.

The — one of the — one basic problem on derivatives — well, there are several problems.

I mean, back in — after 1929, Congress met — there was a Pecora committee and so on— and they decided that it was very dangerous to let people borrow a lot of money against securities and that it contributed to the Great Depression.

And therefore, they said the Federal Reserve should regulate how much people could borrow against securities. And it was important for society.

And the Federal Reserve started requiring margin — they had margin requirements. Those requirements still exist. You are not supposed to be able to borrow more than 50 percent against your securities.

Actually, during one period, they went to where they didn't — the Federal Reserve allowed no borrowing whatsoever. They went to a hundred percent margin.

But derivatives came along and just turned that into a — made those rules a laughingstock. You have what they call "total return swaps," which means you can borrow a hundred percent against what you own. That goes way beyond anything that existed in 1929.

So derivatives became a way around regulation of leverage in markets, which like I say, Congress felt was important and the Federal Reserve still has a responsibility for enforcing.

Derivatives also meant that settlement dates got pushed out. One of the problems in securities markets comes about when you have a trade today, if you had — didn't have to settle it for a year, you'd find it very hard sometimes to find the person on the other side.

And derivatives allow these very long settlement periods. Whereas security markets demand them in three days. There's a reason they demand them in three days.

As you extend out periods, you get more and more defaults. So they're a danger — they are a danger to the system. There's no question about that.

We have a book in The Bookworm called "The Great Crash" by Galbraith. It's one of the great books. You really ought to buy it. It tells the story of the '29 and it gets into margin requirements, so…

Ben Graham would not like a system that used derivatives heavily. But he would — I don't think he would have been above — if he saw something that looked way out of line and he knew he could handle it himself — I think he would have been quite willing to buy or sell one that was mispriced.

Charlie?

CHARLIE MUNGER: I think there's been a deeper problem in the derivative business. The derivative dealer takes two advantages of the customer.

One, there's croupier-style mathematical advantage equivalent to the house advantage in Las Vegas.

And two, the derivative dealer is playing in the same game with his own clients, with the advantage of being a better player. So —

WARREN BUFFETT: And having knowledge of what they're doing.

CHARLIE MUNGER: — and having knowledge of what the clients are doing.

This is basically a dirty business. And you're really selling things to your clients who trust you, that are bad for the clients.

We don't need more of this kind of thing in America. We need less. (Applause)

24. Bailouts shouldn't hurt senior debt holders

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Well, this question came in this morning. And it's a timely, philosophical one, given the results of the stress test that will coming out next week. And it relates to your stakes in Wells, U.S. Bancorp and Goldman Sachs. And the question is the following:

"The government's proposed restructuring plans for Chrysler and GM require creditors, as well as common shareholders, to bear losses.

"Yet, with the banks, the government's actions, to date, have not required concessions from holders of preferred stock and debt. The government has merely required the dilution of common stock holders.

"To what extent should holders of preferred stock and debt share losses in the bank rescue plans or in the resolution of a major bank holding company? And do you expect to be diluted in any of your holdings?"

WARREN BUFFETT: Yeah, I would say this. That's very institution specific. With Freddy and Fannie, the preferred was gone. I mean, there was no equity. And the preferred got — in effect, it's gotten wiped out along with the common stock.

With U.S. Bancorp or Wells, those are companies making lots of money. There's lots of equity there. So there's no reason to go up to senior securities and say that they should give up anything when there's lots of common equity underneath.

It'd be like if I have a mortgage on my house and it's 70 percent against its current value, saying, just because other people are having trouble in the neighborhood paying their mortgages because they got much higher mortgage or something, your saying my mortgage holder with 70 percent mortgage, that he should give up something and increase my equity even further.

There's lots of equity there, which there is at Goldman, U.S. Bank, Wells Fargo. There's lots of equity, lots of earning power. There's really no reason for senior debt to give up anything.

You know, you could make an argument at Freddy and Fannie, about the subordinated debt, whether they should've suffered as well as the preferred stock and the common. But I don't see it as applying to earning institutions with lots of future earning power.

I would love to buy all of U.S. Bancorp. You know, or I'd love to buy all of Wells if we could do it. You know, we're not allowed to do it because it'd make us a bank holding company. But those businesses, there's no reason for the creditors to suffer.

Now, you get into Chrysler or something of that sort, you know, there is no — I mean, they're losing money all of time and they do not have a competitive advantage. You know, whether they've got a sustainable business model under any circumstances is open to question.

Whether there's any common equity there is not open to question. You know, there isn't any common equity. Nobody would pay a dollar, you know, if they had to take on Chrysler and all its debts.

Lots of people would pay billions of dollars to take on U.S. Bancorp or Goldman Sachs, you know, with all their debt. So those are different situations. I —

If you get into a situation where the common equity is wiped out, then you get into a question of — then you get into the proper allocation of things within the capital structure — who gives up so much, and the senior debt may give up something, and so on.

But I don't see it as applying at all to businesses that are worth a lot of money, where the equity's worth a lot money.

Charlie?

CHARLIE MUNGER: I have nothing to add. (Laughter)

25. Ignore original cost when reviewing your portfolio

WARREN BUFFETT: OK, number 9.

AUDIENCE MEMBER: Hello, Mr. Buffett. Sorry, about that. Mr. Buffett and Mr. Munger, my name's Kelly Cardwell from Warrenville, Illinois.

Guys, if either of you were starting a smaller investment fund today, let's say in Warrenville, Illinois, $26 million fund called Central Square Capital — hypothetically?

WARREN BUFFETT: What? You'll get billed for a commercial later on. (Laughter)

AUDIENCE MEMBER: With this smaller asset base, what would you do differently, both in terms of the number of positions and frequency of turnover?

For example, if you owned a portfolio of 10 stocks and five of them doubled in a short time period, would it make sense to actively manage the portfolio and take profits in the five that had doubled and redeploy the proceeds into your positions, into the ones that had not moved higher, where, presumably, more upside exists and the odds are more dramatically stacked in your favor? Or would you favor the strategy of sitting on your hands in the name of long-term investing?

WARREN BUFFETT: We would own the half of dozen or so stocks we like best. Their — and it wouldn't have anything to do with what our cost on them was.

It would only have to do with our evaluation of their price versus value. It doesn't make any difference what the cost is.

And incidentally, if they went down 50 percent, we would say the same thing. I — you know, and using your illustration, I don't know whether that fund has actually had something that went up or went down.

So, we would — our cost basis, except in rare cases — and we actually have a situation like this at Berkshire now, which I may explain a little later. But the cost basis doesn't have anything to do the fund.

When Charlie and I ran funds, we didn't worry about whether something was up or down. We worried about what it was worth compared to what it was selling for.

And we tried to have most of our money in a relatively few — very few — positions which we thought we knew very well. We do the same thing now. We'd do the same thing a hundred years from now.

Charlie?

CHARLIE MUNGER: Yes, he's tactfully suggesting that you adopt a different way of thinking. (Laughter and applause)

26. Berkshire's competitive advantage no longer requires us

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question is from Michael Welter (PH) of Portland, Oregon.

"You've often said that two things you look for in an investment are a sustainable competitive advantage and a simple, easy to grasp business model. Berkshire's sustainable competitive advantage is arguably you, Warren and Charlie. And that obviously is not sustainable over the long term."

WARREN BUFFETT: I reject that. Defeatism. (Laughs)

CAROL LOOMIS: I knew you would.

"While at this point, Berkshire does not have a simple, easy to grasp business model. So if the two of you were outside investors, is it possible that, no matter what combination of intrinsic value and price Berkshire offered, you would not invest in it today?"

WARREN BUFFETT: No, our sustainable competitive advantage is we have a culture and a business model, which people are going to find very, very difficult to copy, even semi-copy.

We have an unusual group of shareholders. We have a business that's owned by people where the turnover on our stock, even allowing for all the double-counting and everything like that, may be something like 20 percent a year, when virtually every stock in the S&P 500 turns over a hundred percent a year.

So we have a different shareholder base. We have people that understand their business differently.

And we have a business that can offer, to people who own private businesses, the chance to keep running their businesses as they have in the past and get rid of the problems of lawyers and bankers and all kinds of things like that.

And I don't see any other company in the United States that has the ability to do that now, or probably the ability to adopt that model in any big way.

So I would say we have sort of an ultimate — and it's not peculiar to me and Charlie. We may have helped create it. But it is a deeply embedded culture which any CEOs that follow are going to be well-versed in when they come into the job, and dedicated to, and able to continue in the future.

And you can't — I don't want to name names about other companies — but you can't do that elsewhere.

So I think anybody wanting to copy Berkshire is going to have a very hard time. And I think the advantages we have are going to be very, very long lasting. And they're not peculiar to the fact that Charlie and are I sitting up here anymore. They may have been, originally. But no longer.

Our culture, our managers join that culture. Our shareholders join that culture. It gets reinforced all the time. They see that it works.

You know, it's something that I don't know how I would copy it, if I were running, you know, some other company.

And it's meaningful. Because there will be businesses, just as there was with ISCAR awhile back, just as the management at GEICO felt back in the mid-'90s in terms of what they wanted to do, there will be people that want to join up with us. And they really won't have a good second choice. They'll be plenty that don't, too. But that's OK.

We just need to have the right ones — some of the right ones — join us. And it can go on a long, long time.

Charlie?

CHARLIE MUNGER: Yes. I might state that a little differently. A lot of corporations in America are run stupidly from headquarters, as they try and force the divisions to come up with profits for every quarter that are better than the profits from the same quarter in the previous year.

And a lot of terrible decisions and terrible practices creep into those businesses. In the Berkshire model, that doesn't happen.

So while Warren and Charlie will soon be gone — not too soon in my case, but I'm a little worried about Warren (laughter) — the stupidity of management practice in the rest of the corporate world will likely remain ample enough to give this company some comparative advantage way into the future. (Applause)

WARREN BUFFETT: OK. We'll go to — it's very important isn't it, to watch what you eat, as you — (laughter) — in terms of preserving longevity. So we watch it for hours up here at a time. (Laughs)

27. We don't keep every stock, but we do keep every business

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Hello, Mr. Buffett, and Mr. Munger. My name is Aznar Midolf (PH). I'm from (Inaudible) organization, San Francisco.

And my question is from one of financial blogs. How do you justify holding stocks forever when the fundamentals have permanently changed?

WARREN BUFFETT: Well, the answer is we don't. You know, and — if we lose confidence in the management, if we lose confidence in the durability of the competitive advantage, if we recognize we made a mistake when we went into it — we sell plenty of times. So it's not unheard of.

On the other hand, if you really get a wonderful business with outstanding management — but mostly the wonderful business part of it — when in doubt, keep holding. But it's no inviolable rule.

Now, among the businesses we own, not just securities we own, we have an attitude, which we express in our economic principles, that when we buy a business it's for keeps.

And we make only two exceptions: when they promise to start losing money indefinitely or if we have major labor problems. But otherwise, we are not going to sell something just 'cause we get offered more money for it, even than it's worth.

And that's a peculiarity we have. And we want our partners to know about that.

We do think it probably helps us in terms of buying businesses over time. It's also the way we want to run our business.

But with stocks, bonds, we sell them. But we're more reluctant to sell them than most people. I mean, if we made the right decision going on, we like to ride that a very long time. And we've owned many — we've owned some stocks for decades.

But if the competitive advantage disappears, if we really lose faith in the management, if we were wrong in the original analysis — and that happens — we sell. Or if we find something more attractive —

Normally we have plenty of money around. But in September of last year, late September, we had committed to put 6.6 million — billion — in Wrigley. We — and then Goldman Sachs needed 5 billion, GE needed 3 billion.

I sold a couple billion dollars' worth of J&J just because I didn't like getting our cash level down below a certain point, under the circumstances that existed then.

That not was a negative decision on J&J. It just — it meant that I wanted a couple billion more around. And I saw an opportunity to do something that I probably wouldn't see too much later. Whereas, I could always buy J&J back at a later date. But that's an unusual situation.

28. We run Berkshire as if we owned all of it

WARREN BUFFETT: I'd like to go back to one point on the earlier question, too.

I always — I frequently ask CEOs of companies what they would do differently if they owned the whole place themselves.

You know, when I'm talking to, either companies where we've invested in, sometimes other companies, friends of mine run them. You know, "What would you do different if this was a hundred percent owned by you and your family?"

And they give me a list of things. There is no list at Berkshire. You know, we basically run this place the same way we'd run if we owned a hundred percent of it.

And that is a difference that — in terms of people joining in with us. They don't have to adjust their lives to a bunch of rules that are kind of self-imposed, in terms of how people think about public companies, in terms of earnings, predictions, and all of that sort of thing.

And there are certain people that would prefer to be associated with an enterprise like that. And also —following through on this rule I just explained — know that they've made a one decision on where that business that they built up over decades and cherish and everything — they make one decision on where it's going to go, and they're not going to get surprised later on.

They're not going to get some management consultant come in and say, "You ought to have a pure player, Wall Street's saying, so you ought to spin this off or sell it," or anything like that.

And they know we're not going to leverage it up. So they know they're really going to get to do what they love the most, which is to continue to run their business, not bothered by bankers or lawyers or public expectancies or anything of the sort.

And that is a — like I said earlier, that's a real advantage.

Charlie?

CHARLIE MUNGER: Yeah, in the show business, they say the show has legs if it's going to last a long time. I think Berkshire Hathaway's system has legs.

29. Why the annual meeting isn't webcast

WARREN BUFFETT: OK. With that, we'll go to Becky. (Laughter)

BECKY QUICK: This is a question from Humin Timadin (PH) in Seattle, Washington. He's got a two-part question. But he says, "From time to time, you purchase shares of public companies.

"Presumably, you feel that those shares are a better investment than Berkshire shares at the time, since you never buy back Berkshire shares.

"If Berkshire shareholders can purchase shares in the same companies for the same price as you, why shouldn't they shell — sell their Berkshire shares and buy what you are buying?"

And secondly, he wants to know why, because he, "like thousands of other shareholders, is unable to attend the annual meeting, how come Berkshire does not webcast the meeting? I am aware of the irony that I will not hear your answer." (Laughter)

WARREN BUFFETT: Well, our meeting does get written up, at least it gets written up a lot with various blogs and everything else. It gets written up pretty well in its entirety by Outstanding Investor Digest.

And there are others that prepare extensive reports. And they pop up on the internet. So he will, in all likelihood, find out the answer.

We could webcast. I get asked the same question about webcasting the meetings I have with students. You know, why not do that? It's so much easier and everything.

I think there is something gained by personal contact. I certainly know that when I was studying and all of that, I gained a lot by personal contact.

Even though I'd read Ben Graham's books, just going and being with him. And I follow that practice in teaching. And I think that —

I like the turnout we get. I like our partners to show up and see the products we sell and all of that. This is not something where we're going to go and hide and hold our meeting, you know, in some hamlet, you know, in western Nebraska or something to discourage attendance.

We've got a different attitude. And I think that that — I hope that comes across. And I think that if we webcast it, you know, it was something like turning on a television show, I don't think it would be quite the same.

30. No "quarrel" with copycats

WARREN BUFFETT: In terms of the first part of the question about buying the securities we buy, plenty of people do that. And some of them — but they — incidentally, they're not buying it with free float that's available from insurance.

So if they have $58 billion that they can get interest-free, they will be in the same position we are in buying those securities. But they are — on the other hand, they have some tax advantages we don't have. So I don't quarrel with people who do that.

We have to publicize to some extent what we own. Some things they wouldn't be able to buy because we make direct purchases.

They wouldn't be able to buy into the businesses we own. But they might very well do better piggybacking us in some way. And they're certainly free to do it.

Charlie?

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

WARREN BUFFETT: Yeah, I used — when I was 21 years old, I had to mail away to the SEC in those days — and you had these crummy copies about a week later and paid a lot per page to get them — but I used to get the semi-annual reports of Graham-Newman Corp before I went to work there.

And I would look at every security that was listed there. And I got some of my ideas that way. So it's a — there's nothing wrong with that.

31. Your best inflation protection

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: My name is Sam Alter (PH). I'm 11 years old and I'm from Westminster, New Jersey.

My question is, how will inflation affect my generation? And how is Berkshire investing to prepare for this time? (Applause)

WARREN BUFFETT: Well, that was about inflation, right? How inflation was going to affect him?

CHARLIE MUNGER: Yeah. How is inflation —?

WARREN BUFFETT: Well, inflation is going to affect you. You know, the — it's certain we will have inflation over time.

Paul Volcker got very upset the other day and spoke out about three weeks ago, I guess, when he read that a majority of the Federal Open Market Committee had sort of targeted 2 percent inflation as the number.

And Volker, who came in when inflation was raging and saw the problems of stopping it when it got a momentum of its own, said, "You know, 2 percent sounds great, but in a generation it cuts away purchasing power by 50 percent."

He was — kind of a long generation, there — but he was right in that once you start thinking about a couple percent, you are on something of a slippery slope.

And we are following policies in this country now to stimulate things, which — stimulate business — which are bound to have some inflationary consequences.

And to the extent that we borrow money from the rest of the world, it would be very human on the part of politicians in the future to decide that they would rather pay the rest of the world back in dollars that are worth far less than the dollars they borrowed.

I mean, it's the classic way of reducing the impact and cost of external debt. And we're building up a lot of external debt.

I always find it interesting when politicians now talk about using the taxpayer's money to do this and the taxpayer's money to do that and how the taxpayers are paying the bonuses at AIG.

We haven't raised taxes at all in this country. You know, I mean, taxpayers are paying nothing beyond what they were paying a couple years ago.

Matter of fact, the federal revenues this year, which were close to 2.6 trillion a couple years ago, you know, maybe more like 2.3 trillion. So we are taking less money from the taxpayers.

The people who are really paying for the things we're doing now will probably be the people who are buying fixed-dollar investments, much of it from the U.S. government, and who will find the purchasing power when they go to redeem those investments to be far less.

So you can — you might say that the AIG bonus is — probably the Chinese have — are the people that are ultimately paying the most in terms of the loss of purchasing power they will have with their holdings of government bonds, U.S. government bonds, many years down the road. But it sounds better to say the taxpayer than to say the Chinese are paying for it.

It's an interesting situation. I read that comment everyday about how the taxpayers are doing this and that. And, you know, I haven't had my taxes raised. You haven't had your taxes raised. They're giving me $250 bucks back here pretty soon.

The taxpayers haven't paid anything so far. And my guess is that the ultimate price of much of this will be paid by a shrinkage in the value of — the real value — of fixed-dollar investments down the road.

And that will be the easiest thing to do. And if it's the easiest thing to do, it's the most likely thing to have happen.

So you will see plenty of inflation. Now, the best protection against inflation is your own earning power.

If you're the best teacher, if you're the best surgeon, if you're the best lawyer, you know, whatever it may be, you will command a given part of other people's production of goods and services no matter what the currency is, whether it's seashells, or reichsmarks, or dollars.

So your own earning power is the best, by far. If you're the best journalist, whatever it may be, you will get your share of the national economic pie, regardless of the value of whatever the currency may be, as measured against some earlier standard.

The second best protection is a wonderful business. You know, if you own the Coca-Cola, trademark, Company, you will get a given portion of people's labor 20 years from now and 50 years from now for your product.

And it's doesn't make any difference what's happened to the price level, generally. Because people will give up three minutes of labor, whatever it may be, to enjoy, you know, 12 ounces, you know, of a product they like.

So those are the — and — those are the great assets, your own earning power first, and then the earning power of a wonderful business that does not require heavy capital investment.

If it requires heavy capital investment, you get killed in inflation. And with those guidelines, I would tell you the best thing to do is invest in yourself.

Charlie?

CHARLIE MUNGER: Yes. The young man should become a brain surgeon and invest in Coca-Cola instead of government bonds. (Laughter)

WARREN BUFFETT: I get paid by the word. He doesn't. (Laughter)

32. Newspapers are fading but we're keeping the Buffalo News

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: OK. This question comes to us from Dennis Wallace (PH) in Waldorf, Maryland. We got a lot of these. And I'm selfishly interested in the answer.

Given the current economic conditions in the newspaper and publishing business, can you please provide some of your thoughts on its impact on Berkshire? Given that our investee, the Washington Post Company, has had a substantial decline in its stock value, is it still a good use of capital?

And given the, quote, "cheap trading prices of newspapers in the current climate," would Berkshire considering — consider purchasing additional newspapers to add to the Buffalo News and Washington Post properties?

At what price does it become compelling to invest in the newspaper business? Or is there no price at which it becomes compelling in today's environment?

WARREN BUFFETT: I would say, it isn't today's environment. I mean, it's an evolutionary development.

But — so the current economic environment has accentuated the problems in newspapers. But it is not the basic cause.

Newspapers are, to the American public as a whole — Charlie and I — I read five a day. Charlie probably reads five a day. We'll never give them up.

But we'll also be the last guys reading a newspaper while having a landline phone, you know, by our side. (Laughter)

So, you don't want to judge consumer preferences by what we do. The newspaper — no. The answer is, for most newspapers in the United States, we would not buy them at any price.

They have the possibility, and in certain places, they've already hit it, but they have the possibility of just going to unending losses.

And they were absolutely essential to a very high percentage of the American public, you know, 20, 30, 40 years ago. They were the ultimate business.

It was a business where only one person won, basically, in almost every town in the country. There were 1,700 papers in the United States. And about 50 of those, 20 years ago, existed in a city where there were multiple papers.

So they were a product that had pricing power, that was essential to the customer, essential to the advertiser. And they've lost that essential nature.

They were primary 30 years or 40 years ago if you wanted to learn sports scores or stock prices or even news about international affairs.

And then that nature, what Walter Annenberg used to call "essentiality," I don't know whether it's in the dictionary or not, but it started eroding. And then the erosion has accelerated dramatically.

And they were only essential to the advertiser as long as they were essential to the reader. And you know, nobody liked buying ads in the paper. It was just that they worked.

And that has — that is changing. It's changing every day. And I do not see anything on the horizon that causes that erosion to end.

We — you know, at the Buffalo News, Stan Lipsey would greet me 10 years ago. And he would say, "Warren, you should — on an economic basis — you should sell this paper." And I said, "I agree 100 percent. But we're not going to do it."

And you know, we could've sold the Buffalo News for many hundreds of millions of dollars some years back. And we couldn't sell it, you know, for remotely anything like that now.

And that's one of the policies. We have a union that's been very cooperative — unions, a bunch of unions — have been quite cooperative with us in recent months in trying to have an economic model that will at least keep us making a little money.

And as I put in the annual report, in our economic principles, that as long as we don't think we face unending losses or have major union problems, we will stick with the businesses, even though it would be a mistake if you were acting as a trustee for, you know, a bunch of crippled children or something of the sort. And that's just our policy at Berkshire.

The Post has a very good cable business. It has a very good education business. But it does not have answers on the newspaper business, as Don Graham wrote in the annual report. Nor does anyone else.

Now, we all keep looking around for somebody that will find the model. But there — I think there are about 1,400 daily papers now in the United States, and nobody yet has found the model.

We are as well-positioned in Buffalo, believe it or not, I think, to play out the game as anyone else. But whether we find something before the lines get so that we're inexorably in the red, whether the situation gets so we're inexorably in the red, I don't know.

But we will play it out as long as we can. It's not what they teach you in business school. But it's the way we run Berkshire.

Charlie?

CHARLIE MUNGER: Well, I think that's all 100 percent right. And it's really a national tragedy. The — these monopoly daily newspapers have been an important sinew of our civilization.

And, by and large, they were impregnable from advertiser pressure. And by and large, they were desirable editorial influences. And by and large, they kept government more honest than it would otherwise be.

So as they disappear, I think what replaces it will not be as desirable as what we're losing. But this is life.

33. Expect weak consumer spending for "quite a bit longer"

WARREN BUFFETT: Number 12.

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. I'm Marc Rabinov, from Melbourne Australia.

I'm wondering if I could ask you how retailing, manufacturing, and service businesses have been severely impacted by the recession given the way consumer spending has changed. Is it likely the results will still be 20 percent below 2007 levels in three years' time?

WARREN BUFFETT: I don't know about three years' time. Certainly those areas you named, to varying degrees, have been hit very hard.

Some of the manufacturing would tie in with residential construction. If we hold housing starts at 500,000 a year, you know, my guess is that in a couple of years at most, we would get something close to equilibrium in housing. Maybe quite a bit sooner. Nobody knows the figures with precision.

But if you keep forming households at a million-3, or something like that, a year, and you create 500,000 new units and a few of the old ones burn down, and a few — you will reach equilibrium at a point that's not ridiculously far in the future.

And that will make a big difference in our carpet business, and brick business, and insulation business, and paint business, and so on.

Retailing has been hit very hard. The higher the end of it, generally speaking, the harder it's been hit.

There's been a big change in consumer behavior. And I think it will last quite a bit longer.

I think for years, government was telling people to save. And now that they're saving, they're unhappy about it.

But I think that — I think the experience of the last couple years, I don't think will go away very fast. I think it could last quite a long time.

So I would not think our retailing businesses would do great for a considerable period of time.

And I would say that in retail real estate, I would think that that would be a tough field to be in for quite a period.

I think the shopping centers will be seeing vacancies that will be hard to fill. I think that the retailers will be struggling in many cases. And of course, the supply of real estate doesn't go away.

So, that could be — the shopping center business, which was selling at, you know, these premiere cap rates of 5 percent or even less sometimes. I think that is going to look very silly before all of this is done. In fact, it already is looking that way. So I wouldn't count — I wouldn't —

The service businesses are generally the better businesses. They require less capital and they can be more specialized in the markets they serve, in general.

But I would not look for any quick rebound in the retail manufacturing service businesses. We've got a ways to go on that.

And we've got a ways to go on the ones that are construction related. But at least there, you can sort of see the math of when it'll work out. And you can get a lot of information on what's going on in real estate markets.

South Florida, I think, will be — for example, I think that's going to be a problem for a long, long time.

I hope it isn't. But I just think the math of it is pretty devastating, in terms of the number of units you have and net household formation down there. You've got a lot to wade through.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: OK.

34. We'll never buy back Berkshire shares at a "silly" price

WARREN BUFFETT: Let's go to Carol.

CAROL LOOMIS: I got lots of question sent in to me about the possibility of Berkshire buying its own shares. And here's what one said:

"You recently described Berkshire's policy regarding share repurchase as self-defeating, because before repurchase, you said, you would write a letter to shareholders explaining why we are going to do it.

"You said the letter would, by necessity, tell investors that the stock price was at a substantial discount to intrinsic value, which would cause the stock price to rise.

"The letter would be, in essence, a buy recommendation, though as a matter of policy, you don't make those.

"In the past, you have emphatically endorsed share repurchase by other companies and criticized managers who would not buy when the price was right.

"You have said no alternative action can benefit shareholders as surely as repurchases. Your previous views suggest little patience for a manager with a self-defeating policy.

"You've said when you have a manager who consistently turns his back on repurchases when these are clearly in the interest of owners, he reveals more than he knows of his motivations. So — and the market correctly discounts assets lodged with him.

"Would it not be rational to conclude that the market will appropriately discount Berkshire's share price unless and until you abandon your self-defeating policy and engage in repurchases of shares?"

WARREN BUFFETT: Yeah, incidentally, the — and this important, actually — the comments I made about repurchasing, overwhelmingly, those go back a lot of years when stocks generally were — frequently were — cheap in relation to intrinsic value. I did not make that —

You haven't seen me writing about that in the last 10 years or so. Because I would say most of the repurchasing done in recent years, I've thought has been foolish, because people have been paying too much.

And companies got, in many cases — they would never acknowledge this — but they were buying because they were basically liked — they were trying to give out a buy recommendation when it wasn't justified.

In the '70s and early '80s, Charlie and I would frequently urge people to repurchase shares because it was so much more attractive than other things they could do with their money.

The only time we felt strongly that Berkshire should repurchase its shares was in roughly 2000, whenever it was, that we thought it was demonstrably below intrinsic business value. And we wrote we would do it, and it did become self-defeating.

There's clearly a point where if we thought it was demonstrably below — conservatively estimated — intrinsic business value and we notified the stock holders we were going to do it, we would do it. I think again, it would largely be self-defeating.

I don't think that situation exists now. I think — I won't give any buy or sell recommendations. But I think it ought to be quite compelling.

Like I say, I don't — I think, probably 90 percent of the repurchase activity I've seen in the last five years, I did not think was serving the cause of the shareholder.

I thought it was being done because management thought it was the thing to do, and their investor relations department told them it was the thing to do, and they were actually buying stock at kind of silly prices.

And that was not the case when Charlie and I looked at Teledyne or the Washington Post or Cap Cities Broadcasting doing it many years ago. But I haven't seen situations like that in recent years.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that, either.

WARREN BUFFETT: Number — it's interesting how many companies were buying in their stock at twice present prices that aren't buying it now. I mean, there are lots of those.

We will never buy in our stock at a silly price. We may make a mistake by not buying it at a cheap price. But we'll never make a mistake, I don't think, by buying it at a silly price.

And we think a significant percentage of corporate America has done that in recent years, including a few stocks that we've owned ourselves.

35. Crisis made opportunity cost calculations difficult

WARREN BUFFETT: Number 13.

AUDIENCE MEMBER: Jack Benben (PH) from Haworth, New Jersey. First, I'd like to thank you. This is — I've been to about a dozen meetings. This is probably the best one.

So thank you very much for the new format. And thank you very much to the journalists who've really helped out a lot. (Applause)

WARREN BUFFETT: Yeah, thank you.

AUDIENCE MEMBER: At past meetings, you and Mr. Munger have talked at great length about opportunity cost. Excuse me. The past year has presented you with many unusual opportunities.

Can you discuss some of the more important opportunity cost decisions of the past year? And were those decisions at all affected by the macroeconomic picture? Thank you.

WARREN BUFFETT: Well, certainly opportunity cost has been much more in the forefront of mind in the last 18 months.

When things are moving very fast, when both prices are moving, and in certain cases, intrinsic business value is moving at a pace that's far greater than we've seen for a long time, it means that in terms of calibrating A versus B, versus C, it's tougher.

It’s more interesting. It’s more challenging. But it’s — and it can be way more profitable, too. But it’s a different task then when everything was moving at a more leisurely pace.

And I described earlier, you know, we face that problem. And it’s a good problem to have. We faced that problem in September and October. Because we want to always keep a lot of money around.

We have all kinds of levels — extra levels of safety — that we follow at Berkshire. And we will never get so we’re dependent on banks or other people’s money or anything else. We’re just not going to run the company that way.

So we were seeing things happen. I mean, we got a call — we got lots of calls. But, most of them, we ignored. But the calls that we got that we ignored helped us calibrate the calls that we paid attention to, too.

And if we got a call from a Goldman Sachs, I think it was on a Wednesday, maybe, you know, that was a transaction that couldn’t have been done the previous Wednesday and might not be done the next Wednesday.

And we’re talking real sums, 5 billion in that case. And we had certain commitments outstanding. We had a $3 billion commitment out on Dow Chemical. I think at that point, I could be wrong exactly on the day when we made it.

We had a $5 billion commitment out on Constellation Energy. We had 6 1/2 billion we were going to have to come up with in early October on the Wrigley-Mars deal. So we were faced with opportunity cost-type considerations.

And as I said earlier, we actually sold something that under normal circumstances we wouldn’t have thought about selling if it was 10 or 15 points higher, in Johnson & Johnson. But we just didn’t want to get uncomfortable.

So you are faced, in a chaotic market, particularly where people needs large sums — so you’re not talking about buying a hundred million dollars’ worth of something that, you know, one day and a hundred million the next day — but all of a sudden you’re called on for billions, if you’re going to play at all.

We faced that opportunity cost calculation frequently during that period. I mean, when we decided to commit to buy Constellation Energy, we had to be willing to come up with $5 billion seven or eight months down the line. And you didn’t know exactly when because it would be subject to public utility commission approval.

But if something chaotic happened in the market next week, we would get phone calls. Or we would see stocks selling or bonds selling at prices we liked. And if the relative values, against what we held, were interesting, we might sell things.

Now, it's harder to sell things in huge quantities than it is to buy things in huge quantities during a period like that. So you have to measure whether you can actually get the offsetting transaction done to move from one to another.

We have a much — if we're going to move billions from one to another, it's much different than the problem you may have in moving hundreds of thousands or tens of thousands of dollars from one holding to another. We really can have big transactional costs unless we're careful.

But that's the kind of calculation we go through. And we love the fact we get the opportunity to make those calculations. It's a sign of opportunity around.

And you know, we'll — we haven't had the flurry of activity like we had last year for a long time. So it was the first time we really faced the question, you know, can we raise a couple billion dollars in a hurry, to be sure that we've offset the cash needs of what we're committing to on the purchase side.

On the Johnson & Johnson we sold, we actually made a deal where we got — I had a floor price on what we sell that for, just because the markets were so chaotic, that we wanted to be absolutely sure that we would not end up a couple billion dollars less than comfortable when we got all through.

Our definition of comfortable is really comfortable. We want to have billions and billions and billions around. And then we'll think about what we do with the surplus.

Charlie?

CHARLIE MUNGER: Again, I've got nothing to add.

36. GEICO spends millions on advertising and will "never stop"

WARREN BUFFETT: Becky?

BECKY QUICK: This is a question from someone named Yem (PH) in Columbus, Ohio. It's —

WARREN BUFFETT: That narrows it down.

BECKY QUICK: Yeah. Very company specific. It says, "GEICO has been spending around 400 to $600 million on media advertising a year in the last few years. What are the deciding factors into how much to spend? And how could one estimate the net return on such spending?"

WARREN BUFFETT: Well, that's a question people have been asking themselves since the beginning of advertising.

And, you know, I'm not sure whether it was Marshall Field or John Dorrance at Campbell Soup, or something, one of those fellows said that, you know, when asked whether they didn't waste a lot of money on advertising, he said, "Yeah, we waste half of it, but we don't know which half." (Laughter)

And that is the nature of advertising. Although, we can measure it better with GEICO than most companies.

We will spend about $800 million on advertising. We spend far more — even though we're the third largest company — we've spent far more than State Farm or Allstate. And we will spend more and more and more. I mean, we will never stop.

We were spending $20 million a year, a little over that, when we bought control of it in 1995.

But we want everybody in the world to — well, everybody in the United States. We're not going to be selling insurance in China or someplace very soon.

But we want everybody in the United States to have in their mind the fact that there's a good chance they can save money by picking up the phone or going to geico.com and checking it out. And important money.

And when we get that message in people's minds, you never know when it's going to pay off later down the line. Because, as I mentioned earlier, starting in — around September 30th, we saw a big difference in the propensity of people to come to us to save $100 or $200, whereas they might not have cared about saving that before. So, we want —

Here's auto insurance. Everybody has to buy it. Nobody likes to buy it. But they like to drive. And if you like to drive, you need auto insurance.

And so it's going to sell. And you're going to buy it from somebody. And if you care about saving money, you're going to check with us. And we want to make sure everybody understands that.

And we won't — you know, we will spend more money on it, I will guarantee you, three years from now.

Now, we're getting more for our money in buying advertising this year. So 800 million this year buys more than 800 million would've bought a couple of years ago. So we're getting more exposure for the money.

But we love spending money on advertising at GEICO. And we want to be in everybody's mind.

Coca-Cola's in everybody's mind around the world. You know, he started in 1886. And they just kept associating Coca-Cola with moments of pleasure and happiness. And billions and billions of billions of people have that in their mind.

And they don't have anything in their mind about RC Cola, you know. You know, or — they just — you say RC Cola to somebody around the globe and they give you a blank stare. You say Coca-Cola and it means something.

And a brand is a promise. We're getting our — we're getting that promise in people's minds that there's a good chance they can save money if they check with GEICO. And we'll never stop.

Charlie?

CHARLIE MUNGER: Yeah, it's interesting.

If GEICO would remain more or less the same size if we didn't advertise so healthy, and if the new subscribers are worth more than the $800 million we're spending advertising, then, in an important sense, GEICO is earning $800 million more pre-tax in a way that doesn't even show.

That's the kind of thing we like to see within Berkshire Hathaway.

WARREN BUFFETT: The value of GEICO goes up by far more than the earnings every year, if we keep adding these people, as Charlie says.

And we could maintain, I'm sure, we can maintain for a very long time our present policy holder count and probably spend $100 million a year, maybe less.

But we are getting more than our money's worth for the — for what we spend. We probably waste some. But overall, we're getting at terrific return on it.

And if I thought we could get anything like the same return by spending 2 billion next year, we'd spend 2 billion. I mean, it — it's a very attractive business. And I don't see how you create anything like it.

I mean, we are the low-cost producer. And if you're the low-cost producer in something people have to buy and is roughly a $1,500 item, I mean, you've got a terrific, terrific business. And we have durable competitive advantage there.

37. Wells Fargo is better than many other banks

WARREN BUFFETT: OK, we'll to go to number 1. And I think then we'll break for lunch. Number 1?

AUDIENCE MEMBER: OK. Hello Warren, Charlie. Felton Jenkins from Savannah, Georgia, a long-time shareholder and partner.

Just want to make a quick comment about something that was a big deal the last couple of years about PacifiCorp. There was some controversy.

But I'm glad that PacifiCorp has agreed to work with the Native Americans and fishing communities on the West Coast to remove the uneconomic and harmful dams on the Klamath River.

So I want to encourage PacifiCorp management to move quickly, close the deal, and open the river soon. But thanks for their improved efforts over the last year.

My question is, you mentioned Wells Fargo got to $9. And that was a great deal, it looks like, at that price.

But what about Washington Mutual, AIG, Wachovia, Citigroup, Fannie Mae, even some Irish banks that I think you were involved with?

Those went through $9. And probably a lot of people thought they were still good deals or mispriced at $9.

And now you've got very expensive toilet paper, essentially, out of those stock certificates. So I mean, how would you know on the way down?

And looking at something like Bank of America, that was on the 13F sometime recently, what's a likely outcome for a Bank of America and how would you analyze what might happen? Thanks.

WARREN BUFFETT: Well, there's some you can't analyze. And on the Irish banks, I couldn't have been more wrong.

But it isn't a matter of whether they go through $9 or anything like that. It's really what their business model is and what kind of competitive advantage they have.

I would say that Wells, among the large banks, has, by far, the best competitive position, you know, of any — of the really large banks in the country.

And essentially, if you look at the four largest, they each have somewhat different models. But the model of Wells is more different from the other three than any one of the other three would be from the remaining group.

But I was wrong on the Irish banks in a very big way. I simply didn't understand. And I should've understood.

It was available for me to understand, the incredible exposure they'd got into in more land development-type loans — not property loans, in terms of completed properties — but all kinds of land development loans.

It was extraordinary. For a country with 4 and a fraction million people, you know, they had money lent for developing properties, homes, that would extend just forever in the future.

It was the terrible mistake by me. Nobody lied to me, nobody gave me any bad information. I just plain wasn't paying attention. The —

If you talk about the WaMus — I don't want to go through all the names on them, because it's specific to some companies.

But there were a lot of signs that they were doing things that a highly leveraged institution shouldn't be doing. And that could cause trouble if this model of ever-rising housing prices turned out to be a false model.

You can get in a lot of trouble with leverage. I mean, it's — you start creating $20 of assets, or something like that. You know, for every dollar of equity, you better be right.

And some of those big institutions did some very — what, in retrospect, for certain here — were foolish things, which, if they hadn't been so highly leveraged, would not have hit them as badly.

And I would say most of them, if you read the 10-Ks and 10-Qs and did some checking, you could spot differences in them. Certainly, you can spot —

There's no comparison, if you take Wells Fargo versus a WaMu or something like that. I mean, you don't have to have an advanced level of sophistication about banking to compare those two.

They're two different kinds of businesses. It's like comparing a copper producer whose costs are $2.50 a pound with a copper producer whose costs are $1 a pound.

Those are two different kinds of businesses. One is going to go broke at a buck-fifty a pound. And the other one's going to still be doing fine.

And banking has real difference in it. But people don't — they don't seem to look at them. The figures are available. And — but they don't seem to look at them very carefully.

When Wells reported the other day, they have an item of expense of over $600 million in a quarter for the amortization of core deposits. That it not a real expense.

I mean, the core deposit figure will be up over time. And they are entitled under the tax law to put up, I don't know, $15 billion or so, and they get to amortize that, which is an advantage.

But I didn't see one newspaper article or any commentator that mentioned that that $600 million charge is in there, which is entirely different than looking at any other bank. But it just — it goes unnoticed.

So the figures are there. And the information's there. And I think with Freddy and Fannie, for example, I think it was pretty clear what was going to happen.

Now, the interesting thing is, the government was telling them to go out and raise some more money for investors. And if those investors had put the money in, it would've been gone. It was already gone, actually, within a month or two, so —.

We had calls on that, people trying to — investment bankers — trying to place billions of dollars with us on something, on those two institutions. And you just could take one look at them and you could tell they were in big, big trouble.

You do have to know a little bit about — you have to know something about banking and what's going on in the various kinds of lending and everything.

And I would say that generally speaking, for people that don't spend a lot of time on their investments, they're going to have trouble separating financial institutions.

I think it's much easier to come to a conclusion on something like Coca-Cola or Procter & Gamble than it is for a person who is spending only a limited amount of time on investing to make a decision on whether to own bank A, or bank B, or bank C.

Charlie?

CHARLIE MUNGER: Yeah, there's another problem. Generally accepted accounting principles allow a conservative, sensible bank to show vastly increased earnings if it changes its practices to make a lot of extremely dumb loans in large volumes.

Generally accepted accounting principles should not be constructed to allow this result. It's — that what seduces so many of these bankers into this ghastly decision-making.

WARREN BUFFETT: Yeah, when we bought Gen Re, they had a financial products division. It was named similarly to the AIG one. It was called Gen Re Financial Products — AIG Financial Products.

And it produced numbers regularly that were always satisfactory numbers. But, you know, when we looked at that, you know, it looked like all kinds of trouble to us.

It cost us over 400 million to get out of. And a black box like that can produce — that's why managements love them to some degree, they can produce numbers.

They don’t necessarily produce cash. And they sure as hell can produce all kinds of problems if you have to start posting collateral and doing things of that sort.

And I would say it is tough for, you might say, the passive investor, the one who’s not spending very much time on it. I would say it’s difficult for them to discern when that’s going on.

So I — it’s not a bad area to just say, “This one’s too tough,” and go onto something else that’s a lot easier.

I think you can analyze a utility operation easier or, you know, some premier consumer company or something of the sort.

I don’t think I would look for the tough situations to differentiate tough industries in which to differentiate things.

But there are huge differentiations. And again, I urge to read the JP Morgan Chase — Jamie Dimon’s letter. Because you’ll learn a lot by reading that.

CHARLIE MUNGER: But a lot of the new regulation that is coming wouldn’t have even been needed if accounting had done a better job, particularly in banking.

And yet, I have yet to meet an accountant from any of the big firms who has said, “I’m ashamed of my own profession.”

That’s a mistake in accounting. If they don’t have shame, they’re not thinking right.

WARREN BUFFETT: Well, with that happy thought, we will — (laughter) — we will go to lunch now.

We’ll reconvene about — let’s reconvene about a quarter of one. We’ll start at that time with Andrew and move onto section 2 when we come back.

Afternoon Session - 2009 Meeting

1. Quarterly earnings release schedule

WARREN BUFFETT: OK, let's get back to work.

I should mention one thing, because it's appeared in the press recently — a bit.

We will — our goal is to issue every quarterly report on the last Friday — after the close — prior to the expiration of the 40-day period after the end of a quarter that we have for reporting to the SEC.

The SEC says 40 business days — or 40 calendar days — unless it ends on a weekend. Forty calendar days after the end of the quarter — that you have to file." If it comes on a weekend, then it's the Monday following that.

That usually means — because we hold the meeting, usually, on the first Saturday in May — it usually means that the last Friday possible will be the day before the annual meeting.

This year, because the meeting is early on a calendar basis, because of Saturday falling on May 2nd, the last Friday will fall on May 8th. And that — our policy —

We like to get it out on a Friday afternoon, if possible, because we want people to have the whole weekend to read it before the market opens. It takes time to — I think it takes time, anyway — to digest the report.

And we'd like — we don't want some headline to determine market prices. We want, as much as possible, a thorough reading of the report.

So we will always, unless something comes up, makes it unfeasible, we will issue our quarterly reports on the last Friday before the expiration of the 40-day period. And that's what we'll do this quarter. And so we have not changed anything.

2. Preliminary Q1 earnings

WARREN BUFFETT: I can tell you some preliminary figures, which then we have to file an 8-K on, because then the information I give you has to be in the public domain before the market opens.

But our — what I call our operating earnings, which would be the earnings before any gains or losses from securities or derivatives or any other transactions of that sort, the operating earnings will be about, after-tax, about 1.7 billion against 1.9 billion last year.

And — as I told you, we're lucky to be — in this particular period — we're lucky to be in the insurance and utility business. They're relatively unaffected by the recession. Whereas most of our other businesses are anywhere from significantly to drastically affected by the recession.

We had an underwriting profit, in our insurance business. It was a little larger than last year.

Our float increased a couple of billion. That was primarily due to a transaction that was announced with Swiss Re, which occurred in March, in which they bought what's known as an "adverse loss development cover" — and gave us 2 billion Swiss francs for that.

Now, that's very, very long float. And the probability is that we will not pay out on that, probably, for at least 15 years and maybe quite a bit longer. So that's long-duration float. And that's what accounts for the 2 billion— roughly — $2 billion gain in float.

The utility business — earnings are reported down somewhat. But there were two items that account for that. One is that, on our Constellation Energy deal, which blew up last year, and we reported a significant gain on it, we got a bunch of Constellation stock.

And that is a mark-to-market and goes through our income account, every day, in theory, but certainly every quarter. And Constellation was down somewhat during the quarter. So that got charged against the utility earnings.

And then a larger item was a payment, and the final payment, in terms of options that were issued 10 years ago, which had the effect of increasing Berkshire's interest in MidAmerican, which we like.

But we wrote a check, a significant check, with MidAmerican to buy out the option. So — and that got recorded as an expense in the first quarter.

But the utility earnings are more than satisfactory with those two items in it.

Then when you get into all of our other businesses, with just a couple of exceptions — those businesses are basically down. I mean, they're all getting hit to varying degrees by the recession. So — that's basically the operating earnings story.

Our book value per share went down about 6 percent in the first quarter, which is a combination of security markets, and the fact that the credit default swaps, which — I'm the one responsible for writing them — that experience has turned worse, even since I wrote the annual report, in terms of bankruptcy.

So that loss — or potential loss — we're actually still funds ahead by a substantial margin — but that potential loss — and, I would say, expectable loss — is reflected in the first quarter figures. And of course, there's been some bounce-back since March 31st. But that's pretty much the story of the first quarter.

We ended the quarter with cash equivalence of about 22.7 billion, excluding any cash at the utility or at the finance company operation.

But we spent 3 billion of that the next day on a Dow Chemical preferred. So we actually ended, effectively, one day later, the quarter with a little less than 20 billion in cash.

We always keep a significant amount of cash at the parent company, not at the regulated subsidiaries, so that — whatever comes along, we're prepared for.

And that's pretty much the story of the first quarter. And I wouldn't be surprised — I mean, I guess I would almost be surprised if the opposite happened, if the world changed much — over the remainder of the year.

I think that we will continue, barring some huge natural catastrophe, we will do quite well on insurance. And we will do in the utility operation. And we won't do well in most of the other operations.

But we will have significant operating earnings, which I mentioned is about a billion-seven the first quarter.

If you look at our operating earnings, a billion, or a little more, that comes from MidAmerican — from our energy business, basically — we're going to leave in that business. I mean, there's all kinds of opportunities to do things even within our present subsidiaries. There's lots of projects that promise decent returns.

So you should not think of that billion or so as being available to us at the parent. It would be, if we wanted it to be. But as a practical matter, we're going to leave it all in.

The rest of the earnings are available to us in cash, plus or minus any change in the float, to do anything interesting that comes along.

So that's an abbreviated summation of the first quarter. We will put out the 10-Q next Friday after the close. And we'll continue to follow that policy.

3. "Value" investments? What other kind are there?

WARREN BUFFETT: With that, we'll go to Andrew.

ANDREW ROSS SORKIN: Excellent. This question actually just came across the BlackBerry before lunch from what I think is an audience member.

Josh Wolfe (PH) of New York writes the following: "BYD appears to be more like a venture capital speculative investment than a value investment. Would you both explain that investment, your logic behind it, and your expectations for it?"

WARREN BUFFETT: Yeah. I'm going to turn that over to Charlie in just one second. But Charlie and I think there is no other kind of investment than a value investment.

In other words, we don't know how anybody would invest in a non-value investment. So we've always been puzzled by the term, "value," and saying that contrasts with growth or anything.

Value relates to getting a lot for the expectable flow of cash in the future, in terms of what you're laying out today.

So we — we've always — every time somebody characterizes us as value investors, we always ask them, what other kind can there be?

4. Munger: Electric car maker BYD is a "damn miracle"

WARREN BUFFETT: But Charlie is our team leader here on BYD. And he gets very excited. So I may have to control him. But go to it, Charlie. (Laughter)

CHARLIE MUNGER: Yes, well, of course, BYD, although its founder is only 43 years old, is not some early-stage venture capital company.

BYD is one of the main manufacturers to the world of the rechargeable lithium battery. And it achieved that position from a standing start at zero under the leadership of the founder, Wang Chuanfu.

And — they went on into cell phone components and developed a huge position.

And then, finally, not satisfied with having worked a couple of miracles, Wang Chuanfu decided he would go into the automobile business.

As nearly as I can tell, it was zero experience in automobiles. And from a standing start at zero and with very little capital, he rapidly was able to create the best-selling single model in China.

And that's against competition that was Chinese joint ventures with all the major auto companies of the world, technological marvels with way more capital and so on.

This is not some unproven, highly speculative activity. What it is, is a damn miracle. And — (Laughter)

WARREN BUFFETT: I warned you. (Laughter)

CHARLIE MUNGER: And of course, Wang Chuanfu has hired 17,000 engineering graduates. And those engineering graduates are selected from a billion, 300 million people in China.

And he's hiring at the top of the classes. And — so you get a remarkable aggregation of human talent.

And then you've got the basic quality of the Chinese people. Which, when unfettered from the wrong kind of government — for instance, the wrong kind of emperor — the Chinese people succeed mightily.

When they came to this country as "coolies" — slaves — they would leave and soon be the most important people in the town.

So this is a very talented group of people. And, in a sense, this particular period may be Chinese — the Chinese day.

And of course, these batteries, these lithium batteries, are totally needed in the future of the world. We need them in every utility company in America. We need them in every utility company in the world.

And we have to use the direct power of the sun. And we can't do that without marvelous batteries. And he's in the — BYD is in the sweet spot on that stuff.

And I know it looks like a miracle. And it looks like Warren and I have gone crazy. But I don't think we have.

WARREN BUFFETT: Well, one of us, at most. (Laughter)

CHARLIE MUNGER: And that car you're going to see in the annex — I think they make everything in that car except the glass and the rubber. There may be a couple of small exceptions.

That's unheard of. Whoever went into the automobile business and made every part, and made the automobile a best-settle — best-selling — thing? This is not normal. I mean, this is very unusual.

And I regard it as a privilege to have Berkshire associated with a company that is trying to do so much that's so important for humanity, when you get right down to it. Because it may be a small company, but its ambitions are large.

And I don't want to bet against 17,000 Chinese engineers led by Wang Chuanfu, plus 100,000 more talented Chinese in a brand-new area — constructed the way they want it. I will be amazed, if great things don't happen here.

I don't think, given the size, it can be all that important to Berkshire, financially. But I have never, in my life, been more — felt more privileged to be associated with something than I feel about BYD.

WARREN BUFFETT: BYD was Charlie's last year. The Irish banks were mine. So he's — (laughter) — the winner.

BYD, incidentally, does $4 billion a year of business. I mean, so it is not a small business. And it will probably get a lot larger.

5. U.S. dollar will buy less in the future

WARREN BUFFETT: Let's go to the — area 2.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name's Dan Lewis (PH). I'm from Chicago.

My question has to do with the U.S. dollar versus other major currencies. You spoke a little bit already about the — government policy and its effect on inflation in the future.

And just by itself, you'd think inflation would hurt the dollar. But obviously, there's a lot of other factors at play. So I'm kind of interested in knowing your latest outlook on the dollar.

I know you've been bearish. But given everything that's been thrown up in the air in the last six months, how you think these various things will come together, trade deficit, budget deficits, and how it will affect the dollar?

WARREN BUFFETT: Yeah. It's pretty unpredictable. But the — I will guarantee you that the dollar will buy less, you know, five, 10, 20 years from now. And it may be — it may buy very, very substantially less.

But I don't know that, obviously. But we are doing things that will hurt the purchasing power of the dollar.

On the other hand, the same thing is happening in countries around the world. So it's very difficult to say whether the dollar versus the pound or the dollar versus the euro, et cetera — how that will behave.

Because, you know, the British will run a deficit this year of 12 and a fraction percent of GDP. And even the Germans, with their, you know, long-time fear of inflation, will probably run a deficit of 6 and a fraction percent of GDP.

So you've got governments around the world all electing to run — and I think properly so — electing to run very material deficits, in some cases, you know, close to unprecedented except in wartime — electing to do that in order to offset this contraction of demand by their citizenry.

And how that plays out in relative exchange rates, I can't tell you. How it will play out in terms of the value of their currencies' purchasing power in the future versus now, I think, is fairly easy to say, and that's that it's going to cause units of currency to buy a lot less over time.

That isn't going to happen in the next year or two. But that doesn't mean that markets won't start anticipating it at some point. And it's going to be a very, very interesting future.

I mean, we are doing things that we haven't seen in the past. And policymakers do not know the outcome of that. I don't know the outcome of it. You do know it will have consequences. And — you can bet on inflation.

Charlie?

CHARLIE MUNGER: Well — I was raised here in Omaha. And I well remember the two-cent first class stamp and the five-cent hamburger. And so, in my life, there's been a lot of inflation.

And in my life, I think I've had the most privileged era of all history in which to live. So a little inflation is not going to ruin the lives of any of us.

The trick is to avoid the runaway inflation. That is a problem Warren and I are going to quitclaim to the younger people. (Laughter)

WARREN BUFFETT: Here is a product, though. Six and a half ounces of this product, 100 years ago, cost a nickel plus a two-cent deposit. And it's hardly gone up in price at all. It's very interesting. And wheat hasn't gone up that much or oats or things of that sort.

And on the other hand, a newspaper that cost a penny 100 years ago costs a dollar now and they lose money turning it out. So it gets very uneven, in terms of its impact.

6. Buffett "irritated" by the loss of triple-A rating

WARREN BUFFETT: Carol?

CAROL LOOMIS: Warren, Charlie — this question, I got a good many of these. This one comes from — who does it come from? Well, it comes from Mr. Kempton (PH) — Kempton Lam or Lam Kempton (PH) — one of the two — from Calgary, Canada.

And the question is, "How would you quantify the financial impact and damage of Berkshire losing its triple-A credit rating — which increased the cost of capital of Berkshire, which was surely a competitive advantage for the company?

"And Warren, what are you doing actively to try to restore Berkshire's triple-A rating? Do you think that Berkshire will be able to regain it?"

WARREN BUFFETT: Well, it won't regain it soon, because I don't think rating agencies will turn around like that, even if they should. We have a triple-A from Standard & Poor's, but it's provisional. And they're going to look at it in about — I think they said about 12 months.

Moody's affirmed the rating early in January. Then we issued a bond at one point, where it was — well, that was right after the rating changed.

And actually, in terms of our credit default swaps, which is a metric you can use for credit acceptance — although, I'll tell you, in a second, an interesting aspect of that — that spread came down, actually.

It makes very, very little difference in our borrowing costs. I mean, very little. And it never has, incidentally. I mean, double-As versus triple-As, the spread has always been very small.

And people would argue, in finance classes and all that, it wasn't worth paying the price to have a triple-A because you didn't save that much on debt. And it costs you, in terms of return on equity.

I never subscribed to that. And I very much liked having a triple-A from both Moody's and Standard & Poor's. I was disappointed when Moody's downgraded us. We didn't really think that was going to happen, but it did.

And — it doesn't have any material effect on borrowing costs. It does cause us to lose some bragging rights around the world in terms of our insurance promise, although nobody ranks ahead of us, that's for sure.

But, it will not change back in a hurry. I mean, people don't make decisions in committees that they reverse very quickly. It's just not human nature.

We're still a triple-A in my mind. And actually, we're a triple-A in Standard & Poor's' mind, till we hear something differently.

We certainly think, and we run it in a way, that there can be no stronger credit than Berkshire.

It's difficult for a rating agency, if they have a checkbox system of ratios and such, to measure something like the attitude of management toward creditors.

But I will assure you that Berkshire has a management that regards meeting its obligations as sacred and a lot more important than increasing earnings per share or anything of the sort.

I mean, we have obligations to people in something like workers' compensation that go 50 years out in the future. I mean, this is somebody that's been injured severely and they get a check every month from Berkshire.

And you know, that's a lot more important than whether we earn X, or X plus a tenth, or a couple of tenths, percent on equity. And we conduct ourselves, or we try to — certainly try to conduct ourselves — so that not only will people get those checks, but they'll never have to even worry about getting those checks.

And that's very difficult for a rating agency to quantify that attitude on the part of the management of Berkshire. But believe me, it exists.

And — I would say that the triple-A change at Moody's is not going to be material in the future of Berkshire. But it still irritates me.

Charlie? (Laughs)

CHARLIE MUNGER: Well, at least they showed a considerable independence. (Laughter)

WARREN BUFFETT: Who knows? That may have entered into it, too.

CHARLIE MUNGER: Yeah. My attitude is quite philosophical. I think the next change at Moody's will be in the opposite direction. And I think that will happen because we deserve a higher rating and they're smart. (Laughter)

WARREN BUFFETT: When Charlie and I disagree, and we do disagree a lot. We never argue, but we disagree.

And Charlie, when he gets to the point where he really wants me to do something, like buy the BYD interest or something, he always says to me, "Well," he says, "in the end, you'll see it my way. Because you're smart, and I'm right." (Laughter)

7. "Crazy" prices for Berkshire credit default swaps

WARREN BUFFETT: I will — I can't resist pointing out one item that is, maybe, a little technical to most of you. But there are some people here who will find it quite interesting. And it actually even enters into credit ratings to a great extent, the credit default swaps enter into it.

When we write a, let's take an equity put option, and we get paid for writing a billion dollar put, somebody pays us $150 million, we get the $150 million of cash that day.

And we set up a liability for 150 million the first day, for the value or the — that we — our appraisal of what it's going to cost us to meet that obligation. I mean, that's the market price for it.

The other guy takes 150 million out of his cash and sets up a $150 million receivable that day.

Now, these receivables and payables change over time. But the first day, no profit, no loss, just cash changing hands. One guy sets up an asset, the other guy — we set up a liability.

Now, as the world has developed in the last couple of years, the value of that asset to the other fellow has increased in a mark-to-market basis.

And he reports that through earnings. So his asset goes up. Our liability goes up. And we report that through earnings as a loss.

But we've got the cash and he's got an asset from us that comes due in 15 years or something like that.

And in the last couple of years, the — his auditors — his credit department — has said, "Gee, you've got a receivable from Berkshire that comes due in 15 years. And, they don't have to post collateral. So you have to go out and buy a credit default swap to protect yourself against that receivable going bad."

Now, that has two effects. A, he's laying out money every year to buy something that doesn't cost us anything but costs him real money. So the — and the more he shows us a profit, the more of the credit insurance he has to buy, so the more money it costs him every year.

And that has driven up the demand for credit default swaps at Berkshire, which made for some crazy prices. So at one point, our credit default swaps were costing that guy five percent a year.

So if he was showing, say, a $200 million asset, he was laying out $10 a year, and he was going to have to lay it out for 15 years, just because of these — this credit department's requirements.

And it made it very unpleasant for the people on the other side of our transactions, even though they keep writing up the profits. It doesn't cost us anything. But it does result in kind of a crazy market in the credit default swaps.

I realize that that has not been a burning issue with many of you. But it is an unusual — it's something I didn't anticipate.

And it explains why, to some extent, people may want to modify their contracts with us. And if they — with us — and if they want to modify them enough, we'll answer the phone. But in the meantime, we're sitting with the money. (Laughter)

8. MidAmerican working with Iowa on wind farms

WARREN BUFFETT: Let's go to area 3.

AUDIENCE MEMBER: Jim Hadden (PH), a Cornhusker in Davenport, Iowa.

On our drive over from Davenport, we noticed two rather large wind farms by MidAmerica Energy.

And my question is, when will be the return on investment of these wind farms? And are Berkshire Hathaway looking at any other alternative energies?

WARREN BUFFETT: Yeah, we're the largest, in terms of owned capacity in wind, in the country, I believe, of any utility. And Iowa has the greatest percentage of its electricity generated by wind.

But of course, the wind only blows about 35 percent of the time in Iowa, something like that. And we've got people here who can be more accurate than that. But — so you can't count on it for your base load or anything of the sort.

But Iowa has been very, very receptive and, I would argue, progressive, in encouraging us — and we've encouraged them, in return — to bring in a lot of wind capacity.

We are a net exporter of electricity in Iowa. Iowa's far more than self-sufficient in our service area in terms of electric generation. And I think that works to the benefit of the people of Iowa.

And we have an arrangement with Iowa. We — as you may know, we have not increased our rates at all — what — for more than a decade now. And that's been achieved by efficiencies. It's been achieved with wind generation.

We have a return that's built in on that that's fair to us, fair to the people of Iowa. And part of that return comes in the form of a tax credit — I think it's 1.8 cents per kilowatt hour — that is given to anybody in the United States that develops wind power generation.

We love the idea of putting in more wind. And we're doing it. We're doing it out at PacifiCorp. And I think we'll continue to be a leader in it.

One advantage we have over, perhaps, some people is that we are a big taxpayer, so that we don't have to worry about whether the tax credits are useful.

I guess the tax credit could be sold, also. But we don't need to do that in our particular situation. So you'll see more and more wind generation by the MidAmerican companies.

When we went into PacifiCorp out on the West Coast, to six states out there, they had virtually nothing — maybe nothing at all — in wind generation. And we've developed a lot. And we've got more coming on.

Charlie?

CHARLIE MUNGER: Oh, I think in practically anything that makes sense in utilities, the Berkshire subsidiaries will be leaders. I think we can all be very proud of MidAmerican and its two leaders.

9. Constellation and Dynergy deals

WARREN BUFFETT: Yeah, we're enormously proud of MidAmerican. And we will do a lot more in utilities over time. Constellation didn't work out. I wish it had. But we were back there — Constellation, we learned of their troubles on a Tuesday at noon. I mean, we saw it in the stock price and so on.

Dave Sokol and Greg Abel were in Baltimore that evening with a firm, all-cash bid to solve Constellation's problems. And Constellation was likely to get downgraded within 48 hours, maybe 24 hours.

And they would've had posting requirements in connection with various derivative transactions that they probably would not have met. I mean, they were facing bankruptcy.

And we literally went from a phone call that Dave made to me at noon or 1 o'clock to handing them a firm bid that evening in Baltimore. And that's one of the advantages of Berkshire. That is — I think that's a durable competitive advantage.

I think there are very few organizations that will act in that manner and that — where you have the talent there that you feel is — as a CEO — you can back them up with that kind of money without worrying about it.

So it's — that is a plus — for Berkshire, even though it didn't work out in that case. We will do more in the utility business.

CHARLIE MUNGER: Well, you bought a pipeline, didn't you, in about two hours?

WARREN BUFFETT: Yeah, we did buy a pipeline, and it's turned out very well.

And, in that particular case, the company, Dynegy, that — this was back in 2002 or so — the company needed the money enormously. They had gotten the pipeline from Enron. It was a very complicated transaction.

But they needed the money. And we needed the Federal Trade Commission approval, the FTC approval, on the deal, as would anybody that was buying it.

And we literally wrote a letter. I wrote a letter to the commission. And I said, you know, "These guys need the money. They need it before the 30-day period is up. And let us go through with this early. And we'll do any damn thing you tell us, subsequently."

And Berkshire can make that kind of a transaction. We don't ask the lawyers before we do it or anything. We just do it.

And that is an advantage. And it was an advantage to Dynegy. It got them through a period that they would've — I'm not sure they would've gotten through otherwise. So, we can move fast when the time comes.

But the — one of the reasons we — there's a couple of reasons we move fast. A, we've always got the money. You know, but — and we've got a mental attitude toward that.

But we also know we've got the managers that can deliver on the properties, once we own them. And that's a huge, huge advantage. Back —

(BREAK IN RECORDING)

10. Foreign ownership rules limit China opportunities

WARREN BUFFETT (IN PROGRESS): — China. We would be restricted by that ownership limitation.

But it's very hard to imagine that we won't find more things to do in China over time. I mean, it's a huge market. We do a lot of things. And some of those are exportable.

And there will also, perhaps, be opportunities to buy more businesses there. We would've bought more than 10 percent of BYD, if we could've. But, that's all that they wished to sell us. So we hope that comes about.

11. U.S. trade deficit is actually China's problem

WARREN BUFFETT: In terms of the Chinese dollar holdings, you know, in a way, they can't get rid of owning more dollar assets. I mean, the nature of it is, if we're going to run a, as we did a few years ago, or a year or two ago —

If we're going to run a $250 billion trade deficit with China, I mean, if they're going to send us goods — and we want those goods — to the tune of $250 billion more than we sell to them, they end up with $250 billion of little pieces of paper.

And they can convert those pieces of paper, called U.S. dollars, they can convert them into — U.S. real estate, into U.S. stocks, U.S. government bonds. They can do all kinds of things.

They can even trade them to the French, you know, and get euros or something in exchange. But then the French have the problem.

So the — Chinese dollar assets are going to build as long as there's a significant trade surplus with China. And then they have the choice of what to put those dollars into. And they have elected, so far, to put a significant amount — into U.S. government bonds.

And — I think — a major official, about a month ago or so in China, said he wasn't too happy about the prospect of what's going to happen in terms of the purchasing power of that money that's been put in U.S. government bonds. And I would say he's right.

I mean, he — it — he — anybody that owns dollar obligations outside of this country is, if they hold them a long time, is going to get less back in the way of purchasing power than existed at the time that they took on those dollar obligations.

And it's a major problem, not the world's worst problem, but it's a major problem for a finance minister or a government in China to decide what to do with this buildup that comes about, because they are running a trade surplus.

And — they've set up the Chinese Investment Corp, which has a couple hundred billion dollars in it — in terms of deciding to make investments around the world, but —

12. Munger: China's economic policies are "exactly right"

WARREN BUFFETT: It's an interesting question, if you made me the finance minister of China, what I would do with the trade surplus, the funds that came in because of the trade surplus.

And I think it'll take it over to Charlie and ask him what he would do, if he were the finance minister of China.

CHARLIE MUNGER: Well, I (Inaudible) that is a very easy question. I would do exactly what they're doing.

I think China has one of the most successful economic policies in the world. And China has advanced more rapidly than the rest of the world. And, I would say their policies are exactly right.

And their rate of advance is so great and so meaningful that if they lost a little bit of purchasing power on their dollar holdings, it's a trifle in the big scheme of things from the viewpoint of China.

So I've got nothing but admiration for the way the Chinese have been running their own affairs. And they're going to be very hard to compete with all over the world. And that is exactly the correct policy for China. That's the way you get ahead fast is to be very hard to compete with all over the world.

So I think they're doing it exactly right. And I think that the United States and China should be very friendly nations. Because we're joined at the hip.

WARREN BUFFETT: So you'd suggest they keep buying U.S. Treasurys at —

CHARLIE MUNGER: You bet.

WARREN BUFFETT: — practically no yield?

CHARLIE MUNGER: Whatever the yield. They're not no-yield. Because they can buy longer.

WARREN BUFFETT: OK, we've got some advice for the Chinese government. (Laughter)

13. Deal post-mortems shouldn't be public

WARREN BUFFETT: Carol?

CAROL LOOMIS: "In the past, you have stated that management should —"

This question comes from Ingrid Hendershot.

"In the past, you have stated that management should be required, after several years, to do a post-mortem on acquisitions it makes. Would you each provide us with your post-mortem on Berkshire's largest acquisition, General Re?"

WARREN BUFFETT: Yeah, I don't think — I'll comment on General Re, but I don't think we generally should make our post-mortems public. I don't think — I think that, if we acquired —

We do believe in post-mortems. We strongly believe in them. We think they're conducted at far too few companies. It's easy to propose a deal and it's much harder to account for it later on.

And — Charlie is a big fan of rubbing anybody's nose in their own problems.

And it absolutely should be done. I don't think it necessarily should be made public.

I don't think that you attract businesses by — and managers — by pointing out — even though you are the one that made the mistake, as the acquirer, in your projections — pointing out the shortfalls that may have occurred with the managers that are maybe doing a very good job to try and overcome the fact that you made a mistake in buying it in the first place. So I don't want to — I wouldn't want to get into that.

14. Buffett: I was "dead wrong" on Gen Re's reputation

WARREN BUFFETT: Gen Re has worked out well after a terrible, terrible start. And I was dead wrong, in 1998, when I bought it, in thinking that it was the Gen Re of 15 years earlier, which had absolutely the premier reputation in the insurance world.

And some practices, in terms of reserving and underwriting, had changed somewhat. But I'm happy to say that, thanks to the combined work of Tad Montross, who is with us here today, and Joe, that the —

CHARLIE MUNGER: That's Joe Brandon.

WARREN BUFFETT: Yeah, Joe Brandon, of course. But Joe and Tad, when they took over in, what, September of 2001, actually — right about the time of the World Trade Center problem — they took after all of the problems. They went right after them, reserving, underwriting, whatever it might be.

And Gen Re is the company now that I thought it was when I purchased it in 1998.

So we're proud of them. It was a very tough job. It wasn't one that was going to get done by itself. And that, to some extent, when you tighten up on an organization that has fallen into some lax ways, it can — you know, that is not an easy job.

Both of them, or each of them, they could've left for some other place and made just as much money, maybe more money, not had to face the problems that they faced at Gen Re. But they hung in there. And now we have an organization that we feel terrific about and has a great future.

Charlie?

CHARLIE MUNGER: Well, I think that's right. And — but it's very important that you have an ability to turn your lemons into lemonade.

And we were very, very lucky to have Joe and Tad to help us in the process. It wasn't pleasant. And it wasn't pretty. And it was very successful.

And it wasn't something that ordinary managers would've been at all likely to do. You had to be very tough minded to fix General Re. And they really did fix it.

WARREN BUFFETT: When we do the post-mortems, we, in a sense, are looking at our own handiwork. I mean, we make the decisions.

You know, it's not some strategy department someplace, or vice president in charge of acquisitions, or some management consultant that comes in and tells us we ought to buy this or that. We're looking at our decisions.

And that's very important. And we talk about that. And we've made some dumb decisions. And most of them have been mine. Because I'm the guy that's sitting in Omaha, making most of the decisions.

But it would really be a mistake to discuss, in public, my dumb decisions, which might reflect, you know, on some of the managers in some of the arenas. So we will not disclose those. But we will tell you that there are dumb decisions made around Berkshire.

CHARLIE MUNGER: The really brilliant decision in the General Re transaction was made by Joe Brandon. He was the one who decided that Berkshire should buy General Re. And he caused the transaction. And it wouldn't have happened, I think, if he hadn't been there. Would you agree with that?

WARREN BUFFETT: Yeah, that's true.

CHARLIE MUNGER: And Joe was the steward for the General Re shareholders. We got a decent result, and they got a fabulous result. So if capitalism has any heroes in that transaction, why, Joe's the hero.

15. "We are not big believers in contracts"

WARREN BUFFETT: OK, let's go to number 6.

AUDIENCE MEMBER: Yes, sir. Mr. Buffett, Mr. Munger, I'm Chuck Hosmer (PH) from California.

And you mentioned earlier the union cooperation at the Buffalo newspapers. Without the introduction of unions, how do you view contracts for other employees of BRK subsidiaries?

WARREN BUFFETT: I'm just trying to think whether we have any real contracts.

CHARLIE MUNGER: I hope not.

WARREN BUFFETT: Yeah, we are not big believers in contracts. We hand people hundreds of millions or billions of dollars, in some cases, to sell us their business.

And the decision we have to make is, are they going to have the same passion for the business after they hand us the stock certificate and we hand them the money? Are they going to have the same passion that they had beforehand?

And if we're wrong on that, no contract is going to save us.

We don't want relationships that are based on contracts. So — I can't — you know, I'm — I can't really think of a formal contract that we have.

We have understandings about bonus arrangements and that sort of thing — and that's not that complicated — with various managers.

I mean, we have — the comp of the top person at each company is basically my responsibility. And we have all kinds of different arrangements, because we have all kinds of different businesses.

Some of our businesses, capital's an important factor. So you have to put that in the comp arrangement. Some of it, capital doesn't mean a thing. Some of our businesses are very easy and very profitable. Some of them are very tough. And it takes a genius to, you know, to get a so-so result.

So we have a whole bunch of different arrangements on that. But we don't try to hold people by contracts. And it wouldn't work. And we basically don't like engaging in them. So you're looking at a company that — can you think of any contracts we have, Charlie?

CHARLIE MUNGER: No. Our model is a seamless web of trust that's deserved on both sides. That's what we're aiming for. The Hollywood model, where everyone has a contract, and no trust is deserved on either side, is not what we want at all.

WARREN BUFFETT: Yeah, we don't — we do not want to negotiate the size of the executive bathroom. I mean, that is not our game.

16. How to get yourself thrown out of Buffett's office

WARREN BUFFETT: Becky?

BECKY QUICK: This is a question from Edward Donahue (PH) from Belmont, Massachusetts.

"In the spirit of raising partnership value in these times, has Warren given any thought to spinning off as separate companies?

"My thinking is that some of these companies would sell at higher multiples to book value that Berkshire currently does. Further, where appropriate, consolidate companies with similar industries with the wish to save on management costs, administration, and even potential selling costs."

WARREN BUFFETT: Yeah, we will not be spinning off any companies. We had to — we were a bank holding company, believe it or not, at one time. We became one in 1969. Then we were given 10 years to dispose of our bank, which was in Rockford, Illinois, and we did have a, in effect, a spinoff of that.

But, we — if somebody comes around us and says, "Gee, you can — you've got a multiple of X, and you can have a multiple of 1 1/2 times X for this subsidiary, if you spin it off," you know, we can't wait to throw them out of the office. I mean, it just doesn't interest us.

We are not looking for something that gives a, you know, a one-month jump or something like that in market value. If we've got a wonderful business, we want to continue it within Berkshire.

We've got this ability within Berkshire, which is a real asset, in terms of moving money around into various opportunities without tax consequences. I mean, they're part of a consolidated return.

So if a See's Candy is a wonderful business, which it is, but it generates a lot of capital that can't be used effectively in that business, we can move it to some other business or buy other businesses with it.

And we have a real advantage in allocation of capital that a shareholder, basically, can't do as tax efficiently as we can do it within the company.

Plus, when we buy businesses from people, we make them a promise. You know, they can read our economic principles in the back of the annual report. And they know that we're buying for keeps.

You know, it is a marriage that's going to last. And we're not going to, because we can get a higher multiple or something for a temporary period of time, spin something off.

On top of it, that — there would be those other costs. But that's not the determining factor. It's the basic principle at Berkshire that we buy to keep. And people can trust us to keep our word on that.

Charlie?

CHARLIE MUNGER: Yeah, the — so many of those spinoffs, because your market cap will be a little higher, Wall Street sells that stuff, so they can get fees.

It isn't really doing that much for anybody, in the ordinary case.

I suppose the one exception that could happen, if the regulation was crazy enough, you know, you can imagine something that might cause Berkshire to go to two parts. But short of something like that, you're looking at what you're going to get.

WARREN BUFFETT: Yeah, if it was actually hurting some operation that — because regulation was focused in that, and that tied the hands of other companies in the Berkshire group, you know, we'd have to look at that.

But, as Charlie said, we have listened to presentation after presentation, over a lot of years, about — by investment bankers, you know, basically saying, you know, "If you just do this wonderful thing," you know, all these — that the market will love you.

And — it — how much is conscious, and how much is subconscious, we'll never know. But the one thing we do know is there's always a fee that accompanies it.

17. Don't know much about student loan business

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: Good afternoon. Mike Nolan from Montclair, New Jersey.

Until recently, the student loan business in the United States has been a very attractive and successful one. However, proposed changes coming out of Washington have thrown the industry into disarray.

Could you comment on the industry, which is highly reliant on both faith, trust, as well as financing, and talk a little bit about the companies in this business?

WARREN BUFFETT: Yeah, I don't know that much about it. Maybe Charlie does.

CHARLIE MUNGER: No, I don't know this much about it, either. There's been a fair amount of scandal, in terms of the sales methods. Some of the companies in the field got awfully cozy with some of the university administrators and so on.

WARREN BUFFETT: It's been a long time since Charlie and I thought about getting a student loan. So we — (laughter) — haven't checked the regulations too carefully on that one.

CHARLIE MUNGER: But, you know, we don't know a lot about it.

WARREN BUFFETT: Yeah. (Laughter)

I actually got approached, I guess it was about a year ago or a year and a half ago, on the deal that fell through, on Sallie Mae.

And I said, at the time, to the fellow that called me, I didn't understand it that well. And it turned out to be a good thing I didn't.

18. Earnings "management" at Goldman Sachs and General Electric

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: OK, this question comes from John McDonald (PH).

And he asks, "Warren, in your General Electric and Goldman Sachs investments, do you think you've picked attractive businesses or simply attractive securities?

"Ben Graham's 'Security Analysis' suggests that the most frightening things an executive management can do is manage earnings, which it could be argued both of these firms do. What is your reaction to that?"

WARREN BUFFETT: Well, I can say that I could argue that a very substantial percentage of American industry over the last 15 years, at one time or another, has managed earnings. And I've witnessed it and argued against it and gotten no place.

So, I don't regard that as a malady that's limited in its experience. I don't know anything. I would not get into the specifics of those companies.

I felt good about those companies, in terms of the quality of the businesses they had and the quality of the management. But it was the terms, primarily, that caused us to make those deals.

I mean, those were made in a period when markets were in chaos and you should've gotten very good terms for committing money then.

Very people were either willing, or in some — many — most — cases, able to commit major sums on short notice. And it took good terms in order for us to do it. It —

And like I say, I'm not sure there was any second possibility in those cases. It was a really extraordinary period.

We were happy to do it. I feel good about the deals, obviously, because we got a very good coupon. But considering the circumstances under which the deals were made, I don't think there was an alternative.

So if they wanted 5 billion and 3 billion, respectively, on those deals, I think we were the low bid, in effect. But I also think we made very decent deals.

And you know, could we have done something better with the money at that time? I don't — as I measured at that time, I could not find anything that I liked better. It was the terms of the deals overwhelmingly, although we obviously liked the businesses.

I know the managers, the CEOs, of both companies very well. And I think they are terrific people. I think they're smart people.

And I think they're very — they've been very straight with us, straight with us long before we made a deal with them. So we're very happy with those deals.

Charlie?

19. "Very happy relationship" with Goldman Sachs

CHARLIE MUNGER: Yeah, you know, there's been a lot of criticism of investment banking in this arena, starting with that movie. But Berkshire itself has had marvelous services from all of its investment bankers, which is interesting.

WARREN BUFFETT: Think of what we'd be saying, if we'd been mistreated. (Laughs)

We've done a lot of business with Goldman Sachs over the years. And my experience goes back to when I was 10 years old and met Sidney Weinberg, who was running the firm and was a legendary Wall Street — well, he was "Mr. Wall Street" for a long, long time.

And I was a friend of Gus Levy's. And Gus Levy also did some really nice things for us, including when we had a little nothing company, called Diversified Retailing, which Charlie and I and Sandy Gottesman jointly formed.

Gus came in on an underwriting of a $6 million issue brought by New York Securities, which he wouldn't have dreamt of coming in, you know, for — in that kind of a deal, under most circumstances. And he had Goldman Sachs join in at that time.

So there have been a lot of things that have made for a very happy relationship with Goldman Sachs. I feel good about them.

And of course, we do lots of business with General Electric. We've bought I don't know how many of those wind turbines from them.

But GE — you know, is a very, very important American institution. We'll do — we'll sell them a lot of things. We'll buy a lot of things from them. And we'll make money on our investment. So that keeps me happy.

20. Buffett optimistic on America's standard of living

WARREN BUFFETT: Area 8.

AUDIENCE MEMBER: Hello. Mark Hoffman (PH) from San Diego, California. Just want to thank you for all your wisdom and advice over the years.

Also like to thank the boys at — the Blumkins — the Furniture Mart. They gave us a great tour the other day. I'm from an organization called Eel (PH). And they really showed us the culture at Berkshire and what you guys do.

My question is, looking at the overall world economy, the Berkshire businesses are great. But my question is, is there underlying issues you see in the world economy, like going off the gold standard 40 years ago and fiat currency in countries making money like crazy?

If the Berkshire businesses are great, but the underlying economy is a problem, where do we go from there? What are the questions you're asking yourself about the world economy? Thanks.

WARREN BUFFETT: Yeah, there's always a lot of things wrong with the world. Unfortunately, it's the only world we've got. I mean, so we live with it, and we deal with it.

But the beauty of it is this system works very well. I don't have the faintest idea what's going to happen in business or markets in the next year or two years.

But the one thing I know is that, over time, people will live better and better in this country. We have a system that works. It unleashes human potential.

I was just thinking, we have, today, about 35,000 people here. That was almost 1 percent of the population of the United States in the first census in 1790. Just 100 groups like this, and you were talking the whole country.

If you look at the — if we had had this room filled, back in 1790, with 35,000 citizens of the United States then, they would've been just as smart as we were, natively, their intelligence.

They would've lived in a country with resources that, obviously, same fertile soil, the same temperature, the same minerals, all of that. So they were just as able as we are.

But they weren't turning out anything like we turn out today. I mean, just look at how we live compared to those people several hundred years ago.

So we have had a system that works. It unleashes human potential. And China went, for a long time, without a system that unleashed potential. Now they've got a system that's unleashing human potential.

We haven't reached the end of that road, by a long shot. I mean, we're just starting, basically. We will have bad years in capitalism. I mean, it overshoots in markets. It gets overcome by fear and greed and all of that sort of thing.

But if you look at the 19th century, you know, we had a civil war. And we had 15 years or so of bad economic times spread out through that century. We had six panics, as they called them in those days.

And the 20th century had a couple of great wars. And we had plenty of recessions. And we had the Great Depression. So we have these interruptions in the progress of our society.

But overall, we move ahead. And we not only move ahead, we move ahead at a pretty damn rapid rate, when you think about it.

I mean, when, in the 20th century, we had a 7-for-1 improvement in living. And we did that. You know, we had slavery for a long time. We had blacks counted as three-fifths of a person. We didn't let women vote for 130 years or thereabouts.

I mean, we have — we were wasting human potential. And we still are. But we were doing it more so for centuries. But we do keep moving forward in kind of fits and starts.

And right now, we're sputtering somewhat, in terms of the economy. But there is no question, in my mind, that there is enormous human potential and that every period, every year we will meet, you can name a bunch of problems.

I mean, it will happen. But the opportunities will win in the end. And you know, your kids will live better than you live. And your grandchildren will live better.

And we will find more and more ways to find easier and better ways to do things that we haven't even dreamt of yet.

Charlie?

21. Munger optimistic about solar energy

CHARLIE MUNGER: Well, now that I'm so close to the age of death, I find myself getting more cheerful about the economic future — (laughter) — which I'm not going to be here to enjoy.

And what I find really cheerful is that we are plainly going to harness the direct energy of the sun. And we're going to have electrical power all over the world.

And that's going to enable overpopulated countries to turn seawater into fresh. And it's going to eliminate a lot of the environmental problems and preserve more of the hydrocarbon resources for future needs in — as chemical feedstocks.

What I see is a final breakthrough that solves the main technical problem of man. And you can see it coming right over the horizon. And of course, MidAmerican and BYD will be participating in it.

So, I think it's hugely a mistake to think only about your probable misfortunes. You should also think about what's good about your situation.

And what's good about our situation now is the main technical problem of mankind is about to be fixed. It's the — if you have enough energy, you can solve a lot of your other problems.

WARREN BUFFETT: He is getting more optimistic as he gets older. (Laughter)

22. Not concerned about Swiss Re reinsurance deal

WARREN BUFFETT: Carol?

CAROL LOOMIS: This is a question about Berkshire's investment in Swiss Re. "Given that you have no control over Swiss Re's underwriting, how can you be comfortable with 2.6 billion invested in a relatively junior security in addition to the relatively sizeable common stock position you already have?

"Did the Gen Re acquisition's problems over the first several years you owned it not make you wary of the potential landmines in reinsurance?

"And isn't Swiss Re even more likely to continue to make mistakes, given that you have no management control?

"Or has your insight into its underwriting culture, since you entered into the quota share agreement, increased your comfort level with the risks it is taking?

"You have said, in the past, that Berkshire's float is worth as much or more than equity. Would you say the same about Swiss Re's float?"

WARREN BUFFETT: About Swiss Re's what, now?

CAROL LOOMIS: Swiss Re's float.

WARREN BUFFETT: Oh. The — we have several arrangements with Swiss Re. One was engaged in a little over a year ago, where we take 20 percent of their property-casualty business, which is reinsurance business, primarily, over a five-year period.

Then we made a — and that started about a year ago. And then, a month or two ago — and at that time, we bought about 3 percent of Swiss Re's common.

Then, about a month ago, we invested 3 million — 3 billion — Swiss francs in a security which pays us 12 percent a year and which they can call, after two years, at 120 percent of its principal amount. And then if they haven't called it by the third year, it becomes convertible to 25 Swiss francs a share.

The odds are probably pretty good that it will get called. And if it gets called, we'll be unhappy, because they only reason they'll call is if it's advantageous for them to call it and disadvantageous to us.

But if it does get called, we will get 120 percent of par plus 12 percent a year for it.

We are senior, actually, to the Swiss re-equity of roughly 20 billion Swiss francs. So I would not regard it as a junior security.

Swiss Re's problems of the last year or so have not come about, in any way, through their insurance underwriting.

Their insurance underwriting has been fine over the years. And we feel fine about having a 20 percent quota share in that. And we feel fine about our investment. So, I would regard —

They develop a large amount — as many reinsurance companies do — they develop a large amount of float per dollar of premium volume.

So we would expect that this 20 percent quota share that we've had for a year will develop a very significant amount of float relative to the 3 billion or so of premiums that it represents.

And I think it will turn out to be attractive float. It will be attractive for us. And it'll even be a little more attractive for Swiss Re. Because in effect, they get — the commission we pay them gives them a little overwrite on that.

I think, like I say, that the most likely thing is that our $3 billion position gets called.

We also have that $2 billion or 2 billion Swiss franc. If I've said, "dollar," I meant Swiss franc. $2 billion — 2 billion Swiss franc — adverse loss cover.

And what that says, essentially, is that, if their reserves — we'll say, in the property-casualty business, at the end of 2008 — were roughly 60 billion francs — that once they've paid out — these are not precise figures — but once they've paid out 58 billion, 2 billion less than their carried reserves, that we pay the next 5 billion.

And like I say, it's very unlikely we would be paying out money before 15 years on that. And if their reserves are accurate, we will pay out only the 2 billion.

So that was a transaction, again, that was made at a time when Swiss Re was under considerable pressure. They were under threat of downgrade, in terms of ratings.

And, I met with the CEO — the then-CEO — of Swiss Re on a Sunday in Washington, D.C., along with his investment adviser. And we arranged a transaction, which their shareholders and their directors later approved. And I think we met their needs. And I think we've got an attractive transaction.

There's nothing wrong — you know, we may prefer Gen Re — but there's nothing wrong with Swiss Re's underwriting. It did not cause any of the problems that they have now.

That arose from something akin to the problems of AIG, although not remotely on the scale of AIG, but both in somewhat in financial products and somewhat on the asset side. It did not arise from underwriting.

Charlie?

CHARLIE MUNGER: Yes, and that's a terrible problem. We wish we had more of it. (Laughter)

23. Irrational CEO compensation and incentive systems

WARREN BUFFTT: Area 9, please.

AUDIENCE MEMBER: I'm Vishali (PH) from the Philippines. My question is about compensation in a capital-intensive subsidiary.

Now, I am going to take the liberty to assume that the large number of bank failures were caused, in large part, by incentive bias.

If a board of directors makes a mistake with compensation, then the board introduces incentive bias towards earnings manipulation.

So bearing in mind rule number one, which is, "don't lose money," and bearing in mind that it's OK to have losses in the short term if the moat is widened, then how do you develop a fair and intelligent compensation package for a manager of a subsidiary that requires a lot of capital?

WARREN BUFFETT: Well, you obviously — it's a very, very good question. It's one that Charlie and I have both thought about. And we've been around so many crazy compensation systems that we've spent a lot of time thinking about it and talking about it.

In a capital-intensive business, you have to have something that — you have to have a factor in the compensation arrangement that includes a capital cost element.

We have dozens and dozens of subsidiaries. And we have different arrangements for different businesses.

Because — as you point out —an arrangement for a business that needs no capital, like a See's Candy or a Business Wire or something of that sort, has to be materially different than something that requires a lot of capital.

We think we've got rational compensation systems. We agree with you that incentives are very important.

I would say that I think your question implied, a little bit, that the board sets these things. The truth of the matter is, at least over 40 years of experience and 19 boards that I've been on and observing behavior a lot of other places — basically, the board has had relatively little effect on it.

The CEO has managed, in most cases — in a great many cases — to be an important determinant of his own — or her own, usually his — own compensation arrangement. They, you know, they — the human relations — first of all, they pick the comp committee, you know.

So I have been on one comp committee out of 19 boards. I mean, people are not looking for Dobermans. They're looking for Cocker Spaniels. And then — (Laughter) and they're looking for Cocker Spaniels that are waving — wagging their table — tails, very friendly.

You know, you — CEOs spend a lot of time thinking about who's on their comp committee. The audit committee is less important. But the comp committee, they think about plenty.

And the comp committee meets every few months. And a human relations vice president comes in, who is responsible, directly, to the CEO and probably recommends a compensation consultant. And believe me, they don't go around looking for the ones that are going to upset the apple cart.

So it's been a system that the CEO has dominated.

And in my experience, boards have done very little in the way of really thinking through, as an owner or as owners' representatives, what the hell is the proper way to pay these people and how to incent them, not only to do the right thing, but also to incentivize them not to do the wrong thing.

Charlie and I are fairly familiar with a company here in town, the Peter Kiewit Organization. And Pete Kiewit, I don't know, 50 years ago or more, you know, figured out a very, very logical way to pay people in this business.

And it wasn't rocket science. And I'll guarantee he didn't consult with any compensation consultant on the subject. He just figured it out.

And you would be able to figure out one. I can figure out one. But you have to understand that not every CEO wants a rational compensation system, you know? Who wants rationality, when irrationality pays off more?

So it's a real problem getting people at the board level — I think the — I don't think there should be a comp committee. I think the board as a whole actually should thrash this sort of thing out.

So that you don't get some report from the comp committee, and that's treated as holy writ, because they've debated for a couple of hours the day before, supposedly, and then come in and give some recommendation, everybody rubber stamps it.

I think it ought to be a subject of general discussion. I think it's very important how you compensate the CEO.

I've said, in our annual reports, choosing the right CEO, making sure they don't overreach, and exercising independent judgement on major acquisitions or divestitures, if the board does that right, you can forget about all this other check the list — checklist stuff. And if they don't get that right, the other doesn't make much difference.

So I would say that it can be done. It's very difficult to have a system where somebody — where the board, thinking as owners or representing owners, care as much about it as the guy on the other side who's getting compensated.

I do think it's gotten better in recent years. But it started from a very low base.

Charlie?

CHARLIE MUNGER: Yeah, there are some counterintuitive conclusions in the field that are quite interesting.

I would argue that a liberally paid board of directors in a big American public corporation is — the liberal pay is counterproductive to good management of the company.

There's a sort of a reciprocation. You know, "You keep raising me, and I keep raising you." And it gets very club-like. And I think, by and large, the corporations of America would be managed better if the directors weren't paid at all.

WARREN BUFFETT: We're working toward that. (Applause)

Well, it is interesting. Because the SEC would define independent directors, you know, as — they would question, you know, my independence, if we would own billions and billions of dollars' worth of some security, but we would sell them some ice cream at Dairy Queen or something of the sort.

And the — to get real owners' representatives is very — and knowledgeable, because they've got to know business. They have to really have some business savvy.

And the truth is, if you get somebody that's getting $200,000 a year, $250,000 a year, for being director of a company, and they don't have that much income outside or net worth, and they would just love to get one more directorship for another $200,000, they are very unlikely to sit there and argue with the CEO and say that the system is rigged in favor of incentive compensation or something of the sort.

There is more baloney in the compensation arrangements —

And now, you have these 100-page proxy statements. If you take 100 pages to explain how you're paying the people of the place, something is wrong. I mean, you don't need 100 — we don't have 100-page, you know, understandings or anything of the sort.

But it's gotten to be more and more of a game as it's gone along.

And I would say that, as Charlie — that when compensation is a very important part of a director's wellbeing, you do not have an independent director.

And the funny thing is, the way it's — the system has been arranged, those are the very people that tend to be regarded as the independent directors, in most cases.

CHARLIE MUNGER: It's way worse than practically anybody recognizes. Elihu Root, who was the ultimate good Cabinet officer in the United States, used to have a saying that no man was fit to hold public office who wasn't perfectly willing to leave it at any time.

And of course, the minute he left public office, he went right back to being the leading lawyer of the world. So he didn't have much to lose by —

But the man who has a lot to lose from his office is going to be very loath to be an independent director.

So the way we do it, at Berkshire Hathaway, is one-tenth of 1 percent of America. And the way everybody else does it is silly. (Laughter)

WARREN BUFFETT: (Laughs) I love being up here with him.

24. Worst-case scenario for insurance operation

WARREN BUFFETT: Becky.

BECKY QUICK: This is a question from Paula Sauer (PH). And, since Charlie seems to be getting more optimistic, maybe we should ask him this question first. And then Warren, you can try and top it.

But Paula writes in, "What's the worst-case scenario you could imagine with respect to the insurance business?"

CHARLIE MUNGER: You mean ours or generally?

BECKY QUICK: I believe she means yours in particular.

CHARLIE MUNGER: Yeah. Well, the very worst case is some catastrophe where we lose quite a few billions of dollars pretax. Even that, I don't think, significantly impairs the basic business in place.

So I think we have a marvelous insurance business. I don't want to trade it for any other that I know. How about you, Warren?

WARREN BUFFETT: Yeah, no, it is a fabulous business.

The worst — I used to say we would probably play 4 percent to 5 percent of the industry loss — from any mega-catastrophe.

I'm not sure where Katrina finally came in. I don't know whether it was 60 billion or something in that area. And we probably did pay close to — we were in that 4 percent to 5 percent range.

We're lower than that, probably, right now, not necessarily way lower. But if we had $100 billion catastrophe, you know, we would probably pay 3 to 4 percent of that, currently, so that you'd be talking 3 to 4 billion.

You know, the worst — I think the worst situation that could occur is if we ran into so much inflation that people got very, very unhappy with anything that they had to buy in their daily life.

This applies in the utility business, too, but certainly like auto insurance, and in effect, that they express their outrage at inflationary increases and said, "Let's nationalize the whole thing." I mean, that would not — that would be a huge asset that would disappear, if that occurred.

I don't think that's a high probability. But if you're asking me to look at worst cases, that's probably the one I would come up with. I —

CHARLIE MUNGER: Well, that happened. Auto insurance was nationalized somewhere, New Zealand or somewhere.

WARREN BUFFETT: Oh sure.

CHARLIE MUNGER: But it's not — if you want the absolute worst cases, you found it.

WARREN BUFFETT: Yeah, we nationalized, to some extent, the annuity business, you know, when we went into Social Security. I think it was a good thing.

But when people get outraged enough about something, you've heard talk about the banks. I mean, when the public gets outraged, the politicians will respond.

And inflation would be — wild inflation — would be the most likely cause, it seems to me, if something like that — I don't think that's probable — but something like that happening in auto insurance.

It's a bill that most people pay, you know, every six months, or even more frequently than that. And if they see that bill going up and they don't want to get rid of their car, they're going to get mad.

And utility companies are going to get — utility customers — are going to get very mad during inflation. Because they need to turn on the lights. And they hate to see, you know, those monthly bills going up.

It's the — it's something they can't give up. And it's very visible. And the reaction will be to go to their public representatives and say, "Do something about this."

And one of the things they can do about it is take it over. So very low probability of that, but it's not nonexistent.

25. No preset goal for international investments

WARREN BUFFETT: Area 10?

AUDIENCE MEMBER: Gentlemen, Patrick O'Donoghue (PH) from Cork in Ireland. So I suppose I should start by saying I'm sorry you've had such a tough time in my otherwise wonderful little country.

WARREN BUFFETT: I love the Irish. We've got some — we've had great luck with the Irish. It was my mistake. (Laughs)

AUDIENCE MEMBER: OK. Now, I'd like to grow my investment in Berkshire Hathaway. And I think we've established it's a wonderful company.

So I'm left with a couple of other issues, which, for a foreigner, are maybe a little different for people domestically, the first of which is that any gains in Berkshire Hathaway may be wiped out by a slide in the dollar versus the euro. And we're talking a long-term investment here, obviously.

The second is, perhaps you could discuss the — your — global acquisitions, which will reduce your dollar dependence and increase your foreign-source income.

I've lost the third. If you could discuss those, please.

WARREN BUFFETT: Sure, yeah, and if it comes to you, that'll be fine.

The — predicting the euro versus the dollar, I'm no good at. You —

CHARLIE MUNGER: You did pretty well.

WARREN BUFFETT: (Laughs) Yeah, we did make a couple billion. But the — (Laughter)

You could, if you wished — I'm not suggesting this at all — but euro/dollar is an easy thing to hedge. I'm not recommending that. I'm just telling you that that is an option, if you're worried about a major currency. It's hard to do with smaller-country currencies.

But when you're talking the euro/dollar thing, you can keep hedging that, if you want to.

But like I say, we don't normally do that sort of thing. And that could be a pain in the neck to you.

I would say, in terms of Berkshire's earnings, we will just keep doing things that make — we think make sense. Now, if we own —

We own over 8 percent, for example, of Coca-Cola. Coca-Cola, you know, makes 80 percent or more of its money outside the United States.

We own a lot of Procter & Gamble. They make a lot of their money out of the United States. Kraft makes a lot of money out of the United States.

So we have a lot of indirect sources of earnings. And then we have a lot of direct sources of earnings outside the United States.

ISCAR makes most of its money — it makes money in the United States, but it makes a lot of money elsewhere. And we have other businesses like that.

We do not have a predetermined goal at all of developing X percent of our earnings here or there or that place. We just keep, you know, every day, we go to work.

And we don't know whether the phone call will come from Israel or from Indiana, in terms of a chance to invest some money.

We want all of our subsidiaries to be looking at opportunities everyplace. And some of them will find them abroad. And some of them won't. So it — we are not a — we are not heading anyplace, in terms of sources of earnings.

There are a lot of countries we feel comfortable with. And we would be happy to put money into those countries.

But we don't wake up in the morning saying that we would like to have more money in Germany or Spain or whatever, or that we would want to take money out of those countries.

And Charlie, have any more?

CHARLIE MUNGER: Yeah. People look at a modern, liberal democracy. And it's very easy to conclude that it's messy and full of defects. And I think that's a correct view.

But it's not at all clear to me that the messy defects that we have are worse than the messy defects of Europe.

I am an agnostic about these things. I think there's plenty wrong and plenty right on both sides of the Atlantic.

26. "Nobody gets any joy" from layoffs

WARREN BUFFETT: OK, Andrew?

ANDREW ROSS SORKIN: So this question comes from three shareholders who happen to be employees of Berkshire portfolio companies. They've asked not to be named in the — they ask the following question.

They say, "We are concerned with both the financial condition of the company and the stability of our jobs. Could you discuss your attitude towards the use of layoffs as a means of responding to short-term downturns in company profits?"

WARREN BUFFETT: Yeah, these are investee companies or subsidiaries?

ANDREW ROSS SORKIN: These are — I imagine they are investee companies. They —

WARREN BUFFETT: Yeah.

ANDREW ROSS SORKIN: And they are shareholders and employees.

WARREN BUFFETT: Yeah, I wouldn't have a different attitude. I was just clarifying it.

The — there's no question that business conditions can change such as to necessitate temporary or permanent layoffs.

I mean, there's — scales of businesses change. We're fortunate, in a place like GEICO, where our business is expanding. So we'll probably add at least, I would guess, a thousand jobs, net, at a GEICO.

But at the same time, we probably have close to half of our brick plants closed in the Southwest, because people just aren't building houses now. Now, that business will come back. And we'll rehire people.

On the other hand, our textile business never came back. And we employ fewer people at the Buffalo News than we did a year ago. And we are not going to regain those or get back to previous levels.

So there are some businesses that may permanently contract. And you have to face up to that, in terms of layoffs.

There's other businesses that have severe cyclical-type contractions, and they are going to face significant layoffs.

There are other businesses that are suffering a little bit during a period like this, but very little. And we will resist the idea of having layoffs.

We — you know, nobody gets any joy out of it. And generally, you do it, probably, a little too late, even, because you keep hoping the business will bounce back up or something of the sort.

But, you know, it — if the business changes in a material way, you'd better change your business model. Or, you know, somebody else will. And then you'll even have more changes facing you.

On balance, we hope we get into businesses that don't face those kind of problems.

But certainly, in our construction-related businesses — we've had layoffs at Shaw, we've had layoffs at Johns Manville, we've had layoffs at Benjamin Moore, we've had layoffs at Acme Brick, and there's really no alternative. I mean, it — and our competitors all have had also.

And you know, in the textile business, we got into it in 1965. In the end, we laid off everybody. I mean, it — we — it had contracted enormously before we got there. We tried all kinds of things. And we finally gave up.

You know, there — capitalism — you know, is creative destruction. And sometimes, you're on the short end of that.

This year, in terms of the businesses we have, you know, our employment will probably be reduced even — I'm almost sure it will — even though GEICO will expand.

It will not be reduced dramatically, because it just hits in certain areas. But it will be reduced. And our managers have to look at the reality of the current situation.

Charlie?

CHARLIE MUNGER: Yeah. Some of our businesses have a shared-hardship model, where they don't layoff, at least not yet. And the businesses with that model tend to be very strongly placed, economically.

So I guess it shows that Benjamin Franklin was right, when he said, "It's hard for an empty sack to stand upright."

And, so we're all over the map on that, and so is all of industry. And —

But I do think the — an ideal model would be a business so strong that it could operate in the shared-hardship mode instead of the layoffs.

WARREN BUFFETT: Yeah, some are doing that, where they — you know, you give up hours. And — but a lot of operations don't lend themselves to that very well, either. So —

CHARLIE MUNGER: ISCAR's operating that way.

WARREN BUFFETT: Yeah, ISCAR's operating that way. And, in other cases, you basically have to close down whole plants. I mean —

CHARLIE MUNGER: Yeah, sure.

WARREN BUFFETT: Yeah, that's just the nature of it. It's better — you really can't operate every plant at 50 percent and have it work as effectively as shutting down the least-productive plants.

CHARLIE MUNGER: In a world where you sometimes have to amputate a limb to stay alive, you can't expect that every business can stay exactly as it is.

27. Fight egregious CEO pay with embarrassment, not legislation

WARREN BUFFETT: OK, area 11.

AUDIENCE MEMBER: Hi, Ralph Witkin from Greenwich, Connecticut. I was first here in 1995. And I really appreciate the way you handle this meeting. I've been to dozens of others. And I know you're not obligated to do this. And I thank you for it, both of you.

My question is very similar to number 9's, regarding executive compensation.

Not so much your view on the compensation, but how we, as shareholders, can make some attempt to try to correct this and bring it back into some level of balance. Thank you.

WARREN BUFFETT: I had a senator call me just the other day. And, his constituents, obviously, are enraged about executive comp.

Probably — you know, AIG really had a huge impact, although, you know, you can take the Merrills and all the rest of them, also. But that story was huge with people.

And it was probably — in a certain sense, the outrage was disproportionate to what happened. But in any — it doesn't make any difference. The people are enraged about it.

So this senator called me. And he said, you know — he was essentially saying, "Tell me about a statute we can enact that will make my constituents happy about executive compensation."

And my advice to him was that he probably couldn't, and that the last time Congress got into this was in the early days of the Clinton administration, when they passed a bill that said, as I remember, for the top five officers, that you couldn't get deductibility for comp in excess of a million dollars annually, unless it was tied to performance in some way.

That was probably the most counterproductive piece of legislation that Congress has ever come up with, which is quite a statement to make in itself. (Laughter)

The net result of that was that when the tax was imposed, of course, the stockholders paid it and the officer didn't. So it penalized the shareholder, who was already getting penalized by the comp.

It led to all kinds of arrangements that were designed to dance around this, which involved lots of lawyering and lots of consultants and lots of pages of proxy statements, the net effect of which was to ratchet up compensation very dramatically. Compensation increased far more, in my view, because that was put on the books than otherwise.

So I suggested to him that the first thing they would do — should do — is probably repeal that and say, "We were wrong," and then figure out whether they should do something right. But that did not go over very well. (Munger laughs)

So I would say that — I've always proposed this. It never has gone anyplace. But that won't stop me from continuing to propose it.

All you need in this country is the top half dozen or so investment managers who manage, you know, we're talking hundreds of billions, trillions, in some cases, of assets.

If they would just speak out on the most egregious cases. Just — you know, there's a lot of stuff about "say on pay" and everything. But half a dozen of them, they get lots of publicity — they wouldn't have to worry about getting their views out.

The way they get big shots to change their behavior is to embarrass them, you know, basically. And the press has great opportunities to do that. And — but they need the cooperation of the big investors.

So if you've got three or four of the biggest investors, when the XYZ Company comes out with some crazy plan, to step up and just say, "This is outrageous," it would change behavior. And it would —

The directors don't like to look foolish. They don't like their names in the paper looking foolish. And you would see some real changes.

I think that the legislation for it is going to be — I just don't know how to write the stuff, you know?

I mean, you read the case recently at Chesapeake Energy, you know, $75 million for kind of a re-signing bonus and some — there were some other things involved, too.

I mean, it just — you wonder what people are thinking. You know what the CEO is thinking. And it just — I don't think you can write the statute that stops it. And like I said, the one they tried to write just screwed everything up royally.

But I do think big institutions — if they spoke out — you'd only need three or four of them that spoke out jointly. And they don't have to do it on every corporation at all, just when it's egregious enough.

But if they get a reputation for speaking out when it's egregious, every now and then, it would act as — I think there would be some restraining factor that might set in in corporate America. Because the restraining factor is not there then — not there now.

I mean, right now, every consultant comes in and brings along what the people at so-called pure companies are making. And they —

Nobody wants to say their CEO is in the bottom quartile or something. So they just keep comparing themselves to the higher quartiles. And then they ratchet up from there.

And, you know, it's a game that works wonders. I call it the honor system. You know, the shareholders have the honor and the executives have the system. (Laughter)

Charlie?

CHARLIE MUNGER: Yeah, well, I don't — I'm not too optimistic about fixing it from the big investor standpoint.

The big investor groups contain many an investment manager making $20 million a year for insignificant contributions. He's like a man in a glass house that starts throwing stones.

And the public pension funds are dominated, in many cases, by left-wing politicians and by labor unions who tend to have an agenda of their own that doesn't really relate to good management. So, sometimes, the cure is worse than the disease.

28. We don't hire potentially great managers

WARREN BUFFETT: Well, on that hopeful note, we'll move on to Carol. (Laughter)

CAROL LOOMIS: This is a question from Peter Poulson, spelled P-O-U-L-S-O-N.

He says, “When you acquire companies, they come equipped with managers. And in general, Berkshire has done a great job putting the right leaders in the right roles.

“But occasionally, you have to hire someone for an executive spot. Please describe an interview that you might have with a prospective Berkshire operating executive. What do you look for? How do you evaluate a person’s potential to become a great manager?”

WARREN BUFFETT: Well, usually, we hire people that have already proven they’re great managers. I mean, when we buy a business, very — a very high percentage of the time, the management comes with it.

When we buy an ISCAR, you know, we get the group that had been knocking the ball out of the park for years and years and years.

And the real question we have to ask ourselves is, you know, will they be with us in the future? Will they keep — will they be feeling the same way after the deal as they did the day before the deal?

And we’ve made occasional mistakes on that. But overall, that does come through. So it’s — we’ve had good luck with managers, not perfect.

And, the toughest part is, since we have no retirement age, is when managers lose the abilities that they had at an earlier age.

And that — it doesn’t relate to — there’s no yardstick you can use up and down the line for that. So it’s — people age, at least in business ability, they age in very different ways and at different paces.

And Charlie and I have the problem of figuring out, sometimes, when somebody has — does not have the same managerial ability that they had at an earlier time.

And then we have the responsibility for doing something about it. And we hate it. But it’s —

CHARLIE MUNGER: By the way, we’ve been slow in those.

WARREN BUFFETT: We’ve been slow every time.

CHARLIE MUNGER: We’ve been slow. If we really love the guy, we’re really slow. (Laughter) We are far from ideal.

WARREN BUFFETT: Yeah, well, it’s very — well, we had a manager, you know, a wonderful — I mean, a guy we both loved at Wesco.

And he got Alzheimer's. I mean, it — you know, and we didn't want to face it. We finally did. But it took us probably an extra year, year and a half, didn't it, Charlie?

CHARLIE MUNGER: Sure.

WARREN BUFFETT: Yeah.

It's the only part of my job that I don't like, basically. I mean, I hate it. But — I'd pay a lot of money not to have to do it. But occasionally, it happens. Fortunately, it doesn't seem to happen that often at —

We find people who love their businesses, you know? I love Berkshire. I — you know, I go to work every day, and I'm excited about it. And we — you can spot that in people.

I mean, I think most of you would probably realize that that's the way I feel about it. And I realize that's the way the managers of our subsidiaries feel about it.

I mean, Tony — Tony Nicely — went to work at GEICO when, you know, he was a teenager. And he's as excited every day about GEICO as I am. It hit me the first time —

I saw him yesterday at lunch. And the first thing he does is hand me the figure, which he knows I'm waiting for. You know, "(Inaudible), we're up 505-thousand," and he carries it out all the way, "policyholders."

And, I mean, I get excited about those numbers. He gets excited about them. You know, we talk about state-by-state, whatever it may be. And, you can't put that into somebody.

But we do recognize it when it's there. And we do our best to make sure that we don't do anything that dampens that in any way.

29. Don't try to time the market

WARREN BUFFETT: OK, area 12.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett, Mr. Munger. Jimmy Chong (PH) here from Dayton, Ohio.

Mr. Buffett, in October of last year, you wrote, in a New York Times op-ed piece, that you were moving your personal portfolio to a hundred percent U.S. equities.

My question is, is that move complete? If not, are you still buying? And in addition to that, how would you rank the recent market downturn in terms of investing opportunities in stocks during your investment careers?

WARREN BUFFETT: Well, it’s certainly not as dramatic as the 1974 period was. Stocks got much cheaper in 1974 than they are now.

But you were also facing a different interest rate scenario. So you could say they really weren’t that much cheaper.

You could buy very good companies at four times earnings or thereabouts with good prospects. But interest rates were far higher then.

That was the best period I’ve ever seen for buying common equities. The country may not have been in as much trouble then as we were back in September. I don’t think it was. But stocks were somewhat cheaper then.

In the recent period, I — you know, I bought some equities. And then corporate bonds looked extraordinarily cheap. The spreads were very, very wide. So I bought some of those, too.

But the cheaper things get, the better I like buying them. I mean, if I was buying hamburgers at McDonald’s, you know, the other day for X, and they reduced the price to 90 percent of X tomorrow — not likely — but if they did, I’m happy.

I don’t think about what I paid yesterday for the hamburger. I think I’m going to be buying hamburgers the rest of my life, you know? The cheaper they get, the better I like it.

I’m going to be buying investments the rest of my life. And I would much rather pay half of X than X.

And, the fact that I paid X yesterday doesn’t bother me, if I get — as long as I know the values in the business.

So on a personal basis, I like lower prices. I realize that that is not the way all of you feel when you wake up in the morning and look at quotes.

But, it just makes sense that when things are on sale, that you should be more excited about buying them than otherwise.

And lately — when I wrote that article in the Times, I did not predict what stocks were going to do. Because I never know what they’re going to do.

But I do know when you’re starting to get a lot for your money. And that’s when I believe in buying.

Charlie?

CHARLIE MUNGER: Well, if stocks go off 40 percent on average, they're obviously closer to an attractive price than they were before.

And, of course, interest rates have gone down a lot recently, at least short-term interest rates.

It's nothing like '73-4. I knew when that happened that that was my time and my only time. I knew I was never going to get another trip to the buy counter like that one.

Unfortunately, I had practically no money available, which is — (Laughter)

WARREN BUFFETT: That's why it happened.

CHARLIE MUNGER: That's why those times occur.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: So, if I were you, I wouldn't wait for 1973-4.

WARREN BUFFETT: No, we don't try to pick bottoms or you know —

We don't have an opinion about where the stock market's going to go tomorrow or next week or next month.

So to sit around and not do something that's sensible because you think there will be something even more attractive, that's just not our approach to it.

Anytime we get a chance to do something that makes sense, we do it. And if it makes even more sense the next day, and if we've got money, we may do more. And if we don't, you know, that — what can we do about it?

So picking bottoms is basically not our game. Pricing is our game. And that's not so difficult. Picking bottoms, I think, is probably impossible, but —

When you get — when you start getting a lot for your money, you buy it. And as I say, after I wrote that, stocks did get cheaper.

Corporate bonds — the corporate bond market got very, very, very disorganized. And we bought some fairly good-sized pieces of bonds for Berkshire. And I also bought a few little things for myself.

But I spend 99 percent of my time thinking about Berkshire. That's —

CHARLIE MUNGER: Warren, by now, don't we have our small life insurance companies pretty well full of desirable debt instruments at 10 percent?

WARREN BUFFETT: We certainly have got a lot more of it than we had, yeah. (Laughs)

No, we've — we got a chance to buy some corporate bonds very, very cheaply — at least in my view — a few months back.

And we had money in life companies that can't be used in certain other areas and for which this was an ideal time to just barrel in.

And anytime we like to do something, we really like to do it. I mean, our idea is not to tiptoe into anything. So we buy them as fast as we can, when prices are right.

CHARLIE MUNGER: Yeah, that bond thing didn't last very long, but —

WARREN BUFFETT: Nope.

CHARLIE MUNGER: — there were perfectly safe bonds that yielded 9 percent or more with very fancy call protection.

WARREN BUFFETT: Yep.

CHARLIE MUNGER: And some of those bonds are up 20, 25 percent. So the opportunities are frequently under shell A, when you're looking at shell B.

WARREN BUFFETT: Yeah. We try to look at all the shells.

CHARLIE MUNGER: Yeah, we look at all the shells.

30. "Decent" rates of return from regulated utilities

WARREN BUFFETT: Becky?

BECKY QUICK: This question is from Jim Mitchell from Costa Mesa, California, who wants to know from both of you.

He says, "Years ago, you taught us to beware of capital-intensive businesses, like electric utilities, that may be overstating profits due to understating depreciation.

"Now that you are investing in utilities and gas pipelines, have you discovered the secret of long life for power plants? Or do we need to discount your utility earnings?"

WARREN BUFFETT: Well, the utility earnings, pretty much, come about through a return on equity capital allowed by the jurisdictions in which you operate.

So, for example, if something like pension costs or something of the sort, you get surprises on, you do get to earn that back over time. But you don't get any bonanzas, either.

So I would say the capital-intensive businesses that scare me more are the ones outside of the utility field, where you just pump in more money without knowing that you're going, in a general way, to get, more or less — within a range, anyway — a guaranteed return.

So I do not have — there's no way we get rich on our utility investments. But there's no way we get poor, either. And we get decent rates of return on the equity that we leave in it.

And we'll probably get those returns with or without inflation. Now, inflation may diminish the value of getting an 11 or 12 percent return on equity, if you get into very high rates of inflation.

So in that sense, I'd agree with Jim, who I know, incidentally. He used to work with my daughter out there at Century 21. He's a good investor.

But the — on balance, if you can find a good business that's not capital intensive, you're going to be better off than in a capital-intensive business over time.

I mean, the world, they're hard to find. But the best businesses are the ones that don't require much capital and, nevertheless, make good money.

They've got some moat protecting them, other than the capital required as entry in the business that's protecting them.

And if you can find those that are durable, you've got a great investment and one that will do the best in inflation, which, as we mentioned earlier, seems fairly likely to come along.

Charlie?

CHARLIE MUNGER: Yeah, unfortunately, a lot of moats have been filling up with sand lately, you know, the daily newspaper, the network television station, all these castles with their lovely moats. The moats are filling up.

31. Surprise marriage proposal from Buffett's great-nephew

WARREN BUFFETT: Well, on that cheery note, we have time for just one more question. And Marc Hamburg, I believe you said there was somebody who wanted to finish this off. Marc, where are you?

MARC HAMBURG: Right here. Right here, Warren.

WARREN BUFFETT: OK, I can't — I still can't see you. But I can hear you.

MARC HAMBURG: He's right up in front.

WARREN BUFFETT: Right up in front. OK, good. Oh, I see you now.

ALEX ROZEK: Hi, Warren. It's Alex from Boston.

I just wondered if you could give us some advice on how we could improve the economy, as we leave.

WARREN BUFFETT: What was your name?

ALEX ROZEK: Alex, from Boston.

WARREN BUFFETT: Ah. Well, the obvious thing to do is to do what our government tells us to do, which is to go out and spend.

And as I mentioned, household formations are important to developing — to getting past this overbuild in residential construction. So does — I don't know whether that gives you any ideas or not. But… (Laughter)

ALEX ROZEK: I think so.

Mimi, you're my best friend. Would you be my wife? (Applause)

MIMI KRUEGER: Yes? (Applause)

VOICE: Mimi, you've got to say yes.

MIMI KRUEGER: I said, yes. Yes!

WARREN BUFFETT: I have just two —

ALEX ROZEK: Thanks, Warren.

WARREN BUFFETT: OK. I have two comments to make. Alex is my sister Doris' grandson, my great-nephew. And Mimi is terrific.

So on that note, we'll end the meeting. And we'll be back in 15 minutes for the board meeting. Thank you. (Applause)

32. Berkshire Hathaway formal meetings begins

WARREN BUFFETT: OK, now we're going to hold an annual meeting.

The meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company. I welcome you to this 2009 annual meeting of shareholders.

I will first introduce the Berkshire directors that are present in addition to myself. We've got Charles Munger. We've got Howard Buffett, Susan Decker, Bill Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott.

Also with us today are partners in the firm of Deloitte and Touche, our auditors. They are available to respond to appropriate questions you might have concerning the firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings. Ms. Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors.

The main proxyholders for this meeting are Walter Scott and Marc Hamburg.

33. Berkshire shares outstanding and quorum

WARREN BUFFETT: Does the secretary have a report of the number of Berkshire shares outstanding entitled to vote and representing at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 4, 2009 — being the record date for this meeting — there were 1,057,573 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting —

And 14,749,861 shares of Class B Berkshire Hathaway common stock outstanding with each share entitled to 1/200th of one vote on motions considered at the meeting.

Of that number, 821,400 Class A shares and 10,298,152 Class B shares are represented at this meeting through proxies returned through Thursday evening, April 30th.

WARREN BUFFETT: Thank you.

That number represents a quorum. And we will therefore directly proceed with the meeting.

34. Last meeting's minutes

WARREN BUFFETT: First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion

WARREN BUFFETT: Motion's been moved and seconded. Are there any comments or questions?

We will vote on this question by voice vote. All those in favor, say, "Aye."

VOICE: Aye.

WARREN BUFFETT: Opposed? Motion's carried.

35. Election of Berkshire Hathaway directors

WARREN BUFFETT: The first item of business is to elect directors. If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles, who will furnish a ballot to you.

Will those persons desiring ballots please identify themselves, so that we may distribute them?

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Tom Murphy, Ron Olson, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It's been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott be elected as directors.

Are there any other nominations? Is there any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: The ballot of the proxyholders in response to proxies that were received through last Thursday evening cast not less than 859,366 votes for each nominee. That number of — that number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxyholders in response to proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren Buffett, Charles Munger, Howard Buffett, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott have been elected as directors.

36. Shareholder motion on working conditions at Russell Athletic plant

WARREN BUFFETT: The next item of business is a motion put forth by Berkshire shareholder Joseph Petrofsky.

Mr. Petrofsky's motion is set forth in the proxy statement and would request Berkshire Hathaway to prepare a sustainability report for shareholders. The directors are recommended that the shareholders vote against the proposal.

We will now recognize, I believe it's Mr. Billenness — Mr. Petrofsky's representative — to present the motion.

To allow all interested shareholders to present their views, I will ask Mr. Billenness to limit his remarks to five minutes. The microphone at zone 1 is available. Well, we go first to Mr. Billenness.

SIMON BILLENNESS: Thank you very much, Mr. Buffett. My name is Simon Billenness. And I represent Mr. Joseph Petrofsky, the shareholder who filed this year's resolution asking for a publication of a sustainability report.

I will move that shareholder resolution. Miss Norma Mejía Castellanos (PH) will then second the resolution. And then I will ask for a preliminary count of the shares voted.

As shareholders, we are proud that, in so many ways, our company is a leader. A prime example is the emerging success story on the Klamath River. This may result in the largest river restoration project in U.S. history. And this makes economic sense for PacifiCorp and for us, as shareholders.

However, when it comes to managing environmental and human rights risk, and disclosing those risks to shareholders, our management is sadly a laggard.

Two respected proxy advisory firms, PROXY Governance and RiskMetrics, have advised shareholders to vote in favor of this resolution on the grounds that management badly lags other companies in disclosing these risks to shareholders.

Last week, CalPERS, the California retirement system, announced that it would vote close to half a billion dollars' worth of stock in favor of this resolution.

Consider the situation today with Russell, the subsidiary of Fruit of the Loom and a Berkshire Hathaway company. Collegiate licensed apparel — sweatshirts bearing university logos, for instance — is a $5 billion a year market.

Russell has admitted to repeatedly committing serious labor rights violations in Honduras. And now, over 50 universities, including Harvard, Stanford, and the entire University of California system, have decided to terminate Russell's license to make clothing bearing their college logos.

This particular sweatshirt, which I'm holding up right here, is University of North Carolina. This was made in a Berkshire Hathaway factory. But the university has since ended their licensing agreement.

The treatment — the management of Russell, through its actions, has put $5 billion of potential business at risk. The management of Berkshire Hathaway should provide proper disclosure of that risk to us, the shareholders in this company.

Now, I will pass over to Ms. Mejía Castellanos. She is a sewing machine operator who worked in the factory in Honduras that is the center of these problems. And after she has spoken, I will ask for a preliminary vote count for this resolution.

NORMA MEJÍA CASTELLANOS: Yo trabajó como operadora de una maquila de costura en la fábrica Jerzees Honduras.

INTERPRETER: I used to work as a sewing machine operator at the factory, Jerzees de Honduras.

NORMA MEJÍA CASTELLANOS: En 2006, cuando Fruit de Loom compró la empresa, las condiciones empeoraron.

INTERPRETER: In 2006, when Fruit of the Loom bought my factory, conditions got much worse.

NORMA MEJÍA CASTELLANOS: La empresa empezó hacer acumulación de personal esto para ahorrarse mas y no pagar renta.

INTERPRETER: Fruit of the Loom began to consolidate personnel in order to save more on rent.

NORMA MEJÍA CASTELLANOS: Esto ocasionó mucho molestar de salud en los trabajadores, como ser dolor en la espalda a causa de maquinaria de esta muy cerca, y esto provoca un recalentamiento.

INTERPRETER: This created many conditions in the factory that caused health problems for workers, such as pain in our backs being caused by the heat from the sewing machines, which were now pressed into our backs, because of the limited space.

NORMA MEJÍA CASTELLANOS: Esto significa una inseguridad en un momento de evacuación.

INTERPRETER: The close proximity also made it very dangerous in the case of an emergency evacuation.

NORMA MEJÍA CASTELLANOS: En nuestra fabrica, la ventilación era tan mala que esto nos provocaba enfermedades respiratorias como el cáncer del pulmón.

INTERPRETER: In part, because of the overcrowding, as well, the ventilation was so poor that it caused many respiratory illnesses, including lung cancer.

NORMA MEJÍA CASTELLANOS: El agua de los filtros era contaminada.

INTERPRETER: Even the filtered water was dirty.

NORMA MEJÍA CASTELLANOS: Trabajamos de la 6:30 de la mañana hasta las 5:30 de la noche, con tan solo 15 minutos para almorzar.

INTERPRETER: We worked from 6:30 in the morning until 5:30 at night with only 15 minutes for lunch.

NORMA MEJÍA CASTELLANOS: Nuestros salarios eran demasiado bajos que no nos alcanzaba para pagar una niñera y la empresa no respeta el código de trabajo de nuestro país, porque no brinda guarderías de niños.

INTERPRETER: Our wages were too low to afford childcare. And the management refused to provide onsite childcare, even though it was required by Honduran law.

NORMA MEJÍA CASTELLANOS: Por eso, decidimos organizarlos para obligar el gerente que nos escuchara y que respetara nuestros derechos.

INTERPRETER: Because of all of this, we decided to organize to compel management to clean up our factory.

NORMA MEJÍA CASTELLANOS: Entonces, fue cuando despidió 145 trabajadores ilegalmente por organizarse a un sindicato.

INTERPRETER: In retaliation, Russell illegally fired 145 workers for organizing a union.

NORMA MEJÍA CASTELLANOS: Russell tenía que respetar el sindicato, constituido por la ley. Y entonces, Russell dijo que por causa al sindicato, iba a cerrar la empresa y que nos íbamos a quedar aguantando hambre.

INTERPRETER: After we finally legally established our union, Russell said that because of the union, they would close down the factory and leave the workers to starve.

NORMA MEJÍA CASTELLANOS: Fue cuando empezamos hacer amenazados a muerte los directivos.

INTERPRETER: And this is when we started to receive death threats.

NORMA MEJÍA CASTELLANOS: Me dejaban mensajes y dibujos en los baños y en el puesto de trabajo, diciéndome que me iban a cortar la cabeza.

INTERPRETER: They would leave me notes and illustrations in the bathroom and at my workstation threatening to cut off my head.

NORMA MEJÍA CASTELLANOS: Finalmente, Russell siguió y cumplió con su dicho, y cerro la planta el 30 de enero de este año.

INTERPRETER: Finally, Russell Athletic did follow through with their threat and shut down the factory in January of this year.

NORMA MEJÍA CASTELLANOS: Russell sostiene que nos ayudara a encontrar nuevos puesto de trabajo, pero en cambio la lista negra que tiene con nosotros y nos han impedido la búsqueda de nuevos empleos.

INTERPRETER: Now, Russell has been claiming that they will help us find new jobs. But instead, they have blacklisted us, preventing us from finding work elsewhere.

NORMA MEJÍA CASTELLANOS: Es por que tantas universidades han cortados su contratos con Russell y porque esto se ha convertido en un problema para esta empresa.

INTERPRETER: This is why so many universities have stopped doing business with Russell and why this has become such a problem for Berkshire Hathaway.

NORMA MEJÍA CASTELLANOS: Y por tanto, yo voto a favor de la resolución y exhortó que a los accionistas voten a favor. Gracias.

INTERPRETER: And therefore, I second this resolution and urge that shareholders vote in favor. Thank you.

WARREN BUFFETT: OK. I'd like to ask Mr. John Holland, the CEO of Fruit of the Loom, to respond to the comments just made, and after which, we will act on the motion.

JOHN HOLLAND: First, I need to give you a little background. Russell was a public company listed on the New York Stock Exchange prior to the time that we acquired them in August of 2006. The acquisition consisted of 47 facilities with a little over 14,000 workers.

And, as we began to get involved with the Russell operations and how they were conducted, to integrate those into our operations, we found that there were a couple of plants in Honduras that had some problems.

And we began — we acknowledged the problems. And we began immediately to remedy these problems.

A little later, we had a letter from the WRC, the Workers Rights Commission (Consortium), indicating that there had been some abuses of the employees and that some had been terminated because they were involved in union activities.

We were unaware of the union activities. And we investigated the abuses. But we thought it best to contact an independent third-party organization to do an audit.

And we contacted the Free (Fair) Labor Association, which is kind of a worldwide organization that's grouped with a group of businesses and the leading universities in the U.S. to try to make certain that workers' rights are adhered to on a worldwide basis.

We asked them to conduct the audit. And they conducted the audit. And all of the abuses that we had been charged with, they said, through the independent audit — they were nonexistent.

But they did tell us that there were two supervisors who had conducted some abusive language with the employees and, also, that it was very likely that some employees might've been terminated due to their union activity.

So as a result, they gave us a list of items that they would like us to follow to remedy the situation. The supervisors, as well as the management of the facilities, were eliminated.

And we have started immediately, progressively, to implement all of the recommendations of the Free Labor Association's independent audit.

And part of that was that the workers that they felt might have been terminated due to union activities, that we reinstate the workers.

The plant had not been organized at that point. So we voluntarily engaged the union and acknowledged them and accepted the union.

And we rehired all of the workers that we could locate into a facility that was across the street from this particular plant.

And since then, we have followed all of the recommendations of the Free Labor Association. And they have a monitoring process.

And after about three months, there was another audit by the Free Labor Association and the Workers' Rights Commission, which is another related organization. And they said that the activity that we engaged in, they were very well pleased with the progress.

And as I said previously, we acknowledged the union and began negotiations. There was approximately 48 issues that they wanted to discuss. And we reached agreement on 24 of those.

And we — the union even agreed that we had had very good relationships, that we had approached the negotiations openly and fairly.

There were some other points that they wanted to move to arbitration on that — or mediation — that we could not agree on.

And by that time, the time had passed till we reached the midyear of 2008, when the recession in the apparel industry dramatically affected our particular business.

And over the course of the next few months, we had to close nine of our facilities. One of those was the Jerzees de Honduras plant that they have referred to.

And there was a total of 12,780 employees involved in the plant closures. And out of that group, about 310 people, which has been acknowledged by the union, that were union employees, because in Honduras, under the laws there, only 30 people are required to form a union and be acknowledged as a union.

And up until that time, there had been no indications of any issues that had been brought up by the union that were not solved.

Now, beyond that, I would like to tell you a little about how we conduct business worldwide in our plants.

We have been in Honduras since 1993. All of our plants are air conditioned, excellent ventilation in all of those facilities. Our wages in those plants are 26 percent, on the average, above the minimums in Honduras.

We offer 11 paid holidays. We have paid vacations. We have free life insurance. We have a doctor and nurse in each one of those facilities.

And the reference to the filtered water, when we acquired that plant, that particular plant had its own filtration systems, which was different from all of our other plants, which we used bottled water.

We immediately had that water tested. Although there was some discoloration, it was tested as pure. But we immediately shut down the filtration system and went to bottled water that we have in the other plants.

Now, we have paid maternity leaves, we have a breastfeeding hour, we celebrate the employee birthdays, in fact. And also, the — we have a children's day.

And that, I think, our benefits, I'm proud to tell you, I think are far and above any that you'll find in most other apparel facilities throughout the world.

And there have been no death threats. We have tried to conduct our business with honesty, integrity.

And quite frankly, I've been with this company, I'm in my 48th year, and I would tell you that I'm very proud of how we operate our particular plants.

We have met with a number of the leading universities to try to tell the other side of the story. We've invited those presidents of the universities and the administration to come to see for themselves what our plant facilities are like.

And we've had two acceptances that were down this past week, the representatives from Princeton and also from the University of Arizona.

And we welcome putting all of this into an open spotlight. We also have a website. That's www.russellsocialresponsibility.com — that all of this activity that we're responding to the recommendations of the Fair Labor Association is posted on that website. It's there for the world to see.

And we continue — Fair Labor Association has a three-step process of continued monitoring. And then they do independent audits periodically to see what our progress is. And all of that is posted on that website. Thank you.

WARREN BUFFETT: Thank you, John. The motion is now ready to be acted upon. (Applause)

If there are any shareholders voting in person, they should now mark their ballots on the motion and allow the ballots to be delivered to the inspector of election. Miss Amick, when you're ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxyholders, in response to the proxies that were received through last Thursday evening, cast 49,251 votes for the motion and 702,963 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes related to all Class A and Class B shares outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The proposal fails.

37. Berkshire formal meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting, before we adjourn? If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second? Motion to adjourn has been made and seconded. We will vote by voice.

Morning Session - 2010 Meeting

1. Opening remarks

WARREN BUFFETT: Good morning. I'm Warren, he's Charlie.

He can hear, I can see. We work together for that reason. (Laughter)

Like to make one correction in the movie. My fast ball was filmed in slow motion. They tried the regular way and you couldn't even see it, so — (Laughter)

Our approach today will be to announce a couple of things, our earnings, and introduce you to the directors. But as soon as that's through, we'll move on to questions. We'll have those until noon.

We'll break for an hour and we'll come back at 1:00. Those of you who are in the overflow rooms may find that you can get into the main arena here at that time.

And we'll go till 3:30 with the questions and then we'll have the annual meeting, business meeting, for those of you who are still around at that point. And at that time, we will have the election of directors.

2. Board of directors introduced

WARREN BUFFETT: But because not all of you may be here at that time, I would like to introduce the directors to you, and I'll ask them to stand.

And if you'll hold your applause until they're all done standing, or you can even hold it after that — (laughter) — it will make — it will make for a very orderly meeting.

So let's start in with Howard Buffett. I'm the next one alphabetically. Our new director, Steve Burke.

They didn't hear the part about stay standing, but that's OK. They're generally fairly obedient, but the — (laughter)

Susan Decker. Bill Gates. David Gottesman, Sandy Gottesman. Charlotte Guyman.

Don Keough is unable to be with us today. He's had a serious operation but he's recovering very well and he's got a lot of friends in this audience and he'll be with us next year.

Charlie, we've already introduced. Tom Murphy. Ron Olson, the manager in our movie. And Walter Scott.

Now you can go wild with applause for the group. (Applause)

3. Some recovery for "sputtering" economy

WARREN BUFFETT: Now, before we start with the questions, we do have preliminary earnings figures for the first quarter.

And I'd like to ask the projectionist to put up slide A. There's nothing really very surprising in these numbers, but we'd like to give them to you. They up there OK? Yeah. If you have any questions on these later on.

What we're seeing in our businesses is that, in what was sort of a sputtering recovery a few months ago, seems to have picked up steam in March and April.

And our businesses that kind of serve broad industry, such as the railroad or Marmon or ISCAR, we're seeing a pretty good uptick. It's a long way from where it was a couple years ago, but what was very spotty in the recovery a couple of months ago, the trends really seem a fair amount stronger in the last few months.

And we always encourage you to focus on operating earnings. We have the figures there for our investments and derivative businesses.

We don't really think they mean anything on a quarterly basis. Obviously, they're meaningful over the years. I mean, we've piled up a lot of net worth over the years with capital gains. But in any quarter, they mean absolutely nothing.

And you'll notice another thing about our report. We don't even put down — we have to when we publish generally — but we don't even put down the earnings per share. We're not focused on that number in any quarter or any year.

We're focused on the buildup of value. And we really think that an undue focus on quarterly earnings, not only is probably a bad idea for investors, but we think it's a terrible idea for managers.

If I had told our managers that we would earn three dollars and 17 1/2 cents for the quarter, you know, they might do a little fudging in order to make sure that we actually came out at that number.

And there was a very interesting study that was published a few months ago where thousands of earnings reports were examined.

And instead of taking it out to the penny, which is customary in the reporting, they took it out one further digit. And of course if you go out one further digit, and it's four or less, you round downward, and if it's five or more, you round upward.

And they found out that a statistically impossible number of — small number — of fours showed up because if they got to four-tenths of a cent, somehow somebody in the accounting department managed to find another tenth of a cent so they could round upward. It was not an accident.

And, you do not want to have — in our view, we think it's terrible practice to be thinking about trying to report to some penny that you've whispered to Wall Street analysts in previous months.

And we probably carry that to an extreme at Berkshire. But we always think of the enterprise as a whole. We think about building value over time.

And we do not worry about earnings per share, and we don't worry about investment gains or losses.

Charlie may want to weigh in on this one a bit. Charlie?

CHARLIE MUNGER: Well, I agree with you. (Laughter)

WARREN BUFFETT: Yeah. He is the perfect vice chairman. (Laughter) They don't come any better. OK.

With that preliminary — we probably ought to quit at that point, actually. (Laughter)

4. Panel of journalists introduced

WARREN BUFFETT: We're going to alternate the questions between a panel of three journalists here. We have Carol Loomis of Fortune magazine on the — on the far right. (Applause)

And we didn't do it quite alphabetically. We have Andrew Ross Sorkin from The New York Times. (Applause)

And Becky Quick of CNBC. (Applause)

Andrew's maneuvered for a seat there, apparently, to get earlier in the questioning order, but I'll probably stick with the alphabetical list.

And we will alternate between our journalists, and then we will go around the auditorium here where people have been chosen by chance to ask questions.

And we also will go to just I guess one of the overflow rooms; we have a whole lot of overflow rooms, but we'll not go to all of them.

5. To be deleted

WARREN BUFFETT: So let's just start things off. Carol?

CAROL LOOMIS: Well, since I won the alphabetical lottery, I get to make two very short statements also.

One is that we received an awful lot of questions. We really don't know how many because some people sent their question to all three of us. But I would guess we had something between 1,500 and 2,000 questions.

And obviously, we're not going to be able to ask all of those, and we're sorry for those we didn't get to ask. They were very good questions and we appreciate the work that people put into them.

The other thing I want to mention is that Warren and Charlie have had absolutely no hint as to what the questions will be so they will have to field them just as they come up.

6. Buffett strongly defends Goldman Sachs

CAROL LOOMIS: However, Warren and Charlie may be smart enough to have guessed that the first question will be about topic A, which is Goldman Sachs.

And I received several emails about the SEC's lawsuit against Goldman, all of them asking a different question about that problem.

I have combined the several thoughts in these questions, and with thanks to Greg Firman (PH), Kai Pan (PH) of Morgan Stanley, Brian Chan (PH), and Vic Timono (PH), here is the question:

Warren, every year in the Berkshire movie, you did it again today, you use the clip from the Salomon crisis in which you tell Congress that you have warned Salomon's employees that if they lose a shred of the firm's reputation, you will be ruthless in your reaction.

Clearly, Goldman Sachs has lost reputation because of the SEC's action. Could you tell us your reaction to the lawsuit, your reflections in light of it about Berkshire's large investment in Goldman?

And what advice, in light of your own Salomon experience, you would give Goldman's board of directors and management?

WARREN BUFFETT: OK. Anytime you ask me these multiple questions, I may go back to you to get all parts.

But, well, let's start with the transaction, because that's the important thing.

A few weeks ago on a Friday, a transaction described as ABACUS was made the subject of an SEC complaint. I think it ran about 22 pages. And I think there's been probably sort of misreporting, not intentional obviously, but misreporting of the nature of that transaction in at least — probably a majority of the accounts that I've read about it.

So, I would like — this will take a little time, but I think it's an important subject. I would like to go through that transaction first. And then we'll get further into the questions posed by the people that emailed Carol.

The transaction, the ABACUS transaction, there were four losers in, but we're going to focus on two of them.

Goldman itself was a loser. They didn't intend to be a loser, I'm sure. They couldn't sell the piece — a piece of the transaction — and they kept it, and I think they lost 90 or $100 million because they kept it.

But the main loser, in terms of actual cash out, was a very large bank in Europe named ABN AMRO, which subsequently became part of the Royal Bank of Scotland.

Now, what did ABN AMRO — why did they lose money? They lost money because they, in effect, guaranteed the credit of another company, ACA.

ABN AMRO was in the business of judging credits, deciding what credits they would accept themselves, what credits they would guarantee.

And in effect, they did something in the insurance world called fronting a transaction, which really means guaranteeing the credit of another party.

We have done that many times at Berkshire. We get paid for it. And people do not want the credit of the XYZ insurance company but they say they'll take a policy from XYZ if we guarantee it. And Berkshire has made a lot of money guaranteeing things over the years.

And Charlie can remember back to the early 1970s when we ran into some very dishonest people and we lost money, and we lost a fair amount of money at that time, because we guaranteed the credit of somebody that turned out to be not so good.

It happened to be some syndicates at Lloyd's, of all things. But they found ways not to pay when our name was on it.

So ABN AMRO agreed to guarantee about $900 million of the credit of a company called ACA. They got paid for that, and this is in the SEC complaint. It's not mentioned very often, but they got paid, what, 17 basis points, that's 17/100 of 1 percent.

So they took on a $900 million risk of guaranteeing credit. They got paid about a million-six. And the company whose credit they guaranteed went broke, and so they had to pay the 900 million. It's a little hard for me to get terribly sympathetic with the fact that a bank made a dumb credit deal.

But let's look at ACA, because they were sort of the nub of the transaction.

ACA, and you wouldn't really know this by reading most press accounts, ACA was a bond insurer. Now, they started out as a municipal bond insurer. They guaranteed various credits and they were like Ambac, they were like MBIA, they were like FGIC, they were like FSA.

And all of those companies — and we wrote about this a few years ago in the report — all of those companies started out insuring municipal bonds. Some of them started 30 years ago. And there was a big business in insuring municipal bonds.

And then the profit margins started getting squeezed in the municipal bond business. So what did they do? Instead of sticking to the business they knew and accepting lower profits, they went out and got into the business of insuring structured credits and all kinds of different other deals.

I described their activities a couple years in the annual report as being a little bit like Mae West who said, "I was Snow White but I drifted." (Laughter)

These bond insurers — and almost all of them did it — these bond insurers drifted into insuring things they didn't understand quite as well but where they could make a little more money.

ACA did it, MBIA did it, AMBEC did it, FGIC did it, FSA did it, and they all got into trouble, every one of them.

Now, is there anything wrong with a bond insurer insuring structured credit or something other than municipals? No. But you better know what you're doing.

Now, interestingly enough, Berkshire Hathaway, when these other guys got into trouble, went into the municipal bond insurance business.

And we insured things that were almost identical to what ACA or others had insured, the difference being that we thought we knew more about what we were doing. We got paid better than they got paid, and we stayed away from things we didn't understand.

We never insured a CDO; we never insured any kind of a RMBS deal or anything of the sort.

But I want to give you an example of something we did insure, because I think it will help you understand better this ABACUS transaction. So if the — if the projectionist would put up slide number 1, I'm going to describe a deal to you.

And as you — as you look at this — is it up there yet? Yeah. Somebody came to us a couple of years ago. I'll tell you the name a little later. But a large investment bank came to us a couple of years ago.

Now, we were insuring bonds regularly. We insured bonds here of the Omaha Public Power District that's familiar to many of you. We insured the bonds of the Nebraska — of the Methodist Hospital, which is six or seven miles from here.

We have told people that if the Nebraska Methodist Hospital does not pay its bonds, Berkshire Hathaway will pay them. And we've done that to the tune of about $100 million in their case. So we are in the business of insuring bonds.

Now, a couple of years ago, somebody came to us, large investment bank, and they said, "Take a look at this portfolio."

And as you can see, it's got the names of a whole bunch of states. Yeah, it's up there. And very different amounts. It's got a billion-one for Florida; it's only got 200 million for the State of California.

And they said to us, "Will you insure these states, that these bonds of these states, will pay for the next 10 years? If any of the states don't pay, you have to pay as the insurer."

And I looked at the list, Ajit Jain looked at the list, and we had to decide, A) whether we knew enough to insure them, and B) what premium we would charge, because that's what we're in the business for.

And we don't have to insure them. We can say, "Forget it. We don't know enough to make the decision." But we made the decision and we offered to insure those bonds for about $160 million for 10 years.

So we collected a premium of a little over 160 million, and somebody on the other side, the counterparty they call it, somebody on the other side, for 10 years, gets an assurance that, if these states don't pay, we will pay as if they did pay.

And this gets to the crux of the SEC's case — or complaint — in respect to Goldman. Somebody came to us with this list; we didn't dream up the list. Another party came to us.

Now, there's about four possibilities. Now I'll tell you who the party was that came to us two years ago: It was Lehman Brothers. So Lehman Brothers, there's four possibilities, roughly.

Lehman Brothers might own these bonds and want protection against the credit. They might just be negative on the bond market and, in effect, be shorting these bonds and using this method as a way of shorting it.

They might have a customer that owned these bonds who wanted to buy protection against the credit.

Or they might have a customer who was negative on these bonds and was simply wanting to short it.

We don't care which scenario exists. It's our job to evaluate the risk of the bonds and to determine the proper premium.

If they told me Ben Bernanke was on the other side of the trade, it wouldn't make any difference to me.

If I have to care about who's on the other side of the trade, I should not be insuring bonds. They could have told me Charlie was on the other side of the trade. (Laughs)

So, in effect, we did with these bonds exactly what ACA did with the bonds that were presented to them.

Now, ACA said, with the list of 120 that was presented to them, they said, "There's about 50 of these that we're willing to insure."

And then they went back and negotiated and took on 30 more of them.

We could have said, presumably, "We don't like Texas that well at a billion-150, and we'd rather have you give us more Floridas," or something like that.

We didn't do it. We just took the list that was submitted. So it was totally the other guy's list that we insured.

In the case of the ABACUS transaction, it was sort of a mutual — a negotiation — as to which bonds were included.

Now, in the end, the bonds that were included in the ABACUS transaction all went south very quickly.

That wasn't quite so obvious they were going to do that in early 2007, as you could see by studying something called the ABX Index.

But the housing bubble — really, mania — started blowing up in 2007.

Now, there could be troubles in these states that we insured. You can say they have big pension obligations, and maybe the guy who's shorting them on the other side knows more about that than we do, but, you know, that is our problem.

I mean, if we want to insure bonds, in the case of ACA, in the case of MBIA, they have teams of people do it. We just do it with a couple people at Berkshire.

But I see nothing whatsoever — I mean, if we lose a lot of money on these bonds, I am not going to go to the guy on the other side of the transaction and say, “Gee, you took advantage of me.”

I don’t care if John Paulson is shorting these bonds to me. He has no worries that I’m going to claim that he had superior knowledge about the finances of these states or anything of the sort.

So that was basically the ABACUS transaction. I think the central part of the argument is that Paulson knew more about the bonds than the bond insurer did.

My guess is the bond insurer employed more people than John Paulson did in his business, and they just made — they made what turned out, in retrospect, to be a dumb insurance decision.

And for the life of me, I don’t see whether it makes any difference whether it was John Paulson on the other side of the deal, or whether it was Goldman Sachs on the other side of the deal, or whether it was Berkshire Hathaway on the other side of the deal.

Let’s say we had decided to short the housing market in some way in early 2007. I don’t think anybody should blame us for taking our position if we did it. We didn’t do it. Or if we’d taken the long side.

I think before we get to the other part of Carol’s questions, I’d ask Charlie to comment as this as Charlie has a law degree, and in other ways is superior to me, so we’ll get his views.

CHARLIE MUNGER: Well, my attitude is quite simple. This was a three-to-two decision by the SEC commissioners under circumstances where they normally act unanimously.

If I had been on the SEC, I would have voted with the minority two and not with the three who authorized the lawsuit.

WARREN BUFFETT: Carol, would you get to the three parts that we probably haven’t answered yet? And then I’ll tackle this one.

But I really feel it’s important to understand the transaction. I have not seen — I have seen ACA referred to as an investor. It’s true that ACA had a management company, but it was 100 percent owned by ACA.

ACA was a bond insurer, pure and simple. And they had this — very simple, as it turned out — and they had one part of the organization did this and that. But ACA lost money because they were a bond insurer.

Yep, Carol?

CAROL LOOMIS: Well, I'm assuming that you have covered the part that says could you tell us your reaction to the lawsuit. So the next part was your reflections, in light of it, about Berkshire's large investment in Goldman.

And then the third was what advice you would have, given your Salomon experience and the thread of reputation that you have planted, those words you have planted. Those are the last two parts.

WARREN BUFFETT: Ironically, very ironically, it's probably helped our investment in Goldman in a certain way, because we have a $5 billion preferred stock that pays us $500 million a year.

Goldman has the right, the legal right, to call that at 110 percent of par. So anytime they want to, they can sent Berkshire 5 1/2 billion, and they get rid of this preferred stock which is costing them 500 million a year.

If we got that 5 1/2 billion in, immediately we'd put it in very short-term securities, which probably, under today's conditions, might produce 20 million a year or something like that.

So every day that goes by that Goldman does not call our preferred is money in the bank. It's been pointed out that our preferred is paying us $15 a second. So as we sit here, tick — (laughter) — tick, tick, tick, that's $15 every tick. (Applause)

I don't want those ticks to go away. (Laughs)

I just love them. They go on at night when I sleep — (laughter) — on weekends.

And frankly, Goldman would love to get rid of that preferred. I mean, they only agreed to sell us that preferred because it was sort of at the height of the crisis.

The U.S., I'm not sure what part of the government, probably the Fed, but they have been telling companies that took TARP money whether they could increase their dividends or not, whether they could redeem preferred, and all that.

Up till now, probably the Federal Government has been doing us a big favor by telling — even before this thing happened — they've probably been telling Goldman that, "You can't call that preferred until we tell you you can. And you can't increase your dividend."

They've been pretty strong with all of the TARP companies. That has not been publicized too much, but believe me that it's the case.

So I was just sitting here hoping that the — basically, that the Fed, or whomever, would be — continue to be — quite tough, in terms of letting Goldman call our preferred. But it wasn't going to go on forever.

I think that — I think recent developments have probably delayed the calling of our preferred by some time so the tick, tick, tick — (laughter) — will go on, and we will be getting $500 million a year instead of $20 million a year.

We love the investment, and I would expect that — the question about losing reputation.

There's no question that the allegation alone causes the company to lose reputation, and obviously the press of the past few weeks, they hurt. They hurt a company. They can hurt morale, a lot of things. Nothing — it's not remotely mortal or anything like that, but it hurts.

Incidentally, Goldman Sachs had a situation in connection with the Penn Central, 30 — 40 years ago now. And that hurt at that time.

They had a connection with one fellow in terms of Boesky that hurt at that time. And it was the source of great pain to John Weinberg, who was running Goldman.

But I don't believe that the allegation of something falls within my category of losing reputation. If something is proven, then you have to look at it.

My advice, in times of some kind of an emergent — when some transgression is either found or alleged, you know, basically, you saw Ron Olson in our movie, he was the manager of the team.

And back when we were working at Salomon together in a somewhat similar situation, we had as our motto, "Get it right. Get it fast. Get it out. Get it over."

But, "Get it right," was number one. I mean, you have to have your facts right, because if you go out with the wrong facts you get killed, and you can't redo it afterwards.

But that does mean sometimes some delay. You have to gather information from within your own organization, and you are on the defensive.

I would not — I do not hold against Goldman at all the fact that an allegation has been made by the SEC. And if it leads into something more serious, you know, then we'll look at the situation at that time.

But what I've seen in terms of the ABACUS activity, I just don't — I do not see that that would be any different than me complaining about the list of municipals that were given to me to insure a couple of years ago.

Charlie?

CHARLIE MUNGER: Well, I agree with all of that. But I also think that every business ought to decline a lot of business that's perfectly legal and proper to accept.

In other words, the standards in business should not be what's legal and convenient. The standards should be different.

And I don't think there's an investment bank in America of any consequence that didn't take too many scuzzy customers and deal in too many scuzzy securities.

WARREN BUFFETT: I would agree with that. But, Charlie — (applause) — do you think we should have done our municipal bond deal?

CHARLIE MUNGER: I think it was a closer case than you do.

WARREN BUFFETT: (Laughs) OK.

We insure, probably, 40 billion now, or something like that, of municipal bonds. And we have done very little in the last year, not because of Charlie's views that he just expressed, but basically because the price isn't right, the premiums are wrong.

And the reaction of other people when premiums are wrong is to take more risk. And our reaction when premiums are wrong is just to go play golf or something and tell somebody to call us when premiums get right again.

I do want to — Charlie and I will give our views on a lot of the activities that have gone on on Wall Street, and we do think plenty has been wrong.

I do want to point out, though, that our experience with Goldman goes back 44 years. And during those years, we've bought more businesses through them than through any other Wall Street investment bank. We've probably done more financing.

They have helped build Berkshire Hathaway. And we trade with them as well.

We don't hire them as investment advisors. They have a big investment advisory business, and, you know, our reaction to that is, "No, thanks." You know, we are in the business of making our own decisions.

But when we trade with them, they can very well be shorting to us a stock we're buying. You know, they can be buying for their own account some stock we're selling.

They do not owe us a divulgence of their position any more than we need to explain to them our reasoning or what we are doing in our position.

We are acting there in a non-fiduciary capacity, and they are operating in a non-fiduciary capacity, in my view, when they are trading with us.

Now, if they're working on our behalf on an acquisition or a financing, that's a different story.

But I would say that we have had a lot of very satisfactory transactions with Goldman Sachs.

And I don't want to prolong this. I won't do this on any more questions. But I'd like to — some people here will remember this — I'd like to take you back to the very first bond issue that Charlie and I ever did.

This was our maiden voyage back in 1967, I believe. Yeah. And if we could put slide 2 up there, I will direct your attention to the —

This is an offering that was made in 1967. We'd just bought a department store and we had a company called Diversified Retailing. Now, Diversified Retailing only owned one retailing operation, but we were sort of imaginative in those days, so we called it Diversified Retailing. (Laughter)

And we went out to raise $5 1/2 million. And Charlie Heider of Omaha, whom many of you know, helped me in the financing.

And you will notice our tombstone ad there has on the top two lines "New York Securities" and "First Nebraska Securities."

They were the lead underwriters. And as customary with tombstones, there are a group of underwriters listed below, and they're usually listed in the degree of their participation.

In other words, the more that they're involved, the higher up in the list they are, with the lead underwriters on top. And that's been true of every tombstone I've ever seen, except this one.

And what happened in this one was that we were having trouble raising $5 1/2 million. And I called Gus Levy of Goldman Sachs, and I called Al Gordon of Kidder Peabody. Those were two of the most prestigious firms in Wall Street at the time.

And I said, "Would you guys help me? We're trying to raise 5 1/2 million and there's nobody that wants to give Charlie and me 5 1/2 million. And the underwriters we've lined up are having trouble getting it done." And both Gus Levy and Al Gordon said to me, "Warren, we'll take a big piece."

And if you'll put — if you put up slide number 3, you will see the list of underwriters, and Goldman Sachs highlighted and Kidder Peabody highlighted were actually the next-largest underwriters. But they were so ashamed of being associated with our dinky little company that they asked us to leave their names off. (Laughter)

They wanted to give us money under an assumed name. (Laughter)

But they did — they did come through for us. They did come through for us. And believe me, a lot of people weren't coming through for us then. I do have a long memory for people that have taken good care of Berkshire over time.

And Al Gordon died last year at the age of 107. He worked until he was 104. He was a remarkable man. Gus Levy was a remarkable man. And I thank them for their participation, even though they did want to do it under an assumed name. (Laughter)

7. Munger: "I would make Paul Volcker look like a sissy"

WARREN BUFFETT: OK, we'll go to — we'll go to area number 1 and we'll shorten the answers. (Laughs)

AUDIENCE MEMBER: Good morning, Mr. Buffett and Mr. Munger. My name is Guy Pope and I'm from Portland, Oregon.

I'm curious about your thoughts on financial reform that Congress is currently working on. Specifically, what are the good ideas that you think are out there that should be included in the bill, and what are the bad ideas that you think should be left out?

WARREN BUFFETT: Charlie, it's 1,550 pages so you take the first 1,500, I'll take the last 50 pages. (Laughter)

CHARLIE MUNGER: Well, I don't think anybody in America right now, including the people in Congress, know what's going to happen. And my guess is that most of them have not read the bill, either.

So I think we're all in the doubt — (applause) — as to what's going to happen.

To me, one thing is perfectly clear and that is that our governmental system, which regulates the big investment banks, was so permissive and the investment banking culture had a nature, that together helped arrange that, under stress, every big investment bank except Goldman Sachs was going to go blooey.

A system that likely to go blooey, that is so important to the country, should be changed so it's less permissive in what it allows the banks and the investment banks to do. And people are thinking about that right now.

The banks and investment banks just hate the idea of losing investment flexibility. For instance, on maintaining the biggest derivative book in the world at, say, JPMorgan Chase.

They hate giving that stuff up. That doesn't mean that it's good for the country that they be allowed to continue to do as they have done.

WARREN BUFFETT: Based on what you know about the bill, and I know you haven't read all 1,550 pages, but would you vote for it today or not?

CHARLIE MUNGER: I simply don't know enough about it. I know what I would do if I were the benevolent despot of America. And I would make Paul Volcker look like a sissy. (Laughter and applause)

WARREN BUFFETT: You want to get more specific than that? That's quite a word picture. (Laughs)

Want to get more specific, Charlie?

CHARLIE MUNGER: Well, I would reduce the activities that are permitted. If you're de facto using the government's credit to help your business run, you shouldn't have a bunch of financial statements in the trillions, which you can't really understand even if you're a partner in the business.

This is crazy. The complexity that has come into the system is quite counterproductive. And of course, the people have proven they can't really control it.

So I think what we need is a new version of Glass-Steagall that drastically limits what — (applause) — what both commercial banks and investment banks are allowed to do.

They should have a much simpler and safer mode of business.

When we owned a savings and loan association, it had a very restricted repertoire that it could use. And of course, it had government credit for its deposits.

And by and large, as long as the repertoire was quite limited, the savings and loans stayed out of trouble. But you give human beings the flexibility the do any damn thing they please with absolutely unlimited credit under the repo system and other systems, and they will go plum crazy. And of course, they did.

8. We shouldn't have to collateralize previous deals

WARREN BUFFETT: OK. On that cheery note, we'll move to Becky. (Laughter)

BECKY QUICK: We received a lot of questions about the financial regulatory impending legislation. This question comes in from Jay Gelb, who wants to follow up on the point that Mr. Pope just made.

“What’s the anticipated impact of pending financial reform legislation on Berkshire? In particular, how much additional collateral may need to be posted on Berkshire’s existed $63 billion of derivative contracts? And could Berkshire get too close to its minimum requirement of $20 billion of cash on hand as a result?”

WARREN BUFFETT: Yeah. As I understand the bill now, the one that got presented a couple of days ago — and I could be wrong but I think I understand it and I’ve read the sections — the requirements would be zero.

If we were found — Berkshire were found — to be a — and I don’t know the exact term in the bill — but basically, dangerous to the system, by the secretary of the treasury, or I believe some commission, then we could be required to post collateral on retroactive contracts — on contracts that were written in the past.

I think the chances of us being regarded as a danger to the system when we have 250 contracts and other companies have a million contracts — our position was described in the Journal not long ago as “huge.”

You know, our position is 1 percent, in terms of notional value or liabilities or a lot of ways of measuring. It’s 1 percent of that of several other very large institutions.

So I — I’ve really wondered if you use the word “huge” to describe our position, what you would use for 100 times that position?

That must be some adjective that lurks out there someplace to be attributed to those other positions.

We had 23,000 positions 10 years ago when we bought Gen Re. And we proceeded promptly to get rid of all but less than a hundred that are left.

So we have absolutely, in my view, we have no problems.

If for any reason though, the Treasury or this commission should go back and maybe in some more sweeping declaration decide that they wanted all past contracts to be collateralized, we would comply, obviously.

We also would feel that we were due substantial money because, in negotiating those contracts, there was one price for collateralized contracts and there was another price for un-collateralized.

So if I sell my house to you for $100,000 and wanted $120,000 if it were furnished, but you said, “I’ll take it unfurnished for $100,000,” and then Congress comes along later on and says, “All houses have to be sold furnished, and by the way, that’s retroactive,” if I give you the furniture now I want something for it. A little unreasonable, maybe.

We do think — well, just a week ago we were offered an equity put contract that's identical, basically, it's a 10-year contract, by one of the very largest investment banking houses.

The price that they would pay us was 7 1/2 million un-collateralized and $11 million collateralized. So there's a very different — there's a price to be paid for having a collateralized contract.

And we elected to forgo probably a billion dollars of extra premiums we could have received in the past for our contracts if we had agreed to have them collateralized.

And with a few exceptions, we declined that. And we would feel, if we ever had to collateralize them, we would be entitled to fair compensation for it, and we would like that language to be in the bill.

And incidentally, Secretary Geithner — we'll put up slide number 7. We have his testimony before the Senate Ag Committee on December 2nd. And as you can see, he testified very strongly, in terms of the sanctity of past contracts.

But if the bill passes tomorrow, the way it reads to us and to our attorneys, we would not have to put up a dime.

And I would think there might be some other companies that would be determined to be dangerous to the system before Berkshire Hathaway would be.

So I really — I don't see any — I don't see any consequences unless there's some sweeping declaration that any company of a certain size that has derivatives shall be required to put up collateral.

And if that's required, we will, and it would be no problem. It would — it would have a cost to us in terms of the opportunity cost, but then of course we would argue about what collateral was proper and so on.

And if we could put our Coca-Cola stock, you know, we're going to hold our Coca-Cola stock anyway. So it really changes nothing. We still get the dividends from the Coca-Cola stock if it's placed as collateral, we get the profit if it goes up.

Charlie?

CHARLIE MUNGER: Well, yes. If collateral requirements were inserted by fiat of the government into existing contracts, it would be just like having a contract to buy a house for a million dollars, and the government passing a law saying, "No, you've got to pay $2 million."

I mean, it would be of dubious constitutionality, and it would be both unfair and stupid. I don't think the government is that crazy. (Laughter)

WARREN BUFFETT: Plus, I think what they would see — there's a whole list, in fact I think I've got a page even for that. Yeah, let's put up slide number 8.

And this is just a sample page of people who oppose putting up collateral — being required to put up collateral — prospectively. And you'll see IBM, you'll see Ford Motor, you'll see 3M, you'll see HCA.

I mean, there's all kinds of companies that don't want to do it in the future. We don't care what we do in the future as long as we get paid for it.

So this is not anything that is peculiar to Berkshire at all. In fact, we happen to be in a different position than the IBMs and the 3Ms and those of the world, in respect to this. As long as we get paid for it, we're indifferent to what the rules are going forward.

But considering the fact that we took lesser premiums in the past, we would not like something retroactively to take money out of our pocket.

But bear in mind, Burlington Northern, when we buy it, it has some fuel contracts. MidAmerican has energy contracts.

There was a story in Businessweek about Anheuser-Busch a couple of weeks ago. And, you know, they say, "We don't want to take money out of our business and send it to Wall Street as a deposit on collateral."

And I think when — if they really saw that the net effect of this would be to send a whole lot of money to be held by Wall Street that was otherwise employed in operating businesses, there might be a little less congressional enthusiasm.

9. Greek debt crisis: "I don't know how this movie ends"

WARREN BUFFETT: OK, we'll go to number 2.

AUDIENCE MEMBER: Good morning to all of you. Switching topics, Charlie and Warren, I'm Norman Rentrop from Bonn, Germany. I want to first give you a big thank you and then a question.

"Come by train," you wrote in the shareholder letter, and that is how I came to Omaha for the first time back in 1997.

I deliberately took the train from Denver to experience Omaha as a railroad city, and I immediately liked Omaha a lot. But the train ride, I saw room for improvement. So thank you very much for taking the future of American railroads into your gifted hands. (Applause)

WARREN BUFFETT: That's one of the best questions I've ever heard. (Laughter)

AUDIENCE MEMBER: Oh, here a question.

WARREN BUFFETT: Oh, OK. (Laughter)

AUDIENCE MEMBER: It's about Greece, the future of the euro, and the fiscal discipline all over the world, and what we have to prepare for as investors.

In the past, you have been warning us about structural weaknesses of the U.S. dollar. Now we see Greece, and potentially other European countries, in crisis.

Berkshire has significant investments in the eurozone, the big ones like Cologne Re, Munich Re, and even small ones like ISCAR's (inaudible) in Hamburg.

How are you preparing Berkshire Hathaway for potential currency failures? And what are your thoughts on the sustainability of the euro? And what is your advice for us as investors?

WARREN BUFFETT: Yeah. I'm going to — Charlie and I have not talked about Greece, actually, recently, so I'm going to be very interested in hearing his views on that. I will — I'll answer the last part of your question first.

We have a lot of exposure in various countries on both the asset and liability side. In other words, we do own stock in Munich Re, and they've got lots of assets, majority, probably, in the euro.

We have Cologne Re, a subsidiary of General Re, which has a substantial net worth that is basically tied to the euro.

On the other hand, we have very substantial liabilities that are denominated in other currencies, including fairly big time in the euro around the world.

For example, when we reinsured three or four years ago, three years ago maybe, Equitas, we took on many, many, many billions of liabilities around the world. And we were paid by, in effect, Lloyd's. And we took that money and invested it in dollars.

So we keep those liabilities for all kinds of old insurance claims arising from Equitas in foreign currencies.

And if the euro depreciates against the dollar, we benefit on that side, but we lose, as you point out, on other sides.

I can't tell you, and it's something I'm not concerned about, whether our net balance in euros or sterling or yen or whatever, I can't tell you what it is on any given day. Some of it enters into our equity put options and things of that sort.

But we have no dramatic exposures in any other currency. That doesn't mean that other currencies are unimportant to us, because what happens with the Greek situation and what may fall out from that can be quite important, in terms of the world's economy.

And Charlie's going to explain to you exactly what that might be. (Laughter)

CHARLIE MUNGER: Yeah. Well, generally speaking and with rare exceptions, of course, we're agnostic about currencies. We simply do our business and we take those fluctuations as they fall, wouldn't you agree with that?

WARREN BUFFETT: Yeah. We're agnostic in terms of the relative values, of —

CHARLIE MUNGER: Yes. Yes.

WARREN BUFFETT: — course. Yeah, we're not agnostic about where we think all currencies are headed, generally.

CHARLIE MUNGER: No, no.

WARREN BUFFETT: But the relative value —

CHARLIE MUNGER: But —

WARREN BUFFETT: — agnostic.

CHARLIE MUNGER: — Greece presents an interesting problem, of course. What's happened is that the past conservatism of a place like the United States gave it wonderful credit, a combination of success and conservatism.

And we used that credit to win World War II, and help revive Germany and Japan in one of the most constructive and intelligent foreign policy decisions ever made in the history of the world.

And we used that credit to help assure prosperity for all these decades in which Berkshire has flourished.

And now, of course, the government does not have quite as good a credit as it had before it started using it so heavily. And that's happened pretty much all over the world.

And so Greece is just the start of a very interesting period, and of course, it's more dangerous to civilization when governments push their credit so hard.

Because if you need credit to help civilization function, and you've blown it by your own aggression in using it in the past, that's not a good thing.

And I think in this country, and in other countries too, responsible voices are now realizing that we're nearer trouble from lack of government credit than we've been, well, in my lifetime.

WARREN BUFFETT: Everything you read about country credits, currency, you always want to make a — you always want to distinguish between countries that are borrowing in their own currency pretty much exclusively, like Japan has or the United States, and countries that are being forced for one reason or another, because the world doesn't trust them, to borrow in other countries' currencies.

I mean, in the past, you know, if you were some South American country and you were borrowing in your own currency, you never default, you just buy a new printing press or work it a little harder.

But the world doesn't like that sort of thing. So with weaker credits, and countries with poorer reputations, they force those countries to borrow in other currencies, frequently the United States currency.

And that can really put you out of business very quickly because, you can't — if you're some South American country, you can't print U.S. dollars, although you can print your own currency. And that's what's caused failures among countries.

The European Monetary Union, it's a really interesting situation, because Greece, they are a sovereign country, in terms of their own budget. But they can't print their own currency, you know, they've got the euro.

And this is — you know, the euro was regarded as quite an experiment 20 years or whenever it was ago, or less than that. But you may be seeing sort of a test case play out here of a country that is not using its own currency, in effect, or using a common currency, and yet is sovereign, in terms of making its own promises to its citizens.

And I don't know how this movie ends. That doesn't mean I'm forecasting disaster or anything, I really just don't know how this movie ends. And I try not to go to movies like that, if I can. (Laughter)

But I'll be watching. Really, this will be high drama, in my view, what happens here.

The one thing, Charlie says we're agnostic on currencies, and we don't make big currency plays. We did make one a few years ago and we did all right on it. But we very seldom will develop a strong view on one currency versus another.

I would say this though, that events in the world of the last few years would make me more bearish on all currencies, in terms of their future — holding their value over time — than previously. But it's not unique to the United States, it's not unique to the United Kingdom.

If you really could run budget deficits of 10 percent of your GDP and do it for a long period of time, believe me, the world would have been doing it a long before this. I mean, that is — that's a lot of fun if you can keep it up.

And the reason it hasn't been done in the past, I think, is probably that most people understand that it can't be kept up.

And how the world weans itself off huge deficit financing by country after country after country — it's going to be easy — I mean, it's going to be interesting — to watch.

You do not need to worry; as long as the United States government borrows in U.S. dollars, there is no possibility, none, of default. If the world won't take our obligations denominated in dollars then we — then you have a real problem.

But you don't default when you can print your own currency.

CHARLIE MUNGER: Well, yes. And of course, the published statistics are quite misleading because the debts of the currencies — of the countries — are normally stated in terms of the government bonds outstanding, and the unfunded promises of the various governments are much greater than the government bonds outstanding.

So whatever you think this problem is when you read the statistics, it's miles bigger.

And those unfunded promises don't bind if you keep growing GDP at 2 or 3 percent per annum, per person, or something like that. You can afford the unfunded promises.

But if you get to where the growth stops, then you're going to have enormous social strains. And God knows what the effect will be on government policy and on currencies.

10. Did Goldman need to disclose SEC notice?

WARREN BUFFETT: Andrew, you've been very patient.

ANDREW ROSS SORKIN: I've received over 300 questions just related to Goldman Sachs, and I know we've covered it already but there are a couple outstanding questions and one individual sent three specific questions that I thought I'd ask.

The first is, since Berkshire is a Goldman shareholder, who would you like the see run Goldman Sachs if not Lloyd Blankfein?

Were you made aware of Goldman's Wells notice, or anything about the case, prior to it being brought?

Do you think the Wells notice constituted material information and should have been disclosed? Would have you disclosed it?

And finally, have you been contacted as part of the Galleon investigation and the allegation that a Goldman Sachs board member passed inside information about your pending investment in Goldman in 2008 at the height of the crisis to Galleon?

I know there's a lot of pieces to that, but I thought we'd get Goldman out of the way —

WARREN BUFFETT: OK, good.

ANDREW ROSS SORKIN: — right now.

WARREN BUFFETT: Good. Yeah. Well, let's answer the third one first.

We've not been contacted in any way about Galleon. I read about that in the paper and the allegation, apparently, of a contact between a Goldman director and Galleon.

And I think in one of the stories, I read something about, presumably, Galleon trading on it. But the answer is no contact from anybody. And I can't pronounce the name of the guy that runs Galleon. (Laughter)

The Wells notice, I've talked to a number of lawyers about that. And I think — when we got a — we didn't get the Wells notice, but when the Gen Re executives got the Wells notice, I'm quite sure we stuck that in the 10-K or 10-Q that came up.

And maybe we filed an 8-K announcing it. That was not us receiving it ourselves but certain executives receiving it.

I have been on the board of at least one well-known company over the past 40 years, and I won't narrow it down any more than that.

But before, they received a Wells notice and they didn't publicize it, and, in truth, it was nothing. So lawyers tell me that if you regard it as material, you report it.

I don't think if I'd received something relating to the ABACUS transaction, based on what I know about it, I would have considered it material to a company that was making many, many, many billions of dollars a year.

Charlie?

CHARLIE MUNGER: Well, I wouldn't have regarded it as material, either.

If every company reported every little thing that might happen with what they regarded a tiny probability, we'd just have unlimited confusing reports.

There has to be some materiality standard. And you don't want to give blackmail potential to people that are mad at you and make claims. I'm not saying that's what the SEC was doing, but —

WARREN BUFFETT: No, but it could happen with a lot of — (laughter) it could happen with individual —

CHARLIE MUNGER: It could happen with other people, yeah.

WARREN BUFFETT: And I know what percentage of Wells notices result in something that's material to the company. But my guess is that there are plenty of them that wouldn't be.

And of course, the bigger the company, the less likelihood that it would be material.

And then your other question about who I would want running, if Lloyd wasn't running it?

I guess if Lloyd had a twin brother, I'd go for him. But I've never given that a thought.

We think about who would run Berkshire — (laughs) — but there's really no reason to think about that.

There wasn't any reason to think about, in my view, back in 1970, when they had the Penn Central problem whether somebody other than Gus Levy should be running Penn Central — be running Goldman.

And when the event happened in connection with the Boskey thing, John Weinberg was running it then. And I thought that John Weinberg was a terrific manager of Goldman.

So I just don't see this as reflecting on Lloyd.

I think, as Charlie — and we've got strong feelings. There's plenty of stuff goes on Wall Street that we don't like. But we do not think it's specific — we know it isn't specific — to Goldman.

Charlie?

CHARLIE MUNGER: Well, there are plenty of CEOs I'd like to see gone in America. (Laughter)

But Lloyd Blankfein is not one of them.

WARREN BUFFETT: OK, number 3. (Laughter)

I was afraid he might start naming names. (Laughter)

11. Driver feedback technology

AUDIENCE MEMBER: Hello. My name is David Clayman (PH) and I come from Chicago, Illinois. This question is for Mr. Buffett and Mr. Gates, principally as Berkshire shareholders, but also as Bill and Melinda Gates Foundation trustees.

The leading cause of death for Americans my age are motor vehicle crashes. Over 6 million occur each year and you insure a significant number of these crashes.

The World Health Organization ranks motor vehicle crashes as the 11th leading cause of death in the world.

A new category of technologies are reaching the market. These technologies not only reduce driver distraction but also deliver positive feedback to drivers to help make drivers aware of how well they're driving or how much better they could be doing.

Will GEICO or the Gates Foundation make an aggressive and visible bet on driver feedback technologies to stimulate road focus and save life, liberty, property, and insurance premiums?

I have a note here for Mr. Gates and Mr. Buffett. I'd be happy if I could get these to you somehow.

WARREN BUFFETT: OK, I think we know your position. (Laughter)

The Gates Foundation, I think, has a fairly major initiative, along with Mayor Bloomberg, in terms of cigarette smoking. And I think you'll find a whole lot more people have been affected by that than auto accidents.

Auto accidents per mile driven, auto deaths, have diminished. I thought I heard a figure of six — I thought the figure was more in the 30,000 to 40,000 range actually, but it's diminished over the years.

You know, there have been a lot of things done to make cars safer. I'm not sure that cell phones and BlackBerries are among them. (Laughter)

And I think they actually are — there will be more people die in auto accidents because the cell phone and various other instruments were invented than would otherwise be the case. I don't know how significant that item will be.

But everybody has an interest in bringing down fatalities. And GEICO has a very active safety program, testing cars, doing all kinds of things, working usually in conjunction with other insurance companies.

I do not think that — The Gates Foundation has fairly specific and intelligent, in my view, guidelines as to where they direct their activities, and they believe in focus, so they are not going to try and solve every problem in the world.

But I can assure you that the insurance industry, as well as auto companies generally, are continuously working to make cars safer.

Charlie?

CHARLIE MUNGER: I've got nothing to add. (Laughter)

WARREN BUFFETT: OK.

12. Berkshire shares not affected by Buffett's donations

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question also concerns the Gates Foundation but it's entirely different.

"One of your owner-related business principles says that you will attempt, through your policies and communications, to keep Berkshire's stock price rational.

"Yet every year, you give large amounts of your Berkshire stock to the Gates Foundation. And my understanding is that more will go to the foundation when you die."

By the way, I forgot to say this is from Michael McLaughlin (PH) of Omaha, who continues: "Already, we have seen that foundation regularly sell Berkshire stock, and it will sell more because its purpose is to give money to charities not hold the stock forever.

"Won't the foundation selling create a downward pressure on the stock because as much as 25 percent of it will be turned over?"

WARREN BUFFETT: Yeah. Basically, there's five foundations I give money to every year, every July.

And the amount I would be giving now, it's a 5 percent declining balance, the amount I would be giving now would amount to about 1 1/2 percent of the shares outstanding annually, something like that.

So if they sell, and they will, that stock fairly promptly after receipt in order to make charitable gifts, you basically have 1 1/2 percent of the shares being sold annually.

Now, if you contrast that with trading on the New York Stock Exchange, which averages well over 100 percent of the amount of shares outstanding, it's not anything unusual at all in the way of sales.

And it is a free country. I mean, I could sell 10 percent of the company if I wanted to. I've never sold a share in my life, and I never plan to sell a share in my life. And I won't sell a hell of a lot of shares after I die either, probably. (Laughter)

If 1.5 percent of the outstanding shares at Berkshire move the price down in a year, it probably deserves to move down.

Charlie?

CHARLIE MUNGER: Well, of course, I regard that degree of stock distribution to aid charity as almost a nonevent, and it may actually have been a constructive event, in terms of getting Berkshire into the Standard and Poor's indexes and so on.

WARREN BUFFETT: Excuse me.

CHARLIE MUNGER: I think you've got more important things to worry about. (Laughs)

WARREN BUFFETT: If I'd owned 100 percent of Berkshire, for sure it would not have been in the S&P 500. It was always a problem of concentration.

So if by selling down it enhanced — and it did to some degree — enhanced the chances of Berkshire being in the S&P 500, that probably accounted for maybe 7 percent or so of the capitalization, some number like that.

So that was extraordinary, you might call it, buying that was brought in, to some extent because of the diminution of my own holdings.

As Charlie said, I would say if none of the stock had been given away in the last four years, I don't know whether — I have no idea — whether the stock would be selling a little higher or a little lower. I think that's sort of an even money bet.

13. Buffett: "I would not run from the United States"

WARREN BUFFETT: OK, number 4.

AUDIENCE MEMBER: Hello, Mr. Buffett. Hello, Mr. Munger. My name's Vern Cushenbery. I'm from Overland Park, Kansas.

What do you see as the biggest challenge facing the United States economy relative to other countries? And what are the implications of that with regard to investing globally over the next decade?

WARREN BUFFETT: Charlie? (Laughter)

CHARLIE MUNGER: Thank you for steering that easy problem to me. (Laughter)

I think the answer to that is that by and large we haven't made our way in life by having great global allocations systems.

Berkshire's attitude, generally, is to find things that seem sensible to us and to concentrate, to some extent, in those matters. And then let the world economy and the world's currency fluctuations fluctuate as they will.

I do think we'd prefer some countries to others, and the more responsible the countries seem, the more comfortable we are. Wouldn't you agree with that?

WARREN BUFFETT: Yeah. But we —

CHARLIE MUNGER: But beyond that, we can't help you very much because we really don't have a global allocation system at Berkshire, unless Warren is keeping it secret from me. (Laughter)

WARREN BUFFETT: Not that one. (Laughter)

We did not buy Burlington Northern with the idea of moving it to China or India or Brazil — (laughter) — and we love that. We love the fact that Burlington Northern is in the United States.

The biggest threat we have is some kind of a massive nuclear, chemical, or biological attack of one sort or another.

And if you would say what are the probabilities of that over a 50-year period, it's pretty high. Over a one-year period, it's very low.

But if you talk about whether the qualities that have led to the last 220 years of incredible progress, with a lot of hiccups, but incredible progress, you know, in the status of mankind that we've experienced in these two centuries compared to any two centuries you want to pick out in history, this country is remarkable and its system is remarkable.

And it does unleash human potential like has never been seen before.

This crowd here is not smarter than a similar crowd 200 years ago, and they don't work harder.

But, boy, do they live differently. And they live differently because this system has enabled fairly ordinary people, over a period of time, to do extraordinary things. And that game isn't over.

There is nothing that says we have come close, in my view, to the limits of what humans can achieve.

We probably don't even know our own potential, any more than the people in 1790 knew their own potential. I mean, they thought it would be great if somebody finally came along with some farm tool that let them work 10 hours a day instead of 12 hours a day.

So I — there's no reason — you know, I hope the rest of the world does well, and I think they will do well. And it is not a zero-sum game. If China and India do well, that does not mean we do worse; it may mean we do better.

So we are not — it's not what they get is taking it away from us. But I would be perfectly content if Berkshire Hathaway were forced in some way to limit its investment to the opportunities available in the United States.

We would have plenty of opportunities. I'd rather have the whole world, obviously, in terms of opportunities, but there will be ample in this country. I would not run from the United States. OK. (Applause)

14. No rush to find new investment chief

WARREN BUFFETT: Becky?

BECKY QUICK: This is a question that has to do with the Berkshire succession plans. It comes from Craig Merrigan in Sprucegrove who asks, "How did the four potential candidates for Berkshire's CIO position perform over the course of 2008 and 2009?

"Did any of the four employ leverage? And have any of the four now been excluded from consideration?"

WARREN BUFFETT: Yes, the answer to that is that, in 2008, I reported to you last year that they didn't, I think we got a question like that last year, they did not distinguish themselves. 2009, they did pretty darn well.

It's not — I would say that the four — it's not the same four. I would say that none of them, Charlie, I believe you may use leverage at all. Do you think so?

CHARLIE MUNGER: Well, the one with which I'm most familiar made a little over 200 percent using leverage of zero.

WARREN BUFFETT: Well, that narrows it down. (Laughter)

The potential investment people, that list will be subject to more movement around than probably the CEO succession.

And it's really far less urgent. If I die tonight, there will be a new CEO in place in Berkshire within 24 hours, and all the directors know who it would be, and they're all comfortable with it.

And there should be somebody in place within 24 hours.

The investments, they don't need anything done next week. I can go on vacation on investments. And we could go — we wouldn't do it, or the directors wouldn't do it, I won't be there — but they could wait a month, they could wait two months.

I mean, the Coca-Cola isn't going to go away, Procter & Gamble's not going to go away, American Express. There's no great need to be doing things day by day. We don't do things day by day.

So they can be fairly leisurely in working out, probably in conjunction with a new CEO, who they would like to bring in, how they would like to compensate them, what the number might be.

That is not fixed in stone at all. The one thing I can tell you is that there are some very able people who would like very much, I think, to be managing money for Berkshire, and who would do a good job, and who are familiar to at least some of the directors. And that problem would get solved.

The CEO problem — which is not a problem — but the CEO question, you want an answer for right now and you want to be prepared to implement it, you know, the next day, although I did just have a physical. (Laughs) Came out fine. (Laughter)

Charlie? (Applause)

My doctor isn't here today so I will tell you, it drives him nuts because I eat like I do and he can't find anything wrong — (laughs) — and he wants to, believe me. (Laughter)

And with that —

CHARLIE MUNGER: Well I'm — (Laughter)

I am not the most optimistic of the two people up here. And — (laughter) — yet, I'm quite optimistic that the culture of Berkshire will last a long, long time and will outlast, greatly, the life of the founder. I think it's going to work.

WARREN BUFFETT: I really think — I mean, we shouldn't be getting into superlatives — but I think we have as strong a culture, and as distinctive a culture, in terms of managers, ownership, the whole works, of any really large company in the country.

And it's taken a long time to develop, but it becomes self-reinforcing after a point. And we love it, and I think they'll love it after I'm gone. (Applause)

Don't clap there. (Laughter)

15. Good, but not brilliant, returns for businesses needing capital

WARREN BUFFETT: OK, number 5.

AUDIENCE MEMBER: Hi, I'm Steve Fulton (PH) from Louisville, Kentucky. Once again, I gave up a box seat to the Kentucky Derby to come ask you a question. (Laughter)

And I appreciate that opportunity.

My question's focused on the shift, if you will, to investing in the capital-intensive businesses and the related impact on intrinsic value.

You again stated in the annual report that best businesses for owners are those that have high returns on capital and require little incremental capital.

I realize this decision is somewhat driven by the substantial amounts of cash that the current operating companies are spinning off, but I would like you to contrast the requirement for this capital against the definition of intrinsic value, which is the discounted value of the cash that's being taken out.

And just for all of us to be aware, you've mentioned the fact that you think these businesses will require tens of billions of dollars over the few decades, and just the time value of that, I'd like to understand a little bit more of your insight into that.

WARREN BUFFETT: OK. Although it's clear you understand the situation quite well, and it's — as important a question as you could ask, virtually, I would say, at Berkshire.

We are putting money into good — big money — into good businesses from an economic standpoint. But they are not as good as some we could buy when we were dealing with smaller amounts of money.

If you take See's Candy, it has 40 million or so of required capital in the business, and, you know, it earns something well above that.

Now, if we could double the capital, if we could put another 40 million in at anything like the returns we receive on the first 40 million, I mean, we'd be down there this afternoon with the money.

Unfortunately, the wonderful businesses don't soak up capital. That's one of the reasons they're wonderful.

At the size we are, we earn operating earnings, $2.2 billion, or whatever it was in the first quarter, and we don't pay it out, and our job is to put that out as intelligently as we can.

And we can't find the See's Candies that will sop up that kind of money. When we find them, we'll buy them, but they will not sop up the kind of money we'll generate.

And then the question is, can we put it to work intelligently, if not brilliantly? And so far, we think the answer to that is yes.

We think it makes sense to go into the capital-intensive businesses that we have. And incidentally, so far, it has made sense. I mean, it's worked quite well. But it can't work brilliantly.

The world is not set up so that you can reinvest tens of billions of dollars, and many, many tens over time, and get huge returns. It just doesn't happen.

And we try to spell that out as carefully as we can so that the shareholders will understand our limitations.

Now, you could say, "Well, then aren't you better off paying it out?"

We're not better off paying it out as long as we can translate, as you mentioned, the discounted value of future cash generation. If we can translate it into a little something more than a dollar of present value, we'll keep looking for ways to do that.

In our judgment, we did that with BNSF, but the scorecard will be written on that in 10 or 20 years.

We did it with MidAmerican Energy. We went into a business, very capital intensive, and so far, we've done very well, in terms of compounding equity.

But it can't be a Coca-Cola, in terms of a basic business where you really don't need very much capital, if any, hardly. And you can keep growing the business if you're lucky, if you've got a growing business.

See's is not a growing business. It's a wonderful business, but it doesn't translate itself around the world like something like Coca-Cola would.

So I would say you've got your finger right on the right point. I think you understand it as well as we do. I hope we don't disappoint you, in terms of putting money out to work at decent returns, good returns.

But if anybody expects brilliant returns from this base in Berkshire, you know, we don't know how to do it.

Charlie?

CHARLIE MUNGER: Well, I'm just as good at not knowing as you are. (Laughter)

16. Making loans vs. buying stock in credit crisis

WARREN BUFFETT: OK, Andrew? (Laughter)

ANDREW ROSS SORKIN: This question comes from Victor and Amy Liu (PH) who are shareholders from Santa Monica, California.

And they ask, "When you made investments during the financial crisis in February of 2009, why did you lean towards debt instruments rather than equity?

"For example, why did you invest $300 million in Harley-Davidson at 15 percent interest instead of buying equity when the shares were at $12? Today, they're at $33.

WARREN BUFFETT: Well, I would say that if I were writing that question now, I might write the same question. But I'm not so sure you would have written the same question in February.

Now, there were different risk profiles, obviously, in investing. And the truth is, I don't know whether Harley-Davidson equity is worth $33 or $20 or $45. I just have no view on that.

You know, I kind of like a business where your customers tattoo your name on their chest or something. But — (laughter) — figuring out the economic value of that, you know. I'm not sure even going out and questioning those guys I'd learn much from them. (Laughter)

But I do know, or I thought I knew, and I think I was right, that, A) Harley-Davidson was not going out of business. And that, B) 15 percent was going to look pretty damned attractive.

And the truth is, we could probably sell those bonds, I don't know, probably at 135 or something like that. So we could have a very substantial capital gain, a lot of income.

I knew enough to lend them money; I didn't know enough to buy the equity. And that's frequently the case. And, you know, we love buying equities, but we love buying the Goldman preferred at 10 percent.

Now, let's say Goldman, instead of offering me the 10 percent preferred and warrants had said, "You can have a 12 percent preferred, non-callable," I might have taken that one instead. I mean, the callable — so there's a tradeoff involved in all these securities.

And obviously, if I think I can make very good money, as we did on Harley-Davidson, with a very simple decision, just a question of, "Are they going to go broke or not?" as opposed to a tougher decision, "Is the motorcycle market going to get diminished significantly? And, you know, are the margins going to get squeezed somewhat?" And all of that. I'll go with a simple decision.

Charlie?

CHARLIE MUNGER: Well, of course your one good answer, that you simply didn't know enough to buy the stock but you did know enough to buy the bond, is a very good response.

The other side to that is, after all, we are a fiduciary for a lot of people, including people with permanent injuries and et cetera, et cetera. And to some extent, we are constrained by how aggressively we buy stocks versus something else. And you mix those together, why, you get our investment policy.

I think, generally speaking, you raise a very good question. I think very often, when you're looking at a distress situation and buy the bonds, you should have bought the stock. So I think you're looking in a promising area.

WARREN BUFFETT: Yeah. Ben Graham wrote about that in 1934, actually, in "Security Analysis," that in the analysis of senior securities, the junior securities usually do better, but you may sleep better with the senior securities.

And we, as Charlie points out, we have 60 billion of liabilities to people in our insurance operation that, in some cases, extend out for 50 years or more.

And we would never have all of our money in stocks. I mean, we might have very significant amounts, but we are running this place so that it can stand anything.

And a couple years ago, we felt very good about where that philosophy left us.

I mean, we actually could do things at a time when most people were paralyzed, and we'll keep running it that way.

17. Creating a good corporate culture is easier than changing a bad one

WARREN BUFFETT: Area 6.

AUDIENCE MEMBER: Mr. Munger and Mr. Buffett, thanks for having us here.

I recently joined a new organization and for me to succeed there, the culture of the organization needs to change.

So I'm interested in hearing your thoughts about how do you change culture of an organization? And if you're building a new organization, then how do you make sure you have a strong and unique culture?

WARREN BUFFETT: Well, I think it's a lot easier to build a new organization around a culture than it is to change the culture of an existing organization. It is really tough. And I like that fact, in the sense of Berkshire.

I mean, it would be very tough to change the culture of Berkshire. It's so ingrained in all our managers, our owners. Everything about the place is designed, in effect, to reinforce a culture.

And for anybody to come in and try and change it very much, I think the culture would basically reject it.

And the problem you describe, if you want to walk into, you know, whatever kind of organization you want to name — I've got to be a little careful here — it is tough to change cultures.

Charlie and I have bucked up against that a few times. And I would say if you have any choice in the matter, I would much rather start from scratch and build it around it.

But that was the — I've had the luxury of time with Berkshire. I mean, it goes back to 1965, and there really wasn't much of anything there, you know, except some textile miles, so I didn't have to fight anything.

And as we added companies, they became complementary and they bought into something that they felt good about, but it took decades.

And, you know, at Salomon, I attempted to change the culture, in terms of some respects, and I would not grade myself A+ in terms of the result.

Charlie?

CHARLIE MUNGER: Well, I'm quite flattered that a man would say that he's in a new place where he can't succeed unless he changes the culture and he wants us to tell him how to change the culture.

In your position, my failure rate has been 100 percent. (Laughter) And —

WARREN BUFFETT: Yeah, Charlie started a law firm. Go back to, what, 1962, Charlie, what was it?

CHARLIE MUNGER: Yeah. I can move out but I couldn't change the culture. (Laughs)

WARREN BUFFETT: We can tell some interesting stories from the old law firm, but we'll go on to Carol now.

18. Ajit Jain can't be replaced

CAROL LOOMIS: This question is from Jon Brandt of Ruane, Cunniff in New York City.

"You have emphasized many times how important Ajit Jain is to Berkshire and National Indemnities reinsurance operations. So I'm wondering whether you expect National Indemnities' float to continue to grow or instead to unwind after he retires?"

Well, of course we don't think —

WARREN BUFFETT: No.

CAROL LOOMIS: — Ajit will retire.

"Another way of asking that is whether National Indemnity has competitive advantages beyond Ajit, or is all of its value, above book value, tied up in Ajit and the runoff profits from the deals he has already put on the books?"

WARREN BUFFETT: His operation has competitive advantages that go beyond Ajit, but they have been developed by Ajit, and he has maximized them, and he knows how to use them in a way that's far better, in my view, than anyone else in the world could.

But they don't all go away. I mean, he has a cadre of about 30 people who are schooled in it, you know, in a way that would make the Jesuits look quite liberal, in terms of what they let their membership do.

Ajit — you can't imagine a more disciplined operation than Ajit has. But Ajit cannot be replaced. On the other hand — well, I'll state that absolutely, categorically — it would be a huge loss to Berkshire if anything happened to Ajit.

But it would not mean that the Berkshire Hathaway reinsurance operation would not continue to be an extremely special place that would do large deals that nobody else would do, that could think and act quickly in ways that virtually no other insurance organization can.

We've got something very special in that unit, and then we've got the most special of leaders in Ajit.

As to our float, every year I think our float has peaked. I never see how we can add to it. It's up to 60 billion-plus now. And we have things like the Equitas deal that are runoffs.

Every day, in insurance, some of the float runs off, it's just that we add additional amounts. And like I say, I was ready to quit, you know, at 20 billion and think, you know, that we'd reached the apex of it.

But it's over 60 billion. Things keep happening.

Berkshire has become, in my view, the premiere insurance organization of the world, and we've got — a lot of good things come from that.

I don't see how, with 60-odd billion of float, I don't see how we can increase it significantly unless we would make some very significant acquisition. And I don't rule that out, but there's nothing imminent on that.

But we will not organically grow the float of Berkshire at a fast clip from here. It can't be done. And we may fight to stay even.

But we may come up with something out of the blue. I mean, who would have known that Equitas was going to come along three years ago? There are various things that could happen of a positive nature.

But when I tell you about the value that Ajit has added to Berkshire, believe me, if anything, I've understated it.

Charlie?

CHARLIE MUNGER: Well, I agree with you, and I've got nothing to add.

WARREN BUFFETT: Well. (Laughter)

19. Opportunities in India, but government paralysis is a deterrent

WARREN BUFFETT: In that case, we'll go to number 7. Here we are.

AUDIENCE MEMBER: Good morning, Warren and Uncle Charlie. I have to call you Uncle because my parents are from India and we call anybody older than us Uncle or Auntie.

WARREN BUFFETT: You may have to call us great uncle. (Laughter)

SABRINA CHOOG: I'm Sabrina Choog (PH) from Los Angeles and I'm 12 years old.

My mom owns a bunch of Berkies, which obviously I'm gonna get one day. (Laughter)

My question is, 17 percent of the world is Indian. That's one of six people in the world.

India's economy has been growing at 7-8 percent per year. At this rate, it will surpass total U.S. GDP in 2043.

Can you please tell me why aren't you investing in India?

WARREN BUFFETT: Well, it's a good question — (applause) — and we have connections there, obviously.

But it hasn't — in the insurance field, there have been very distinct limitations on what a non-Indian company — a non-Indian-owned company — can do.

We've looked a lot, mostly through Ajit. We've looked a lot at the possibility of being in the insurance business there.

And actually, as of yesterday, I agreed next March to go to India because our ISCAR business — (applause) — is doing very well there.

But, I don't know what they think I can do additionally, but in any event they said, "Come on to India in March and see if we can't expand it substantially."

India is going to grow dramatically, and ISCAR belongs in every industrial country in the world. I mean, we are very basic to industry, and we've done wonders for our customers all over the world.

And we have a good-sized operation in India. But ISCAR management hopes that if we take a trip over there in March, we might land a few more accounts.

We do not rule out India, believe me, in looking at either direct investments or marketable securities.

In fact, POSCO, Charlie can describe the POSCO situation better than I, but they have big plans for India.

Charlie?

CHARLIE MUNGER: Yeah, the one trouble that India presents is that its governments tend to have a fair amount of paralysis, endless due process, endless objection. Zoning is hard, planning permissions are hard, et cetera.

And that has caused the very wise founder of modern Singapore to say that China is going to grow much faster than India, because their government causes less paralysis.

So these countries are different in the opportunities they present.

But of course we like India, and we — kind of admire the democracy that causes the paralysis, but we still don't like the paralysis.

WARREN BUFFETT: It's not ordained, however. You know, if you'd looked at China 40 years ago, you wouldn't have dreamt of what would happen.

So countries do learn from each other, I mean, and they should. I mean, I think they've learned many things from the U.S. that they adapt — I'm not talking about India specifically, I'm talking about other countries generally.

They don't take on everything we have. But if you looked at a country that was as successful as this country has been over a couple hundred years, you might figure that there could be a few good ideas you could steal.

And I think that you're seeing that around the world, and maybe they can improve on us.

So I don't think I would feel that any impediments to growth that existed now are necessarily ones that have to be permanent. Indian — we ought to figure out a lot of ways to do business in those countries.

My preference is, obviously, in something like insurance, which I understand, and where we've got terrific people. Both China and India do limit us right now quite significantly in what we can own of a company.

And I really hate to take some of our managerial talent and put them to work for something we only own 25 percent of. I'd rather have them working on something we own 100 percent of.

So it will depend on the laws. But people in India are going to be living a lot better 20 years from now than they are now, as they are in China, and as they are in the United States.

20. "Prospects for significant inflation have increased"

WARREN BUFFETT: OK, Becky.

BECKY QUICK: This question comes from Jonathan Marsh (PH) in Sydney, Australia.

He says, "Many shareholder letters in the 1970s and 1980s discussed various aspects of inflation and its potentially destructive effects on investment.

"The 2008 letter mentioned the current Federal Reserve's quantitative easing could again bring about inflation, yet the 2009 letter made no mention of this threat.

"What are your current thoughts on the risk level of higher inflation in the United States?"

WARREN BUFFETT: Well, I may be a little biased on this because I've always worried a lot about inflation, and there's been a lot of inflation.

You know, Charlie's pointed out, you know, since I was born in 1930, the dollar's depreciated by well over 90 percent. But as he also points out, we've done OK. So it isn't the end of the world, necessarily.

I think that the prospects for significant inflation have increased, you know, with what — not only here, but around the world, with the situation that governments have either been forced into or elected to embrace.

And they may well have been the correct responses, but we may find that weaning ourselves from the medicine was harder than solving the original illness. And the medicine, you know, has been massive dosages of debt. And, like I say, not only here, but elsewhere.

And I don't see any way that countries running very high deficits, relative to GDP, don't have a significant diminution in the value of their currency over time.

Now, it could be done for a while. I mean, we've done it through wars and everything else, and maybe we will correct the situation.

But if we don't, I wrote an op-ed piece in The New York Times about a year ago on this.

And I do think that if you wanted to bet on higher or lower inflation, bet your life on it, I'd bet on higher, and maybe a lot higher.

Charlie?

CHARLIE MUNGER: Well, again, I agree. (Laughter)

21. Munger: McDonald's is better educator than universities

WARREN BUFFETT: OK, number 8.

AUDIENCE MEMBER: My name is Lucas Rineswell (PH) and I'm from Whangerei. And in case you don't know where Whangarei is, it's in New Zealand.

At the moment, it's quarter past 4 in the morning in New Zealand, so I'd be safe to say that my wife will be sound asleep.

So I'm an idealist. What can be done to educate the children about the sage of Omaha's philosophy of successful money management, and to prevent another reoccurrence of the financial mayhem that we've all seen and experienced in the 2007 and 2008 years?

WARREN BUFFETT: We will see financial mayhem, as you put it, from time to time. I hope we reduce it, I hope we reduce the magnitude, et cetera.

But people do crazy things, and it's not a function of IQ, and sometimes it's not a function of education.

In fact, I would argue that some of the problems, and not a small part of what's occurred in the last 30 years, has been because of what became the prevailing conventional wisdom in the leading business schools.

So, I'm not particularly positive about modifying the madness of mankind from time to time.

The first part though, however, is the kind of thing in our movie. I really do believe that getting good financial habits — other kinds of habits, too, but what I'm thinking about here is primarily financial habits — getting those early in life is enormously important.

I mean, Charlie and I were probably lucky that we grew up in households where we were getting all kinds of unspoken lessons, even, in terms of how to handle our life, but in particular, how to handle finances.

And not everybody gets that. And Andy Heyward, who did a terrific job with "Liberty's Kids" in teaching about the history of America three or four years ago, has come up with this idea of "The Secret Millionaires Club."

And if we get through to 2 or 3 percent, or 5 percent, or whatever it may be, of the kids, in terms of giving them some ideas they might not otherwise have, and they build some habits around it, you know, it isn't going to change the world, but it could be a plus in their lives.

It's very important to get the financial habits. And really, Charlie's a big fan, and so am I, of Ben Franklin's. And he was teaching those habits a couple hundred years ago. So we're just going to try and take Ben Franklin's ideas and make them entertaining for children's stories, in effect.

And I think that's about what you should be doing. I don't think — I think it's much more important to have good learning at the elementary level than, frankly, to have it in terms of advanced degrees and graduate schools.

Charlie?

CHARLIE MUNGER: Yeah, there are other great educational institutions in America to help handle this problem. One of the ones I admire most is McDonald's.

I had fun once at a major university when I said I thought McDonald's succeeded better as an educator than the people in the university did.

And what I meant was McDonald's hires a lot of people who are quite marginal at the very start of their working career. And they learn to show up on time for work and observe the discipline.

A lot of them go on in employment to much higher jobs. And they've had an enormous constructive effect about educating into responsibility a lot of people who were threatened with not making it.

So I think we all owe a lot to the employment culture of McDonald's. And it's not enough appreciated.

WARREN BUFFETT: I learned a lot from a paper manager at The Washington Times-Herald named John Daley (PH).

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: And probably 13 years old or 14 years old, and I was lucky to run into him.

Basically, my life would have been somewhat different if I didn't get those lessons from a guy that taught them to me in a very enjoyable manner. He wasn't preaching them to me, he just told me I'd do better if I did this and that, and it worked.

So you're lucky if you've got the parents to teach you that. But anything that brings it into a broader teaching environment, I'm for.

And like I say, I really think Andy has got a terrific project in this and we'll see how it goes.

22. Giving away everything is a "terrific tax dodge"

WARREN BUFFETT: And speaking of Andrews or Andys, Andrew? (Laughs)

ANDREW ROSS SORKIN: So we received about a dozen questions, at least I did, on the subject of your taxes, Mr. Buffett, from shareholders no less. And I chose what I hope is the most polite version of the question.

WARREN BUFFETT: I hope so, too. (Laughter)

ANDREW ROSS SORKIN: This one came from Tom Cornfeld (PH).

And he says, "Mr. Buffett is often quoted as saying that his assistant pays at a higher tax rate than he does, because of the disparity between the long-term capital gain and ordinary income tax rates.

"The implication is that taxes should be much higher on people like himself.

“However, I note that Mr. Buffett has donated virtually 100 percent of his estate to charitable organizations. Because he has owned his Berkshire shares for many, many years with no dividend distributions, it is virtually certain that the bulk of his estate will therefore never be subject to taxation by the U.S. government.

“My question is that, if Mr. Buffett feels that he should pay more taxes, how should the tax system be changed?”

WARREN BUFFETT: Well, you could have a wealth tax, would be one way. I mean, you could tax — I don’t know how many countries do that now, Charlie.

In effect, you have that with a property tax in certain ways, but you could have a wealth tax. I would say this: he is absolutely correct. If you want to give away all of your money, it’s a terrific tax dodge. (Laughs)

Although, I will say this also. In the tax return I just filed, on the “charitable contributions” line, I have an unused carry-forward of something over $7 billion that I haven’t gotten a deduction for. (Laughter)

But I welcome the questioner or anybody else following my tax dodge example and giving away their money. They will save a lot of taxes that way, and the money will probably do a lot of good. (Laughs) (Applause)

Taxes — if we continue to spend 25 percent or 26 percent of GDP, as a country, and we made those elections through our representatives, we are not going to be able to keep taxation at 15 percent of GDP.

Now, we’ve got a deficit commission. You couldn’t have two better guys than Erskine Bowles and Alan Simpson heading it. You have got two classy individuals there. They’re smart, they’re decent. People like to work with them. I mean, the president made a great choice in picking those two.

But in the end, they’re either going to — they’re going to have to recommend, and it will be some combination of taxes quite a bit higher, and expenditures quite a bit lower, and then they won’t be quite as popular as they are today.

And I doubt very much if you’re going to be able to increase taxes significantly as a percentage of GDP and do it, essentially, from taxing lower income people a higher amount. So it’s going to be an interesting equation to solve and I wish them the very best. They’re two terrific fellows.

Charlie, what do you have to say about taxes?

CHARLIE MUNGER: Well, I think those who worry about your unfairly low taxes should be consoled by the fact that eventually you pay 100 percent. When you die and they ask, "How much did old Warren leave?" the answer will be, "I believe he left it all."

WARREN BUFFETT: And I hope they emphasize old. (Laughter)

No, it's kind of interesting. I mean, just take Berkshire. You know, essentially, I will never sell a share of Berkshire.

But I've known that for a long, long, long time. So basically, that's fine.

If I was a trustee for some trust and they owned Berkshire, which, in effect, I am, you know, it's a lot of fun to run and everything. And I've got everything in life I could possibly need, and I always will.

And, you know, in the end, because Berkshire's done well, we can give away the rest.

Now, if you want, you can argue that if I gave it all to the federal government instead of giving it to the charities, society would be better off, but I don't think many of you would want to hold that position. (Laughter)

23. The best defense against inflation

WARREN BUFFETT: Number 9. (Applause)

AUDIENCE MEMBER: Hello.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: Mr. Buffett, my name is Jeff Chen (PH) from San Francisco.

I wanted to ask you a little bit more detail about the inflation question, wanted to know what are the key metrics you look at when you evaluate future inflation and your valuation methodology?

And what are some of the catalysts that's going to cause the inflation to rise in the future?

WARREN BUFFETT: You give me credit for more brain power than I actually bring to the question.

I don't think you can look at any given metric in any given month and figure out exactly what that's going to do to inflation rates because, so much — if it gets going so much, it creates its own dynamic.

You know, we saw that in the late 1970s and early 1980s until Volcker came along with a sledgehammer to the economy.

But we had people running from money at that time, and, of course, we got the prime rate up to 21-and-a-fraction percent, and we got governments up to very close to 15 percent.

So we had a little demonstration project 30 years ago in this country of what happens when people get fearful about money.

And if we were to continue the policies we have now, I would think something — a rerun of that, you know, could be fairly likely.

But, you know, trend is not destiny. We have the power to do things, and Congress has the power. And that's why I wrote that op-ed piece a year ago, to sort of flash a yellow light.

We have the power to control our future, and we do it through elected representatives.

I will just go back to the conclusion that, based on what I see happening, American people, government around the world, I think currencies are a poorer bet than they have been for some time. But I have no idea what that means in terms of rates of inflation. And I hope I'm wrong on it.

I would say if inflation ever really gets in the saddle, that it gets very unpredictable as to how fast it can accelerate and how faith in institutions can break down. A lot of things — a lot of bad things could happen with it.

Charlie?

CHARLIE MUNGER: Yeah. The best defense, of course, is to contribute as much as you can to the civilization and expect to counter inflation's effects by your own merits.

That's the safest antidote. The idea that just by outsmarting other people you can somehow profit from the inflation is a much more dangerous course of action.

WARREN BUFFETT: Yeah. Your money can be inflated away but your talent can't be inflated away. If you're the best brain surgeon in Omaha, or the best painter, or whatever it may be, you will always command your share of the resources around you, you know, whether the currency is seashells or $10 million notes, or whatever it may be.

Talent is a terrific asset to deal with any kind of a monetary situation. But Charlie and I have to fall back on money.

WARREN BUFFETT: Carol? (Laughter)

CHARLIE MUNGER: Too late for talent.

WARREN BUFFETT: Yeah.

24. Problems at NetJets

CAROL LOOMIS: This question comes from Douglas Ott of Banyan Capital Management in Atlanta.

"In your recent letter to shareholders, you wrote that it was clear you failed us in letting NetJets descend into such a condition that it has recorded an aggregate pre-tax loss over the 11 years we have owned the company.

"What specifically were the errors committed by you and the previous CEO? What have you learned? And how will you prevent such a thing from happening with any of our other businesses in the future?"

WARREN BUFFETT: Well, I probably won't. (Laughs)

We'll make mistakes from time to time, and some of our managers may make mistakes. And sometimes you run into conditions that are really extraordinary.

But the mistake, the biggest mistake made with NetJets is essentially we kept — we were buying planes at prices that were fictitious, in terms of the price at which we would later be able to sell them. And there's a certain time lapse involved in buying fractional shares.

There's a lot of explanations for it. But in the end, we didn't properly prepare for what was obviously happening. And we lost a lot of money, a good bit of which was attributable to the write-down of planes, which you could call is our inventory, where we bought them at X and we couldn't sell them at X or 90 percent of X.

Some of those were new planes that we should not have taken on, and many of them were planes coming back from owners.

We also let our operating costs get out of line with recurring revenues.

But, you know, I've made plenty of mistakes. I stayed in the textile business for 20 years. I knew it was a lousy business. Charlie was telling me it was a lousy business in the first year, the second year.

And 20 years later, I woke up. I was like Rip Van Winkle. I mean, it's kind of depressing when you think about it. (Laughter)

But the one thing we will guarantee, we'll make some mistakes. It was a big mistake at NetJets, $711 million is the figure.

We are now operating at NetJets at a very decent profit. The figures you saw there on the screen reflect a pretax profit of well over $50 million in the first quarter, and that's not with any big boom in plane sales or anything else. It's just with a business plan that involves not an iota of diminution of safety or service, but just got things in line that needed to be in line.

And I give Dave Sokol enormous credit. I mean, he turned that place around like nobody could have, and all the shareholders here owe him a big vote of thanks for that.

Charlie? (Applause)

CHARLIE MUNGER: Yes, but I believe that the episode ought to be reviewed in context.

If we buy 30 big businesses and generally let the people who run them successfully and before run them with very little interference from headquarters, and it works out 95 percent of the time very well, and we have one episode when the basic franchise was protected but we lost profit opportunities for a while, it's not a big failure record.

Nor does it indicate that we should stop being pretty easy with the remarkable people who join us with their companies.

WARREN BUFFETT: No, it does not change our management approach at all. I think that we have gotten performance, overall, from managers that are beyond the dreams I would have had when I was first putting this company together.

So, it's been a — we let managers do their stuff. And I think —

CHARLIE MUNGER: It's worked for us, net.

WARREN BUFFETT: Oh, it's worked — it's worked very well for us, net. And we're going to keep doing it.

25. BYD investment shows the "old men" are still learning

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger. This is Eric Chang from Beijing, China.

First, thanks for the occasion for us to engage with you like this, and also for inspiring young people to learn. Mr. Munger has described you as an incredible learning machine in terms of learning new areas, and expanding your circle of competence.

So I would like to understand is if you can make it more concrete, recently you make investment in BYD, a company in China that makes batteries and also electric cars which are, arguably, technology companies.

So can you sort of go through that example and see how you sort of like analyzed the case and asked questions that helped you make a decision to invest in such a company? Thank you.

WARREN BUFFETT: Charlie deserves 100 percent of the credit for BYD, so I'm going to let him answer that.

CHARLIE MUNGER: Well, it's an interesting example because Berkshire would not have made an investment in BYD if the opportunity had come along five or 10 years earlier. And it shows that the old men are continuing to learn, and that's absolutely essential.

Berkshire would have a lower potential than it does if we had stayed the way we were. And — so you are absolutely right in calling attention to this episode.

Again, Dave Sokol helped. I wasn't at all sure I could get Warren to do this all by myself so I inveigled Dave into going over to China, and the two of us were able to help the learning process. (Laughter)

WARREN BUFFETT: Well put. Well put.

26. Why we will never hire a compensation consultant

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Mark Wares (PH) and it has to do with Berkshire's compensation.

He says, "How does Berkshire structure the performance based-compensation of the CEOs of its subsidiaries? Please because as specific as you can regarding the metrics on which you focus the most, and how the degree to which those are attained translates into compensation."

WARREN BUFFETT: Yeah, well, the first thing we do is we never engage a compensation consultant. (Applause)

And we have, whatever it may be, 70-plus or whatever number businesses we have.

They have very different economic characteristics. To try to set some Berkshire standard to apply to businesses such as insurance, which has capital as a bulwark but which we get to invest in other things we'd invest in anyway, so there's minus capital involved, to a BNSF or our utility business where there's tons of capital involved, or in between See's where there is very little capital involved.

We have other businesses that are basically just so damn good that a, you know, a chimpanzee could run them, and we have other business that are so tough at times that, you know, if we had Alfred P. Sloan back, you know, we wouldn't be able to do very well with them.

So there's enormous differences in the economic characteristics of our business.

I try to figure out what — if I owned the whole business — what is a sensible way to employ somebody and compensate them, considering the economic characteristics of the business. So we have all kinds of different plans.

It doesn't take a couple of hours of my time a year to do it. We have managers who stay with us, so they must be reasonably happy with the plans.

And, you know, it is not rocket science, but it does require — it requires the ability to differentiate.

If we had a human relations department, it would be a disaster. They would be attending conferences and people would be telling them all these different things to put in equations and so on. It just requires a certain amount of common sense.

And it requires, incidentally, an interaction with the managers where, you know, I listen to them, they listen to me, and we sort of agree on what really is the measure of what they're actually adding to the company.

And — what do you — what do you say to that, Charlie?

CHARLIE MUNGER: Well, I think the U.S. Army and General Electric have centralized personnel policies that probably work best for them, and we have just the opposite system, and I think it clearly works best for us.

And practically nobody else is entirely like us, which makes us very peculiar. And I like it that way, don't you?

WARREN BUFFETT: Yeah, we really like it that way. We get worried when people agree with us. (Laughter)

We pay people — we pay some very big money. We have managers that have made and will make in the tens of millions annually, and we have managers that, you know, when we suffer, they suffer.

But you've got to treat people fairly. Even though they don't need the money, everybody wants to be treated fairly.

And so the rationale for how you're doing it should be understood, but there is no cross-Berkshire rationale at all. I mean, if you run See's Candy, to put a cost of capital factor in or something like that, what the consultant would tell you, it's nonsense.

It isn't going to make any difference whether there's 40 million or 43 million or 37 million of capital in the business.

The main thing to do is, in terms of market position and all that sort of thing, the real thing I really want to pay managers for is widening the moat that separates our business from our competitors' businesses over time. Now, that gets very subjective, so I don't have any perfect way of doing that. But that is always going through my mind in trying to design compensation systems.

So far, like I say, I don't think — I can't — can you recall any manager that's ever left us over compensation, Charlie?

CHARLIE MUNGER: I think it's amazing how simple it's been and how little time it has taken and how well it has worked.

There's this idea that headquarters can do these wonderful things. Headquarters, in a conglomerate kind of a company, is frequently hated in the field. We don't want to be hated in the field. We don't want an imperial headquarters with big costs that's imposed everywhere.

And averaged out, it's worked wonderfully well for us.

WARREN BUFFETT: Yeah, we make no headquarters charges. We charge for our credit with a couple of companies, but — most companies are allocating a couple percent of sales, maybe, or whatever it might be, to all their different operations. And usually it's resented out in the field. And —

CHARLIE MUNGER: Is it ever.

WARREN BUFFETT: Yeah. So we don't do it.

27. "We won't trade reputation for money"

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Thank you. My name is Joe Bob Hitchcock. I'm a winemaker from the Napa Valley in California.

I would like to suggest that the next time you and Charlie have a steak at Gorat's that you accompany it with a new health food, a Napa Valley red wine. (Laughter)

WARREN BUFFETT: We just went in the wine distribution business, as you may know. (Laughs)

AUDIENCE MEMBER: Excellent.

CHARLIE MUNGER: Warren is helpless, but I'm with you.

AUDIENCE MEMBER: OK. (Laughter)

I'll send you a bottle.

One of the keys to the success of Berkshire is your policy to allow the managers of the various Berkshire Hathaway companies to operate with minimal interference from Omaha.

But if you became aware of unethical or illegal activities at a Berkshire Hathaway-owned company, would you directly and personally intervene?

WARREN BUFFETT: Sure. We have to jump in.

We have a hotline, which I think was a very good invention of — it wasn't an invention, but a good policy embodied in Sarbanes-Oxley. And, you know, that's been a plus to us. I get letters directly sometimes.

So I want to hear about problems. I hope somebody else has heard about them first and already gotten them solved, but if they don't get solved someplace else, I want to hear about them.

And we have an internal audit function, which is important at Berkshire. And anything that comes in, you know, when somebody calls in on the complaint line and says, "The guy works next to me has bad breath," I tend to skip over those.

But if anything comes in that relates to alleged bad behavior, it's going to get investigated at Berkshire. And it does.

And every now and then, there have been some important transgressions that have come to us via either letters to me, or calls on the hotline, or maybe letters to the audit committee, whatever. We encourage that.

Charlie?

CHARLIE MUNGER: Yeah. We care more about that than business mistakes, way more.

WARREN BUFFETT: We have a letter that goes out every roughly two years; it's the only communication. I probably ought to put a copy of it in the annual report sometime so that the shareholders see it.

But it’s a page and a half long. It asks the manager to tell me who, if something happened to them that night, who I should consider putting in charge of the place the next day.

Doesn’t mean I’ll follow their advice, but I want to know their reasons and the pluses and minuses.

But it starts off basically and it says, “Look, we’ve got all the money we need.” We’d like to make more money. We love making money.

But we don’t have a shred more reputation than we need, and we won’t trade reputation for money.

And we want that message to get out. It’s the reason we stick that Salomon thing in the movie every year. I mean, you can — probably some of you can recite it by now, but I don’t think it can hurt to keep repeating that story.

And the one thing we tell — we tell them that message, and then I’ve added a new line in this. And I say, if the reason you’re doing something, the best reason you can come up with, is that the other guy is doing it, it’s not good enough.

There’s must be — there’s got to be some other reason besides, “The other fellow’s doing it,” or you’re in trouble. And I tell them, “Call me if anything’s questionable. You think it’s close to the line, give me a call.”

By saying that, nobody gives me a call because they — (laughs) — they know that the very fact that they think it’s that close to the line probably tells them it’s over the line.

But I want to hear about stuff. We can cure any problem if we hear about it soon enough and take action soon enough. But if it’s allowed to fester out someplace and people cover it up — and sometimes they have — then we’ve got a problem.

And we will have more of that in the future, there’s no getting around it, you know. If you have 260,000 people, there can be some things going on. I just hope we hear about them fast.

And I hope their managers hear about them even faster and do something before it even gets to us. But we want very much to protect the reputation of Berkshire. It’s the right thing to do.

Charlie?

CHARLIE MUNGER: Well, it is absolutely essential. And Berkshire, averaged out, has a very good reputation, as you can tell by the ratings from major media and surveys.

And that is absolutely precious to us. In a sense, you people are part of the culture, too.

The ideal is not to just make all the money that can be legally be made without causing too much legal trouble. The idea is bigger than that. It's that we celebrate wealth only when it's been fairly won and wisely used.

And if that idea pervades the culture of a place, including the shareholders, we think that's very helpful to us. (Applause)

28. BNSF has benefitted from good regulations

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question relates to your investment in Burlington Northern, and it comes from Josh Sanbules (PH), who I believe is in New York City.

And he asks, "You mention in your annual letter that regulators of the railroad industry need to provide, quote, 'certainty about allowable returns,' unquote, in order to make huge investments. If you were going to help the regulators calculate, quote, 'allowable returns,' how would you suggest they do it?"

WARREN BUFFETT: Well, I think the Service Transportation Board — and maybe Matt Rose could help give more details — but I think they've adopted something like 10 1/2 percent, or thereabouts, on invested capital.

And if you had a major enough change in interest rates or something, you could argue that there should be some adjustment, perhaps, in one direction or another.

Usually, in the case of regulated utilities, they talk about return on equity. And you have different amounts in different states, but some states it may be 11 percent, in some states it may be 12 percent or something like that. It's usually in that range.

With the railroads, they've gone toward this return on invested capital, which includes debt as an adjusted figure.

And I don't think that's a crazy, crazy standard. I mean, the railroad, unlike the electric utility, when you get an allowed return in the electric utility you're almost certain of earning it, I mean, if you behave yourself. And your demand is never going to fall off that much, probably, that you'll go way below your return.

The railroad's got more downside in it if you run into a terrific industrial recession, so you're not as protected on the downside.

But there should be some figure, and I would argue that the 10 1/2 percent, or whatever it may be on invested capital, that's been achieved by the four big railroads in recent years, something close to that or right around that figure.

And you want the railroads investing a whole lot more than depreciation, and I would think that would be — it's certainly an inducement to me to invest money in improving the transportation system.

And on the other hand, if that return were far lower than that, it would be crazy to put money, because you can't change that railroad system and do something else with it.

So I think the country and the railroad systems have a very common interest in not earning exorbitant profits or anything like that, but getting a decent return on what is sure to be much needed investment over the next 10, 20, 30 years.

And I'd go along with — if the Service Transportation Board says 10 1/2 percent, or some number like that, I think that's not a crazy number.

Charlie?

CHARLIE MUNGER: Well, yeah, the railroads have been a hugely successful system, in terms of a regulated business. If you stop to think about it, the railroads of America have been essentially totally rebuilt in the last 30 or 40 years.

They've improved the tracks, they've changed the size of the tunnels, they've improved the bridges. The average train can be more than twice as long and twice as heavy.

And you can hardly imagine a business that's done a better job in adapting to the needs of the rest of us than the American railroad industry. And that's by and large been a system of wise regulation accompanied by wise management. And that was not always the case.

If you go back a long time, neither the management nor the regulation was all that wise. But the existing system has worked very well for all of us.

29. "Lumpy" earnings as competitive advantage

WARREN BUFFETT: OK, number 12.

AUDIENCE MEMBER: Hello, my name is Ashish Texali (PH). I am from New Delhi, India.

First of all, I would like to thank Kelly Bruce (PH) and Carol from American Express to the help they've extended to make this event possible.

The question regarding General Re and reinsurance business.

As the insurance business uses complex models, how is Berkshire more comfortable that insurance business models are not exposing you to significant risks like the models did for Wall Street?

Also, if it is not confidential, is there concentration of risk? That is, what are those few events which can cause significant loss for insurance businesses?

WARREN BUFFETT: I'm not sure I got all of that, but we run significant risks from earthquakes. We had, in the Chilean quake — I don't know how much would have been in the first quarter. When you read our 10-Q there will be a number in there. But we insure 20 percent of Swiss Re. We will take 20 percent of their loss from that.

We have various other exposures in something like that. We included our best estimate in those figures I put up earlier.

Our peak risks now, in terms of earthquakes or hurricanes — which are the two biggest natural catastrophes, in terms of frequency and severity — are probably down quite considerably from a few years ago, not because of any diminished appetite for risk. But we just haven't felt that the rates were that attractive in those areas.

But if we thought the rates were attractive, we're perfectly willing to take on a group of risks where, if something very close to worst case happened, you know, we would lose $5 billion or something like that.

We lost 3 billion-plus in Katrina. We lost well over 2 billion, I think quite a bit more than that actually, on 9/11.

There will be things come along like that. Nothing that ever remotely comes close to making us uncomfortable, though, in terms of the level. I don't know whether I got his full question there or not, Charlie, but you —

CHARLIE MUNGER: Well, pretty close. I would say that the main difference between our practice and that of most other people is that we are deliberately seeking a method of operation which will give us occasional big losses in a single year, big overall losses.

And everybody else is trying to avoid that. And we just want to be rich enough so a big loss in a single year is a blip.

And that's a competitive advantage, that willingness to endure fluctuating annual results. Big advantage, wouldn't you say?

WARREN BUFFETT: It's a huge advantage. It's a huge advantage. And it's one that no one else is going to pick up on. I mean, they know what we do, they just don't want to do it, or they're unable to do it, in terms of financial resources.

So, I would say that comes very close to a permanent and substantial advantage at Berkshire.

I don’t — forget about — you shouldn’t forget about it, but forget about the human suffering and all that. Just the financial consequences of a Katrina, you know, when we lose 3 billion in that, I don’t feel any different the next day than I felt the day before, financially. I mean, it just doesn’t make any difference, because we are in that particular game.

And as long as we make the right decisions over time, in terms of the premiums we get, and as long as we never expose ourselves to a loss that would really shake up our capital structure or anything, you know, that is a game in which we have a huge competitive edge. And it gets wider every year.

So, you know, risk — we are in the business — in insurance, we are in the business of taking the other guys’ desire to smooth their earnings, and, in exchange, get what we think are larger, lumpy earnings over time. We like the business.

Carol? Oh, go ahead, Charlie.

CHARLIE MUNGER: I was going to say Warren has a different position than a lot of other people in the insurance business. After a year in which Berkshire has a big loss, he can look into his shaving mirror and say, “Your shareholder still loves you.” (Laughter)

WARREN BUFFETT: That’s right.

CHARLIE MUNGER: Other people are not in that position.

WARREN BUFFETT: Charlie and I knew a guy from Omaha who, 40 or 50 years ago, was one of the richest guys in the United States, named Howard Ahmanson. And Howard had a fetish about owning 100 percent of everything that he came in contact with.

And so he said, when asked why, he said, “I like to look in the mirror and say, ‘All my shareholders love me.’” (Laughter)

And I’m not quite that extreme, but I like to look in the mirror and say, “Enough of my shareholders love me.” (Laughter)

30. “Gambling” with derivatives

WARREN BUFFETT: Carol.

CAROL LOOMIS: This question is about derivatives.

“What useful function do derivatives serve in our economy? We got along quite well without them for many years. If they serve no useful purpose, and in fact, have demonstrated that they can do considerable damage to the economy, why are they not made illegal, especially the naked ones? There is precedent for that.

"I believe that short selling of stocks that one does not own or has managed to borrow is illegal."

WARREN BUFFETT: Charlie has — he can get worked up more on this than I can, so I'm going to let him answer that. (Laughs)

CHARLIE MUNGER: Well, I think the usefulness of derivatives has always been overrated. If we didn't have any derivatives at all, including contracts to buy and sell grain that were traded on exchanges, we'd still have plenty of oats and wheat.

I mean, I think it is slightly more convenient for people to be able to hedge their risks of farming by using derivative markets and commodities.

And the test is not, "Is there any benefit in derivatives?" The question is, is the net benefit versus disadvantage from derivatives useful? Or would we be better off without it?

My own view is that, if we went back to having nothing but derivative trading in commodities, metals, currencies, safely conducted under responsible rules, and all other derivatives contracts vanished from the earth, it would be a better place. (Applause)

WARREN BUFFETT: We'll take a current example. Burlington Northern has hedged diesel fuel, which they use a lot of, over the years. And then they also have fuel adjustment clauses in a lot of their contracts for transportation.

With Matt Rose, who does a wonderful job of running Burlington, I basically say, "Look at. If I were running the place, I wouldn't bother to hedge them," because if you hedge it — if you hedge it for a million years, you know, you're going to be out the frictional costs, probably, of doing it, unless you're smarter than the market generally on diesel fuel. And if you're smarter than the market on diesel fuel generally, we'll go into the business of speculating on diesel fuel.

I mean, if we've really got an edge, you know, why bother to run the trains? Let's just speculate diesel fuel.

But I also say, you know, they've got — and if you have an organization where you have somebody in charge of that activity, it's going to take place.

On the other hand, Matt Rose has done a fabulous job, as well as his management team, in running Burlington Northern. If they are more comfortable, or they find it useful in any way, in terms of pricing contracts, or anything, to hedge it, that's fine with me, too.

I mean, it's his company, he can figure out the best way of running it. I'll hold him responsible for how it does over time. And, you know, I would do it one way and somebody else would do it another way. I don't think that's —

I would not condemn anybody that's running a railroad for hedging diesel fuel, nor would I condemn anybody that runs an energy company, like we do at MidAmerican, for hedging energy costs in certain ways.

But I do think, if we could put up a presentation, number 4 on the screen, please.

I think it was said very well in 1935. In fact, chapter 8 of Keynes's General — chapter 12, I'm sorry — chapter 12 of Keynes's "General Theory" is, by far, in my view, probably Charlie's too, the best description of the way capital markets function, the real way people operate. It's prescriptive, it's descriptive.

Everybody should read chapter 12. It's a little — it starts a little slow in the first few pages.

But Keynes — I'm going to read this because I don't think Charlie has it in front of him.

The first part of it is very familiar to people. I mean, this quote has been used a lot. But every word in this, to me, is right on the money.

"Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation."

You can change that to "gambling" if you want to.

"When the capital development of a country becomes a by-product of the activities of a casino, the job is likely to be ill-done." That's the famous part of the quote.

Keynes went on to say, "The measure of success attained by Wall Street, regarded as an institution of which the proper social purpose is to direct new investment into the most profitable channels in terms of future yield, cannot be claimed as one of the outstanding triumphs of laissez-faire capitalism - which is not surprising, if I am right in thinking that the best brains of Wall Street have been in fact directed towards a different object."

That was written in 1935. I don't think there's been anything better written about how government, how citizens, should look at Wall Street and what it does and it doesn't.

It's always had this mixture of a casino operation and a very socially important operation.

And when derivatives became popular, and academia was behind them 100 percent. They were teaching more about how to value an option than they were about how to value a business. And I witnessed that and it drove me crazy.

But in 1982, Congress was considering, really, the expansion of a derivative contract to the general public in a huge, publicized way. It was the S&P 500 contract. That changed the whole derivatives game.

At that point, basically, Wall Street just said, "Come on in, and everybody can speculate in an index. Not any real company, just an index. And you can buy it at 10 o'clock in the morning and sell it at 10:01, and you're contributing to this wonderful society by doing it."

And I wrote a letter to Congressman Dingle, and we'll put up exhibit 5. I just excerpted a few of the statements I made there. This was one month before they put in trading in the S&P 500, April. They put it in April, 1982, in Chicago; did a little in Kansas City first.

And I went through four pages of things and I just pulled out a few things. But I think that, to some extent, what I forecasted then has turned out to be the case.

And then it got squared and all of that, as both the people in Wall Street kept dreaming up new and new ways for people to gamble.

And as I say, academia was applauding all along the way and getting hired as consultants to various exchanges to tell them how wonderful they were, in terms of their social purpose.

I think that — well, it's up there for you to read. I'd be glad — the whole letter was reprinted, I believe, in Fortune at one time, Carol. Was it—?

CHARLIE MUNGER: By the way, if I remember right, this was like the only letter in opposition to this uniformly acclaimed new world of better gambling in things related to securities. Warren wrote the letter —

WARREN BUFFETT: And it's a —

CHARLIE MUNGER: — all those years ago, and it was the only letter —

WARREN BUFFETT: Incidentally —

CHARLIE MUNGER: He basically said the idea's insane. It will do more harm than good. Then, as now, people didn't pay that much attention to him.

WARREN BUFFETT: And I'll venture that very few people in this room know — you all know that if you buy a stock, you have to hold it for a very long period of time to get a special capital gains treatment on it.

If you buy an S&P 500 contract at 11 o'clock and sell it at 11:01 and have a profit, it's taxed 60 percent as a long-term capital gain, and 40 percent as short-term capital gain.

So you really get better tax treatment if you're gambling on an S&P 500 derivative, which is what it is, in Chicago, than you do if you invest for four or five months in some security and then have to sell it for some reason.

It’s a tribute to the lobbying power of a rather small group that has done very well off this particular activity.

Charlie, can you think of any reason why it’s 60 percent long-term gain if you hold something for 30 seconds? (Laughs)

CHARLIE MUNGER: Well, of course it’s crazy. It’s neither fair nor sensible.

But if a small group with a lot of money and influence cares a great deal about something and the rest of us are indifferent, why, they tend to win before our legislative bodies.

That’s just the way it is. I always liked Bismarck’s remark that you shouldn’t watch two things: sausage making and legislation making. (Laughter)

31. Buffett is losing his bet against hedge funds

WARREN BUFFETT: OK, with those hopeful words — (laughter) — we’re going to break for lunch. Before we break for lunch, I made a charitable wager with a group, Protégé Partners, two years ago about the behavior of funds of funds that they would select, hedge funds, and the S&P index fund.

The duration of our wager is ten years, and whichever one loses, the money goes — well the money from both goes to the winner’s charity, is what it amounts to.

Interesting firm out on the West Coast that supervises what they call these long bets. So if we’ll put up exhibit 6, you can see at this point I’m behind.

And have we gotten exhibits? Yeah. Let’s go to lunch. OK. (Laughter)

Afternoon Session - 2010 Meeting

1. Speak out, but speak responsibly

WARREN BUFFETT: And I think therefore we go to 13, which is in a separate room. And is there anybody at the microphone in 13?

AUDIENCE MEMBER: Yes, there is.

WARREN BUFFETT: OK.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. This is a shareholder from New York. One could argue that a major contributor to the great bubble was that there wasn't a healthy and open debate. That all the opinion and all of the money was on one side of the trade.

And I was thinking about this recently as I read Christine Richard's new book, "Confidence Game," about Bill Ackman and his battle with what was once the largest bond insurer, MBIA.

The story also reminded me of David Einhorn and the questions he raised about Allied Capital and Lehman Brothers. We now know that they were 100 percent correct, but at the time that they first spoke up they were attacked by the companies, pilloried by the media, ignored by the accountants of those firms and the rating agencies, and perhaps most alarmingly were investigated by the SEC for daring to go public with their bearish analyses.

And I can tell you that watching what happened to them, it's a real deterrent to anyone else speaking up and raising similar questions.

So I'd be curious for your thoughts on this, and is having short sellers speak out healthy for our markets?

And in general what should be done to encourage a greater diversity of opinions so that we can avoid future bubbles? Thank you. (Applause)

WARREN BUFFETT: Yeah, I don't see anything wrong with people who are positive or negative speaking out, as long as they're willing to be held responsible for the kind of statements they make. I mean, there are — obviously —

Well, take the extreme example. If there were two banks in town, and I owned one of them and I was of kind of a devious type of mind, I might go out and hire 50 people to stand in line in front of the other bank, and I would probably not have a competitor before long.

So you can do things on either side, the long side or the short side, that I would regard as certainly unethical and in many cases should be illegal.

But anytime you attack the conventional wisdom, you're going to meet with a lot of opposition because you're threatening people's positions.

When we would talk about the efficient market theory 30 years ago when it was absolutely de rigueur that — and virtually every finance department in the country, major schools, you either had to swear allegiance to it or you were not going to be promoted.

You know, people don't like that. And any institution, when they get a threat from the outside, they will attack both the threat and the threatener.

But that exists on both sides. I have no problem with short selling, and I have no problem with speaking out responsibly about your reasons for doing so, any more than I have on the long side.

There have been some very bad practices on the short side, and there have been some very bad practices on the long side, in terms of people trying to literally spread things that are untrue.

But that has probably been more on the long side over the years than on the short side, by some margin.

Charlie?

CHARLIE MUNGER: Yeah, I think to some extent you're criticizing the wrong people. In many cases, the accountants that allowed the lousy accounting are the ones that ought to be held in the dock. And they get very little criticism in America and that's a mistake.

2. Why there's no synergy among subsidiaries

WARREN BUFFETT: Becky? (Applause)

BECKY QUICK: This question comes from Ben Soh (PH) who lives in the metro Vancouver area in British Columbia, Canada. This is for either Mr. Buffett or Mr. Munger.

He wants to know about synergies at Berkshire, specifically, "Does it make sense that the Dairy Queen stores here sell PepsiCo products and would not expect — accept — American Express, only Mastercard or Visa? (Laughter)

WARREN BUFFETT: There are — around the world, there are pretty close to 6,000 Dairy Queen outlets of one sort or another. And some are called Grill and Chill now, different things, but roughly 6,000, and company-operated are 70 of those.

So almost 99 percent are franchised, and at Dairy Queen we do not control what the franchisees do. Most of the franchisees — last time I checked sometime back — but most of the franchisees serve Coke, the enlightened ones — (laughter) — but it is entirely their business.

They can — they can — they can serve Coca-Cola products or Pepsi. It seems some of the other franchise operations seem to have more control over that than Dairy Queen.

But if you think about it, Dairy Queen goes back before McDonald's, before Wendy's, before Burger King, before Kentucky Fried, all of those. It goes way back into the '30s, and a lot of the agreements with franchisees were territorial operators were done on the back of a napkin, or something of the sort.

So to some extent we have less control over what franchisees do, particular in certain — a few parts of the country — than other people.

But we'll — keep asking for Coke, and maybe you can cause them to see the light. The synergies, any synergies, any synergies at Berkshire come about at the operational level pretty much.

We do not tell our companies to do business with each other. We hope they do do business with each other, and, you know, and we hope that each side of a subsidiary A offers good reasons for subsidiary B to do business with them.

But the whole idea at Berkshire is that our managers are responsible for their businesses, and if they're going to be responsible for their businesses it means we shouldn't tell them what to do, except in very limited ways.

Charlie?

CHARLIE MUNGER: Well, you've accurately described the way it is. What's interesting about it is we really like it that way. (Laughter)

WARREN BUFFETT: It's a lot less work. (Laughs)

CHARLIE MUNGER: Yes.

WARREN BUFFETT: And I think, actually, that there's some merit. Sometimes people work better together if it's their decision to work together than if you tell them to work together.

CHARLIE MUNGER: It goes beyond that. Warren and I would like it that way if we were in the subsidiaries. There's no doubt about that.

WARREN BUFFETT: Yeah, we'd probably leave if it wasn't that way. (Laughs)

3. Act as if "you were an owner of the place"

WARREN BUFFETT: OK. Area 1.

AUDIENCE MEMBER: Dear Mr. Buffett, dear Mr. Munger, my name is Steven Roman (PH). I'm a student of engineering maschinenbau at the University of Vienna in Austria.

If I one day want to apply as a manager with one of the Berkshire companies, what qualities are you especially looking for? And what do I have to do to become your successor? (Laughter)

WARREN BUFFETT: Probably shoot me. (Laughter)

The managers of our subsidiaries hire their own people. The number of decisions I have to make about managers are really, really few.

As I mentioned earlier, they do send me a letter that if something happens to them, gives me their ideas about who should succeed them.

But I make no decisions about who gets hired at GEICO, or Burlington, or Mid-American or anything of the sort. I mean, if they need a CFO they go out and hire a CFO, or if they need somebody to run a plant they go out and hire them themselves.

They are responsible for their operations, and occasionally we have a death, we have an occasional — very occasional, I can't even hardly think of one — resignation.

And at that point I have to make a decision about who should be put in charge of the operation. But I don't think I've had more than 10 or 12 of those in 45 years.

So I'm not a very good employment agency. We have 21 people, I think it is, at headquarters, and I made a terrific hire here a few months ago. But that'll take care of me for four or five years.

Charlie?

CHARLIE MUNGER: Yeah, there's no indication we'd be particularly good at it, either. (Laughter)

WARREN BUFFETT: Yeah. I wasn't going to mention that. (Laughter)

But I would say this: if you want — what is interesting to me is that when you find somebody outstanding, boy, do they jump out. I mean, somebody that is thinking about the place the right way, is working extra hard, whatever it may be.

There aren't — you don't have that much competition in this world. So, in terms of generally advancing within organizations, I think you'd be surprised at how little competition you really have if you start thinking like you would if you were an owner of the place, and working like you would if you were an owner of the place, and pretty soon you may be running something.

4. Retained earnings, present value, and dividends

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from Tomer Malon (PH) from Tel Aviv, Israel. And he has clearly been a long-time shareholder because he references your 1984 Chairman Letter.

He writes, "You have previously stated that a company should retain its earnings only if, quote, 'For every dollar retained, at least one dollar of market value will be created for owners,' unquote.

"You also noted that if such conditions will no longer apply to Berkshire, as measured on the basis of a five-year rolling average, then quote, 'We will distribute all unrestricted earnings that we believe cannot be effectively used.'

"However, during the five-year period between July third — I'm sorry, January 3rd, 2005 and December 31st, 2009, the average annual earnings per share for class A, as reported, amounted to $5,930, while at the same period the average annual change in the share's market price was only $2,420.

"Consequently, are you considering a distribution of a dividend or buying back shares? I imagine I know the answer, but I thought we had to ask." (Laughter)

WARREN BUFFETT: Well, he does know the answer, but we'll elaborate.

I did write that, not only in 1984 but continuously in the back of the Berkshire annual report where I've got our economic principles.

And frankly, the way I wrote that the first time was not well thought out. And in the 2009 annual report, partly because somebody asked that question last year, I actually rewrote that section.

And I pointed out that even when I wrote it in 1984, we would have flunked the test in many previous years when, generally speaking, the stock market had suffered a significant decline over a period of time.

As you can tell by looking at our report, right now every dollar that we have left in the business, you know, has produced, in present value terms, something over $1.30 of market value.

We have met the test of retained earnings proving their worth. But the way I phrased that originally, anytime the stock market went down a whole lot in a five-year period, because we were carrying our Coca-Cola at a certain price five years earlier or whatever it was that entered into our asset value, we could have done a great job of allocating capital in the five-year period and we still would have looked bad.

And similarly if the stock market had gone up a whole lot, we could have done a dumb job and looked good.

So, if you will look in the back of the 2009 annual report, I think it's number 11, or — I'm not sure about that.

But read the economic principles. You'll see that I had to confess my error in how I originally worded that.

But I think it is still intellectually honest, in terms of meeting what I intended to say.

You know, I voted against this before I voted for it, or something like John Kerry said in 2004. (Laughs)

I think it does meet the test of a dollar retained earnings producing more than a dollar of market value. And we will continue to measure ourselves based on whether we meet that test.

If we don't — if keeping a buck doesn't produce more than a buck in present value, I don't mean every day or every week, but over time, we should figure out something else to do.

Charlie?

CHARLIE MUNGER: Well, I like people that parse through a long series of documents and find an error and rub my nose in it, particularly when it's your error.

WARREN BUFFETT: Rub my nose in it. (Laughter)

CHARLIE MUNGER: Yeah, yeah.

WARREN BUFFETT: How tolerant. (Laughter)

I should have had him word it originally. Actually I think those were his words. It's just coming back to me. (Laughter)

5. Safety net needed for the unemployed, but Berkshire isn't it

WARREN BUFFETT: OK. Number 2.

AUDIENCE MEMBER: Glen Molinar (PH) from Cleveland, Ohio. It's been on my bucket list to come meet you, Mr. Buffett and Mr. Munger, so it's a privilege to be here.

My question has to do with hope and jobs. You know, in America, I think we need to figure out how we can go about creating jobs. I have been trying to help people get jobs.

My question is, and a challenge maybe, how can we get Berkshire Hathaway and your board to maybe go out and just basically hire people to give them hope?

WARREN BUFFETT: Well, we will hire people when we have something for them to do. (Applause)

But — and we are actually, net, hiring people now.

I mean, when the Burlington is carrying 173,000 cars a week like last week, as opposed to some time back 155,000, we need more people. And we need more people at some of our other businesses.

But our carpet business, we are down 6,000 people-plus from our peak. But people aren't going to quit buying carpet forever. And we will be hiring a number of people, but there's no sense hiring them when they're not — when there's nothing for them to do.

I went through a period, particularly, it was dramatic to me, because we owned — Berkshire Hathaway owned — a couple of textile mills, one of them in New Bedford.

And eventually we had to close those mills after we tried for 20 years to make them work.

And if you get somebody that's working in a textile mill and they're 55 years old, and in many cases still were speaking Portuguese, you know, retraining doesn't mean much to them.

I mean, you need — if you believe in creative destruction and you believe in capitalism, essentially figuring out ways to do the same things with less and less people, you better have a social safety net.

And we've got a pretty good one in this country, a whole lot better than we had 30 or 40 years ago.

But right now there is significant unemployment. Not any higher than it was in 1982 or thereabouts, but it's a lot and it's not going to go away fast, although it is going to go away.

And we should take — in my view, society owes some minimum living standard to people who are looking for work, trying to get work, and frankly, at a time like this, they're not going to be able to find it.

But I don't think that Berkshire Hathaway should be the social safety net.

Charlie?

CHARLIE MUNGER: Yeah, I would say that if Berkshire started out to create a bunch of make-work jobs in order to increase human hope, the net effect would, over time, would be the reduce human hope. (Applause)

WARREN BUFFETT: I think that's true, but I'd rather have Charlie saying it than me. (Laughter)

6. Why GEICO isn't looking at China or India

WARREN BUFFETT: Carol?

CAROL LOOMIS: "Our car insurance business" —

Oh, this comes from a New York man who asked that I use his initials, A.J.

"Our car insurance business has continued to return excellent profits and expand its business within the United States. Why hasn't Berkshire made any progress in the car insurance business in China, or India, or even Europe?

"As BYD has shown, these markets are exploding in automobile sales, so aren't they ripe for the picking?"

WARREN BUFFETT: Yeah. There's no — we've known for a long time there's no shortage of drivers around the world. That — there may be a lot of business in the United States, but there's a whole lot of business elsewhere.

In terms of India and China specifically, we can only own a limited amount, I believe 24.9 percent, of a company in either of those countries. And we're not eager to work hard on something where we own 24.9 when we could work hard on something where we can own 100 percent.

Obviously, we talk all the time, we've thought for decades about ways we can possibly expand GEICO, because it's a wonderful, wonderful company.

And we have gone from a market share of 2-and-a-faction percent when we bought control to 8 1/2 or so now.

But there's plenty to do here. And we do not have the same kind of advantages — or we don't think we could build those in any reasonable period of time — as we look at other markets.

I mean, obviously we look at Canada. You know, I mean — Tony and I talk about this kind of thing frequently.

I agree with his decision that now, and probably for a long time to come, there is so much opportunity in the United States. And the other areas, for one reason or another, as we're looking at them, do not give us the same kind of competitive advantage we have here, that we pass on them.

But we love the idea of taking a business that's working in one area and figuring out a way to have it work in other areas. Whether it's geographical adjacencies or product extensions, or all kinds of things.

We're well aware of possibilities out there. In the case of GEICO, we have not decided to go to other countries, but it isn't because we didn't know there were cars there. (Laughter)

Charlie?

CHARLIE MUNGER: I've got nothing to add. (Laughter)

7. China's economic growth is "fun" to watch

WARREN BUFFETT: OK. Number 3.

CHINESE STUDENT: Good afternoon. My name is Shin Tse Chen (PH). I am a Chinese student from Kansas State University.

My question is, Mr. Buffett, what is the most important thing that you have learned from China? Thank you.

WARREN BUFFETT: Most important thing I've learned from China?

CHARLIE MUNGER: China, yeah.

WARREN BUFFETT: Yeah. What's the most important thing you've learned from China, Charlie? (Laughter)

CHARLIE MUNGER: It has some very unusual people in BYD. (Laughter)

WARREN BUFFETT: I've learned —

CHARLIE MUNGER: No other lesson is as important as that one. (Laughter)

WARREN BUFFETT: I've learned they like Sprite better than Coke. Sprite outsells Coke in China by two-to-one. But they're both growing dramatically.

I think China is an amazing economy. I mean, there is no question in my mind that, you know, the growth on a per-capita basis is going to be dramatic going forward. They're just starting to exercise their potential.

When you think about it, in 1790, there were four million people in the United States, just under four million. There were 290 million in China in 1790. Just as smart, you know, just as hard working, resources of the land, the minerals, everything, its climate, very, very similar.

And for 170 years or so, relatively little progress was made in the standard of living for those people, like you say, who had all the native abilities that America had.

But, you know, in recent decades, the potential of the Chinese is being unleashed and it's huge. And I think it's very, very interesting to watch.

Charlie and I, and a group of some of the directors, are going over there at the end of September.

You know — and I was over there a couple of years ago. It's a sight to behold.

But, in terms of specific lessons, they haven't taught me how to eat Chinese food, I will say that. (Laughs)

CHARLIE MUNGER: I think I always knew that the Chinese people had an enormous potential for huge and rapid progress, because I could see that in all the Chinese-Americans that I dealt with.

And indeed, people came in here as Chinese "coolies" — in effect, slaves — and they rose so rapidly that it was a marvel.

So I always knew that China had a potential to be a huge credit to human civilization. But I think I underrated how fast it could happen.

China is setting a new record for advancement of civilization at a very rapid rate. It's fun to watch.

8. Why Buffett addresses the annual report to his two sisters

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from a shareholder in Aiken, South Carolina who asks not to be identified, but he asks that Mr. Buffett or Mr. Munger discuss changes that have been made in the Berkshire annual report in the last several years, and the reasons for making some of these changes.

Two of the changes that he's noticed are, number one , look-through earnings no longer seem to be discussed, and number two, the unaudited combined financial statements of the business groups no longer seem to be included, although at least some of the business groups material seem to be covered in other places in the report.

WARREN BUFFETT: Yeah, the second point I'm confused about, because we have broken them down into four groups and tried to give the relevant financial information for what we thought was a logical grouping, and will continue to do that. So I'm not sure I totally get that.

We really do have four fairly logical breakdowns. Now, you can break it down 70 ways and all that, but there's a point at which adding 100 pages to an annual report obfuscates information rather than illuminates.

And that's what — we're trying to, in a reasonable number of words — Carol might say too many — but in a reasonable number of words, convey as much as we can about the information we'd want to have if we were in your place and you were writing to us.

And we think these four classifications — regulated industry is terribly capital intensive. You know, insurance: capital, really not a factor, but the amount of capital it gives us being a factor, and so on.

And so I don't think we really changed on that. Now, when you get into look-through earnings or sometimes when we talk about the earnings per share and the investments per share, some of that I don't repeat every year because we try to get — run at, maybe, 12,000 words or something like that in the annual report.

I really think if you extend it too much — I'll say this, nobody's told me it was too short, yet — (laughs) — including my editor, who is here today.

And every other year I may do that breakdown between operating earnings and the — but that takes 1,000 words or so to explain it to people.

The whole report is guided, as it has been ever since I really started taking it seriously in the mid '70s, is guided by the idea that I'm — actually, I'm writing it to my two sisters who are here. And I have my audience in my mind — is two very intelligent, interested people but who are not around the place, been gone for a year, and they're very capable of understanding anything but they're not necessarily familiar with all the lingo.

If I get too esoteric on it, so I should explain that. And I really want them to understand how I'm thinking about the business, and by implication, how I think they should think about it, and to answer the questions that I think would be in their mind.

And they've got most of their net worth in it, so they're going to read to the end. And I really haven't changed that framework in my mind for how I've written it.

I start mentally off writing, "Dear Doris and Bertie," and then I just cross them off and put, "To the shareholders of Berkshire Hathaway." But that's the way it's done.

Charlie?

CHARLIE MUNGER: Yeah, but the details can change as the facts change. The undistributed earnings of corporations in which we hold shares, but do not control, used to be way more important than they are now. It's perfectly natural that the emphasis would shift.

WARREN BUFFETT: Yeah, the undistributed earnings now, without me looking at it very carefully, you know, are probably — they're not more than, probably, 15 percent of our reported earnings or something like that.

They used to be a much higher percentage. And they're still important. But I don't think they're — I think the people that understand that Coca-Cola and American Express aren't paying out all their earnings, and it's not a big enough number that I would want to spend a lot of the report explaining it.

9. Munger endorses Roth IRAs

WARREN BUFFETT: Number 4.

AUDIENCE MEMBER: My name is Joe Hudson (PH), a shareholder from Culver, Indiana.

I doubt either of you have any money in Roth IRAs, but what are your thought on the opportunity this year for anyone to convert IRAs to Roth IRAs, thus having all future growth on Berkshire or other investments 100 percent tax free?

Is the government making a big mistake here, and should people be concerned about the deal changing down the road?

CHARLIE MUNGER: I'll take this one, because I have an IRA that I am going to convert to a Roth IRA. So there's your answer. (Laughter)

WARREN BUFFETT: Well, I still don't understand it, but —

CHARLIE MUNGER: You don't have to. (Laughter)

WARREN BUFFETT: OK. He's always telling me that. (Laughter)

I assume - if Charlie said it, it must be true.

10. Newspapers are losing ground in battle with internet

WARREN BUFFETT: Let's go to Andrew. (Laughter)

ANDREW ROSS SORKIN: This question I'm actually very self-interested in. It comes from Anton Ossip (at) Alexander Forbes from Johannesburg, and (he writes), "Last year you said you were down on the newspaper industry.

"Given your life-long interest in newspaper companies and your stake in the Washington Post Company and others, has your view changed in the past year with the introduction of the iPad and other e-reading technologies?

"Do you think we will see a contraction in the value of — in the value retained by — media houses versus what will be passed on to distributors of the media?"

WARREN BUFFETT: Well, you could probably answer it better than I can.

My relatively uninformed opinion — because I'm not that up on the technology — but I just have a feeling that when the money — has basically — the money to run good newspapers has come from advertising, you know, three-quarters of the money or thereabouts — the papers become less useful to advertisers.

I mean, they were the only game in town for a long, long time. They are not the only game in town. And what a difference that makes if you're selling something.

So, when the Philadelphia Inquirer, I — Stan Lipsey is here — I called Stan up and I said, "Stan, this is probably like an old fire horse or something, but let's think about it anyway a little bit."

And it was sold yesterday at a bankruptcy sale, although I think that's pending confirmation.

But, you know, it is very tempting, if you've still got fairly substantial circulation - The Philadelphia Inquirer and they've got the Daily News there, too.

But the math is really tough. I mean, the distribution costs, the printing costs, everything, and maybe all this changes that in some way that you would understand better than I would.

But since I don't understand it, I have to stay with — and there are plenty of things I don't understand — and I cannot make an affirmative decision on newspaper ownership.

I just got the — the ABC puts out Fast Facts, this big yellow publication — I just got it a couple days ago and I can't resist looking through there. And I flip the pages and look at circulation of all kinds of papers.

Actually, in Buffalo, we were down less than a great many papers, even though, you know, our population demographics are very tough. We were down less than Rochester, I might mention, which is owned by Gannett.

But you look at San Francisco Chronicle, you know, down 20-odd percent. Dallas —

These are communities that are thriving, and it blows your mind how fast people are dropping it.

It’s not just older — it’s not just that younger people aren’t picking it up. I mean, the world has really changed, in terms of the essential nature of newspapers.

There’s nothing that looked — back when Charlie and I would talk about them in 1970 or ’65, there was probably nothing that looked more bulletproof than a daily newspaper where the competition had melted away.

But it’s a form of distributing information and entertainment that has lost its immediacy in many cases.

It’s certainly — it is not the essential place to get — think about how stock market quotations were, you know, 30 or 35 years ago. You looked in the paper to see what stocks had done. You looked in the paper to see how sports games had turned out.

So its primacy has withered away, and the advertisers weren’t there because they love the publisher of the newspaper. They were there because it was a microphone to talk to everybody in town, and they had to talk to everybody in town.

And so you get this chicken and egg thing that the newspaper becomes less valuable as the advertisers float away, and the advertisers float away as the subscribers diminish. And I don’t see a good answer to it, but Charlie, what do you have to say?

CHARLIE MUNGER: Well, the independent newspapers, due to the accidents of history, as they became dominant in their individual towns, for decades had impregnable economic strength.

And by and large they behaved better because they were so strong. And they were called the ”Fourth Estate.” They were really a branch of the government, they helped keep government honest.

And if you take this state in which we’re located, The World-Herald has been a very constructive force, net, over a long period of time. As those dominant franchises have weakened and weakened, it’s not good for the country.

I think we’re losing something that we have no substitute for. And I think it’s very sad and I don’t have the faintest idea what to do about it.

WARREN BUFFETT: Charlie and I love newspapers.

I think The World-Herald hit a 300,000 circulation peak on Sunday at one time. I don’t think they averaged that for the six-month period, but I seem to remember that, I could be wrong.

And the figures — 100,000 off that or something of the sort, and the state has gained population, the city’s gained population.

I think it's as vital to me as ever, but it clearly — it has changed for the populous as a whole.

And, you know, when I look at the Philadelphia Inquirer and I forget what it was, 350,000 or something like that of circulation, and, you know, I'm not worried about Philadelphia going away.

But when I look at the figures being down — I don't know, I forget what it was now — 30 or 40,000, you know, in a year, it doesn't work very well as that goes along, because the advertiser just does not need you the same way as they needed you 10 or 15 years ago. So your ability to price evaporates in them.

It used to be — Charlie and I met Lord Thompson in 1970 or so, and he owns the paper — he owned the paper — in Council Bluffs, right across the river. And he was a jovial fellow, he was very happy to see us.

And we said to him, "Lord Thomson," we said, "We noticed you own the paper in Council Bluffs. Have you ever been there?" He said, "I wouldn't dream of it." (Laughter)

And then I said, "Well, Lord Thomson," I said, "You seem to increase the price of your paper every year and your poor advertisers" — I mean the advertising price. And I said, "What can they do about it?" He says, "Nothing."

And then I said to him, "Well, in that case, how do you decide how much to increase prices, since it's totally at your discretion?"

And he said — I think Charlie will remember these words — he says, "I tell my U.S. managers to price to make 40 percent pre-tax. Above that, I feel I may be gouging." (Laughter)

Those days are gone. (Laughs)

CHARLIE MUNGER: Yes, and the politicians are not behaving better as the newspapers are weakening. We're going to miss the newspaper power.

WARREN BUFFETT: I agree with that. (Applause)

11. There will "always be opportunities to overperform"

WARREN BUFFETT: Number 5.

AUDIENCE MEMBER: My name is Robert McArthur (PH) from Boston, Massachusetts.

I'm starting a career in investing, and many, if not most, investors my age think they're value investors.

Also, there's a record number of people here to see you this year, and the same value investors who were laughed at three years ago are now celebrated by the financial press.

Will there be fewer metaphorical $100 bills left on the street going forward, and if so, should I look for a career in managing a business instead of managing money?

WARREN BUFFETT: There will probably be fewer, but I would say there will always be — except in the most bubbly of markets, perhaps — but there will always be opportunities if you're not working with large amounts of money.

The money manager — there's a basic conflict. There's conflicts in most businesses. Everybody's pointing out the conflicts now in the investment banking business.

But the investment management business has a conflict that's equally as significant in the fact that asset gathering can become a way more important part of your income than asset managing.

But if you manage moderate sums of money, I think there will always be opportunities to overperform. That doesn't mean lots of people are going to do it, but they will be out there.

And, you know, it might have been easier many years ago when there were fewer people looking and not as much information was available on the internet and all that.

But people still make the same mistakes and they still get — well, I'll give you an illustration.

Charlie has a company called the Daily Journal Company. And the Daily Journal Company has a bunch of cash. And it sat there with cash, and it sat there with cash, and I own 100 shares — which is all he'll let me own — and I got their annual report here a while back.

And in their fiscal year of 2009, they never bought stocks before that I'd seen, and all of a sudden they'd bought $15 million worth of stocks and they were worth 45 million.

So by sitting around for a while, but waiting until things got really ridiculous in certain cases, he put $15 million out that became 45 million within, probably, a six month period or so.

So opportunities come around. You have to be prepared to grab them when they come. And you can't do it with the kind of money — I mean, you can't get the extraordinary things with the kind of money that we're running.

With moderate amounts of money, I think there will always be opportunities. Charlie's going to tell you something more pessimistic now, probably. (Laughter)

CHARLIE MUNGER: Yes. One piece of advice that Warren frequently gives — and it's particularly useful to those going into money management — take the high road. It's far less crowded. (Laughter and applause)

WARREN BUFFETT: Alan Simpson used to say, he said, "Those who take the high road in Washington are seldom bothered by heavy traffic." (Laughter)

But getting to the last part of your question, there's going to be opportunities for talent, whether it's in money management, operating management, whatever. It's going to work.

Money management, you know, is easier to scale up and easier to get into and all of that. So it was certainly my natural inclination, in any event.

I would not have wanted to work my way up to plant superintendent and all of that — (laughs) — until I got a job at the top, you know, about the time they were going to give me a gold watch.

But there's opportunities in both places.

12. Municipal bond insurers must worry about contagion

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question is about municipal bonds. Municipal bond defaults, on the scale you described in the 2008 letter, have so far not materialized.

To what extent will we see municipalities default outright in the next five to 10 years? Will the bond insurance companies be able to swallow the losses? Will there be federal bailouts of states?

And considering all of these risks, should investors be getting paid more than they already are for holding municipal bonds?

WARREN BUFFETT: Well, if the bonds are insured by Berkshire, you don't need to worry at all. (Laughs)

But we're not insuring a lot of bonds currently, because we don't think the premiums are appropriate, which gets to the question.

Just the other day, within the last few days — you've probably read about it in the papers — Harrisburg, Pennsylvania, defaulted on a relatively small amount of bonds.

And the bond insurer, named Assured Guarantee, starts paying the interest.

And Harrisburg may get things worked out in a week, you know, and they may not. There's certainly some incentive to do that. And if they do get it worked out, the bond insurer's not too much on the hook.

But what you worry about is correlation in this field, that if one entity defaults — and particularly if nothing terrible happens, that the police are on the street the next day, and the fire trucks still go to fires and all that — and people start thinking, "Why should I have a great fiscal reputation when I can have lower taxes and still have all the services I need?"

It's very hard to tell how that will play out. I personally think it would be very hard, in the end, for the federal government to turn away a state that was having extreme financial difficulties when they'd, in effect, gone into General Motors and various other entities and saved them.

I don't know exactly how you would tell the governor of state X that you were going to stiff-arm him, and when you'd participated in so many other bailouts of corporations.

But who knows what would happen, and who knows how contagious it would be? The big thing you worry about if you're a bond insurer is contagion.

Obviously the bond insurers — except for Berkshire — the bond insurers, in my view, have got extraordinary liabilities in relation to their capital.

And virtually every one of them either failed or effectively failed — had to spin off a bad bank versus a good bank type of thing, or something like that — with merely the troubles they encountered when they got into structured securities.

And I think they've had a very optimistic attitude toward what could happen in the field. But I don't know the answer on what default rates are going to be over the next few years.

I knew that I felt I was getting paid fairly for taking that risk on a year-and-a-half ago, and I don't feel that we're getting offered a premium that's fair now, so we're going to let somebody else do it.

Charlie?

CHARLIE MUNGER: Yeah, with the municipal bonds, I would try and invest in places that were both prosperous and disciplined.

You want to invest in the prosperous, because Ben Franklin was right when he said, "It's hard for an empty sack to stand upright."

And you want to invest in the disciplined places because integrity still matters. It's not very difficult, it's not very complicated.

WARREN BUFFETT: But you could argue that in a country, if the undisciplined are not being punished for being undisciplined, that the taxpayers in disciplined areas would say, “Wait a second. You know, why should we keep up a record of financial prudence and all that and pay our bills when other guys aren’t paying their bills?”

CHARLIE MUNGER: Well, there’s no question about the fact that bad behavior is contagious. That’s the way human nature works. But I’d still rather be with the disciplined, —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — prosperous people.

WARREN BUFFETT: Number 6.

CHARLIE MUNGER: That’s why I like the Berkshire meeting. (Laughter)

WARREN BUFFETT: That, and free fudge. (Applause)

13. Short-term stock moves aren’t predictable and don’t matter

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I’m (inaudible) from Fort Lauderdale, Florida. First of all I want to thank you for sharing your wisdom with us so generously.

Back in October of 2008, you highly recommended buying U.S. stocks and that was a brilliant idea, it worked very well.

And I just want to get your opinion how you think about the market going forward.

Are you still that optimistic, and what’s a reasonable rate of return to expect from equities in the next decade or so?

WARREN BUFFETT: Well, I write articles very infrequently, or get interviewed very infrequently, on the subject of the general level of the market itself. Probably only four or five times in 40 years have I really declared myself about — what I thought — about the general level of the stock market.

And it turned out I was pretty premature, actually, in October of 2008, as was pointed out to me by a number of people.

But I felt — and what I said in that article really was that it would be way better to own stocks over the long term than to follow a policy of buying either long-term bonds or holding cash. And I knew I could make that statement and I would be eventually — I thought odds were very high — I’d be proven right on that.

But I don't like — I don't know what the stock market's going to do next week, or next month, or next year. I don't have any idea.

People always think I do. I know I don't have any idea, I don't think about it, it doesn't make any difference because Charlie and I — I can't recall a discussion we've ever had on it, basically.

But I do think over the next 10 years or 20 years, I'd much rather own equities — including U.S. equities — I'd much rather own them than cash, or I'd much rather own them than a 10 or 20-year bond. But that's partly because I'm very unenthusiastic about the alternatives.

I think equities are likely to give you some positive — modest positive — real return over time. But beyond that I really don't know anything.

Charlie?

CHARLIE MUNGER: That's a cheerful thought that equities are the best of a bad lot of available opportunities. (Laughter)

WARREN BUFFETT: You disagree with it?

CHARLIE MUNGER: No, I think you're right. (Laughter)

I think people should get accustomed, on average, to doing less well in their investment portfolios, in real terms.

WARREN BUFFETT: Charlie and I don't —

CHARLIE MUNGER: I think we're in for a long period of where the ordinary result is not going to be very exciting.

WARREN BUFFETT: But we like owning businesses. And we're in a position where we can own entire businesses, but we also like partial ownership of businesses.

And we want to own businesses where we really think they have some competitive advantage over time, and where we feel good about the management, and where we think the price is reasonably attractive.

I think you can find things like that now, but they aren't dramatically attractive at all. They do beat, in my view, they do beat holding cash or five, 10, or 20-year bonds.

14. Why we don't use bond rating agencies

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from John Bailer (PH), who's asking about the rating agencies. He points out that you started selling your stake in Moody's this year.

"Has the investment case for Moody's changed due to potential regulation, and if so, why not sell the position to zero?"

WARREN BUFFETT: We won't discuss what we will or won't do with any position, but I would say this. The ratings agencies have had, and still have, under current conditions, an incredibly wonderful business.

I mean, it takes no capital at all, you know, the pricing power is significant. And certain parts of the world feel they need rating agencies.

There are also — a certain part of the world is very mad at rating agencies. And many feel that the rating agencies let them down when the rating agencies, essentially, succumbed to the same mania, in effect, you can say, that prevailed throughout the investment world, and, really, the political world, and the media world, et cetera.

They made the same mistake that, again, politicians made, I made, you know, you made, mortgage brokers made, whomever.

They couldn't see a world where residential housing, countrywide, would collapse.

And I don't think that was done because they were — the incentive part of it, there may have been some small aspect that that played. I just think that, you know, it's very hard to think contrary to the crowd.

And on the other hand, there is a, obviously, a backlash against rating agencies. There may be legal remedies. You can get views on that either way.

If they are not forced to change their — the whole structure around them does not change in some dramatic way — it's a pretty darn good business in that you can't shop pricing in the rating agency business.

We have never paid any attention to ratings for bonds, I mean, you know, at Berkshire. We don't think we should farm out, outsource, investment judgment.

If we can't do it ourselves, we just don't do it. And we're not going to rely on somebody else's opinion, whether it's a rating agency or an investment advisory organization, or a management consultant firm, or anybody else.

So, it's not a business that we rely on, but we do recognize that if the, sort of, the social model doesn't change, it still remains a phenomenal business.

Charlie?

CHARLIE MUNGER: Well, I would argue that the rating agencies, in their present forum, and structured with their present incentives, have been a wonderfully constructive influence in our country for a great many decades.

And what happened, of course, is that the cognition faltered. They drifted with the stupidity of their times in a way that was regrettable.

Part of it came out of asininity in American business education. They overbelieved in these ridiculous models and so on and so on. And I have yet to hear a single apology from business academia for its huge contribution to our present difficulties. (Applause)

15. World will find a solution when oil "windfall" gives out

WARREN BUFFETT: Area 7.

AUDIENCE MEMBER: Mike McCoy (PH) from San Francisco.

Chairman Buffett, you frequently speak favorably about the prosperity of future generations, that our children and our children's children will live better than us.

How much of our current prosperity do you attribute to us being able to get oil out of the ground at a fraction of the cost of its value to us in the economy?

And how will we be able to live better in the future when we can no longer get more and more of this free lunch and we become dependent on more dilute sources like solar and wind?

Couldn't this turn out like trying to satisfy a drug addict with a Coca-Cola?

WARREN BUFFETT: The oil business — obviously, the discovery of oil — what was it, about 1850- something? Colonel Drake at Titusville, Pennsylvania, or something?

That changed the world in a very major way, and it was only 150 years ago.

And since then we've been sticking straws into the earth at an incredible pace. There's over 500,000 producing wells in the United States, would you believe that? I mean, 11 barrels, 10 barrels a day average or something of the sort.

We have really exploited what may have taken, I don't know, whether it was hundreds of thousands of years or millions of years to create.

It's contributed in a huge way to the prosperity of the world, but the world, in my view, will not be dependent upon that particular — call it "windfall" — for the next hundred years.

And Charlie knows way more about this subject than I do, but there will be other free lunches available. You know, whether it's solar or — there's lots of possibilities.

Don't ever give up on humans' ability to innovate in ways that create solutions to problems that seem insolvable.

We've faced all kinds of predictions. You know, all of the inventions having been invented — there's some famous statement, I forget who made, on that.

We haven't really started. I mean, if you could pick a time in history when you would want to be born — leaving out the nuclear, chemical and biological threat, which is something to leave out — but I would pick today. The world has a bright future.

Now, Charlie will give you the other side of that. (Laughter)

CHARLIE MUNGER: No. I think you're failing to recognize something really important. In the technology of 150 years ago, they really needed the oil to get ahead.

In our advanced civilization, which has benefited from this last 150 years of technological expertise, we can get ahead without the oil if we have to.

Now, Freeman Dyson is a physicist who is not an economist but a genius, and he's been very good at pointing out that it isn't that horrible to contemplate a world which goes off oil, provided that world is as rich and knowledgeable as ours is now.

So the fact that they couldn't have got to where we are now without the oil starting 150 years ago, does not mean we can't do without the oil if we have to.

We need the oil and the gas, and the coal, eventually, for chemical feed stocks more than we need it for keeping warm and propelling our vehicles.

WARREN BUFFETT: And the adjustment, fortunately, will be fairly gradual. I mean, it isn't like 85 million barrels in the day goes to 50 million or something in five or 10 years. So it's a workable period of adjustment, in my view.

CHARLIE MUNGER: If it doesn't bother Freeman Dyson, who knows more about it, I don't think it should bother you too much. (Laughter)

WARREN BUFFETT: He's always pulling that on me. (Laughter)

16. Buffett doesn't like Kraft's purchase of Cadbury

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: I received a number of questions regarding Kraft, and this one comes from a shareholder who says they prefer to remain anonymous.

The question is, “Given your stake in Kraft and your public criticism earlier this year about the Kraft-Cadbury deal, how would you grade the Kraft board of director’s capital allocation and the management compensation abilities?

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

WARREN BUFFETT: Well, I didn’t like either the Cadbury decision or the pizza decision. But we’ve made our share of dumb deals at Berkshire, you know.

So I’ve gotten more tolerant of other people, and incidentally the fact I think it’s a dumb deal doesn’t for certain make it a dumb deal, but I think the odds are it was a dumb deal.

In fact, I think the odds are that both deals were dumb. The pizza deal was particularly dumb, but — in my view.

But just think of all the dumb things we’ve done, right? Starting with that department store in Baltimore.

CHARLIE MUNGER: Oh yeah, right. A few Irish banks, you know.

WARREN BUFFETT: Right, (inaudible).

CHARLIE MUNGER: We never seem to go —

WARREN BUFFETT: I wish you hadn’t brought this up.

CHARLIE MUNGER: — we never get over it. (Laughs)

WARREN BUFFETT: We expect to do some dumb things, it’s just we get mad when other people do dumb things with our money. (Laughs)

You know, the pizza business — somewhere I probably have some figures on that — but when they sold the pizza business for $3.7 billion they announced it as selling it for $3.7 billion.

They didn’t sell it for $3.7 billion, that’s what the other guy paid. What they got was about $2.5 billion. And that was a terribly tax-inefficient deal when they’d already shown their ability to understand that you could do a tax-efficient deal when they sold the Post cereals business earlier.

And when they referenced — well, they didn't reference at all what pizza was earning beforehand, but I think that Nestle said it was earning something like 280 million pre-tax, but that was referring to the previous year.

When they talked about the Cadbury earnings they were buying, they were talking about next year. And when they talked about the pizza earnings they were selling, they talked about last year.

Pizza in 2009, believe it or not, earned three hundred and, I think, 40 million pre-tax.

So they got 2 1/2 billion for 340 million of pizza earnings that were growing as fast or faster than the Cadbury earnings and where the sales were going as fast or faster. It really didn't make sense in my view.

Now, you know, Irene is a perfectly capable manager and she may know a lot of things about that business I don't know. Like I say, we've made plenty of mistakes ourselves.

But if it'd been me, I would have voted to keep pizza and not buy Cadbury. And I expressed myself, and I don't do that too often, but we owned a lot of Kraft.

And Kraft, still, is selling for considerably less than the value of its constituent parts, particularly if you value them the way they valued Cadbury. (Laughter)

But if they don't sell them all like they sold pizza, you know, the present price is below the value of Kool-Aid and A.1. Sauce and — and Jell-O and Oscar Meyer wieners and a few things.

Those are very good businesses. I just hated to see them give up a significant portion of those businesses to buy Cadbury at what I felt was a very fancy price.

Charlie?

And in terms of her compensation, you know, we've got a compensation system at Berkshire that I regard as quite rational. And there's a lot of companies in the United States that have different compensation systems. (Laughter)

CHARLIE MUNGER: Yeah, I think generally, at the top of American businesses, people think they know too much about strategy. And they tend to hate the tough competitive conditions in the business they're in, and to yearn for some business where it's less difficult.

You remember when Xerox bought Crum & Forster, an American insurance company, one of the dumbest acquisitions in all time?

The reason Xerox did that is they didn't have any tough Japanese competing in the insurance business. They were really tired of facing the tough competition they had in the business they were in.

I think it's quite typical to dream, if you're in business, that something that's a little different, no matter how much you pay for it, will make your troubles less.

WARREN BUFFETT: And you will have an absolute army of lawyers, investment advisors, public relations people, all of whom will have a strong economic interest in having you push ahead on deal, after deal, after deal, regardless of how the shareholders come out. It's just — it's the way it works. OK.

CHARLIE MUNGER: That's why Berkshire is a better deal. (Laughter)

We are very stupid in many ways, but we have avoided a slight subset of stupidities. (Laughter)

And they're important.

17. Biggest threat to integrity: "everyone else is doing it"

WARREN BUFFETT: OK Number 8.

AUDIENCE MEMBER: Dear Mr. Buffett, dear Mr. Munger. My name is Richard Rentrop. I'm a shareholder from Germany.

Mr. Munger, you just mentioned again the importance of integrity. My question is about changes in integrity of management.

One of your three key questions is, does management love what they do or does management love the money? So how do you see the crisis having changed integrity of management?

CHARLIE MUNGER: I think what led to the crisis involved, to some extent, a lack of integrity in many a management. Fortunately, some of them are now gone. So, integrity's very important.

It's the safest way to make money, also. There's an occasional perfect knave who succeeds pretty well with money, but that kind of success reminds me of what Pope Urban said about Cardinal Richelieu.

He said, "If there is a God, Cardinal Richelieu has much to answer for. But if there is no God, he's done rather well." (Laughter)

And too many people want to be like Pope Urban's view of Cardinal Richelieu.

And — the integrity is important, it's terribly important. And of course everybody mouths the integrity, even when it's lacking.

So it's difficult to be sure that professing integrity is the same as having it.

WARREN BUFFETT: The "everyone else is doing it" is the toughest thing. I think —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: You had this classic example. In about 1993, roughly, you know, the Accounting Standards Board came out and says what was obvious to everybody all along, was that stock options were actually expense, and that expenses, for some reason or another, belonged on the income statement.

And America — corporate America — fought back like you cannot believe. I mean, it was like World War III had broken out, in terms of armies of CEOs marching on Washington.

So the Accounting Standard Board backed off. Congress — the Senate — voted 88 to 9 to tell them that, you know, what the hell did the Accounting Standards Board know about accounting, and that the Senate would tell them what accounting was all about.

When the Accounting Standards Board backed off, they said, "We'll now say that you can do it one of two ways. Number one is preferred," which was to expense. Number two was acceptable, but not preferred.

Of the Standard & Poor's 500 companies, 498 chose number two, the non-preferred way. Two took the preferred method.

And I talked to a number of people in that 498 that I would trust to be a trustee of my will, you know, I'd love to have them as a next door neighbor, they could marry my daughter, but in the end they said, "I can't do it if the other guy isn't doing it."

It was a variation on the, "I'm doing it because the other guy is doing it."

They basically said, "I'll be penalizing my shareholders if I report less in the way of earnings than I can report. And all the other guys are doing it that way, and I understand your point."

And the situational ethics problem is huge. I gave you earlier that illustration of how rare it is to find, if you carry it out to tenths of a cent, a four in reported earnings, quarterly.

That's not accidental and it's — but if you talk to the people that play games to get that four up to five, they would say, "Everybody else is doing it, your own statistics proved that."

And that is, you know, it is a tough problem to deal with.

We try to create as few situations in Berkshire as we can that would induce such behavior. I don't have the managers submit budgets to me, there is no Berkshire budget, you know. They can use them in their own operations. Some do and some don't. Many do, a great many do.

But if they submit them to me, you know, and the temptation becomes, if they're not quite making it and they think I'm looking at them all the time, the temptation becomes to fudge in some way.

And very few would do it, but the more that thought the other ones were doing it, the more that would do it. It's just human behavior. And you want to try and create a structure that minimizes the weaknesses in human behavior.

And I think Berkshire's about as good a place at that as any, although I'm sure we're not perfect at it.

Charlie?

CHARLIE MUNGER: Yeah, what's really interesting on this issue is that so much of the bad behavior does not come from malevolence or overweening greed or anything like that.

It comes from subconscious poor cognition that justifies a lot of behavior that's really not justifiable if it's better understood. And that happens to practically everybody.

And the cure is very difficult. The best cure is to have a system where the people who are making the decisions bear the consequences.

And that's why the system that Wall Street created where nobody really owned the mortgages, they just passed them rapidly to somebody else at a profit. And so nobody felt any responsibility that the mortgages be any good.

Systems like that, at a basic level, are irresponsible systems, and it's deeply immoral to create irresponsible systems like that.

But the people who create them don't realize they're being immoral, they think those systems are wonderful.

Who do you see apologizing for the behavior you now find so regrettable in our recent mess?

There are very few apologies, you'll note. People think they did fine.

18. Can't make money if you're scared when everyone else is scared

WARREN BUFFETT: Carol? (Applause)

CAROL LOOMIS: This question is from James A. Star.

"I have read an enormous amount about past market declines and the opportunities they presented to investors.

"The last two years have seemed to me, a 43-year-old investor, a real opportunity. Yet in the thick of the action, I was too scared, because I felt the market decline, while severe, was not necessarily sufficient to match the risks of global financial meltdown.

"So my question is, given that we are possibly not totally out of the woods, how did the two of you assess this latest buying opportunity against the previous opportunities of your life?"

WARREN BUFFETT: It's not the greatest one. We've seen a few that scream at us, and we've seen a few periods of overvaluation that scream at us. And 90 percent of the time we're somewhere in between and we don't know exactly where we are in between.

The business of being scared, you know, I don't know what you do about that.

If you're of that — if you have a temperament that when others are fearful you're going to get scared yourself, you know, you are not going to make a lot of money in securities over time, in all probability.

You know, people really — if they didn't look at quotations — but, of course, the whole world is urging them to look at quotations, and more than that, do something based on small changes in quotations.

But think how much more rational — we've talked about it before — but think how much more rational investing in a farm is than the way many people buy stocks.

If you buy a farm, do you get a quote next week, do you get a quote next month? If you buy an apartment house, do you get a quote next week or month?

No, you look at the apartment house or the farm and you say, "I expect it to produce so many bushels of soy beans and corn, and if it does that, it meets my expectations."

If they buy a stock and they think if it goes up it's wonderful, and if it goes down it's bad.

We think just the opposite. When it goes down we love it, because we'll buy more. And if it goes up, it kills us to buy more.

And I — you know — all kinds — you know, Ben Graham wrote about it. It's been explained. But if you can't get yourself in that mental attitude, you're going to be scared whenever everybody else is scared.

And to expect somebody else to tell you when to buy and therefore get your courage back up or something, you know, I could get this fellow's courage up substantially by saying this is a wonderful time to buy, and then a week from now he'd run into somebody else that tells him the world is coming to an end and he'd sell.

I mean, he's a broker's friend, but he's not going to make a lot of money.

Charlie?

CHARLIE MUNGER: Yeah, I think I developed more courage after I learned I could handle hardship. So maybe you should get your feet wet with a little more failure. (Laughter and applause)

WARREN BUFFETT: I've certainly followed that advice. (Laughter)

No, some people really do not have the — apparently, they don't have the temperament, or emotional stability, or whatever it may be, to invest in securities.

They'd be much better off if there were no quotations at all. And Keynes talked about that some in the past, too.

To take something that should be an asset, a quotation every day, you know, terrific liquidity, nobody says, "How liquid is my farm?" or something of the sort. So they're not expecting the prices to tell them something about how they're doing.

The market is saying this or that. Whenever anybody says, "The market is saying this or that," you know, it's sort of unbelievable.

But there's a lot of interest in investing, and people are going to yak about it all the time.

And in the end, what counts is buying a good business at a decent price, and then forgetting about it for a long, long, long time. And some people can do it and some people can't.

19. Munger is "enormously optimistic" about solar power

WARREN BUFFETT: Number 9.

AUDIENCE MEMBER: Hi, my name is Joe McCabe (PH). I'm from Littleton, Colorado. I want to thank you for the opportunity to ask a question and for your annual discussions in your report, just wonderful reading.

Charlie Munger, you are on a YouTube video that discusses BYD and solar energy, and I really appreciate that interview and it being available to everyone. I want to talk about that in relationship to your other companies.

So the BYD was mentioned as electric car and battery, but I understand their second goal is solar energy.

And you also own roofing companies and buildings companies, (inaudible) and Clayton, as well as utilities, Mid-America, PacifiCorp, and Pacific Power.

This seems to be a perfect golden opportunity for solar to be on these buildings in those kinds of utility companies.

You've mentioned you don't interfere with individual companies, but is there a way you can direct, suggest, motivate a synergy between all these companies to bring solar solutions? Thank you.

CHARLIE MUNGER: As the solar solutions are coming, because they're so obviously needed.

And regarding solar panels on roofs, I never pass an opportunity to decline to put them in, because I think they're going to get a lot cheaper and I'd rather wait.

WARREN BUFFETT: Well, at 86 you can afford to, Charlie. (Laughter)

CHARLIE MUNGER: Yes, I have to think about the long term. (Laughter)

And I'm going to miss you terribly. (Laughter)

WARREN BUFFETT: Touché.

CHARLIE MUNGER: It reminded me of the wife, and the husband said, "Will you still love me if I lost all of my money?" And she says, "Yes, I would always love you, but I would miss you terribly." (Laughter)

Well, the solar is coming because we have no other practical alternative.

And it should be regarded as a very good thing, because what in hell would modern civilization do if we had no alternative to fossil fuels? That would be a really serious problem.

And so of course, the cities that are chocking to death on their own poisonous air are going to go to electric cars and we're going to get a lot more renewable energy from the sun.

I'm also quite negative about growing corn in America using fossil water and fossil fuels in order to burn up in automobiles. (Applause)

That is a stunningly stupid idea, and another example of how our politicians have failed us.

But I am enormously optimistic about what is going to happen. Our politicians will eventually create a big electric grid that's way better than what we have now. We'll eventually have the energy we need, and we will be way better for it.

And it's wonderful that these technical problems are proving solvable.

It is not all that important over the long term, if solar power costs twice as much as what we're used to. That's a blip in the economic future of our country, it's just a blip.

And I think it's probably a good thing that we have all these big capital needs coming that will create a better system in the end and solve our problems in the end.

So I'm quite optimistic. But in terms of immediate business decisions, I think frequently the right answer is counterintuitive, like mine, to say, if you want to put in solar panels, wait. They're going to get cheaper.

Warren, do you want to criticize that?

WARREN BUFFETT: I have nothing to add. (Laughter)

20. No "exploding bananas" now in our stock portfolio

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Jennifer Mancuso (PH) who is a shareholder here in Omaha. And she's hoping that you can settle a debate between her husband and her.

WARREN BUFFETT: That a promising assignment. (Laughs)

BECKY QUICK: She says that he believes the Berkshire Hathaway stock will rise significantly in the next one to two years because of all the smart buys Warren made last year in Fortune 500s when stock prices were bottomed out.

She says she knows this type of purchasing has driven much of your financial success, but she doesn't know how impactful these buys are, given the size of Berkshire Hathaway and that Warren himself indicates that we shouldn't expect to see large increases in his stock price in the next few years.

So the question is, what percentage of the portfolio is represented by those stock purchases, and what kind of an impact might they have on the fund's value as the valuation of that stock increases?

WARREN BUFFETT: I would say this, that our portfolio now — I've always regarded our portfolio as something that we thought would be worth more money later on.

But the degree of undervaluation in our portfolio now compared to what I would expect it to produce over time is not dramatic, and that undervaluation has been exceeded many times in the past.

So it isn't like we're sitting here on some exploding bananas or anything like that. That couldn't be further from the truth.

We think we'll do reasonably well over time. We've got a lot of good businesses, we try to allocate capital rationally, we don't waste a lot of money at the top.

But we do not have a whole bunch of things that are likely to increase dramatically in value from here, it just isn't the case. So I hope she and her husband get along fine. (Laughter)

Charlie?

CHARLIE MUNGER: I don't think I can solve any of those domestic troubles, either. In my own day, I simply accepted the other point of view. (Laughter)

21. "If I can be optimistic when I'm nearly dead, surely the rest of you can handle a little inflation"

WARREN BUFFETT: Number 10.

AUDIENCE MEMBER: Hello gentlemen, my name is Randy Bellows (PH) and I'm from Rock Hall, Maryland.

I've been coming here for many, many years, yet today I sense from each of you a guarded sense, a sense of reserve.

Not quite overt pessimism, but real reserve. You have spoken of impending inflation, government debt, both here and abroad, that's higher than we're accustomed to, increased regulation and red tape that may slow innovation and growth.

And just a few minutes ago, Charlie, you spoke of that we have to reduce our expectation of investment returns.

And yet in the same day you say children in India will live better than we do, Chinese will live better than we do, and our own children here in this country will live better than we do today.

Can you give me four or five facts that explain your optimism? And thank you.

CHARLIE MUNGER: Well, having the main technical problems of civilization — which, of course, are all energy related — having a solution that's on the horizon and nearly here, that is not a small benefit to humanity.

That is the biggest single problem we have, so of course I'm optimistic about that.

And — I'm optimistic about the culture that generally pervades in Berkshire, because I think it will continue to work.

And of course it gives me some pleasure to see people that have had it tough for a long time — through their own extreme efforts and talents — rising rapidly, as in many parts of China and India.

All of that gives me pleasure, and why shouldn't it? Of course there are terrible problems, and of course reduced expectations are the rational way. There's no better way to be happy than getting your expectations down, it's much easier than —

WARREN BUFFETT: Getting your results up.

CHARLIE MUNGER: — than getting your results up, yeah. (Laughter)

It's just — we never know anything here except the most elementary common sense. It's amazing that it's sufficed for us.

So no, I'm optimistic about life. If I can be optimistic when I'm nearly dead, surely the rest of you can handle a little inflation. (Laughter and applause)

WARREN BUFFETT: I really have nothing to add to that. (Laughter)

22. Why Buffett prefers TV interviews

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from Myard Shields (PH), and I want to say in advance that I don't — I'm not thrilled asking this question and you'll see why.

The question is, "The American public almost certainly benefits from Mr. Buffett's increasing media exposure, but is it the best use of your time for Berkshire's shareholders?"

WARREN BUFFETT: Probably not. (Laughter)

I do a lot of things that aren't the best use of my time for Berkshire shareholders. I play bridge on the internet 12 hours a week, you know. I'm not sitting there thinking improving my bridge skills is going to do wonders for Berkshire. (Laughs)

No, I — I do — I have seen over the years that the development of broadcast television, as opposed to print, and I would say that if you want to have a record of exactly what you said as opposed to interpreted through not only reporters but editors who bounce back things and say, “Take six paragraphs down to four paragraphs, and why don’t you ask this question?”

I would much rather have a record on Charlie Rose which is permanent. Where people can go back and look at exactly what I said, and my body language, and whether I was kidding.

I’m sure Lloyd Blankfein would have preferred to have a television interview. He would like to take back that remark about, you know, doing God’s work, under any circumstances. But I would bet that that was delivered as a throwaway line in terms of something that was said earlier.

Clearly he did not mean that in a literal sense, but he’s gotten killed in the media because somebody elected to treat it halfway seriously, and then other people, to fit other stories, play it that way.

I like the idea, whether it’s, you know, in terms of CNBC keeping a record of it or Charlie Rose keeping a record of it, of being judged by my own words rather than somebody writing a few paragraphs trying to summarize some views.

And that requires being on television instead of having people, essentially, take a one-hour interview, often just shopping for a single quote that fits their storyline, and having that somehow become representative of what I think.

So the clearer I can be about what I think, whether writing my own annual report or whether being in broadcast, the better I feel about the accuracy of the reporting.

And I figured that out a few years ago. So that’s the direction I go now. And whether it’s the best use of the time, it works fine.

I’ll tell you one story on that. You even have to be a little careful about broadcast.

After we made the Burlington deal, Charlie Rose, who may be here, did an interview with me and we taped it on a Friday morning. And we did the tape, and we had a good time doing it.

And during the tape there was a little section on it showing great railroad scenes, and one had Cary Grant and Grace Kelly, and another one had Marilyn Monroe in “Some Like It Hot,” and then they showed a bunch of the kind of things we had about railroads in our movie this morning.

And when we got all through that, he asked me some question. And just to give a flip answer, but it did tie in with what I’d just seen, I said, “Well, I would have paid more for the Burlington if they’d thrown in Grace Kelly and Marilyn Monroe.” (Laughter)

Well, this taped interview ran an hour and six minutes, so when they ran the tape that night they had to take out six minutes and they took out these railroad scenes that showed Grace Kelly and Marilyn Monroe. (Laughter)

So to anybody that viewed this thing, it looked like I was spending my time there fantasizing about these — while Charlie was talking to me. (Laughter)

So even television isn't safe. (Laughter)

23. How Berkshire gets loyal shareholders

WARREN BUFFETT: Number 11.

AUDIENCE MEMBER: Hi, my name is Kip Johann-Berkel from Boston, Massachusetts.

First, thank you both for your writings, annual shareholder meetings, and even the Charlie Rose interviews — (Buffett laughs) — as they have helped me grow both as an investor and as a person.

Berkshire has, in my opinion, the best and most loyal shareholders of any publicly-traded company or mutual fund.

How do you attract and retain a shareholder base, particularly when many of the same behavioral tendencies that produce mispriced securities also produce fleet-footed shareholders? Thank you.

WARREN BUFFETT: Yeah, the interesting thing about marketable securities is that, basically, anybody can buy them.

You might elect to join somebody in buying a McDonald's franchise or a farm, or apartment house, or something, but if you're running a public company, you know, you can have anybody from, you know, Osama Bin Laden, you know, to the Pope as your shareholder.

I mean, they elected — you don't elect them, they elect you.

Now, if you want a shareholder body that is going to be in sync with you, it's important — in my view — it's important that you let them know exactly what sort of institution you plan to run.

And we've got the annual reports, we've got television interviews, we've got various ways of conveying to people what kind of a place Berkshire is. And to some, that says, "Come in," and to others it says, "Stay out."

Phil Fisher wrote a great book on investing back in the very early 1960s and he described the situation this way.

He said, "Look it, you can have a restaurant and it can say 'French food' and if you have French food inside, you know, people are going — you're going to get a satisfied and returning clientele. And you can have another one that says hamburgers. But what you can't do is have hamburgers on the outside on the marquee and deliver French food inside."

And so many companies sort of try and promise everything to everybody. Their investor relations department tells them that any shareholder they can get interested, you know, they want.

We want people who think the way we do. And we think, on balance, we won't disappoint them too much.

But if we get a bunch of people who think that the earnings next quarter are going to be up 10 percent for some reason, and that's the reason they own the stock, we're going to have a lot of disappointed people.

And our goal in life is not to spend our time associating with people who are going to be disappointed with us.

It's our fault if we give out the wrong advertisement. So we try to advertise what we are, and then we try to deliver on that.

And I do think we have the best group of shareholders in the world, you know, among large publicly-traded companies.

And I think it's because we've got people that basically look into buying a business, becoming our partners over the years, and they know we'll treat them like partners.

And they, in turn, give us a lot of comfort in having a stable shareholder base and a good feeling about just running the whole place.

Charlie?

CHARLIE MUNGER: Well, what happened here is, to some extent, an accident.

Warren and I started out investing money for our families and friends, and the people who trusted us when we were young and unknown, of course, we developed a strong affection for.

And we morphed into controlling public companies from that base, and so we tend to regard our shareholders, including the new ones, as family.

And that's not put on, that's the way we regard you. Other people can't do that because they morphed into their situation in a different way.

And if you were a CEO and dealt with the average institutional investor, who is interested in having his portfolio management look good the next six months, you'd find it hard to love your shareholders.

They're sort of a hostile force that are putting unreasonable expectations on you. And so I don't think Warren and I deserve such wonderful credit for the fact that we have better relations with our shareholders. We came up in a totally different way.

Now, we did have enough sense, when we saw that it was such a good thing and so satisfying, that we stayed with it. But weren't we — we got into this by accident, didn't we?

WARREN BUFFETT: Yeah, we got in by accident, and we also were blessed with the fact that we did not have an investor relations department that wanted us to go out and pump up.

CHARLIE MUNGER: But that was on purpose.

WARREN BUFFETT: Yeah, yeah. (Laughter)

I have seen them in operation at dozens of companies, I've been involved in one way or another. And it is really ridiculous, the idea that you go out and try and cater to the expectations of people that are expecting you to do things you can't do by operations, but maybe you can do by accounting for a short period of time. It leads to the worst behavior.

And in the end, somebody's going to own all your shares, you know. There's no way that shares remain empty, you know, in the shareholder list. So why not get a bunch of people who are going to stick with you who are in sync?

And the way they're going to be in sync is if you told them rather accurately what you expect, how you expect to do it, and tell them when you make mistakes, all of that.

CHARLIE MUNGER: But we probably shouldn't be as critical of people who came up a different way dealing with a different shareholder face.

It's not at all clear that we wouldn't have ended up somewhat the same way if we'd had the same manner of rising.

WARREN BUFFETT: Sure. Yeah. So we'll give up being critical for the next five or 10 minutes, and then we'll go back. (Laughter)

24. Low interest rates are hurting people scared out of stocks

WARREN BUFFETT: Carol?

CAROL LOOMIS: Very short question. Please comment on the implications of our existing, and perhaps continuing, zero percent interest rate.

WARREN BUFFETT: Well, it's very tough for anybody that's got their investment in short-term money.

You know, if you're getting a tenth of a percent on some money market fund currently that if you'd started doing that when Columbus landed, and didn't pay any taxes, you'd have almost doubled your money by now. (Laughter)

It's really — I mean, people talk about easy money policies, but it isn't so easy on the people who've got the money.

It won't go on forever, but it may seem like forever to people that are on fixed income. I'm very sympathetic with them.

Basically they got, many of them, became fearful when the world was looking like it was collapsing in late 2008. And the price they pay is really — I know some people like that that are — it's terrible in terms of returns and their purchasing power will be eaten away. But this will end at some point.

I don't know how it will end, but I would not like to be chairman of the Fed or secretary of the treasury. Nobody's ever asked me, but maybe that's why I say I wouldn't want to do it.

But the — we will — it won't work forever to run huge budget deficits and try and have very easy monetary policy. And when — if we do run into trouble, the blame should not go to the Fed, the blame should go to Congress. (Applause)

CHARLIE MUNGER: In some sense, the reality of our situation is almost amusingly depressing.

Stocks are up because the return from loaning your money out at interest in a safe way is so lousy, and of course, one answer is that can't last.

In which case, stocks won't be as pronounced a value, relatively speaking. And of course, if it does last, as it has in Japan, we won't like that either because it will mean we're mired in some horrible stagnation.

This is a very cheery message. (Laughter)

WARREN BUFFETT: The pressure that is exerted by extremely low interest rates — short-term rates — on the value of everything else, it's hard to overestimate that.

I mean, the reason people have their money out at one-tenth of 1 percent is that they're afraid of everything else. But as they're being afraid of everything else abates, as it has over the last couple years, the pressure to push stock prices up, push real estate prices back up, it's enormous.

And of course, that's understood by people who have something to do with those matters. But I don't think you should underestimate the degree to which the last year of stock prices has been a result of the agony that people are being put through that keep their money in short-term money instruments.

Unless they're terrified of the world, they get pushed into other investments, and I think we've seen a lot of that, and we'll see what happens when money rates do go up, if they do.

25. Valuing businesses by asking questions

WARREN BUFFETT: Twelve.

AUDIENCE MEMBER: Hello, my name is Jeff Colvette (PH) and I'm from Olathe, Kansas.

I got started in investing in 1999, right before the big tech bubble, and unfortunately I learned buy and hold and don't fret about market price fluctuations before I learned the importance of valuing a business and applying a margin of safety.

So, as Charlie said, I got my feet wet with huge failure right away. And —

CHARLIE MUNGER: Join the club. (Laughter)

AUDIENCE MEMBER: Thank you, I don't feel so bad now.

So that leads to my question. It seems like I've read all the Berkshire reports and all the reading I can do about you two, and I thank you for these wonderful meetings.

But it seems like it boils down to some simple things, valuing a business and applying a margin of safety.

So my question is, what do you recommend for an approach to getting better and better at valuing companies?

WARREN BUFFETT: That was a very, very good question. And in my own case, you know, I started out without knowing anything about valuing companies.

And Ben Graham taught me a way to value a certain type of company that would prove successful, except the universe of those companies dried up.

But nevertheless — it was almost a guarantee against failure, but it was not a guarantee that these things would continue to be available.

Charlie taught me a lot about the value of a durable competitive advantage, and a really first-class business.

But over time, I've learned more about various types of businesses. But you'd be amazed how many businesses I don't feel that I understand well.

The biggest thing is not how big your circle of competence is, but knowing where the perimeter is.

You don't have to be an expert on 90 percent of the businesses, or 80 percent, or 70, or 50. But you do have to know something about the ones that you actually put your money into, and if that's a very small part of the universe, that still is not a killer.

And I think if you think about what you would pay for a McDonald's sandwich, you think you would pay for — you know, think about the businesses in your own hometown of Olathe.

Which would you like to buy into? Which do you think you could understand their economics? Which do you think will be around 10 or 20 years from now? Which do you think it would be very tough to compete with?

Just keep asking yourself questions about businesses. Talk with other people about them.

You will extend your knowledge over time. And always remember that margin of safety. And I think you basically have the right attitude because you recognize your limitations, and that's enormously important in this business. You will find things to do.

Six or seven years ago — maybe not that long — six or seven years ago, when I was looking at Korean stocks, for example, I never had any idea that Korean stocks would be something that I would be buying.

But I looked over there, and I could see that there were a number of businesses that met the margin of safety test.

And there I diversified, because I didn't know that much about any specific one, but I knew that a package of 20 was going to work out very well, even if a crook might run one of them, and a couple might run into competition I didn't anticipate, because they were so cheap. And that was sort of the old Graham approach.

You will find opportunities from time to time, and the beauty of it is you don't have to find very many of them.

Charlie?

CHARLIE MUNGER: Well obviously, if you want to get good at something which is competitive, you have to think about it a lot, and learn a lot, and practice doing it a lot.

And the way the world is constructed in this field, you have to keep learning, because the world keeps changing and your competitors keep learning.

So you just have to get up each morning and try and go to bed that night a little wiser than you were when you got up.

And if you keep doing that for a long time — and accumulate some experience, good and bad, as you try and master what you're trying to do — people who do that almost never fail utterly.

They may have a bad period when luck goes against them or something. But very few people have ever failed with that.

If you have the right temperament, you may rise slowly but you're sure to rise.

WARREN BUFFETT: Charlie, did you take any business courses in school?

CHARLIE MUNGER: None. I took accounting.

WARREN BUFFETT: And when did you start valuing businesses and how did you go about it?

CHARLIE MUNGER: When I was a little boy. (Laughter)

I can remember, I would come down to the Omaha Club, and there was an old gentleman who hit the Omaha Club about 10:30 every morning. He obviously did almost no work, and yet was quite prosperous.

WARREN BUFFETT: He became your ideal. (Laughter)

CHARLIE MUNGER: Yeah. But he made me very curious as a little boy. I said to my father, "How in the hell does he do that?" And he said, "Charlie," he said, "A business where he enjoys practically no competition. He gathers up and renders dead horses."

That was an example of avoiding competition by one stratagem. And you keep asking questions like that of reality, starting at a young age, you gradually learn. And weren't you doing the same thing?

WARREN BUFFETT: Yeah, thankfully he went beyond his original insight there. (Laughs)

CHARLIE MUNGER: I noticed, it was rather interesting — you take the rulers of the businesses when I was a little boy, an awful lot of those businesses, in Omaha, a lot of those businesses went broke, a lot of them sold out at modest prices under distress.

And some of the people who rose, like Kiewit, from small beginnings, nobody thought of as the great glories of that early time.

And I think that's kind of the way life is. It's hard to get anywhere near the top, and it's hard to hold any position once you've attained it.

But I think you can predict that Kiewit was likely to win. They cared more about doing it right. They cared more about avoiding trouble. They put more discipline on themselves.

WARREN BUFFETT: Well, if you knew the individual well, you would have bet, right?

CHARLIE MUNGER: What?

WARREN BUFFETT: If you knew the individual.

CHARLIE MUNGER: I would not have bet on any of the people I knew who were already wealthy. But I would have bet on Pete Kiewit. His sister taught me math, and no, half-Dutch, half-German, you know, this is a tough culture. (Laughter)

WARREN BUFFETT: There's your — you just heard it folks. Half-Dutch, half-German. (Laughter)

CHARLIE MUNGER: Well but —

WARREN BUFFETT: Go out looking for them. (Laughter)

CHARLIE MUNGER: Well, the man who's recommending this is named Munger. (Laughter)

Anyway, the — no — I don't think it's that — I was just automatically doing that. What was working, what was failing, why was it working, why was it failing?

If you have that temperament, you are gradually going to learn. And if you don't have that temperament, I can't help you. (Laughter)

WARREN BUFFETT: If you'd followed Pete Kiewit around for 10 years, you never would have seen him do anything dumb, right?

CHARLIE MUNGER: Oh yeah. It's so —

WARREN BUFFETT: It's avoiding the dumb thing. You really don't have to be brilliant, but, you know, you have to avoid just sort of what almost seem the obvious mistakes.

But I would say that you're on the right track back there, in terms of having the basic fundamentals, knowing your limitations, but still seeking to learn more about various kinds of businesses.

Charlie, I think, when he practiced law, any client that came in Charlie was thinking about that business as if he owned the place.

And he probably generally thought he knew more about the place than the guy that actually owned it, who was his client. (Laughs)

But I remember talking to him, you know, 50 years ago, and he would start talking about Caterpillar dealerships in Bakersfield or something of the sort. He was incapable of looking at a business without thinking about the fundamental economics of it.

How'd that guy do with the Caterpillar deal? (Laughs)

CHARLIE MUNGER: Well, he sold it for a perfectly ridiculous price to a dumb oil company. (Laughter)

It wasn't worth half what he got for it.

WARREN BUFFETT: But they had a concept and a strategy.

CHARLIE MUNGER: They had a concept and a strategy, and turned out they had consultants. (Laughter)

WARREN BUFFETT: Yeah. (Laughs)

26. Companies with the best return on capital

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Carson Mitchell in Aberdeen, South Dakota, who asks both of you, "What business has had the best return on capital for Berkshire, and what business of any on earth has had the best return on capital?"

And he adds, "PS, I would have come by rail but there are no seats in the grain rail cars." (Laughter)

WARREN BUFFETT: There's two ways of looking at it.

If you talk about the capital necessary to run the business, as opposed to what we might have paid for the business — I mean, if we buy a wonderful business — you could run the Coca-Cola Company —assuming you had the bottling systems — you could run it with no capital.

Now, if you buy it for $100 billion, you can look at that as your capital or you can look at the basic capital. When we look at what's a good business, we're defining it in terms of the capital actually needed in the business.

Whether it's a good investment for us depends on how much we pay for that in the end.

There are a number of businesses that operate on negative capital. Carol's with Fortune magazine. You know, any of the great magazines operate with negative capital.

I mean, the subscribers pay in advance, there are no fixed assets to speak of, and the receivables are not that much, the inventory is nothing.

So a magazine business — my guess is that People magazine operates, or Sports Illustrated operates, with negative capital, and particularly People makes a lot of money.

So there are certain businesses. Well, we had a company called Blue Chip Stamps where we got the float ahead of time, and operated with really substantial negative capital.

But there are a lot of great businesses that need very, very little capital. Apple doesn't need that much capital, you know.

The best ones, of course, are the ones that can get very large while needing no capital.

See's is a wonderful business, needs very little capital, but we can't get people eating ten pounds of boxed chocolates every day.

CHARLIE MUNGER: Except here.

WARREN BUFFETT: We want to. (Laughs)

Generally, the great consumer businesses need relatively little capital. The businesses where people pay you in advance, you know, magazine subscriptions being a case, insurance being a case, you know, you're using your customer's capital.

And we like those kind of businesses, but of course, so does the rest of the world, so they can become very competitive in buying them.

We have a business, for example, that's run wonderfully by Cathy Baron Tamraz, called Business Wire. Business Wire does not require a lot of capital. It has receivables and everything, but it is a service-type business and many of the service-type businesses and consumer-type businesses require little capital.

And when they get to be successful, you know, they can really be something.

Charlie?

CHARLIE MUNGER: I've got nothing to add, but at any rate, the formula never changes.

WARREN BUFFETT: If you could own one business in the world, what would it be, Charlie? (Laughter)

I hope we already own them, myself.

CHARLIE MUNGER: You and I got in trouble by addressing such a subject many decades ago.

WARREN BUFFETT: That's right. (Laughs)

CHARLIE MUNGER: And I don't think I'll come back to it.

WARREN BUFFETT: OK. (Laughter) Number 13 —

CHARLIE MUNGER: If you name some business that has incredible pricing power, you're talking about a business that's a monopoly or a near monopoly.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: And I don't think it's very smart for us to sit up here naming our most admired business or something, that other people regard as a monopoly.

WARREN BUFFETT: OK. We'll move right along. (Laughter)

27. Phone hasn't been ringing, but we're still ready to buy

WARREN BUFFETT: Let's see, have we done number 13? No, I don't think so, that's in the other room again. Anybody there?

AUDIENCE MEMBER: Yes, Mr. Buffett, Mr. Munger, greetings from the breakout room.

My name is Glenn Tongue from New York. I would like to thank you both for your exemplary stewardship through the economic crisis. We are all wealthier in several ways as a result of your efforts.

I'd like to ask about Berkshire's growth, specifically your acquisition outlook and appetite. Has the phone been ringing?

WARREN BUFFETT: The phone doesn't ring very often at Berkshire, you know. That's partly because — well, we set out our criteria in the annual report for what we're looking for, and we're not looking for larger and larger things.

So when we start saying that we want to buy businesses that earn 75 or 100 million, at a minimum, before tax, that weeds out a lot of phone calls.

And I would say that, you know, if we get a couple of — three or four serious phone calls a year that sort of meet our criteria that look like they might be a possibility, that's a good year, I like that.

I don't think there's been any major change in the frequency that something comes along that might interest us.

The answer is, in terms of being interested, we're as interested as ever. I mean, we wrote a big check and issued shares in connection with BNSF.

But I would love it if Monday morning my phone rings with some big deal. We'll figure out a way to do it.

Charlie?

CHARLIE MUNGER: Yeah, it's amazing to me that we have been as successful as we have been in buying desirable places.

And it's human revulsion that has helped us, because many of the people who sell to us are so smart that they're revolted by almost everything else.

They don't want to sell into some fee-driven buying system that doesn't care about their employees or their business.

And they finally decide they want to join this one, they don't want to join the alternatives. And of course, that's marvelous for us.

We've got a screening device out there that is protecting us, to some extent, from the wrong sort of people. And very few people have this particular —

We get offered things by people who would not sell to anybody else. That is really peculiar. And it's happened what, how many times?

WARREN BUFFETT: Well —

CHARLIE MUNGER: A lot.

WARREN BUFFETT: It's happened, and on important ones. There's one I've mentioned before, so I can mention the name.

When I heard from ISCAR, and I'd never heard of ISCAR before, I'd never heard of Eitan Wertheimer, who wrote me, but he basically told me and made it quite specific, they either wanted to sell to Berkshire Hathaway or they didn't want to sell it to anybody.

And we met and we made a deal. And there was another person — I won't even define exactly the time period — but he came in and he'd been thinking about it for about a year on this business, and he'd built it over many decades.

And he said, "There were three possibilities. One was to sell it to a competitor." And he said, "They would have ideas immediately about all the people they could take out of this place and move the headquarters," and everything, and they would dismantle something that he'd spent 30 years or so building.

And he decided that he didn't want to do that, even though it was probably worth more to a competitor, because that's often the case, than to anybody else.

And then he looked at selling to a leverage buyout firm — and now would call itself a private equity firm — and he decided he did not want his place being, basically, a piece of meat that would be resold in not that many years. He really wanted to find a permanent home.

So he said, "When I come to you, I don't come to you because you're so damned attractive." He said, "You're the only guy left." (Laughter)

And we bought the business. So that happens from time to time, and it's accidental. It's when something happens in someone's life that they decide they really want to assure a permanent home.

It may be because the family isn't getting along. It may be, you know, a half a dozen reasons. Maybe somebody wants to monetize it because they want to give away a lot of money.

But periodically that will come up, and we are a logical place to get the call, and we will get the calls. But there's not much we can do to accelerate the process or do anything of the sort.

We are ready to act when it happens. I mean, if I get a call, and it's a $10 billion deal, on Monday, and I like it, I will say yes. (Laughs)

And then I'll figure out how we do it.

CHARLIE MUNGER: Yeah, I don't think it's over. It may be, in fact, it will be, slower than it was in the early days. But that's not so bad, considering how much richer we all are than we were then.

28. Big question for Berkshire's future

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Since I imagine this may be one of the last questions, Peter Brotchie, a shareholder from Wenham, Massachusetts, writes to say, "Thank you, Warren and Charlie, for improving the Q&A session last year.

"Along those lines, are there important questions that you were surprised that you don't get asked about Berkshire's financials or businesses? And if so, what is the question you would ask yourself if the roles were reversed?"

WARREN BUFFETT: Well Andrew, first of all, I will say we got a lot of compliments on changing the format. It worked, and that's why we're continuing it. So it's worked very well. (Applause)

And that applause is for you, not for me, and you deserve it.

It really has improved the quality of questions, in terms of having it Berkshire-related and having a system of weeding them out without us being the ones that do the weeding out.

Now, I've given Charlie time to think about what the answer to that question is going to be, so I'm going to turn it over to him. (Laughter)

CHARLIE MUNGER: Well, I don't have a lot of comment about things that should be done differently at Berkshire.

I think it is quite interesting that we got into BYD, because BYD is surfing along on the developing edge of new technology, and that has not — we have always bragged about avoiding that.

Isn't that a fair statement?

WARREN BUFFETT: That's fair.

CHARLIE MUNGER: And yet here we are.

I think it's because we've shown some capability for learning. And I think the BYD investment is going to work out very well. And I think it'll work out very well in a way that gives great pleasure to all of us shareholders, because I think they're going to help solve some significant problems of the world.

And, that place is — you know, I spoke with pride of Kiewit. They tried harder, they were more self-disciplined. That's the way I feel about BYD.

And it's a pleasure to associate with such people, and in my life those are the people with whom I've achieved the most.

So as far as I'm concerned, we found our own kind, except they're better. And we may do more of that.

And we wouldn't have felt confident enough to go into venture capital, typically with just a bright young man with an idea, no matter how brilliant.

WARREN BUFFETT: Not me.

CHARLIE MUNGER: No, I wouldn't either.

But BYD had won its spurs in life by the time we found it. They had accomplished things that struck me as almost impossible to do, and yet they'd done them.

And so I don't think that's the last unusual thing that Berkshire will do, and the last one that will work.

And I think the Burlington Northern acquisition — when we did it, we knew it would be better for their shareholders than it was for ours, because, after all, they were getting into Berkshire. (Laughter)

But we also thought it was good for our shareholders. And why should we care that it was better for theirs, if it was satisfactory for us? And I think that will happen again, too.

That's our kind of a culture. You know, Middle Western, and constantly improving the place. And with MidAmerican and Burlington, we're getting a fair amount of engineering into Berkshire, which of course, I like.

And so I hope you people are comfortable with the way things are going, because I think they'll keep going in the same direction. (Applause)

WARREN BUFFETT: Yeah. (Applause) I think they will keep going in the same direction.

But to answer your question on that, Andrew, I would probably ask the question, you know, "Can you keep using all of the capital you generate, effectively, for a very long time?"

And the answer, I think, to that is that even — we will see more things and we will do some more of this. There comes a point where the numbers get big enough that it gets extraordinarily hard to do things that add value.

I mean, if you just play out the numbers, you could see where in 10 or 15 years, not only the capital that's already accumulated, but the generation of capital in everything, would make it very hard to do things that are, essentially, creating more than a dollar of value per dollar invested.

A portion of the money may be able to be used that way, and likely would be used in the kind of businesses we're in.

There comes a point where the numbers get too big. And actually, our history is a curve that approaches that point all the time.

It's turned out to be that now I think we can go a lot further than I would have thought 30 years ago. I mean, it's just — it's developed that way. And partly that's because we see things that I never would have thought we would have seen 30 years ago.

But there is a limit. And there will come a time when we cannot intelligent — in my view — there will come a time when we cannot intelligently use 100 percent of the capital that we develop internally.

And then we'll do something that's — whatever is in the most interest — best interest — of the shareholders will be done at that point.

CHARLIE MUNGER: I think we will get into Berkshire, on the investment side — probably starting sooner than many of you expect — people who have some promise of being, well, if not as good as Warren, a decent approximation. And in some cases with abilities that Warren lacks.

In other words, it won't be all negative. (Laughter)

And so I'm really quite optimistic. (Laughter)

I can see — the reason I think we will succeed at that is because Warren never looks twice at anybody who isn't a little eccentric, which, of course, is what you're looking at when you look up here.

WARREN BUFFETT: Living proof, yeah. (Laughter)

29. "Find your passion, and then don't let anything stop you"

WARREN BUFFETT: Well I think we'd better move on to section 1. (Laughs)

AUDIENCE MEMBER: Hello, my name is Joseph Mazzella from Jim Thorpe, PA.

I wanted to first thank Mr. Munger and Mr. Buffett, as well as the board of directors for this meeting, as well as the whole shareholder weekend. I've had a great time so far.

WARREN BUFFETT: Terrific. (Applause)

CHARLIE MUNGER: Thank you.

AUDIENCE MEMBER: With that, I wanted to share. Aristotle, when asked how to define wealth, answered simply this, “It is he who spends less than he earns.”

What advice could you give a young entrepreneur as myself on how to go about defining and both building wealth within their own business, as I hope to build a business that, one day, you’d be interested in acquiring.

WARREN BUFFETT: I predict you’re going to build one. You know, it may not quite get to the size that — and we’re a moving target as well — but if you start off with that principle you just enunciated, there are probably some other similar principles that you’ll have that we would also agree with.

There’s nothing like following your passion. I mean, I love what I do, obviously, and I’ve loved it the whole time I’ve done it. Charlie is the same way.

We have managers, you know, they come — some of them went to business school, some of them didn’t, you know.

They’re all types. But the common factor in them — they’re successful — the common factor is they love what they do, you know.

And you’ve got to find that in life. And some people are very lucky in finding it very early. It was dumb luck that my father happened to be in the securities business, so when I would go to his office there were a lot of books to read, and I got entranced with that.

But, you know, if he’d been in some other occupation — I think I would have read those books eventually, but it would have been a lot later.

So if you find something that turns you on, my guess is you’re going to do very well in it.

And the beauty of it is, in a sense, there’s not that much competition. There are not a lot of people out there that are going to be running faster than you in the race that you elect to get into.

And if you haven’t found it yet — you may well have found it — but if you haven’t found it yet, you know, you’ve got to keep looking.

And we’ve got 70-plus managers. You know, some of them didn’t — we had one guy that didn’t go to high school, even, didn’t he, Charlie? (Inaudible)

CHARLIE MUNGER: Oh yeah.

WARREN BUFFETT: He quit in fourth grade, I think.

Well, Mrs. B never went to school a day in her life.

And when you go out to the Furniture Mart — I hope you go out this evening, we expect to set a record today in sales (laughter) — what you are looking at on those 78 acres, you know, is the largest home furnishing store, about 400 million in sales. The largest store in the United States, and it comes from $500 of capital paid in by a woman that never went to a day of school in her life and couldn't read or write.

She loved what she was doing, and, you know, I tell the story, this is a true story.

When she was well into her 90s, she invited me over to her house for dinner. That was very unusual.

And a very nice house, six or seven blocks away from the store. And I went into the house, and the sofa, the chairs, the lamp, the dining room table, they all had little green price tags hanging down. (Laughter)

It made her feel at home. (Laughter)

And I said to her, "Mrs. B, you are my kind of woman." Forget Sophia Loren and all of that, this is my kind of woman. She loved it.

And she loved it all her life, and just think of what that produced. I mean, it just — it's incredible.

I mean, you know, one time — my dad used to quote Emerson, that "the power that lies within you is new in nature."

And basically, the power that was within Mrs. B was new in nature. And over a lifetime it produced amazing things.

So find your passion, and then don't let anything stop you.

30. Munger's fundamental algorithm of life

WARREN BUFFETT: OK, Carol? (Applause)

CAROL LOOMIS: This is a deeply philosophical question. "Many things that you" — the man did not want his name announced — "Many things that you and Charlie do and preach are opposite to those of what people practice and expect.

"For example, you do not change the management of the acquired company, you applaud long-standing employees while others always look for fresh blood and try to fire people as they grow old. You probably do not encourage retirement, while many companies do.

"You do not give large compensation to directors or compensate them using stock options. You do not seem to hire many MBAs. You don't invest in high tech, but your company has grown very fast.

"You do not provide earnings guidelines. You do not live near New York. You do not like sushi." (Laughter)

WARREN BUFFETT: That's the key. (Laughter)

CAROL LOOMIS: "I wonder, what is the fundamental reason for all of these things? In other words, there appears to be a central philosophy here that I am missing.

"I can understand these as isolated principles, but where is the beef? Scientists and philosophers look for a unifying theory when possible.

"What is yours? Is it Buddhism, or Paganism, or something else? Yes, I am looking for your fundamental or unified theory of management in life or fundamental guiding principles."

WARREN BUFFETT: In ten words or less. (Laughter)

CHARLIE MUNGER: Let me try that one, Warren.

WARREN BUFFETT: Oh good. (Laughter)

CHARLIE MUNGER: It's pragmatism. Partly, we do things in our different way because it suits us. And partly, we do it — it suits our temperaments and our natures — and partly, we do it because we've found through experience that it works better, at least with us sitting where we sit.

It's just that simple. And we've had enough good sense when something is working very well to keep doing it.

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

Is that terse enough for you? (Laughter)

31. Private high-speed passenger trains aren't economic

WARREN BUFFETT: We'll go on to number 3, I like it. (Laughs)

Or number 2, I'm sorry. Number 2.

AUDIENCE MEMBER: Good afternoon, I am Carolyn Boyle, from Barrington, Illinois.

Thanks for the meeting and thanks everybody from behind the scenes who put this together. It's quite well orchestrated. (Applause)

WARREN BUFFETT: If I may interrupt you for just one second, that's very well deserved. And I would to point out that at Berkshire, everybody in our home office — we have 21 of us — they all participate in working at this meeting.

I mean, our CFO works on it — you name anybody in the office — because they enjoy it.

We don't think we should have a department, you know, for this or that, or the other thing. And I think that's probably fairly unusual with companies with market caps of close to $200 billion. (Laughs)

But you've seen Marc Hamburg walking around here and doing things. It's a group effort, and they have — I hope they have — fun doing it, because they sure don't get a bonus for it. (Laughs)

But I think it exemplifies the organization. Thank you, I'm sorry to interrupt you, go ahead.

AUDIENCE MEMBER: That's OK. Let me share a bit.

I had some trouble getting the annual statement information, so I finally got on the internet and sent in the postcard request a week ago Friday, yesterday, and I got my tickets before the meeting. So it was very well orchestrated.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Now that you own some rail business, I'd like to have your perspective on whether our country needs a high-speed passenger rail service.

And if you think it does, should that be a private or a public endeavor?

WARREN BUFFETT: Yeah, I think by its nature, it would be non-economic when it competes with auto and competes with air. We don't have the point-to-point density and demand that would produce a return on capital.

That just — that is my guess. I made no big study of it. But all of the times I've seen projections of the economics of it, it just doesn't work that well.

So it will be — if it gets done — unless it's heavily subsidized in some way, which means it's public anyway — I don't think it will happen under private — it won't meet the test of private economics.

Charlie, you know, they've got a big proposal in California on this. What do you know about the economics of that?

CHARLIE MUNGER: Well, I know very little, but I'm at least as dubious as you are.

The cost of putting in a high-speed rail system in a place that's already densely populated is awesomely large. And of course, you're competing with a system that people prefer.

WARREN BUFFETT: They're talking about in Omaha —

CHARLIE MUNGER: I'm very skeptical about sticking high-speed rails. I think it's great in Japan and China.

WARREN BUFFETT: It's working.

CHARLIE MUNGER: They have a different calculus.

WARREN BUFFETT: Yeah, in Japan, But it worked — yeah.

CHARLIE MUNGER: But putting high-speed rail into Los Angeles just looks to me like a bottomless pit of cost and trouble. And just think of how difficult that would be.

WARREN BUFFETT: If it's going to be high-speed, it can't stop very often, you know, by definition. And it can't go off into spurs and all of these kind of things.

So it really gets to point-to-point operation, and the cost gets staggering. There's talk in Omaha about a trolley system, and I think — they're talking about, you know, a couple hundred million dollars or something like that from the federal government.

And the projections of actual revenue are, as I remember, are something like $400,000, and that's before operating costs.

So the math — you put $200 million into something to move people a few miles in Omaha, and most of the people are going to want to ride their cars. And to have it be efficient it has to be point-to-point, pretty much, for them. I mean, if you start living six blocks one way or eight blocks another way, you say, "Nuts, I'll take the car."

The math really gets to be staggering on these things.

And now, you know, everybody figures if you can get the money from the federal government, you know, it doesn't cost anybody anything. But it would be a lot of money.

It's been done in Buffalo, and people like it. But I've also — I've requested the figures on it, and it blows your mind, in terms — I mean, you could give everybody a cab ride or something and it'd be cheaper for society as a whole.

So I have a feeling that it works marvelously, maybe, between Tokyo and Yokohama or something. And it really does. And it even works well enough so I think it justifies private investment.

But it's tough in a country of, you know, three million-plus square miles, and within the continental lower 48. It's very tough to make the math work.

Now, if people get — it becomes a huge project or something of the government so it isn't anybody's math, you know, maybe it'll happen. I don't think it'll ever happen with money that wants a return.

32. We can handle claims from a major earthquake

WARREN BUFFETT: Becky?

BECKY QUICK: This is a question on the insurance portfolio from Jerry Haller (PH).

What would be the impact on insurance companies, and the U.S. economy in general, if an earthquake of the same magnitude that struck Chile were to be focused on Los Angeles or San Francisco?

WARREN BUFFETT: Well, I don't know the answer to that. The Richter Scale is not a perfect — it's far from a perfect — index of the damage caused, even if you tell me where the epicenter will be.

And then you get into the — you know, the big damage in the famous San Francisco quake was the fire following.

They call that — when they distinguish between the — what coverages are involved — they call that the "shake and bake."

I mean, how much is shake and how much is bake afterwards? (Laughter)

I think it gets hard to get up — I mean, in a really extreme quake — I think it gets hard to get up much more than 100 billion.

You know, a very big quake — the frequency is way less — but if you get up in the Pacific Northwest, you know, there is a possibility of a very high Richter Scale quake there.

And of course, the big ones that we know about — I mean, our history doesn't go back that far — but New Madrid, Missouri, had three quakes in a relatively short period of time that were all well over eight.

And that will happen again someday, maybe 500 years, you know, maybe 1,000 years, and maybe tomorrow. That's what the insurance business is all about.

I tend to think — and when I think about quake exposure, sort of worst case in California — I think 100 billion is getting up there.

Northridge caused far more damage than the one that was up near San Francisco a few years earlier.

But we'll have them. And Berkshire is totally prepared to handle anything that comes along, even if it's considerably worse than what I've —

The worst insured loss — I don't know whether Katrina came in finally at 70 billion or something like that — I think in terms of a 250 billion sort of worst case.

And my guess is if that came along, and we had a normal year and everything else, Berkshire would still have positive earnings of some substantial amount. So we are prepared.

Charlie?

CHARLIE MUNGER: Yeah, and, you know, the big San Francisco quake of whatever it was, '06, caused a terrible fire. But the recent California quakes, the big ones, have not caused much fire. And a lot of earthquake damage is totally uninsured.

So you might have a hell of a lot of damage without massive — Warren would know more about that than I.

WARREN BUFFETT: So far in Chile —

CHARLIE MUNGER: The earthquake insurance is not universal like fire insurance.

WARREN BUFFETT: Oh no, no, not at all, not at all. And —

CHARLIE MUNGER: So it — an earthquake — a really terrible fire, or terrible wind conditions, it seems to me, catch people worse than the earthquakes.

WARREN BUFFETT: And so far in Chile, as I understand it — and I could be wrong on this and it may not be the way the final numbers come in — but as the numbers have been coming in, something like 40 percent of it has been the tsunami and 60 percent has been the quake, in terms of damage.

But that may well not hold to be — in terms of final figures.

There will be huge catastrophes from time to time. We're in a different class, in terms of even being able to handle them.

I mean, we've got so much earning power outside of the insurance business that if you take a $250 billion quake, or hurricane, or whatever, and we have, probably now, not much more than 3 percent of that — but call it 4 percent — that'd be $10 billion — and, you know, our pre-tax earnings, in any given year, I would expect would be substantially greater than that.

So we would have other — we have net earnings in a year that every other insurance company, you know, would be gasping. So we're in pretty good shape on that.

33. "Huge amounts of debt are not going to do us in"

WARREN BUFFETT: Area 3.

This is probably the last question, and then we'll go to the business meeting.

AUDIENCE MEMBER: My name's Frank Teed and I'm from Arkadelphia, Arkansas.

This is also an insurance-type question, but I did want to thank Mr. Buffett and Mr. Munger, the board, and in Arkansas we call them the associates — the managers — for your integrity in running Berkshire Hathaway and dealing fairly with the shareholders. So thank you very much.

WARREN BUFFETT: Thank you. (Applause)

AUDIENCE MEMBER: We saw in the credit crisis the gross overuse of credit, which led to the big financial meltdown with the government ultimately stepping in.

Now we see a huge increase in debt in our cities, our states, our countries.

For Berkshire Hathaway, what could be our exposure on a global financial meltdown? Could there be correlated risk that could get us in trouble?

You've said we have 40 billion in municipal bond insurance. There's 8 billion to the states, which I'm not sure exactly if that was a municipal bond.

Could a large event cause a large number of losses that was coupled with a decrease in our investments to make an AIG-type situation? Thank you.

WARREN BUFFETT: Well, if you postulate something where there was a total meltdown, and we essentially made the bet in 2008 there would not be.

It would be unnecessary, but we came close in 2008, and I decided that A) the government could solve the panic that existed, and finally that they would.

There wasn't any question in my mind they could. The question is, would they get so muddled up, would decision making get paralyzed, would rivalries break out, would, you know, Congress grandstand? All of those sort of things.

And I thought there'd be some of that, but I thought in the end we would do the right thing, which was go all in, which we did.

And that would happen again. So I — if you talk about some massive nuclear, chemical, or biological attack that really does in a very significant proportion of the population or something, you know, who knows what would happen.

But I would say this, that I think Berkshire can withstand anything that any corporation can.

And it won't be our insurance business that causes a problem. If something extraordinary happens — and I don't anticipate that at all — but there could be a situation where the world becomes paralyzed.

But I think that having gone through 2008, I think that our government probably better understands the necessity of taking massive action at a time like that.

Doing whatever is necessary — when the guaranteed money market funds, when the guaranteed commercial paper — I mean, when there are things like that, you know, they were sort of unprecedented, and they did them very quickly.

They'd do it again, in my view. There is no reason — the plants of the country don't disappear, the land doesn't become less fertile, you know, people don't become less innovative — things will work unless somehow the gears get all entirely messed up. And I don't see that happening.

Berkshire, from any insurance catastrophe — and you're right that things correlate on the downside — when things are bad in one area, they really do spread to another.

But we were built, I think, to withstand anything that — other than a total sort of wipe out of the world. That isn't going to happen.

Charlie?

CHARLIE MUNGER: I'm not worried about it. (Laughter)

WARREN BUFFETT: Yeah. Huge amounts of debt are not going to do us in. That's one thing I can guarantee you.

I can't tell you about comets hitting us or something of that sort, but I don't care how silly governments get in terms of finance, or corporations get, or anything of that sort, that will not harm Berkshire.

I want to thank you all for coming. Charlie and I really appreciate it. (Applause) And thank you.

CHARLIE MUNGER: Thank you. (Applause)

WARREN BUFFETT: Thank you. I appreciate it, we appreciate that, I'm sure the panel does.

Now we'll break for about five minutes. Some of you can go shop and some of you will want to stay around for the business meeting, and we'll start the business meeting in five minutes and we'll see how long it takes.

34. Berkshire business meeting begins

WARREN BUFFETT: OK. I've already introduced the Berkshire Hathaway directors.

Also with us today are partners in the firm of Deloitte and Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Mr. Forrest Krutter is secretary of Berkshire. He will make a written record of proceedings.

Miss Becki Amick has been appointed inspector of elections at this meeting, and she will certify to the count of votes casts in the election of directors.

The main proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 3, 2010, being the record date for this meeting, there were 1,029,738 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 926,013,086 of Class B Berkshire Hathaway common stock outstanding, with each share entitled to one ten-thousandth of one vote on motions considered at the meeting.

Of that number, 705,611 Class A shares and 566,627,821 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 29th.

WARREN BUFFETT: Thank you. That number represents a quorum, and we will therefore directly proceed with the meeting.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place the motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last annual meeting of the shareholders and the special meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions?

We will vote on this motion by voice vote. All of those in favor say aye.

VOICES: Aye.

WARREN BUFFETT: Opposed? The motion's carried.

35. Election of Berkshire directors

WARREN BUFFETT: Second item of business is to elect directors. The shareholders present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, he or she may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to meeting officials in the aisles who will furnish a ballot to you. Would those persons desiring ballots please identify themselves so that we may distribute them?

I now recognize Mr. Walter Scott to place a motion before the meeting with respect to the election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ron Olson, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It’s been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott be elected as directors.

Are there any other nominations? Is there any discussion? Nominations are ready to be voted upon.

If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you’re ready, you may give your report.

BETSY AMICK: My report is ready. The ballot of the proxy holders, in response to proxies that were received through last Thursday evening, cast not less than 756,041 votes for each nominee.

That number far exceeds a majority of the number of the total votes related to all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes, including the additional votes to be cast by the proxy holders in response to proxies delivered at this meeting, as well as any cast in person at this meeting, will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott have been elected as directors.

36. Business meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move this meeting be adjourned.

WARREN BUFFETT: Second?

VOICE: I second the motion.

WARREN BUFFETT: Motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say aye.

VOICES: Aye.

Morning Session - 2011 Meeting

1. Welcome

WARREN BUFFETT: Good morning. I'm Warren. He's Charlie.

I can see, he can hear. That's why we work together. (Laughter)

Have trouble remembering each other's names from time to time. (Laughs)

We're going to — we're going to introduce the directors, we're going to give you some information on the first quarter earnings.

We're going to talk briefly about the David Sokol/Lubrizol situation, and then we're going to open it up for your questions.

Anything as it relates to the Lubrizol matter is going to be transcribed and will be put up on the website — the Berkshire Hathaway website — just as promptly as we can, maybe this evening or this afternoon, maybe tomorrow morning, but very promptly, because we want to be sure that all shareholders hear — or get to read every word of what has been said here about the matter.

2. Board of directors introduced

WARREN BUFFETT: First thing I'd like to do is introduce the directors. And if they'd stand and remain standing, you can withhold your applause as they stand, but you can go crazy at the end, or you can continue to withhold your applause. That will be your call. (Laughter)

Charlie and I are up here, and we don't like to stand up too often so we'll skip our standing.

The — Howard Buffett, Stephen Burke, Susan Decker, Bill Gates, Sandy Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott. (Applause)

3. Q1 earnings hurt by Asian catastrophes

WARREN BUFFETT: Now, we have a few slides that deal with the first quarter earnings.

I think Marc Hamburg would like me to emphasize that these are preliminary. This is about as early as we ever have a meeting, in relation to the quarter.

Normally it's always the first Saturday in May, so they had to work a little harder than usual to get these numbers together.

And I will tell you as background that basically pretty much all of our businesses, with the exception of those that are related to residential housing, are getting better, and you can almost see it with most of them quarter by quarter.

We have a wide diversity of businesses. We have more than 70 companies we list, but then Marmon itself has over a hundred businesses. So we are a cross section of not only the American economy, but to some extent we see a fair amount about what's going on internationally, too.

And in the first quarter, as has been the case, really, since the fall of 2009, both our nonresidential construction businesses, except for those nonresidential construction businesses, our other businesses have generally gotten better quarter by quarter, and there was no exception to that in the first quarter.

What was very different in the first quarter was that we had a — probably the second worst quarter for the insurance industry, in terms of catastrophes around the globe.

Normally, the third quarter of the year is the worst period because that's when hurricanes tend to hit the U.S. with most of them — well, about 50 percent of them occurring in September and then sort of forming a normal curve on either side of September — so the third quarter usually is the record quarter, and the third quarter was the record quarter back at the time of Katrina.

But in the first quarter of this year, we had some major catastrophes in the Pacific Asian areas, and that hit the reinsurance industry particularly hard.

No one knows at this point. I mean it's a wild guess, but probably those catastrophes cost the reinsurance industry on the order of $50 billion, and we usually participate to the extent of 3 to 5 percent.

First of all, I'll give you our overall earnings the way we normally present them. And if we'll put the first slide up.

You can see that our insurance underwriting suffered an after-tax loss of $821 million.

Now, when I wrote the annual report, I postulated normal earning power of Berkshire at about 17 billion pretax and about 12 billion after tax, assuming breakeven on insurance underwriting.

Our insurance underwriting has done better than breakeven. In fact, it's made quite a bit of money for eight consecutive years.

But I would say with a start of these catastrophes in the first quarter — or the catastrophes experience we had in the first quarter — I would say that it's unlikely that we would have an underwriting profit for 2011.

If it was remarkably catastrophe-free from this point forward, including hurricanes in the United States, it's conceivable we would break even or make a tiny profit.

But that's an improbable assumption, so I think for the first time in nine years we will likely have an insurance underwriting loss this year.

I think our record may very well be quite a bit better than, certainly, most other reinsurers and it does not change my expectation that over time, our insurance underwriting should at least break even. And if you have followed the — what I've written in the annual reports — if insurance breaks even, we get the free use of float, and that's been enormously valuable in the past and I would expect it to be in the future.

And if you look at the other lines, insurance investment income is down a little. That will go down more because our Goldman Sachs preferred was called in April.

Our General Electric preferred is almost certain to be called in October. So we have lost — and we lost a — we had called a note from Swiss Re that was paying us 12 percent and came to something over $360 million a year when the Swiss franc went above par.

So we have lost, or are losing, at least three very high-yield investments, which we cannot replace with similar investments at present. So that line will go down.

On the other hand, at the end of the quarter we had 38 billion in cash, and that does not count the 5 1/2 billion that we were going to receive in April from our Goldman Sachs preferred. So that money is earning virtually nothing now, and I would not expect that to be part of the long-term picture, either.

So there would — you know, just a few percent on that would be many, many hundreds of millions of dollars.

So I think over time, our insurance investment income, even though it will dip throughout this year, I would expect that if we have a similar level of investments, to actually grow from the level we show here.

We had the full ownership of BNSF in the quarter this year. We only had it, I think, from February 12th last year, so that, in a significant way, accounts for the gain in that next line of railroad, utilities and energy.

But the BNSF also had a significant gain in earnings and the railroad business looks to me like it will have a very good year this year, not just our railroad but all railroads, and the competitive advantage of railroads is becoming more and more evident, almost by the day, particularly as fuel prices increase.

And in the remaining lines, we also had gains in most of our businesses.

So overall, we got hit very hard in the insurance business.

And if we'll move to slide 2, we list the three major catastrophes that occurred, which in aggregate we estimate we have a total loss of a billion, 673 pretax, and that figure, as with all estimates — early estimates about major catastrophes — is subject to a lot of change. Nobody knows what the insured losses will be from the Japanese earthquake.

But this is our best estimate now. You'll notice that over 40 percent of the underwriting loss comes from a contract we have with Swiss Re where we get 20 percent of their business.

That contract is in the fourth of its five years. They have indicated that they will not be interested in renewing it. I just wish they told us that a few months ago. (Laughs)

But we've enjoyed the relationship with Swiss Re, it's just that we enjoy it some quarters more than others.

Our estimate — we've added a little something into their estimate because on balance we feel that most catastrophe losses develop upward. It's sort of the nature of the business.

But that — incidentally, the tornadoes in April, just at GEICO, we expect — and all we're talking about is automobiles here, cars, because we don't insure homeowners. We act as agent in placing insurance for people, but we do not take the insurance risk.

We estimate that 25,000 cars will get automobile claims. That's a lot of automobiles when you think about it, and our market share is about 9 percent, although it varies by state.

But it's been an extraordinary tornado season, as you know. That does not hit — I do not believe that that hits the reinsurance business particularly hard, because there are multiple, multiple events but no one event is anything like, say, the New Zealand earthquake.

The New Zealand earthquake estimated at $12 billion of insured damage. Charlie, how many people are in New Zealand?

CHARLIE MUNGER: Well —

WARREN BUFFETT: We don't practice these things, as will become evident here. (Laughter)

CHARLIE MUNGER: I'd guess —

WARREN BUFFETT: What, about four million? Three million?

CHARLIE MUNGER: I'd guess a little more than that.

WARREN BUFFETT: Four?

CHARLIE MUNGER: Five, maybe.

WARREN BUFFETT: Five, OK. Five million people. So that's 1/60th of the population, we'll say, of the

United States. And if you take 12 billion and multiply it by 60, you come up with 720 billion, which is 10 times Katrina, in terms of the impact on a place like that.

So those — there's been some really extraordinary earthquakes. And as I say, the worst part of the season is, generally speaking, for reinsurers, is yet to come. So this may be a year that the reinsurers will remember, although they might prefer to forget it.

There's some good news on the insurance front. On the next slide I show the growth in policies at GEICO month by month this year versus last year.

Now, if you'll remember, in the annual report I gave an explanation, in talking about goodwill value, about how the goodwill of GEICO is carried on our books at about a billion dollars. And no matter how successful the business becomes, that goodwill value is never increased on the books, but it does grow.

And as I put in the annual report, I estimate its value currently, using the same sort of yardstick we used when we purchased the second half of the company back in 1995, I estimate that value has grown, maybe, to 14 billion.

I mean, every policyholder at GEICO, on average, has a value to us, the way I calculate it, of something on the order of $1,500.

And when we add 318,000 — and as of yesterday it was up to 381,000 — when we add that, we've added something approaching $500 million to the goodwill value.

That does not count the earnings from underwriting, which were substantial for GEICO. That does not count the investment income from the float, it does not count the investment income from the net worth we have attributed to it. That is added goodwill value, the same sort of goodwill value that a Coca-Cola has, or a Mars has, or any company like that.

And people think of it differently when they think of most consumer products. But a policyholder to Berkshire at GEICO has very, very significant value.

There's a very significant percentage have been there for 10 years or more. And it's something that we do not realize on our balance sheet or income account, but it's an asset that's every bit as real as the numbers that we do put on the balance sheet.

So there's good news at GEICO. We are gaining market share every day.

As a matter of fact, if you think about it, we have some people in the adjacent room that will be glad to sell you GEICO policies, and if only 66 of you sign up, that's a goodwill value of about $100,000, so it will take care of some of the expenses of this meeting. (Laughter)

Not that I care whether you do it or not but — (Laughs)

Now, there's one more item I want to go through on the earnings picture, just because it illustrates to some extent the capriciousness of accounting and how we value our securities — or whether we take write-downs on them, I should say.

There's something called "other than temporary impairment," which is an accounting rule. It's kind of a fuzzy accounting rule, but it says that if you own a security for a while, and you paid X for it, and it's been selling at, say, 80 percent of X for quite a while, nobody knows exactly what quite a while means, and I'm sure they phrase it differently in the accounting textbooks, but anyway, if it sells there for quite a while, you're supposed to mark it down to that new valuation and have that markdown go through your income account, through your profit and loss account.

Now we mark it down in any event for the balance sheet, and the balance sheet is what gives you the number for book value and is our reference point.

But only when it meets this other than temporary thing does the mark down actually get run through the profit and loss account.

Now, on March 31, as is shown, I believe, on the next slide, we owned some Wells Fargo stock, which had a cost of about 8 billion and the market value was 11.3 billion.

But some of the Wells Fargo stock we bought had been bought at higher prices than the March 31 figure, whereas, as you can see, a lot of the stock, which had a gain in it of 3.7 billion, had been bought at lower prices.

Well, under the rules, we were required to mark down the stock we bought at a higher price by 337 million, whereas we ignored, in the income account, the 3.7 billion of gain.

Now, interestingly enough, there's two ways you can account for securities, as I understand it, both fully meeting GAAP accounting requirements. And if we had — if we had used the average cost method, we would not have had to mark down.

But we use what they call the specific identification method. Now the specific identification method is actually useful to us from a tax standpoint, because it means whenever we sell a security we can pick out the highest priced security and attribute the sale to that.

So it actually saves us money, or the time use of money, to get into specific identification.

But we could just as easily use the average cost method and then we would not have a write-down like we have and that's why I — one of the reasons I emphasize that — the fact that you should ignore gains or losses in securities or derivatives on a quarterly basis, or even an annual basis.

The important thing is what the operating earnings of our businesses are doing and what the gain in book value, generally, has been.

And then on top of that, you have to make your own estimate for what intrinsic value is, which would include things like the goodwill value that has been developed at GEICO.

I apologize for taking you through the accounting lessons, but the headlines often just say what the final net income is, as if that's the all-important figure. And sometimes it's the all-deceptive figure.

I mean, it really bears — if you include gains and losses — it bears, really, no connection to the reality of whether a quarter has been satisfactory from our standpoint.

But it does get a lot of attention in the press and that's why we spend, perhaps, an inordinate amount of time trying to explain what really takes place in our financials.

Now, I think we're going to get to the questions and answers here in just a second. We'll alternate between the press group on my right and 13 stations that — microphones that have been placed. I think a dozen of them in this room and maybe one in one of the overflow rooms.

4. David Sokol and Lubrizol: "inexcusable" and "inexplicable"

WARREN BUFFETT: I'd like to just comment for a few minutes — and this will be transcribed and up on the internet at our web page — I'd like to comment for just a few minutes, and I'd like to ask Charlie then to give his thoughts, on the matter of David Sokol and the purchase of Lubrizol stock.

You saw in the movie a clip from the Salomon situation, and that occurred almost 20 years ago. It will be 20 years ago this August.

And at the time, it was a Sunday, Charlie was there, and I was elected the chairman at — what, about 3:00 in the afternoon or so I think on a Sunday at Salomon, and I went down to address a press group.

And almost the first — somewhere in the early questions, somebody sort of asked me, you know, what happened?

Well, A) I'd just gotten to Salomon fairly recently, so I didn't know too much about it, but the phrase that came out of my mind then — out of my mouth then — sometimes my mind and my mouth are coordinated — (laughter) — the phrase that came out of my mouth then was that what happened was inexplicable and inexcusable.

Now, it's 20 years later, and looking back on Salomon, I still find what happened inexplicable and inexcusable. You know, I will never understand exactly why some of the events that transpired did transpire.

And to some extent, in looking at what happened a few months ago with Dave Sokol's failure to notify me at all that he'd had any kind of contact with Citigroup. In fact, he directed my attention to the fact that they represented Lubrizol and never said a word about any contact with them.

And then the purchases of stock immediately prior to recommending Lubrizol to Berkshire, I think I — for reasons that are laid out in the audit committee report, which I urge you to read and which is on our website — I don't think there's any question about the inexcusable part that Dave violated, and that the code of ethics, he violated our insider trading rules, and he violated the principles I laid out — I lay out — every two years in a direct personal letter to all of our managers and which I've been doing for a long time. So I — you can read the audit committee report about that.

The inexplicable part is somewhat — well, it's inexplicable, but I'd like to talk about it a little bit because I will tell you what goes through my mind in respect to it.

Certainly — well, one interesting point is that Dave, to my knowledge, at least, made no attempt to disguise the fact that he was buying the stock. I mean, you know, you read about insider trading cases and people set up trusts in Luxembourg, or they use neighbors who know neighbors, or they use third cousins — I mean, they have various ways of trying to buy the stock so that when it's later — FINRA is a supervising organization — looks at the trading activity in the months prior to a deal, they do not see names that jump out at them as being associated with the deal.

To my knowledge, Dave did nothing like that, so he was leaving a total record as to his purchases.

Now, I think at least usually — and maybe always — we are queried after any deal. We are asked who knew about it when, and we supply a list of whether it's people at the law firm or people that are in a secretarial position at our place or the law firm.

We give them a list of everybody that might have known or did know about the deal prior to the public announcement. And I don't know whether they do that 100 percent of the time, but certainly it's my experience that you get that.

And then a while later, you get a list of names of people that FINRA, again, has picked up as trading it, and they ask you whether any of those names ring a bell with you. So they're trying to put together whether anybody did any inside trading ahead of time.

So the odds that if you're trading in your own name, and you're on that list of people who know of a deal ahead of time, the odds that it's not going to get picked up seem to me are very much against you.

But, to my knowledge, Dave did not disguise the trading. Which, you know, that's somewhat inexplicable that if he really felt he was engaging in insider trading and knew the penalties that could be attached to it, that he essentially did it right out in the open.

The second fact, which is less — perhaps less — puzzling, but Dave obviously has a net worth in very high numbers. He made, I think, close to $24 million. He earned it from Berkshire last year, and we got our money's worth, but he did get $24 million, too.

So I would say that there are plenty of activities in this world that are unsavory that are committed by people with lots of money.

So I don't regard that as, you know, totally puzzling. But I will give you one instance that does make it puzzling. It makes it very puzzling to me.

We bought MidAmerican at the end — Berkshire Hathaway bought MidAmerican — at the end of 1999. Berkshire Hathaway bought about 80 percent.

Walter Scott, who I just introduced, and his family was the second largest holder, I think something over 10 percent, and then two operating people, Dave Sokol the senior one, owned or had options on a big piece, and Greg Abel, a terrific partner of Dave's, also had a piece.

And Walter Scott — and I've told this story privately a few times but not — I don't think I've done it publicly.

Walter Scott came to me a year or two after we'd bought it, and Walter said, I think we ought to have some special compensation arrangement for Dave and Greg if they perform in a really outstanding manner. And he said — I think maybe he suggested something involving equity and he saw me turn white.

So he said, "Why don't you design one and let me know." So I just scribbled something out on a yellow pad. It didn't take me five minutes.

And we call it, sort of in honor of Charlie, although he didn't know about it, we called it the Lollapalooza.

And it provided for a very large cash payout, which I'll get to in a second, based on the five-year compounded gain in earnings. And we were starting from a high base, in other words this was not from any depressed level, and we set a figure that no other utility company in the United States was going to come close to.

But if that figure were achieved, we were going to give $50 million to Dave and $25 million to Greg Abel.

And I had Dave come to the office and I said, "Here's what Walter and I are thinking," and, "What do you think of this plan?"

And it had these figures on per share that — that like I say, move forward at 16 percent compounded per year, and then I say, "Here's the payout."

And he looked at it for just a very short period of time and he said — he said, "Warren, this is more than generous." But he said, "There's just one change you should make."

And I said, "What's that?" And he said, "You should split it equally between me and Greg, instead of being 50 million for me and 25 for Greg. It should be 37 1/2 apiece."

So I witnessed — and Walter witnessed, you can talk to him about it — we witnessed Dave voluntarily, without any — Greg had nothing to do with it, he wasn't there — we saw Dave transfer over 12 1/2 million dollars — getting no fanfare, no credit whatsoever — to his, in effect, junior partner.

And I thought that was rather extraordinary, and what really makes it extraordinary is that $3 million, you know, 10 or so years later, would have led to the kind of troubles that it's led to.

I find — that is really the fact that I find inexplicable, and I think I'll probably — you know, it's 20 years after Salomon — 20 years from now Charlie will be 107 — (laughter) — and we won't mention what I'll be — but I think 20 years from now, I will not understand what causes a man to voluntarily turn away 12 1/2 million dollars to an associate without getting any credit for it in the world, and then 10 or so years later, buy a significant amount of stock the week before he talked to me.

And when he talked to me about Lubrizol, it was either the 14th or 15th — he says it was 14th, I have no reason to disagree with that. The only reason I couldn't say specifically was I had eight university groups, 160 students, in on that Friday. That's the only thing that shows, and I spent most of the day with them.

And the 10K and the 10Q that got printed out on Saturday have that date on them, the 15th, when I looked at Lubrizol for the first time.

You might be interested in knowing, I've been looking up 10Ks and 10Qs for 20 or 30 years, but I don't know how to print them out. So, fortunately, Tracy Britt was in the office, and I said, "Tracy, would you print this damn thing out? I don't know how to do it yet." (Laughter)

But that is why I don't know whether it was the 14th or the 15th. The 10Q says the 15th.

But, at that time, when Dave called me on it, he said nothing about contact with Citigroup or anything of the sort and he — and I said, "I don't know anything, really, about the company." He said, "Well, take a look at it. It — you know, it might fit Berkshire."

And I said, "How come?" And he said, well — he said, "I've owned it and it's a good company. It's a Berkshire-type company."

And, you know, I obviously made a big mistake by not saying, "Well, when did you buy it?"

But I think if somebody says I've owned the stock, you know it sounds to me like they didn't buy it the previous week.

So there we are with a situation, which is sad for Berkshire, sad for Dave, still inexplicable in my mind, and we will undoubtedly get more questions on that. We'll be glad to answer them.

Charlie, do you have any thoughts on this?

CHARLIE MUNGER: Well, I think it's generally a mistake to assume that rationality is going to be perfect, even in very able people. (Laughter)

We prove that pretty well, regularly.

WARREN BUFFETT: Do you have any explanation for the irrational?

CHARLIE MUNGER: Yeah. I think hubris contributes to it.

WARREN BUFFETT: Well, we've gotten quite a bit out of him, folks. (Laughter)

5. Journalists introduced

WARREN BUFFETT: OK. Let's go to work.

We'll start with Carol Loomis of Fortune Magazine. I might as well — I should introduce our group here.

Oh, we didn't go alphabetical this time. We've got Carol, and then we've got Andrew Ross Sorkin of the New York Times, and we have Becky Quick of CNBC. (Applause)

In terms of my check-off system, I'm still going to go to Becky. That's alphabetical.

So, Andrew, it didn't do you any good to try to move over there into the center spot. (Laughs)

Carol, you're on.

CAROL LOOMIS: Good morning from all of us, and I will make the small preamble that I've made before.

We've been getting questions for a couple of months, each of us on our e-mail.

Sometimes a question will be sent to all three of us and sometimes they'll just send to one of us, therefore it becomes very hard to count how many we've had, but certainly it's in the many hundreds and probably in the — up into a thousand, 2000.

And obviously we aren't going to be able to ask every question — every good question. We have a lot of good questions we won't be able to get to. But it's just that you had to pick and choose.

And the other thing I should say is that whatever we do ask, Warren and Charlie have no idea of the question. None. No hint.

WARREN BUFFETT: Sometimes we have no idea of the answer either, but go ahead. (Laughter)

6. Buffett's David Sokol timeline

CAROL LOOMIS: So I will begin. I don't think that anybody will be surprised that it is a Sokol question.

And actually, the — this particular long-term shareholder believed, as Warren has believed, he says, "I do not see why he should have been expected to ask Sokol about his Lubrizol stock holdings when he said he owned the stock. That wouldn't have been a natural question.

"But when you found out the details of his stock purchases a short time later, I do not understand your reaction.

"Surely you realized immediately that these facts were going to become known and that they were going to damage Berkshire's reputation, something you had said repeatedly you would be ruthless in protecting.

"Being ruthless probably would have meant your firing Sokol on the spot, but you didn't do that.

“And then you put out a press release that many Berkshire shareholders that I have talked to found totally inadequate.

“You have always been very direct in stating things. You were not direct in that press release, except in praising David Sokol. Otherwise you stated some facts and behavior that you said you didn’t believe was illegal.

“And then you ended the release, leaving us — now maybe you thought somehow we were going to read between the lines — without expressing any anger about what had happened. Why were you not incensed?

“If you were, why did you not express your anger? Why did you handle this matter in the inadequate way you did?”

WARREN BUFFETT: Yeah. The — (applause) — it wasn’t really immediately thereafter. I learned on March 14th, which was the day we announced it. Now bear in mind his first conversation when he said he owned the stock was January 14th.

In between January 14th and March 14th, Dave gave no indication that he’d had any contact with Citigroup of any kind, and as we learned later, I mean, he went — they met in, maybe, October or something like that where — and talked about possible acquisition candidates for Berkshire.

But none of that — he told me at one point, he said Evercore and Citi represent Lubrizol. One of them represents the directors and one of them represents the company, and not a word about any contact.

On March 14th, when the deal was announced in the morning, I got a call from John Freund. John Freund is probably here today. John Freund works for Citi in Chicago, and he handles — he’s handled the great majority of our business in equities for decades, and I’ve got a direct line to him. I talk to him frequently.

And he called and said congratulations and — you know and aren’t you proud of our — words to the effect. You can talk to John directly, although I’ve been told that the Citi lawyers have told him not to talk, but that — knowing the press, they probably can work something out of him.

The — he’s — essentially his words were that Citi’s team had worked with Dave on this acquisition, and they were proud to be part of it, et cetera, et cetera.

And this was all news to me, so that set up some yellow lights, at least. And the next day, I had Marc Hamburg, our CFO, call Dave, and Dave readily gave him the information about when he had bought the stock and how much.

Marc also asked him what the participation of Citi had been in reference to Berkshire's side of the transaction, and Dave said that he thought he called a fellow there to get their phone number, which turned out to be somewhat of an understatement.

Now, during the period when we announced the deal on March 14th, Lubrizol is the one that needed to prepare a proxy statement. We were not issuing shares at Berkshire. So there was no proxy statement, no — nothing of this — that sort — on our part.

The Lubrizol legal team, Jones Day, went to work with Lubrizol management to start preparing the proxy statement.

We eagerly awaited to see the first draft of that because I was going to be leaving for Asia on Saturday, which, I guess, would be the 19th, and I wanted to see what Lubrizol had to say about this whole Citi matter or anything else.

The most interesting part of every proxy statement is something that says — it's basically the history of the transaction, and it's the first thing I read on any deal because it gives you a blow-by-blow of what has taken place.

And as Marc Hamburg can tell you, I kept — and our law firm can tell you — I kept urging them to get that to me before I took off for Asia.

We got that the afternoon of Friday the 18th, and it had a fair amount of material in it about Dave's involvement with Citigroup.

Then at that point — I believe it was at that point — our law firm got involved, Munger Tolles got involved, in their input to the Lubrizol lawyers as to what we had seen that was different or what we had seen that they didn't know about that we could add.

Ron Olson, the director of Berkshire and partner of Munger Tolles, was on the trip to Asia. So we got on the plane on Saturday the 19th and traveled over the next week until the 26th.

And we knew at that point that his partners at Munger Tolles were interviewing Dave, as — maybe some other people too, but certainly Dave — and I believe that he was interviewed at least three times about both the stock purchases, the history of things with — of his relationship with Citigroup, and they were assembling this information.

I don't have a BlackBerry or whatever it may be. Ron does. So he would get some information as we were over there. And he was getting some input but — and we decided that when we got back we would need to have a prompt meeting of the Berkshire board about this matter.

And we would also learn what — the full details, at least — of what Bob Denham, and maybe other attorneys at Munger Tolles learned from their interviews with Dave.

And we back on — I guess it would be Saturday the 26th — and on the 28th we were going to bring Charlie into it before calling a board meeting.

But there would have been a board meeting that week. And then about five or so in the afternoon, a letter was delivered by Dave's assistant, which really came out of the blue.

And I — he said to me he felt he was retiring on a high point and he gave the reasons why he was retiring, which I laid out and so on.

I don't know whether the questioning the previous week had affected his attitude. He would say not.

But in any event, we had that resignation. That resignation as is — I believe it may have been put in the audit committee report — may have saved us some money.

If we'd fired him, the question would be whether it was with cause or not with cause, and we would have said it was with cause, but that might have very well gotten litigated, and a retirement did provide, in effect, the same non-level of severance payments that a firing with cause provided.

So I drafted up a press release, which has since been the subject of at least mild criticism — (laughs) — and I laid out the good things that Dave had done, which he had done for the company. He'd done many good things, some extraordinary things.

And then I laid out some actions which I said, based on what I knew then, did not seem to me to be unlawful, and incidentally, I talked with both Charlie and Ron about that.

Ron would have been more careful in that wording. I'm not sure Charlie would have been. I'll let him speak for himself on that.

And we ran it by — I ran it by Dave Tuesday morning, just to be sure the facts were accurate, and he said — he objected very much to something I'd put in where I said that I thought that he was, in effect, had had his hopes dashed for succeeding me and that was part of the reason, and he said that was absolutely not true, that he had no hopes ever of succeeding me and that I — you know, basically he was telling me what was in his mind, and I shouldn't be trying to second-guess what was in his mind.

So I took that part out. But he affirmed all of the other facts in that letter, and then I took it out, I sent it to him a second time to make sure that he was OK with the facts, and he said they were accurate.

Now, in there was included the fact that Dave had no indication that Lubrizol had any interest in an approach from Berkshire and that, at least according to the final Lubrizol proxy, is not the case.

I have not talked to anybody except John Freund at Citigroup, so I have no idea what took place with the investment bankers at Citigroup, except for what I read in the Lubrizol proxy. But the Lubrizol proxy now says that Dave did know that Lubrizol had an interest on December 17th.

But, both in the two chances he had to review it, and then when he went on CNBC on a Thursday and he talked for a half an hour, he made no attempt to correct any of the facts in it.

Now, on Wednesday, when we put out the report, we had to have a board meeting first. It was news to the board. They got the release a little bit ahead of time and then we had a board meeting.

We also delivered — well, through our law firm, we phoned the head of the enforcement division of the Securities and Exchange Commission and told him exactly the facts regarding the stock purchases and anything else that they might have cared to know.

So I think we acted in that case, very, very promptly, to make sure the Securities and Exchange Commission, and the top of the enforcement division, was well-versed on what had taken place, to our knowledge up to that point.

So, from our standpoint and my standpoint, Dave was gone, minimum severance costs, minimum chances for lawsuits about compensation due him, and we had turned over some very damning evidence, in my view, to both the public and to the SEC.

What I think bothers people is that there wasn't some big sense of outrage or something in the release, and, you know, I plead guilty to that.

I — this fellow had done a lot of good things for us over 10 or 11 years, and I felt that if I'm laying out a whole bunch of facts that are going to create lots of problems for him for years to come, that I also list his side of the equation, in terms of what he'd done for Berkshire.

And I — and as I said a little bit earlier, you know, one thing I didn't even lay out was this extraordinary act where, in effect, he turned over 12 1/2 million dollars to a fellow employee.

So that's the history of my thinking on it.

Charlie, do you want to add anything? (Applause)

CHARLIE MUNGER: Yes. Well, I think we can concede that that press release was not the cleverest press release in the history of the world. (Laughter)

The facts were complicated, and we didn't foresee, appropriately, the natural reaction.

But I would argue that you don't want to make important decisions in anger. You want to display as much ruthlessness as your duty requires, and you do not want to add one single iota because you're angry.

So, Tom Murphy, one of our best directors — (applause) — one of our best directors, always told the people at Cap Cities, you can always tell a man to go to hell tomorrow if it's such a good idea. (Laughter)

So the anger part of it — and I don't think it was wrong to remember the man's virtues as well as his error. (Applause)

WARREN BUFFETT: I might add as an aside, Charlie and I have worked together for 52 years, and we have disagreed on a lot of things. We've never had an argument.

I need Tom Murphy's advice to remind myself of it a lot of times on other things, but with Charlie it's never even been necessary. It was long before I met Murph.

7. Market reaction when Fed ends stimulus

WARREN BUFFETT: OK. Let's go to area 1.

AUDIENCE MEMBER: Mary Broderick, Berkeley, California. Good morning, Mr. Buffett. Good morning, Mr. Munger. And a big thank you. You probably aren't aware of this, but you've been my personal financial and investment advisors for years.

I would like to know what you think the effect of the government ending the POMO program mid-July this year will have on the stock market and the economy in general.

WARREN BUFFETT: The government ending the — QE2 or —

AUDIENCE MEMBER: Permanent open market operation.

WARREN BUFFETT: Well, you're one acronym ahead of me. (Laughter)

The — well, just as we're discussing it now, it's no secret what they're going to do.

I mean, it's sort of the most advertised open market purchase in history, and probably in terms of defining the amount per month and when it comes to an end, you know, what the balance sheet will look like at the end of the Fed.

So I don't think — you know, if something is that well known by all participants in a market, I think any effect of it has been discounted by this point in time.

I mean, if you say you're going to increase tax rates in a year, we'll say, on corporations or decrease them or whatever it may be, and it's really done and locked in stone, the market doesn't wait until the date when the tax increases or decreases go through to build that into market prices. So I don't — I see no reason — there may be some other things that happen then — but I see no reason why simply having that program come to an end will cause any significant change in stock or bond markets at that time.

You know, obviously, a huge market force will be withdrawn.

I mean you buy $600 billion worth of Treasurys and, you know, you probably leave a few traces along the way that you've done it. And it has been 100 billion or so a month, and that purchasing will not be in the market but the government issuances of debt will still be at a level that are consistent with what they are now.

So it will be a different market, but I think it's a different market that's already been anticipated.

Charlie?

CHARLIE MUNGER: I have nothing to add. (Laughter)

WARREN BUFFETT: Yep.

8. Role of Berkshire's next chairman

WARREN BUFFETT: Becky?

BECKY QUICK: I'd like to ask a question that comes from Ron Taracant (PH) from Sugar Land, Texas.

He says, "Good morning, Mr. Buffett and Mr. Munger. You have always put great emphasis on hiring and retaining managers that not only have exceptional talent but also adhere to the higher standards of corporate ethics and behavior.

"Recent events surrounding Mr. Sokol's actions have demonstrated that we were not very far from a situation where someone running Berkshire Hathaway had great talent, but lacked the other quality that has made Berkshire the envy of the business world.

In some ways, we are relieved these events happened when you were still at the helm.

But coming back to the succession plan that you have in place, how can you ensure that there are no more Sokols in the lineup of successional managers that you have.

WARREN BUFFETT: Yeah, he made an assumption there about Sokol being the next in line, which I'm not sure was warranted.

But he certainly was entitled to think that he was a candidate. And there are — that is, one of the reasons that I think it's a good idea if my son, Howard Buffett, who would have no — get paid nothing, and have no activities in the company, be the chairman after I'm not around, because you can make a mistake in selecting a CEO.

I mean, I think the odds of us making a mistake are very, very low. And certainly the candidate that I think is the leading candidate now, I wouldn't — I would lay a lot of money on the fact that he is straight as an arrow.

But mistakes can be made. You know, the — the Bible says the meek shall inherit the earth, but the question is, will they stay meek? (Laughter)

The idea of having an independent chairman, who would be voting a lot of stock — because even at my death, because of the concentration of A stock and so on, the executors would have a very significant block of stock — and if some mistake were made, it would be easier to change if not only a very large block of stock were available to express an opinion, but also if the chairmanship was not locked in with the CEO.

It's gotten less tough to change CEOs at companies where either their moral or their intellectual qualities are found lacking, but it's still difficult.

If — you know, it's particularly difficult if they turn out to be a mediocre CEO. If the person is really bad, you know, people will rise up sometimes and — particularly if they have meetings without the CEO present.

But it's not an easy job to displace a sitting CEO who also holds the chairman's position and controls the agenda and all of that.

So I think an independent chairman, particularly one that represents a very large block of stock, and has no designs himself on taking over the place, is a safety measure for the possibility, however remote, that the wrong decision is made.

But I will tell you that the directors at Berkshire will be thinking every bit as much about the quality of the person as a human being as they will be thinking about their managerial skills, because it's vital that you have somebody at Berkshire, in my view, that is running the place that really cares more about Berkshire than he does about himself, in terms of advancement.

And I think we have multiple candidates that fulfill that. And the idea of an independent chairmanship is a — is, you know, part of the belt and suspenders.

Charlie?

CHARLIE MUNGER: Well, you know, your idea about the Buffett family has a precedent.

The Rockefellers left the management of Standard Oil many, many decades ago, and they — but they did intervene once, and that was to throw out, what was it, the head of Standard of Indiana, and it was on moral grounds.

So that sort of thing can happen and you have put another string in our bow.

9. Picking tech stocks is difficult but could be profitable

WARREN BUFFETT: OK. We'll go to area 2.

AUDIENCE MEMBER: Caroline Tile (PH), Boston, Massachusetts.

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

WARREN BUFFETT: Well, that's a very good question, and I particularly like the preamble. (Laughter)

Well, you would — you would certainly pick a sector that's large, because it isn't going to make any difference to Berkshire if we get to be experts on some tiny little industry or business.

I would say that — that, you know, it would have to be something in the — this isn't going to happen — but if I could really become expert — and I mean really expert, knowing more than most — almost anybody else about the subject — in the tech field, you know, I think that that would be terrific.

It isn't going to happen, but it's going to be a huge field.

There are likely to be, you know, a few enormous winners, a lot of disappointments. So that the ability to pick the winners, you know, is far disproportionate to the ability to pick the winners, we'll say, among integrated major oil companies where they're all equated in price.

You're not going to have a big edge in trying to pick Chevron against Exxon against Continental and Occidental, and you name it.

But the degree of disparity in results among larger tech companies in the future is likely to be very, very dramatic. And if I had the skills where I could pick the winners there I would do a lot better than if I had the skills to pick the winners in the major integrated oil field.

You probably will have better luck with Charlie on this one because he knows a lot more about a lot of industries than I do. Charlie, what's your answer?

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

I think if we were going to do it, it would have already happened.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I do think we might identify someone else who has abilities that we lack. That's been very hard for us but — (Laughter)

WARREN BUFFETT: We're not going to tell you. (Laughs)

CHARLIE MUNGER: But we've done a little better lately.

WARREN BUFFETT: That's a good question.

10. Why Buffett got past his skepticism about Lubrizol

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from a shareholder named Ralph Coutant (PH) who asks, "In in your press release, your original press release, you noted that Dave 'brought the idea of purchasing Lubrizol to me on either January 14th or 15th.'

"Initially you said, 'I was unimpressed.' You went on to note that on January 24th you sent another note to Dave indicating your, quote, 'skepticism' about making an offer for the company.

"However, in a very short period of time after Dave's discussion with Lubrizol's CEO, you, quote, 'quickly warmed' to the idea.

"Please clarify what caused you to, quote, 'warm' to the idea so quickly if this didn't strike you as being a great business at first glance. What changed? And what was David Sokol's role in convincing you?"

WARREN BUFFETT: Yeah, the — it wasn't that it didn't — it struck me as a business I didn't know anything about, initially.

You know, you're talking about petroleum additives. I never would understand the chemistry of it, but I — but that's not necessarily vital.

What is important is that I understand the economic dynamics of the industry. Is there — are there competitive moats? Is there ease of entry? All of that sort of thing. I did not have any understanding of that at all, initially.

As a matter of fact, I suggested to Dave, I said, “Charlie is a lot smarter about oil than I am. Why don’t you give him a call because I don’t — you know, I just don’t know anything about that business?”

And I talked to Charlie a few days later, and I don’t remember whether I asked him whether Dave had called or anything, but I mentioned it to Charlie, and Charlie says, “I don’t understand it, either.”

So when I talked to Dave later he had not talked — he had not gotten ahold of Charlie. I told him, “Forget it. He’s as bad as I am.”

What Dave passed along to me after having that dinner with James Hambrick, and which I later confirmed in a lunch when James Hambrick came out here on February 8th, but it was the same thing.

I thought I — and I still feel — I thought I got a good understanding of industry dynamics and how the business had developed over time, what the role of oil companies was and would be, in relation to a chemical additive.

The oil companies are the biggest customers. They sell base oil to a Lubrizol, but they buy the — they are the big customers, and they have gotten out of the business to quite a degree, although there’s two of them left in it.

So this industry had consolidated over time. I looked at the question of ease of entry. You know, every time I look at a business — when we bought See’s Candy in 1972, I said to myself, if I had a hundred million dollars and I wanted to go in and take on See’s Candy, could I do it?

And I came to the conclusion, no, so we bought See’s Candy. If the answer had been yes, we wouldn’t have done it.

I asked myself that same question, you know, can I start a soft drink company and take on Coca-Cola if I have a hundred billion dollars, you know?

Richard Branson tried it some years ago in something called Virgin Cola. You know, the brand is supposed to be a promise. I’m not sure that’s the promise you want to get if you buy a soft drink but — laughter) — in any event, I felt after my conversation with Dave, subject to a second conversation with James Hambrick, but covering the same ground, that it’s not impossible at all for people to enter this business.

But in terms of the service that — and the relatively low cost of what Lubrizol brings to the party, and in terms of people trying to break into a market and take them on — and it’s not a huge market, it’s probably only about a $10 billion market overall, I decided that there was a pretty good-sized moat around this.

They’ve got lots and lots of patents, but more than that, they have a connection with customers. They work with customers when new engines come along to develop the right kind of additive.

So I felt that I had an understanding — didn’t understand one thing more about chemistry than when I started — but I felt that I had an understanding of the economics of the business, the same way I felt that when the ISCAR people talked to me — I mean, who would think you can take some tungsten out of the ground in China and put it in the little carbide tools and that you could have some durable competitive advantage? But I decided ISCAR had a durable competitive advantage after looking at it for a while.

That’s the conclusion — I have come to the conclusion that — and Charlie as well — that the Lubrizol position is the dominant — or the number one company, not dominant — but the number one company, in terms of market share, in that business — is sustainable and that it’s a very good business over time.

It helps — you know, they are helping engines run longer, run smoother, you know. You know, when metal is acting on metal, the lubricants are important, and they’re always going to be around. And I think Lubrizol will be the leading company for a very, very long time.

And that’s the conclusion I came to. And I did not have a fix on that, nor did Charlie, prior to Dave relaying on to me what he had learned at that dinner, which incidentally, Lubrizol had been telling the world — I mean they made investor presentations and all that quite extensively over the years.

I simply hadn’t paid any real attention to it. And when it was explained to me, I thought I understood it, and I still think I understand it.

I think Lubrizol will be a very, very good addition to Berkshire. And I saw James Hambrick just yesterday, and despite the turmoil around this, they are very enthused about becoming part of Berkshire, that they regard it as the ideal home.

Charlie?

CHARLIE MUNGER: Yeah, you know, ISCAR and Lubrizol, to some extent, are sisters under the skin.

You’ve got very small markets that aren’t really too attractive to anybody with any sense to enter, and fanaticism in service. So if you have any more like that why, please give Warren a call. (Laughter)

11. Using Berkshire’s stock for acquisitions

WARREN BUFFETT: OK. Area 3.

AUDIENCE MEMBER: This is Hsiang Hsiao Chu (PH) from Ottawa, Ontario. Warren, Charlie, I admire you guys tremendously.

I want to ask a question about the valuation of your company. You said, “Price is what you pay and value is what you get.”

In your letter to the shareholders this year, each Class A share owns about — investment about $95,000, and each share commands an earnings of $6,000.

So in my simplistic way of calculation, each share is worth $95,000 of investment plus the earnings discounted at 7 percent. That’s another about $90,000. So it adds up to about 185,000. Is that correct?

Does that mean the complexity of your empire is a value trap?

WARREN BUFFETT: We give those figures because we think they’re important, both the investments per share and the operating earnings per share, excluding earnings that come from the investments, and leaving out insurance underwriting profits or losses, because we think at worst they’ll break even, but they do bounce around from year to year.

Those figures are pretax on the operating earnings, so I’m not sure whether you’re applying your discount factor to pretax or after-tax.

But we think they’re important. And I would expect — well, the operating earnings, you know, are almost certain to increase. How much, you know, who knows? But that number is likely to go up.

The investments are still about the same as at year-end but that — they could go up or down based on whether we’re able to buy more operating businesses.

Our goal is to build both numbers to some extent, but our primary goal is to build the operating earnings figures.

We never — we — if Charlie and I had to stick a number in an envelope in front of us as to what we thought the intrinsic value of Berkshire was, well, neither one of us would stick a figure, we’d stick a range, because it would be ridiculous to come up with a single specific number, which encompasses not only the businesses we own, but what we’re going to do with the capital in the future.

But even our ranges would differ modestly, and they might differ tomorrow, in terms of how I would feel versus today, but not dramatically at all.

I would say this: I think — I certainly — well, you've received signals once or twice when we said we would buy in our stock, we obviously thought that it was selling below the bottom of a conservative range of intrinsic value, and we did that once some years ago.

And by saying so, of course, the stock went up, and so we never got any stock bought. So there's sort of a self-defeating factor about taking the kind of approach to it that we do, in terms of really telling people that the only reason we'll buy in stock is because we think it's cheap. That is not standard practice in corporate America at all.

In fact, corporate America, to some extent, buys in their stock more aggressively when it's high than when it's low. But they may have some equation in their mind that escapes my reasoning power.

But the — I would — we do not regard Berkshire as overpriced. And I would say that we had, very recently, we had a very, very large international company that might well have been interested in doing something with Berkshire, and it's a very nice company, but it's bigger than we can handle unless we would use a lot of stock.

And we won't use the stock. We just think our shareholders would come out behind. It would be a wonderful company and, you know, make a lot of headlines, but in the end our shareholders would be poorer because our stock is a currency, and unless it's fully valued, it's a big mistake to use it as a currency.

Now, we used some in the Burlington deal, but we used a whole lot more cash, and, in effect, we only used 30 percent for stock, and it was worth doing, but it was painful.

And if Lubrizol had wanted to do a deal involving stock, we would not have done it. I told James Hambrick that right off the bat.

So we had absolutely no interest in buying Lubrizol — we were perfectly willing to give, you know, close to $9 billion in cash, and in my view, we're getting our money's worth.

But we would not have given a significant portion of it in Berkshire stock, because we would be giving away part of the businesses we already own, and we like Burlington, and we like See's Candy. We like ISCAR.

And to give away a portion of those, even to get another very good business, would not make financial sense for our shareholders.

So you can draw your own deductions about our calculations of intrinsic value from that statement.

Charlie?

CHARLIE MUNGER: Well, he's obviously looking at two right factors. And I think that we have not permanently lost the ability to do some interesting things eventually with our enormous wealth in cash and marketable securities.

We won't always be as inactive as we are now.

WARREN BUFFETT: We're not that inactive, Charlie. (Laughter)

CHARLIE MUNGER: Well, I don't know. You practically crawl out of your skin, sometimes.

WARREN BUFFETT: Nine billion is — you know, we say normal earning power is 12 billion. That uses up a good portion of one year's quota.

Although we'd like to use more. I mean, there's no question.

CHARLIE MUNGER: Now you're talking.

WARREN BUFFETT: Can you see us using stock in the next few years?

CHARLIE MUNGER: If the business were good enough, of course.

Our trouble is — it's a terrible trouble you people have — the businesses you already own are so good it's not wise to part with them to get a business we don't own. Ordinarily.

12. Buffett is always optimistic about American capitalism

WARREN BUFFETT: Carol?

CAROL LOOMIS: This is for Warren — and Charlie, too — from your longtime Omaha friend Dick Holland.

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

"Some experts believe that we may reach the point where future bond offerings to cover the rising debt might fail. Many wonder if we are not entering a time of national decline.

"How can a lousy long-term U.S. economy make you so happy, and why do you see gold nuggets where others see salt?"

WARREN BUFFETT: That's from Charlie's good friend as well, Dick Holland, who we both have known for 60-plus years.

I don't see how anybody can be other than enthused about this country.

If you look back to 1776 or 1789, whichever one you want to date it from, you know, it has been the most extraordinary economic period in the history of the world.

In fact, if you go back — I was born on August 30th, 1930.

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

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

You know, it would be like in that Woody Allen movie where he says, "Go back, go back."

All that's happened since August 30th, 1930, is that the standard of living of the average American has increased six-for-one. Six-for-one.

You know, that's absolutely incredible. I mean, you look at centuries where nothing happened for the average person. I mean, century after century. So we have a system that works magnificently.

It gets gummed up periodically. And it always has troubles. I mean, you know, I — my father was very anti-New Deal, so my sisters and I sat around a dinner table from the first we can remember hearing how things were going to go to hell.

As a matter of fact, my father-in-law told my wife-to-be and her mother that he wanted to have a talk with me before we got married.

And he was very much on my side, so I was not in a panic about this or anything, but I went down to his house shortly before the marriage and this wonderful man, Doc Thompson, sat in a chair for a couple of hours, and he said, "Warren," he said. "I just want to tell you that you're going to fail but it's not your fault." (Laughter)

And he said, "You and Susie, my daughter, if you starve, she would have starved anyway. I mean, it is not your fault. It's because — you know, it's because the Democrats are in, you know, and they're going to take the country down the road to Communism and, you know, and just don't worry about the fact you're going to fail."

And this went on for quite a while. And then he blessed me and we got married. It was a happy ending.

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

There's always negatives. The country always faces problems. I mean, this country went through, you know, it went through a civil war, you know. It — it's gone through all kinds of things. But what happens?

You know, we have a few lousy years from time to time. We've had, probably, 15 recessions since the country started. And we will always have a list of 10 or 15 things at the start of the year that will tell you why this country can't possibly work well.

But all I can tell you is that it doesn't do it in a straight line, but the power of capitalism is incredible. I mean, you know, that's what is bringing us out of this recession.

I mean, monetary and fiscal policy add some utility, and certainly in the fall of 2008 the government was needed in a huge, huge way. It could do what — it was the only one that could do what was needed.

But if you look at the history of the United States, you know, probably half of our recessions have occurred during — we'll say in the 19th century — when people didn't even know what fiscal or monetary policy was.

I mean, what happened was that excesses would come in and then the resuscitative power of capitalism would set the country back on the right — on a stronger growth pattern — and that's happened time after time after time.

And the game isn't over. I mean, it is not like the potential of America has been used up.

What has happened is the rest of the world has caught on, to some extent, so you're seeing some state capitalism in places like China, and they are turning economies loose that have been dormant for centuries.

But it's not because the people are smarter. It's not because they work harder. It's just because they have tapped into a system that works marvelously over time.

And I will tell you, in the next hundred years you're going to have probably 15, maybe as many as 20 lousy years, but we will be so far ahead of where we are now that it will be unrecognizable.

Charlie? (Applause)

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

WARREN BUFFETT: That's wildly optimistic for Charlie. (Laughter)

Have you got anything more encouraging than that to say, Charlie? (Laughter)

CHARLIE MUNGER: I don't know. I kind of — I understand a little bit of Dick Holland's point of view.

And by the way, I've known him a long time. He aced me out of any hope of being the chief candle snuffer at the Unitarian church. (Laughter)

He was so damn good at it. (Laughter)

Anyway, what was the question? (Laughter)

WARREN BUFFETT: Can you bring yourself to say anything optimistic?

CHARLIE MUNGER: Well, I have a little bit of a twist on that. And so I would say that you can be cheerful even if things are slightly deteriorating, and that's a very good quality to have.

I have a personal saying that has always amused me. I say, the politicians are never so bad you don't live to want them back. (Laughter)

WARREN BUFFETT: Well, on that note of wisdom — (Laughter)

13. Best assets in an inflationary environment

WARREN BUFFETT: Let's go to area 4.

AUDIENCE MEMBER: Good morning. Angie Janssen (PH) of Cambridge, Massachusetts.

My question is, aside from the need to put huge amounts of capital to work, do you still believe that a high return on tangible capital business, like See's or Coke, is the best asset to hold in an inflationary environment, or do you now think an irreplaceable hard asset with pricing power, like a railroad or a hydroelectric dam, is superior?

WARREN BUFFETT: The first group is superior. I mean, if you can have a wonderful consumer product — doesn't have to be a consumer product — a product that requires very little capital to grow, and to do more dollar volume, as will happen with inflation even if you don't have unit growth, and it doesn't take much capital to support that growth, that is a wonderful asset to have in inflation.

I mean, the ultimate test of that is your own earning ability. I mean, if you're an outstanding doctor, lawyer, whatever it may be, teacher, the — you — as inflation goes along, your services will command more and more in dollar terms, and you don't have to make any additional investment in yourself.

People think of that, you know, with a very long-lived real estate asset or something of the sort, or a farm, or anything where additional capital is not required to finance inflationary growth.

The worst kind of businesses are the businesses with tons of receivables and inventories and all of that.

And in dollar terms, if their volume stays flat but the price level doubles, and they need to come up with double the amount of money to do that same volume of business, that can be a very bad asset.

Now normally, we are not enthused about businesses that require heavy capital investment, just like utilities and the railroad.

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

But the ideal business — See's Candy is doing — it was doing $25 million of volume when we bought it, and it sold 16 million pounds of candy — a little more than — well, it retails $1.90, and we had some quantity discounts, so we were doing close to $30 million worth of business.

Now, we're doing well over $300 million worth of business. It took $9 million of tangible assets to run it when it was doing 30, and it takes about 40 million of tangible assets at 300-and-some.

So we've only had to ploy back $30 million into a business which will make us — well, it's made us, probably, a billion-and-a-half pretax during that period.

And if the price of candy doubles, we don't have any receivables to speak of. Our inventory turns fast. We don't store it or anything like that. We gear up seasonally and the fixed assets aren't big, so that is a much better business to own than a utility business if you're going to have a lot of inflation.

Charlie?

CHARLIE MUNGER: And what's interesting about it is that we didn't always know this. And so — (Laughter)

WARREN BUFFETT: And sometimes we forget it. (Laughter)

CHARLIE MUNGER: That's true, too.

But it shows how continuous learning is absolutely required to have any significant achievement at all in the world.

WARREN BUFFETT: Yeah, and it does show — you know, I've said in the past that I'm a better businessman because I'm an investor and I'm a better investor because I'm a businessman.

There's nothing like actually experiencing the necessity, particularly in the 1970s when inflation was gathering strength, and early '80s, you would see this absolutely required capital investment on a very big scale that really wasn't producing anything commensurate in the way of earnings.

I wrote an article for Fortune called "How Inflation Swindles the Equity Investor" back in 1977.

You really want — the ideal asset, you know, is a royalty on somebody else's sales during inflation, where all you do is get a royalty check every month, and it's based on their sales volume.

And you made — you came up with some product originally, licensed it to them, and you never have another bit of capital investment. You have no receivables, you have no inventory, and you have no fixed assets.

That kind of business is real inflation protection, assuming the product maintains its viability.

So even though we are going into some very capital-intensive businesses, part of that reflects the fact we can't deploy the amount of capital we have in a whole bunch of See's Candies. We just can't find them. We would love to find them, but we can't find them in that quantity.

So we are not doing as well with capital when we have to invest many billions a year, as we would if we were investing a few millions a year. There's no question.

That's true in investments. It's true in operating businesses. There is a real disadvantage to size, and we just hope that problem grows.

CHARLIE MUNGER: Now you're talking.

14. No dividend, so sell a slice of Berkshire if you need cash

WARREN BUFFETT: Becky?

BECKY QUICK: Aside from questions about Dave Sokol, the questions I've received most from shareholders have to do with dividends.

And Dave Corneal (PH), who is a shareholder who couldn't be here this weekend because he's at his daughter's wedding, writes in, "I know that Berkshire is a great allocator of capital, but as an owner of stock and as I get closer to retirement, there will be a time when I will need income from my assets.

"Currently Berkshire does not pay dividends, yet it loves collecting on dividends on its investments. It also generates extensive cash flow in which it could pay dividends if it chooses to.

"Currently the only real option to get income from your Berkshire investment is to sell a share or two of the stock. Is there a point in the future where Berkshire shareholders may expect a dividend payment, or what conditions would be needed for Berkshire to consider paying a dividend?"

WARREN BUFFETT: Yeah, we will pay dividend — as a matter of fact, there may be an argument that when we pay dividends we should pay out almost 100 percent, because it does mean that we lost the ability to find ways to invest a dollar in a manner that creates more than a dollar of present value for the shareholders.

But let's assume you had a savings account, and the savings account paid 5 percent. And you had your choice of taking $50 a year out, or letting the $50 stay in and somebody would pay you 120 percent of that savings account any time you wanted to sell a piece of it.

Now, would you want to take the $5 out or would you rather let it accumulate and have the ability to sell at 120 cents on the dollar, that account?

Every dollar that's been reinvested in Berkshire has created more than a dollar of market value, so it's much more intelligent, if you control the dividend policy of Berkshire, it's much more intelligent for people to leave the dollar in, have it valued at $1.20 or $1.30 or whatever it may be valued, and then sell off a little piece if they want the income, or if they want to receive some cash.

And the logic of it, I think, is unquestionable. The execution of it is a problem. I mean, the question of whether we can keep investing dollars to create more than a dollar of present market value, you know, there's an end to that at some point.

But so far, people, by leaving 160 billion at the end of third quarter in the business, have $200 billion that they can cash out for at any time they wish.

There will come a time and, you know, who knows how soon, because the numbers are getting big — there will come a time when we do not think we can lay out, you know, 15 or 20 billion a year and get something that's immediately worth more than that for our shareholders.

And like I say, when the time comes where a dollar is only buying us 90 cents of value, we'll quit spending the dollar. We'll give it to the shareholders.

But I predict that the day that Berkshire declares a dividend, the stock will go down. I mean, it will — and it should go down — because it's an admission, essentially, that a compounding machine has lost its ability to continue on that course.

Charlie?

CHARLIE MUNGER: Well, and there's nothing wrong with selling a little Berkshire stock to buy jewelry if you do it in the right place. (Laughter)

WARREN BUFFETT: I would like to announce that my niece, Cynthia, visited Borsheims yesterday around — I guess around 3:00 — and she was there with her boyfriend, and he proposed, and they bought a ring. Congratulations. (Applause)

Her mother did the same thing a few years ago. And, you know, these things become family traditions, so go out there and who knows what will happen? (Laughter)

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

WAREEN BUFFETT: OK. Number 5.

AUDIENCE MEMBER: Jeremy Pozen (PH), Newton, Massachusetts.

Mr. Buffett and Mr. Munger, Berkshire Hathaway has had large investments in Wells Fargo and U.S. Bank.

What are the revenue outlooks and business prospects for these two banks, given the backdrop of slow U.S. growth, an extended U.S. consumer, a tepid rebound in the U.S. housing market with foreclosures and write-downs lessening but still at historically high levels, and the potential for greater-than-expected inflation, or worse, possibly, deflation similar to Japan?

Thank you for your time and consideration.

WARREN BUFFETT: Yeah, Wells Fargo and U.S. Bancorp are both among the best large banks, if not the best, in the country and they're different than what you think of in terms of some money center banks, but they're very large. Wells is four times as large as USB.

Banking as a whole — U.S. banking — profitability will be considerably less, in my view, in the period ahead than it was, say, in the early part of this century.

And a very important reason is that the leverage will be reduced. And that's probably a good thing for society.

It's — it may be a bad thing for individual banks that could use leverage intelligently, but the trouble was that they all thought they could use leverage intelligently, and the actions of one, or more, that were unintelligent about it, you know, had consequences for everybody, which you can see if you view HBO on whatever it is — is it May 26?

The — so I would say that return on assets — even if return on assets were as good as it was some years ago, there will be less assets per dollar of common equity than before which means returns on common equity will be less.

We still think that Wells Fargo and U.S. Bank are very good operations. We think they're very decent businesses. They're not as attractive as when leverage ratios could be higher.

In terms of the troubles in banking, I think you've seen, by far, the worst in the past. And loan losses have been trending downward now for several quarters, and I think the expectation is that will continue, and I think banking is a very fundamental business.

But as John Stumpf said a few years ago at Wells Fargo, he said, "I don't know why we keep thinking of new ways to lose money when the old ones were working so well." (Laughter)

And banks periodically go crazy. It's always on the asset side.

I mean, here you've got cheap money. You've got the federal government behind, although the federal government has never had to pay out anything on — in terms of the FDIC.

The FDIC has handled 3800 since it was established on January 1, 1934. The FDIC has paid out probably 3800, 3900 by now, institutions, 250 of them or so in the last couple years. And that has not cost the U.S. taxpayer a penny. I mean, that has all come from FDIC assessments on other banks. It's been a mutual insurance company.

Banking, if you just keep out of trouble on the asset side, is a very good business because you get your money so cheap and, you know, because of the implicit federal guarantee, and you do get to leverage up to a fair extent, and America's been a pretty good place to lend money.

So I like our positions in there. You will see that — if you looked at those totals — you'll see we've added to Wells Fargo. And both those companies are very well run institutions, but they will not be able to earn — I don't know what the figures were, but I think they were up 25 or — to 30 percent on tangible equity — and that's not going to get repeated in the future, and it shouldn't be.

Charlie?

CHARLIE MUNGER: Well, yeah, we might add that M&T Bank, which most people —

WARREN BUFFETT: Oh, yeah.

CHARLIE MUNGER: — never talk about, is headed by a really sensible fellow, and it's been a wonderful investment for us.

WARREN BUFFETT: Yeah, as a matter of fact, if you get the M&T annual report, it's written by Bob Wilmers, the letter, the first part of it is about M & T specifically, but the second part is about particularly the American financial economy, and I would really recommend you read that.

Bob is a very smart guy and he has a lot of good observations.

And, frankly, the other one I recommend you read is Jamie Dimon's letter, at JPMorgan, is a tour de force, in terms of describing the banking scene, the economic scene. He has some real insights in there about some very important subjects.

We don't own that stock, but it's a letter that I think everybody could learn a lot from reading, as they could from reading Bob Wilmer's letter at M&T.

CHARLIE MUNGER: And those people who like an element of morality in business, Wilmer sounds like an Old Testament prophet.

I mean, he really doesn't like it that all the really big banks are making so much money out of trading, because he says you're really trying to outsmart your own customers, and he'd rather serve them in a culture of deserved trust in both directions. It's hard to think he's totally wrong.

WARREN BUFFETT: He also expresses quite a dislike for the fact that a market system creates a reward system where money sort of disproportionally flows to people who work with money, and that that tends to attract a disproportional number of people that — of lots of ability that he thinks might be — at least some of them — might be better deployed elsewhere. It's an interesting read.

CHARLIE MUNGER: It's one of the best annual reports that's ever came out of banking. Right out of Buffalo.

16. Productive assets will always beat gold

WARREN BUFFETT: Ok. Andrew?

ANDREW ROSS SORKIN: This question who comes from Neil Steinhoff (PH) who writes, “The commodity market, and particularly gold, have appreciated astronomically over the last few years.

“My Berkshire Hathaway stock is only slightly better — doing better — than it was in 2006. It’s barely kept up with inflation,” he says.

“Please explain why you have not invested more heavily in commodities. As long as Ben Bernanke continues to print money and there’s no indication he’s going to stop any time soon, isn’t it right that commodities, and particularly gold, will continue to appreciate?”

WARREN BUFFETT: Well, I would point out that when we started with Berkshire, it was about 3/4 of an ounce of gold, and gold was $20 an ounce then, and it was 15.

So gold, even at 1500, has a ways to go, and the — (Laughter and applause)

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

Now, the first category is anything denominated in a currency. It could be bonds, it could be deposits in a bank, it can be a money market fund, it can be cash in your pocket.

And the — if you will reach in your pocket — I don’t like to do this, but — and pull out your wallet — you’re watching an historic event. (Laughter)

If you look at this — and I might point out this is a one. Charlie carries a — on the back of it, it says, “In God We Trust.” And that’s really false advertising.

The — if Elizabeth Warren were here, she would say, quite properly, it should say, “In Government We Trust,” because God isn’t going to do anything about that dollar bill, you know, if government does the wrong things, in terms of keeping it as valuable as it was when you parted with it to buy a bond or put it in a bank.

Any currency-related investment is a bet on how government now, and in the future, will behave. And if you happen to be unfortunate to live — fortunate to live in Zimbabwe and you decided to make currency-related investments, you know, you — family would have left you by now, and it was not a good decision.

Almost all currencies have declined in value over time. I mean, it may be built into almost any economic system that it will be easier to work with a value of currency that declines in value than a currency that appreciates in value, and the Japanese might reaffirm that here with their experience.

So as a class, currency-related investments, whether they are in the UK, or the United States, or anyplace else, unless we're getting paid extremely well for having them, we do not think make much sense.

The second category of investments regard items that you buy that don't produce anything but that you hope someone will pay you more for later on. And the classic case of that is gold.

And I've used this illustration before, but if you take all of the gold in the world — don't get too excited now — and put it into a cube, it will be a cube that's about 67 feet on a side. That would be 165,000 or 170,000 metric tons.

So you could have a cube — if you owned all the gold in the world — you could have a cube that would be 67 or 68 feet on a side, and you could get a ladder and you could climb up on top of it, and you could say, you know I'm sitting on top of the world, and think you're king of the world.

You could, you know, you could fondle it, you could polish it, you could do all these things with it. Stare at it. But it isn't going to do anything.

All you are doing when you buy that is that you're hoping that somebody else a year from now, or five years from now, will pay you more to own something that, again, can't do anything, but you're hoping that the person then thinks that somebody else will buy something five years later from him.

In other words, you're betting on not just how scared people are now of paper money, you're betting on how much they think a year from now people will be scared two years from then on.

Keynes described all of this. I think it was in Chapter 12 of "The General Theory," when he talked about this famous beauty contest where the game was not to pick out the most beautiful woman among the group, but the one that other people would think was the most beautiful woman, and then he carried it on to second and third degrees of reasoning.

Any time you buy an asset that can't do anything, produce anything, you're simply betting on whether somebody else will pay more for, again, an asset that can't do anything.

And actually, we did that with silver, but silver had an industrial use, and we — about 13 years ago I bought a whole lot of silver. And if you'll notice, silver has moved recently, so my timing was only about 13 years off, but, you know, who's perfect?

The third category of asset is something that you value based on its — what it will produce, what it will deliver. You buy a farm because you expect a certain amount of corn or soybeans or cotton or whatever it may be, to come your way every year. And you decide how much you pay based on how much you think the asset itself will deliver over time. And those are the assets that appeal to me and Charlie.

Now, there's some logical follow-on to that. If you buy that farm, and you really think about how many bushels of corn, how much bushels of soybeans will it produce, how much do I have to pay the tenant farmer, how much do I have to pay in taxes and so on, you can make a rational calculation, and the success of that investment will be determined in your own mind by whether it meets your expectations as to what it delivers.

Logically, you should not care whether you get a quote on that farm a day later, or a week later, or a month later, or a year later. We feel the same way about businesses.

When we buy ISCAR, or we buy Lubrizol, or whatever, we don't run around getting a quote on it every week and say, you know, "Is it up or down or anything like that?" We look to the business.

We feel the same way about securities. When we buy a marketable security, we don't care if the stock exchange closes for a few years.

So when we look at Berkshire, we are looking at what we think can be delivered from the productive assets that we own, and how we can utilize that capital in acquiring more productive assets.

And there will be times, you know, cotton doubled in price, much to our chagrin at Fruit of the Loom, but, you know, if you own cotton for the right six or eight months in the past year, you came close to doubling your money.

But if you go back a century and try to make money owning cotton over time, it has not been a very good investment.

So to pick a product, crude oil, cotton, gold, silver, anything that — and, of course, cotton has utility. Gold really doesn't have utility.

I would bet on good-producing businesses to outperform something that doesn't do anything over any period of time.

But there's no question that rising prices create their own excitement. So when people see gold go up a lot — I mean, if your neighbor owns some gold, and you think you're smarter than he is, and you didn't own any, and your wife says to you, you know, "How come that jerk next door is making money, you know, and you're just sitting here?" It can start affecting behavior.

And people like to get in on things that have been rising in price and all of that. But over time, that has not been the way to get rich.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that. And besides, something peculiar to buy an asset which only will really go up if the world really goes to hell. (Laughter)

It doesn't strike to me as an entirely rational thing to do.

I think you can figure on leaving the country because the country is going to kill you. And all the countries you might go to will also be thoroughly screwed up.

I think all those people should buy a little gold, but I think the rest of us would be better off with Berkshire Hathaway stock. (Laughter and applause)

And, of course, there's another class of people that think they can protect themselves by buying paintings of soup cans. (Laughter)

I don't recommend that, either. (Laughter)

WARREN BUFFETT: One thing about gold, also, is that in addition to this 67-foot cube, more gold is being produced every year.

So you have to have buyers not only to offset sellers in the natural course of events, but you have to absorb something like a hundred billion dollars' worth of added items of no utility.

I mean, it's really interesting. I mean, they dig it up out of the ground in South Africa, and then they ship it to the Federal Reserve in New York and they put it back in the ground.

I mean, if you were watching this from Mars you might think it was a little peculiar. But think of how many people it makes happy.

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

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

That may seem like a close choice to some people, but not to me. (Laughter)

CHARLIE MUNGER: Well, you would also need an army to defend the gold. And it's really not a very good spot.

17. Buffett on getting his first investors

WARREN BUFFETT: OK. Number 6.

AUDIENCE MEMBER: — Millard, Dallas, Texas.

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

WARREN BUFFETT: Sounds to me like a man that's about ready to start a hedge fund. (Laughter)

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

I could not do as well managing money if people were watching every decision as I could if I did it in a room all by myself.

So I just told these seven members of the family — one of them, actually, was my roommate in college and his mother, they came in also — I said, you know, if you'd like to join up in a partnership, I'm not going to tell you what's going on, but I will tell you that I will be doing with my own money what I'm doing with yours. Later on, I put all my own money in.

And it just was very slow.

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

And another fellow, late in the fall, had seen the notice of partnership formed in some legal paper and he said, "What's this?" and came in with me. It's just — we just stumbled along.

And for almost six years, I operated out of my house, no employee. I kept all the books, I filed the tax returns, I, you know, went out and picked up the stocks personally and stuck them in a safe deposit box.

When Charlie came along, I kept chiding him about the fact — I met him in 1959 — and I said, "Law is OK as a hobby, but it's no place for a man with your intellect to spend his time." (Laughter)

And, well, I'll let Charlie take it over from there. (Laughs)

CHARLIE MUNGER: It actually took me a long time to leave what was a family business.

And so any of you who are having a slow time accepting good ideas, why, you should be cheered by my example, because it was some years after you started working on me, and you pounded on me, and I slowly got the point.

WARREN BUFFETT: And he was actually asking about attracting money.

CHARLIE MUNGER: Well, of course, it helps if you conducted yourself in life so that other people trust you. (Laughter)

And then it helps even more if —

WARREN BUFFETT: You can see why I was so slow and he was so fast. (Laughter)

CHARLIE MUNGER: And then it helps even more if other people are right to trust you. So the formula is quite simple. First one, then the other.

WARREN BUFFETT: Unfortunately, with the present fee structure, just attracting money, rather than performing with it, can be enormously lucrative.

So the skill of attracting money may be — at least in the short run, and maybe the intermediate run — it may be a more important quality than the ability to manage money.

But we, neither one of us, ever charged any fixed fee of any kind.

Am I right on that, Charlie?

CHARLIE MUNGER: Well, we stopped taking any significant overrides on other people's money at very young ages and at very small amounts of net worth.

I wish our example were more common. But I like our compensation practices, too, and they're spreading slowly.

We get a new company every, what, five years?

WARREN BUFFETT: Yeah.

18. Berkshire isn't a '60s "Go-Go" conglomerate

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: This is from Jeff — sorry, Jeff Cunningham of Directorship.

"Berkshire's corporate strategy resembles that of the go-go conglomerates of the 1960s: Geneen's ITT, Teledyne, Textron.

"Small corporate team, tight financial controls, sector neutrality, and little involvement in subsidiary operations, and ultimately not fully valued for the sum of their parts. If you disagree with this, how does Berkshire differ?"

WARREN BUFFETT: Yeah, it — we are a conglomerate and, you know, people shy from that name, but that's exactly what we are.

And I think I laid out in the annual report at least one of the advantages of being a conglomerate, namely the tax-efficient transfer of money from businesses that do not have good ways of using it to businesses that have better ways of using it, which is, if it's carried out intelligently, is a very significant plus.

The conglomerates you mentioned — and I'm familiar with all of them — really became sort of stock issuance machines, where the idea was to get your stock to sell at a very high multiple, and then trade it for something else that was selling at a lower multiple, and voilà, you know, earnings per share went up, and then people said you'll do it again.

So it was — it was really accepted and endorsed by Wall Street that if you had this sort of semi-Ponzi scheme of issuing shares constantly for things that had lower P/E ratios, everybody knew what the game was, but they thought the game would continue to succeed. And for a while it did.

And the Gulf and Westerns of the world, and the Littons of the world, and there were numbers of them, it was almost like an unspoken conspiracy that nobody will point out that this is kind of a perpetual motion machine, and if they don't it will keep working.

But if something says anything about it, somebody says, "The emperor has no clothes," it will all collapse.

The interesting thing, of course, you mentioned Teledyne in there. Teledyne played that game, and then it ended, and all of this stuff came back to Earth, but then Teledyne went into reverse and bought in stock like crazy when their stock got underpriced.

So they issued stock like crazy when it was overpriced, and they bought it in to an extraordinary degree when it was underpriced, and it created a sensational record.

Most of those companies, though, I think have very little relationship to Berkshire.

It's true that, I think, some of them were pretty decentralized, although I remember — didn't Harold Geneen have some famous room that he brought everybody in —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: —chewed them out, you know, monthly for not making their projections, so they learned to make them whether they were actually really making them or not.

The managers were — if you took Charlie Bluhdorn at Gulf and Western, or, you know, take the group, they were primarily thinking about how — Jimmy Ling at LTV — they were primarily thinking about how they could pump the stock up to a level where they could buy big established businesses that were selling at lower P/E ratios and sort of have this perpetual motion game going. And it came to an end.

I don't think there's — you know, at Berkshire we are not in that game. We are in the game of trying to buy very good businesses that we're going to keep forever and having them grow their earnings and have them also throw off cash that we can use to buy more similar businesses.

It is a conglomerate. Conglomerates, generally, are unpopular, and I don't disagree with why they are. But I think it's a very rational way of running the business as long as you keep it focused on running businesses and not as a stock-issuance machine.

Charlie?

CHARLIE MUNGER: Well, yes, and some of those companies got into really pretty heavy manipulation of the numbers.

One of them said, "I know what I'm going to report, I just don't know how I'm going to do it." (Laughter)

That's not the attitude around this place.

WARREN BUFFETT: Yeah, we don't know what we're going to report. (Laughs)

CHARLIE MUNGER: No, no. And sometimes we don't know how to do it, either. (Laughter)

19. Buffett's preferred legacy: "teacher"

WARREN BUFFETT: OK. Number 7.

AUDIENCE MEMBER: Good morning, Warren and Charlie. John Norwood from West Des Moines, Iowa.

I have a question on legacy. A hundred years from now, Warren and Charlie, what would each of you like to be remembered for?

WARREN BUFFETT: Old age. (Laughter)

CHARLIE MUNGER: I've heard Warren say that what he wants said at his funeral is that's the oldest looking corpse I ever saw. (Laughter)

I have a different saying that came down from one of my great grandfathers. And I think it — he wanted to be remembered for a fortune fairly won and wisely used. That's a pretty good system.

WARREN BUFFETT: Yeah, I would — if you really ask me, I'd probably like "teacher." I enjoy teaching a lot.

Some people think I do a little too much of the didactic stuff, but I like students coming. And, you know, I've benefited by some fabulous teachers, starting with my dad, but going on to Ben Graham, going on to Tom Murphy, I mean, lots of great teachers. So I would say that.

I might point out that on Wilt Chamberlain's gravestone, I think it says, "At last, I sleep alone." (Laughter)

Well, we have some people from Kansas here, anyway. (Laughs)

20. Dollar will decline, but inflation won't destroy the economy

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from Pierre Sorel. He's a portfolio manager at Fidelity and he says that the U.S. dollar has been depreciating against major currencies.

"The Federal Reserve continues to run a zero interest rate policy in contrast to other major economies that are raising rates or have stepped back from quantitative easing.

"A few years ago, Berkshire had a short U.S. dollar position to preserve the company's value from the devaluating dollar.

"So what's the company's management doing about the risk of further U.S. dollar weakness, given that most of the company's assets and operating businesses are denominated in the U.S. dollar?"

WARREN BUFFETT: Yeah, we had a significance short position some years ago. Last year we had a small short position in two currencies, and we made about a hundred million dollars in them, but we have not been really active in the foreign exchange market.

We think — shouldn't speak for Charlie here on this — but I think that there's no question that the purchasing power of the U.S. dollar will decline over time. The only question is at what rate.

But I also think that the purchasing power of most currencies around the world — almost most currencies around the world — will decline.

And, of course, a short position is just a bet on which one declines at the faster rate, and I don't have a strong conviction on that. I've got some mild feelings about it but not enough to where I want to back it up with a lot of money.

We do own some businesses — I mean, l take Coca-Cola.

Coca-Cola — I don't have the exact figures — but my guess is that 80 percent or thereabouts of the earnings will be non-dollar. And we've got exposure in various other ways.

But we are not — we're unlikely to make another big currency bet, although I — you know, I do think that the purchasing power of the U.S. dollar is destined to decrease. And I have fears, but I've long had some unwarranted fears, of it declining at a rapid rate.

Now, Charlie has pointed out to me that the dollar of 1930, when I was born, is worth 6 cents now. You know, 16-to-1 in terms of depreciation. And as he points out, we've both done pretty well.

So inflation has not destroyed us.

If somebody had said to me in 1930, In addition to this Great Depression you're facing, and a World War where it looks like we're even losing for a little while, and all these terrible things, on top of that that dollar that, you know, your grandfather is going to hand you when you're born, is only going to be worth six cents in purchasing power, that might have been discouraging.

But overall, we've still done pretty well.

So, I hate inflation, but we've adapted pretty well to it over the years, and we have not had the total runaway-type inflation that really can be upsetting to a society, yet, but I think it's something you always have to guard against.

Charlie?

CHARLIE MUNGER: No, but God knows where the world is headed. I just think that one way or another, the world muddles through.

Take a really god-awful culture, which is Greece, modern Greece.

I don't mean there's anything wrong with the Greeks, but — in their family life — but the way they manage their money and pay their taxes. The main industry in Greece — or one of the main industries — is tourist attractions, and they closed right — most of the time — during the tourist season.

It's a pretty dysfunctional government. (Laughter)

And, of course, people don't want to pay any taxes or do much work, and yet there it is. It's — the people of Greece are surviving.

WARREN BUFFETT: It's lasted a long time.

CHARLIE MUNGER: Yeah, yeah.

Adam Smith said it very well. He said, "A great civilization has a lot of ruin in it."

It takes a long time, and there's a lot left after you've been through a good deal of ruin.

In fact, it's an easier game than the ordinary process of living and then dying.

WARREN BUFFETT: Well, I think we'll see a lot of inflation, but if I had a choice, I would rather be born in the United States today than any other place, any other time in history, so — (Applause)

21. Buy Berkshire stock or a mutual fund?

WARREN BUFFETT: OK. Area 8.

AUDIENCE MEMBER: Good morning, Mr. Munger and Mr. Buffett. This is Mary Bundrick (PH) from Rochester, Minnesota.

I was wondering, what factors would you consider in deciding between investment in Berkshire Hathaway versus a no-load mutual fund?

WARREN BUFFETT: Well, I advise people to buy index funds, actually, if they're not going to be active in investments.

I mean, if you just are going — if you've got a day job, and you want to just put money aside over time, I think the average individual will do better buying an index fund consistently over time than almost anything else available to them.

I think it will be a perfectly satisfactory investment. It won't be — it'll never be regarded as a great investment, but it will be a perfectly satisfactory investment.

If I personally had a choice between an index fund and Berkshire at present prices, I would rather own Berkshire. But I wouldn't be unhappy if you told me I had to leave all my money in an index fund for the rest of my life and then — but I like Berkshire better. (Laughs)

Charlie?

CHARLIE MUNGER: Well, I like it a lot better, and I'd be very unhappy if I had to own an index fund. My ambitions are larger.

I don't think the average return of a skilled investor over the next 50 years is going to be as good after all factors as it was over the last 50 years.

So I think reduced expectations are the best defense any investor has, and after that, I think Berkshire is a pretty good bet.

WARREN BUFFETT: Charlie's big on lowering expectations.

CHARLIE MUNGER: Absolutely. (Laughter)

That's the way I got married. (Laughter)

My wife lowered her expectations. (Laughter)

WARREN BUFFETT: And he lived up to them. (Laughter)

22. "Rules are not meant to be danced around"

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: The question is, "Can you explain the company's policy for your own personal investing outside of Berkshire and that of your other managers, and why aren't all trades in investments first cleared through a compliance department like that of most other companies?"

WARREN BUFFETT: Well, I don't think it is true of most other companies.

We have 260,000 employees, and we have one company that's a subsidiary of General Re called New England Asset Management, but that's the only company that advises other people on investments or operates in the investment field.

At Berkshire, there are presently three people that can execute trades, and then there are a few other clerical people that would see what was done.

But we are not an investment advisory firm. We're not a mutual fund or anything of the sort.

So if we — we have some, I think, pretty clear rules that are going to be looked at, again, I can assure you, by the audit committee.

But in terms of the Code of Conduct, Code of Ethics, and insider trading rules, which go to the managers, I don't think there's anything ambiguous in those.

Now, to extend those beyond — I don't know, Marc, how many people those go to but — whether 60 or 70 or something, I'm not sure of the number — but the problem with rules, you know, is, I mean, you've got to have them and we emphasize not only the letter of them, but the spirit. That's why I write that letter every couple years.

I was on the audit committee, for example, of Coca-Cola. And Coca-Cola has about one-fifth as many employees — or did then — had about 50,000 — had about one-fifth as many employees as Berkshire. And each time the audit committee met we had eight or 10 code violations.

I mean, people — if you take Berkshire at 260,000 people, you know, that's about the number of households in the greater metropolitan Omaha. And perfect as we like to think we are in Omaha, I will tell you there's a lot of things going on in Omaha right as we sit here that, you know, do not match the rules. So it's a real problem.

The problem, obviously, with the Sokol thing is it hit very, very high up, you know.

But we had a case sometime back where a fellow that was a friend of mine, vice president of one of our subsidiaries, and, like I say, a personal friend, and we supplied the evidence that sent him to jail.

You know, it has happened. We had a — as I remember some years ago, I think it was in Woodbury, New York, we may have had a woman arrested in the offices just because we want to make very clear, you know, what — that we mean business and as the — as the audit committee said that this is not public relations, this is reality.

Here's a letter that went out from Johns Manville. I didn't know anything about it until Todd Raba gave it to me the other day, but it describes what — dated April 27, and it said, "The audit committee clearly found that Mr. Sokol compromised the integrity-related values of both Berkshire and JM have worked so hard to ingrain in the fabric of both companies.

"This should serve as a tragic lesson learned for every employee in JM." And then in boldface, "There are no gray areas when it comes to integrity." And it goes on.

So we hope to get some value out of this experience that will help us reinforce, with not only the 60 or 70 managers, but with 260,000 people that we do mean business on this, and we've showed them we mean business when we have sent more than one person to jail.

But there will be, you know, we can have all the records in the world and if somebody wants to trade outside them or something, you know, I — they're not going to tell us they're trading in their cousin's name. I mean, you know, it just doesn't work that way.

We will have occasions in the future when people do wrong things.

Usually they get handled at the subsidiary level. I mean, it's somebody doing something, whether it's getting a kickback from a vendor or stealing out of a cash register, whatever it may be, and then, you know, we get the occasional mega one, which is very painful.

But we will — if there's anything we can do in the rules that will make it even more explicit or get across further the idea that rules are not made to be danced around but rather that the spirit of them extends beyond them, we want to be sure we do it.

Charlie?

CHARLIE MUNGER: Yeah, all that said, if you look at the greatest institutions in the world, they select very trustworthy people, and they trust them a lot. And it's so much fun to be trusted. And there's so much self-respect you get from it when you are trusted and are worthy of the trust, that I think your best compliance cultures are the ones which have this attitude of trust, and some of the ones with the biggest compliance departments, like Wall Street, have the most scandals.

So it's not so simple that you can make your behavior better automatically just by making the compliance department bigger and bigger and bigger.

This general culture of trust is what works. And, you know, Berkshire hasn't had that many scandals of consequence, and I don't think we're going to get huge numbers, either.

23. Deficit spending is economic stimulus

WARREN BUFFETT: OK. Number 9. (Applause)

AUDIENCE MEMBER: Hi, Charlie and Warren. I'm Michelle from Decatur, Illinois.

Half the U.S. economy seems to be in a sluggish recovery while most foreign economies are showing solid growth numbers.

Are there any significant changes that you think can be made to either current U.S. economic policy or Federal Reserve policy or tax laws to get the economy healthy and growing in the U.S.?

WARREN BUFFETT: Yeah, we've really had our foot to the floor in both monetary and fiscal policy.

You know, you've seen it, obviously, on the monetary side, with extended period of effectively zero interest rates and actually with the chairman, just the other day saying this is going to go on for an extended period.

And then they asked him what an extended period meant, and he was — he said an extended period. (Laughter)

The — but we — it's hard to imagine pushing harder on monetary policy than has occurred.

The interesting thing is people think of fiscal policy and they think, well, we had a stimulus bill.

Well, if you think about what stimulus really is, it's not whether you call something a stimulus bill. If you had something that was called a stimulus bill and you didn't run a deficit, it would not be, you know, it would not be a stimulus. You'd be —

And if you don't have anything you call a stimulus bill at all, but you're spending 10 percent more of your GDP than you're taking in, you are applying an incredible stimulus — fiscal stimulus — to the economy.

We have a huge fiscal stimulus program going on now, and it's called taking in 15 percent of GDP and spending 25 percent of GDP. That's extraordinary.

So, I think that we have used those levers in a way that's almost unprecedented. And I think it's been wise, in general, to do what's done, and I think it was particularly wise what was done in the fall of 2008.

But I think, generally, we have followed the right policies. I think they're less important than most people think they are.

I think if you did the wrong policies it would really screw things up. But I don't — I don't — I think the natural resuscitative powers of capitalism are — will be the biggest factor in taking us out.

And I think you've seen that over the last two years and we're seeing it month by month.

I would say this: residential construction is flatlined at, you know, 500,000 or so units per year.

I think when it comes back, and it will, but it will take — it takes working off a crazy excess inventory we had, and there's no way to do that except through creating fewer residential units than you create households. That's how you reduce the oversupply.

When that ends — when part comes back — I think you're going to see much more of a pick-up in employment than you might think just by looking at construction workers.

I mean, we have Shaw Carpets. You know, I'm sure they're not counted as construction jobs, but we have thousands fewer people working there because residential construction is where it is.

And we have people at the Furniture Mart and how much carpet they're selling or houses, so I think there's a lot of indirect, as well as direct, reservoir of jobs that will be drawn upon, or utilized, when residential construction comes back.

I don't think I'd measure it just by the number of construction workers that are being employed currently versus, say, four or five years ago.

It will come back. I don't know when. I said in the annual report I thought you'd be seeing it by the end of the year. I may or may not be right on that, but that would be my best guess, still.

We are creating households faster than we're creating housing units. And, you know, we lose housing units just — you know, you look at the — with the tornadoes recently.

So there are — that problem will get cured. And I don't think, when you mention we're progressing more slowly than other places, certainly in terms of Asia, you know, there's no question about it, or Brazil, but actually, I think our pace of coming out of this, while it's been slow compared to the hit we took in 2008 — the American economy was paralyzed — it's come back quite a distance, and we see that in our businesses.

Now, you know, our peak on railcar loadings were 219,000 one week, I believe, in 2006, but — and our bottom was 150- or 51-thousand. We'll probably run 190,000, or thereabouts, currently, and that will pick up more as the year goes along.

So it's come back a significant way. We have certain companies that are setting records that serve basic industries. If you look at TTI, which makes — which distributes — electronic components, has thousands and thousands of customers all over the world — it's setting new records, and it's way up in the first quarter and it set a record last year.

If you look at ISCAR, which supplies nothing but basic industry, I mean, nobody buys little carbon cutting tools, you know, to put in their recreation room or anything. This stuff is used, you know, for making big things, and their business is going up and up and up, you know, month by month.

So, the economy is coming back, and when residential construction finally gets this huge overhang largely eliminated I think — I think you'll see a lot of improvement in the employment picture.

Charlie?

24. Munger tells how he'd take "an ax to our financial sector"

CHARLIE MUNGER: Yeah, the one place that I feel we're making a huge mistake is not learning enough from the big mess that came from wretched excess in our financial system.

I don't think we throttled the sin and folly out of that aspect of the economy nearly enough. And I think — if you look at all the panics and depressions in the United States, they all came from financial collapses, usually preceded by perfectly asinine and greedy behavior. And I think that would be a lot to be said for taking an ax to our financial sector and whittling it down to a more constructive size.

WARREN BUFFETT: Tell us more about how you use that ax. (Applause)

CHARLIE MUNGER: Well, Warren, I'll make myself ridiculous, but I guess I'm so old I'm entitled to do that.

The — I would have the tax system discourage trading. I would have various kinds of Tobin taxes.

I would have securities trading more with the frequency of real estate than the trading by computer algorithms where one person's computers outwit another person's computers in what amounts to sort of legalized front running.

I don't think we need any of that stuff. And I think making heroes out of the people who succeed at it is not good for the fiber of the country, either.

I hate the idea that 25 percent of our best engineers are going into the financial sector.

So, I think it's crazy what we've allowed. (Applause)

And I think the lack of contrition in our financial sector, after the disgraceful stuff they got us into, is perfectly awesome. It makes Dave Sokol look like a hero. (Applause)

WARREN BUFFETT: He's getting warmed up. (Laughter)

Just as a sidelight, how many of you know that if you trade an S & P future contract — 500 — S&P 500 contract — and you hold it for 10 seconds and you have a profit, that 60 percent of the gain is long-term gain and 40 percent is short-term gain. So, essentially, our Congress has said that this activity should be more lightly taxed, you know, than cleaning washrooms or doing all the things that you people do every day. You get a special tax treatment.

Now that illustrates one of the problems with the tax code, in that there's a few people that care intensely about having that in there, and the cost of it, in terms of less revenue for the U.S. government, is diffused among a large group, none of whom have enough interest to want to go out and write their Congressman or hire a lobbyist to fight the other way.

But it’s pretty extraordinary that we have decided that that particular form of activity should get 60 percent taxed at a 15 percent maximum rate, even though it may only take 10 or 20 seconds and be just a little flicker on a screen.

CHARLIE MUNGER: And the hedge fund operators of America get a much lower tax rate than the professors of physics or the drivers of taxis. This is demented. (Applause)

25. Update on Buffett’s bet against hedge funds

WARREN BUFFETT: Well, with that, we’re getting to our break at noon, and I promised — I made a bet three years ago with some fellows that run a fund of funds, and I promised to put the figures up every year as to how we’re doing.

It’s a 10-year deal, and if we can put up the slide — what number would that be? Probably five.

As you can see, these funds of funds — these are five funds of funds groups chosen by these people who I like, Ted Seides and his friends, and Ted couldn’t be with us today, but we will put these figures up annually.

He got off to a very good start with his group. Obviously, hedge funds should do better in a down market. And we haven’t caught them yet with the S&P 500, but it will give you all a reason to keep coming back over the next seven years as I report regularly on how we are doing in the S&P 500 versus the five funds of funds.

As [Fortune Magazine’s] Carol [Loomis] pointed out in an article recently or a — maybe it was on the web — in reporting on this, she looked at the bottom line where the investors in the S&P 500 are behind for the three years, and the investors in the funds of funds are behind, and the only people that are ahead so far are the investment managers. (Laughs)

They’re doing very well at this point. So we’ll keep you up to date on that.

Afternoon Session - 2011 Meeting

1. Two clarifications on David Sokol and Lubrizol

WARREN BUFFETT: OK. If you'll all be seated.

I can't see whether Ron Olson is in the front row or not.

Ron, are you here?

OK. Ron wanted to — well, we'll get you a mic.

Because we're transcribing this and we want to get it all corrected, Ron has one point or two points that he wants to correct in terms of dates that I used. So we are going to give the microphone to him.

RON OLSON: Not that they're all that telling, but I thought since we are creating a record, I wanted to clarify two points.

The Berkshire law firm, namely Munger, Tolles & Olson worked with the Lubrizol counsel in pulling together what Warren described as Lubrizol's proxy describing the background of the transaction.

We, as counsel for Berkshire, started to work on that gathering of facts pertaining to Berkshire's involvement, essentially David Sokol's and Warren's, during the week of March 15.

Warren, in speaking to you about the facts this morning, I believe, placed the beginning of that work in the subsequent week. So I simply wanted to clarify that as we gathered the facts, and that gathering included several interviews of David Sokol during that week.

Secondly, in describing internal policies at Berkshire to protect against misbehavior or negligent behavior, Berkshire maintains a — something that those in the trading business describe as restricted lists.

And on that restricted list are any securities in which Berkshire is buying, selling, has a peculiar interest, and that prohibits any of the corporate officers or the top officers of the subsidiaries of Berkshire from participating in trades in those securities without the consent of the CFO, Marc Hamburg.

That is what I wanted to clarify, Warren.

WARREN BUFFETT: Thanks, Ron.

2. Munger still bullish on electric-car maker BYD

WARREN BUFFETT: OK. We'll move right along. And we're going to go to 3:30 and then we'll adjourn for a couple minutes, and then we'll go to the regular meeting.

WARREN BUFFETT: Carol again leads off.

CAROL LOOMIS: Warren and Charlie, both of your expressed a very positive view of BYD and its chairman, Wang Chuanfu, when MidAmerican bought its stake in 2008.

Does BYD remain as attractive a long-term investment now as it was when you acquired your stake?

If so, why? Has BYD's recent pattern of unexplained product launch delays affected your confidence in the operation?

WARREN BUFFETT: Charlie is the BYD expert, so I'm going to let him start on that one.

CHARLIE MUNGER: Well, of course, the price is still way higher than the price Berkshire paid, and so almost by definition it's not quite as cheap as it was then.

Any company that tries to move as fast as BYD does, and on as many fronts, is going to have various delays and glitches. But I would say I'm quite encouraged by what's going on, and I expect delays and glitches.

They had trouble in the auto distribution, but they tried to double auto sales every year for six years, and it worked the first five times. (Laughter)

WARREN BUFFETT: I have nothing to add. (Laughter)

3. Making money by trading oil is too hard

WARREN BUFFETT: OK. Number 10.

AUDIENCE MEMBER: Hi, Warren and Charlie. My name is Catherine Brood (PH). I'm from Los Angeles, California.

I invest primarily in commodities and commodity equities. I started out back 2007 buying oil.

In the summer of 2008, we reached the peak of the oil bubble. That's when I reversed my holdings and started shorting oil.

I made a nice profit.

In 2009, I started buying oil again and oil equities, and I've been doing pretty well. But given the status of the world today and the price of oil, I'm questioning my investments.

Is this another oil bubble? Has oil reached its peak? Should I keep my holdings? Should I short oil? Should I exit oil altogether and move into other commodities or other investments?

So my question to you is, what your sentiments regarding oil?

WARREN BUFFETT: Well, I would say you've done a whole lot better than we have. (Laughs)

I think the crowd would rather hear from you.

We actually did take a position in oil — I don't know how many years ago.

CHARLIE MUNGER: A long time ago.

WARREN BUFFETT: A long time ago.

CHARLIE MUNGER: It was $10 a barrel. (Laughter)

WARREN BUFFETT: It wasn't that long ago though, incidentally. That was in the 1990s, although we've seen oil a lot cheaper than that.

East Texas Oil sold for a dime a barrel in 1932.

The — we really don't know.

I mean, obviously, you're dealing with a finite resource. I don't know whether the world is up to 88 million barrels or — it was down around 85 million barrels, but there's got to be some comeback, so I wouldn't be surprised if the current figure is getting pretty close to 88 million barrels a day.

That's a lot of oil to take out of the ground every day. And, of course, there are — new frontiers have been found, but you are — you've stuck a lot of straws into the Earth, and it is a finite number.

So, the one thing I can promise you is — almost promise you — is that oil will sell for a lot more someday.

Interestingly enough, how many producing oil wells do you think there are in the United States?

The answer is something like 500,000. You know, there's these stripper wells, there's wells out near Charlie that have been going for a hundred years.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: But we have looked in a lot of places now.

And what's happening, of course, from the standpoint of United States companies, is that the smaller countries where oil is being found now are quite a bit smarter about how they grant their concessions than people were 50 or 75 or 100 years ago, so that they drive much more intelligent deals than was originally the case when we went exploring around the world.

But I have no idea — you know, we — traditionally, BNSF had hedged a certain amount of oil and — because they obviously use huge quantities of diesel — and I suggested to them — although how they run the BNSF is up to them — but I really didn't think we could guess the price of oil.

And I thought if we could guess the price of oil, we didn't need to run the railroad. I mean, it was a — took a lot of effort, time to run that railroad. And if we know how to make money just sitting in a room trading oil, why not do that instead?

So I don't really — we don't hedge — well, in terms of Berkshire's parent company policies, we don't hedge anything in the way of commodities. Some of our subsidiaries do, and that's fine. They're responsible for their businesses.

But there are very, very few commodities that I've ever thought I was going to — would know the direction of their movement in the next six months or a year.

The one thing I'm quite convinced of, as we talked about this morning, is the fact the dollar will become less valuable over time, so that the dollar price of most things will go up, and maybe go up very substantially.

Whether they go up enough so that you have the same amount of purchasing power after you pay tax on your nominal gains is another question.

I really think that an intelligent person can make more money, over time, thinking about assets that — productive assets — rather than speculating in commodities, or for that matter, fixed dollar investments, but that's maybe my own bias.

Charlie?

CHARLIE MUNGER: Well, if we'd done nothing but oil from the very beginning, I'm confident that we would not have done nearly as well as we have.

To me, that's perfectly obvious. So I think what we've done is much easier than what you're trying to do.

WARREN BUFFETT: And we like easy.

CHARLIE MUNGER: We're not trying to make it any more difficult than we have to.

WARREN BUFFETT: I really don't know any way to have an edge in that sort of activity.

I mean, if you are going to try and figure out whether when to be long or short oil, or natural gas, or copper or cotton or whatever, I don't know of people who I feel would have an edge in trying to do that over the next 10 years.

But I do know people where I think they'd have a very significant edge in investing in common stocks, and maybe distressed bonds, for that matter, too.

CHARLIE MUNGER: Yeah, trading oil worked best of all for the people who bribed Nigeria.

That's not our milieu.

WARREN BUFFETT: Well, that's an insight I hadn't heard before. (Laughter)

4. Clarification of the clarification on Sokol and Lubrizol

WARREN BUFFETT: Becky? Oh, I got Ron here.

RON OLSON: I wanted to clarify my clarification. (Laughter)

Sounds like a lawyer, doesn't it?

WARREN BUFFETT: It sounds like a lawyer. (Laughter)

RON OLSON: Marc Hamburg was concerned that when I spoke of our insider trading policy and mentioned that we had a restricted list, that it — somebody may interpret that as suggesting that Lubrizol was on that restricted list. It was not.

What goes on our restricted list are securities that we have a position in that we publicly reported.

So I just simply wanted clarify that point. Lubrizol was not on the restricted list.

5. "I'm going to have Charlie write the next press release"

WARREN BUFFETT: OK. Becky?

BECKY QUICK: Charlie, I've got several variations of this question, but this one comes from Peter Kerr (PH) in Waterloo, Canada.

He says, "Could you please let us know a couple of the most important things you learned during the last year?"

WARREN BUFFETT: I'll let Charlie go first. (Laughs)

CHARLIE MUNGER: Well, I hate to admit this because I've ignored high-tech all my life, but I actually read that book "In the Plex" about Google, and I found it a very interesting book.

And so here I am at my advanced age, and I find it interesting the way people have created these engineering cultures, which are quite peculiar and different from most of what we have at Berkshire.

And will I ever make any use of this? I doubt it. But I certainly enjoyed learning it.

And if I enjoy learning it, I regard it as important, because I think that's what you're here for, is to go to bed every night a little wiser than you were when you got up.

WARREN BUFFETT: I'm just trying to hold my own, actually. (Laughs)

What I learned in the last year is that I'm going to have Charlie write the next press release. (Laughter)

CHARLIE MUNGER: Warren, I approved that damn press release with no objections. (Laughter)

The Berkshire shareholders are going to be in terrible trouble if they're relying on me to fix your errors. (Laughter)

6. CEO should be left "dead broke" after a bailout

WARREN BUFFETT: OK. Let's go to number 11.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Getting too close to confession time up here. (Laughter)

AUDIENCE MEMBER: Good afternoon, Warren and Charlie. My name is Phil Drew (PH), and I'm here with my wife Tina and our good friends the Grummys (PH) and the Henriksens (PH).

We're all from Indianapolis, and we're all small businesspeople. So we are not too big to fail.

And our question, basically, is simply this: do either of you gentlemen think that we might be headed down the same type of path years from now when we get into a situation as taxpayers, that we might have to bail out a company on Wall Street that is too big to fail? And if so, have we done anything to avert that?

WARREN BUFFETT: There are institutions around the world that I think governments should properly — although people won't like it — but I think that there are institutions around the world that governments would properly — I think bailout has got a little bit of a pejorative term on it, in the sense that stockholders should not be saved, managers should not be saved — but certainly the institutions, in some cases, should not be allowed to collapse immediately.

I mean, right now, we're continuing to follow that policy, for example, with Freddie Mac and Fannie Mae. I mean, they have not reconstituted themselves, as many of the banks and the auto companies.

I mean, Chrysler is even paying back, which, you know, surprises me, but my hat is off to them, and I mean that sincerely. I was really on the fence on saving the auto companies, but I think the administration did the right thing.

I mean, there were — they weren't saving the auto companies, per se, they were still working at saving a very fragile economy.

And, like I say, particularly in retrospect, they certainly, in my view, made the right decision.

There are — right now, you know, in Europe they're deciding whether countries are too big to fail.

And so I think that problem will always be with us.

I think for that reason that you have to do things to reduce the propensity to fail, and among those things, I think you have to make it so that the CEO, and to some extent the board — but not to the draconian degree that I'll suggest for the CEO — I think that any institution that requires society to come and bail it out for society's sake should have a system in place that leaves their CEO, basically, and his spouse, dead broke, because I think that the upside and downside incentives are vastly different. (Applause)

And I think the board of directors of those institutions should suffer severe penalties. Nothing like that, but they certainly, you know, should give back, say, the last five years of directors' fees or whatever it may be that they received.

Because they — if you run an institution that actually needs — society can suffer such a blow if you fail — that society needs to come in and save you, you ought to have somebody running that institution, and you ought to have incentive practices in place that make it very, very, very painful to the people involved for the failure if it indeed happens.

And you also ought to reduce leverage in the system, and I think we've gone, to some degree, in that direction.

But there will be too big to fail institutions 10 years from now or 20 years from now. Right now Freddie Mac and Fanny Mae are sort of too big to figure out.

We just sit there — and incidentally, here's nothing wrong with that. It's more important to come up with the right solution than it is to come up with an immediate solution on those.

But particularly, I would say, in Europe there are banking institutions in countries that people are facing the question of whether they are too big to fail.

Charlie?

CHARLIE MUNGER: Well, my answer is that the past panics and depressions, by and large, started on Wall Street or in stock brokerages.

They tended to involve great waves of excessive speculation and bad behavior in the people who were profiting from those waves as salesman, or market makers, or promoters or what have you.

And I think that this last mess, which created so much danger, should have caused something like happened in the aftermath of the '30s, where we prevented a new mess for a long, long time, but, of course, it hasn't done that.

And so I think you can confidently expect a new mess or two before you career is over, and I think it is really stupid for our country to have allowed this.

Partly the failure is not one of evil, it's one of stupidity. And part of the stupidity is in our great academic institutions who believe a whole lot of things that aren't true. And that is a really hard problem to solve.

WARREN BUFFETT: You're talking about particularly in finance?

CHARLIE MUNGER: Yes, of course, and economics, too.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Those are not hard sciences, finance and economics. And finance really attracts people who should have gone into snake charming or — (Laughter)

WARREN BUFFETT: If there's anybody we've forgotten to insult, just pass a note up, and we'll get to you. (Laughter)

CHARLIE MUNGER: Yeah.

7. No Washington Post shares will be sold after board resignation

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: This question comes from a shareholder based in Washington, DC, who has asked to remain anonymous.

This person says, "Warren, in the past year you and Melinda Gates resigned from the board of the Washington Post. What does this say about Berkshire's intention to hold the Washington Post stock over the long term, and is this related to the problems at its for-profit education business, Kaplan?"

WARREN BUFFETT: No, I made this statement, actually, publicly, and they may have only run it in the Post, I'm not sure about elsewhere.

But I made the statement that we would not be selling any stock, and it had nothing to do with that, that I'm a phone call away from Don Graham or anybody else at the Post, and they can just save a lot of directors fees and I can save a lot of travel if at age 80 I decide that I'd rather spend a few more days at Berkshire and less on the road.

I am — we will not be selling any Post shares.

Normally I won't comment about what we'll do on marketable securities, but I'll be unequivocal about that.

And my enthusiasm for the Post itself and the management is 100 percent what it's always been, and I — I'm just available a lot cheaper than before if the Post management wants any advice.

I don't think Melinda did it on the basis of age. You'll have to ask her.

I really decided at 80 that I'd been there since 1974, with an interruption when I was at Cap Cities/ABC, and it's just a lot easier this way.

Charlie, do you have any thoughts on serving on boards generally? Charlie is on the Costco board.

CHARLIE MUNGER: Well, that's because I really admire Costco. And that's one of the pleasures of my life, is interfacing with those people.

But that's the only one where we don't — where I don't have a big ownership interest.

I think, generally speaking, serving on a whole lot of different boards is for the birds. (Laughter)

WARREN BUFFETT: Yeah. I agree. (Laughs)

8. Can't predict if Berkshire will outperform the Australian dollar

WARREN BUFFETT: OK. Area 12.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I'm Marc Rabinov from Melbourne, Australia.

As an investor from the Asian region, I am concerned that a weaker dollar will erode the value of my Berkshire stock.

However, Berkshire is highly productive with real pricing power, so can I be confident that over the long term any fall in the dollar will be offset by a rise in the value of my Berkshire stock? And by that I mean in addition to any intrinsic growth in the underlying business.

CHARLIE MUNGER: The answer is no. (Buffett laughs)

WARREN BUFFETT: It would be a lot easier if you just had the Australian dollar go down. The Australian dollar was one of two currencies that we did own last year that contributed to the $100 million profit.

But, no, I cannot tell you what policies will be followed in the United States and what policies will be followed in Australia that will — what they will be and how they will affect the relative value of those two currencies, say, 10 years from now.

I think the movement could be quite dramatic, and I think it actually could be dramatic in either direction. That's why I don't know what to do.

But the only promise you'll get from Charlie and me about Berkshire is that we do every day, as I said in the annual report, try to think about increasing the earning power and the intrinsic value of Berkshire.

And to the degree we increase it, the shareholders will — or to the degree we decrease it — the shareholders will share in exactly the same proportion as Charlie and I do.

We will — our interests are 100 percent aligned. We will make or lose money through our stock and luck, to some extent, will depend — will determine — how well we do.

We know we can't do remotely as well in the future as we have in the past.

There is no way to compound — there's no way we know to compound the kind of sums we're working with now at rates that are anywhere close to what we were able to do when working with much smaller sums. But you'll get our best efforts.

Charlie?

CHARLIE MUNGER: I can't add to that.

Australia has these fabulous open pit mines, and at a time when Asia is just totally booming with its demand for metals, I can't tell you how Berkshire stock is going to perform vis-a-vis mines in Australia.

I think we'll do pretty well compared to companies here in the United States.

WARREN BUFFETT: Yeah, I think so, too.

9. We're not neglecting the stock portfolio

WARREN BUFFETT: Carol?

CAROL LOOMIS: This shareholder wishes to be known only by his initials, AJ.

The importance of Berkshire's equity portfolio has diminished other the past few decades. Today I view Berkshire's appetite for equity as an afterthought and instead see its focus as being on large acquisitions.

Would you agree with this, and where do you see the equity portfolio going over the next five or 10 years?

WARREN BUFFETT: Well, I prefer large acquisitions, but it's not an afterthought at all in terms of the portfolio.

I mean, we — Charlie and I spend — well, we probably spend more time thinking about the portfolio because it's only occasionally that we get a chance to think about acquisitions that are sizable and that are available to us.

So we are equally interested in both aspects of Berkshire's operations. But where we hope we really get lucky is in adding significant companies to what we have already, and having our — the companies that we already own — make various bolt-on acquisitions.

We've had several of those already this year that you don't read about.

A lot of our companies have the potential to do — to earn — considerably more money five or 10 years from now than they're earning now.

So both the development of those businesses, which really resides with the managers — Charlie and I don't contribute anything on that — but we will — we spend as much time thinking about the portfolio as we ever did.

And, you know, it's important. I mean, if you talk about $150-some billion in cash and marketable securities, the performance of that particular segment is going to have a lot to do with how well Berkshire does over time.

Charlie?

CHARLIE MUNGER: Yeah, we'll always have a fair amount of marketable securities because of our insurance subsidiaries and — but as we get forced by our size into the bigger and bigger stocks, of course we're going to do less well than we did when we had a bigger universe of practicable things to consider.

WARREN BUFFETT: A lot less well. I mean, it really is the nature of things.

We are buying securities where we have to put billions of dollars in them in most cases, and that is not a field that is unlooked at by other analysts.

So it's impossible to have a big edge. We hope we have a small edge.

CHARLIE MUNGER: On the other hand, when we were doing so well in marketable securities, nobody called us and said, I have a wonderful business, and you're the only place in the world where I would want to transfer it.

And now that happens, what, a couple times a year at least?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And I really prefer, in some ways, this part of the game to the earlier game. It's more fun to create permanent partners doing constructive things than just outsmart other people and shuffling little pieces of paper.

WARREN BUFFETT: It's fun to do both, actually. (Laughter)

CHARLIE MUNGER: Yeah. Well, I don't see you holding back. (Buffett laughs)

10. "We have an unbelievable insurance operation"

WARREN BUFFETT: OK. Let's go to the other room. 13.

AUDIENCE MEMBER: Hi, I'm Whitney Tilson, a shareholder from New York. Thank you for including in your latest annual letter such complete and clear valuation information regarding Berkshire.

You stated that the operating earnings of the insurance businesses are excluded from your earnings table, and I know you said this morning that 2011 is going to be a break-even year at best.

But in light of the disclosure in the annual report that Berkshire earned $17 billion in profit over the last eight years without a single money-losing year, are you being overly conservative?

Don't you think the intrinsic value of your insurance businesses is more than just their float, especially GEICO, for the reasons you discussed this morning?

WARREN BUFFETT: Yeah, I'd agree with that, Whitney, but I — it's very hard to estimate, you know, what the normal underwriting profit might be — might be over the next 20 years or something of the sort.

And so I agree with you. I don't know whether I'd call it overly conservative. I would say it's conservative to assume break-even underwriting.

But as you — I mean, if we had another Katrina or something of the sort — and forget about, you know, winter storms in Europe and all that — I mean, we could lose significant money in underwriting this year, and we expect to lose significant money in underwriting, you know, maybe every fifth year, every tenth year, whatever it might be.

But I think you're right in saying it would not be inappropriate to include some normalized underwriting profit in addition to the calculation that I made in the annual report.

CHARLIE MUNGER: Whitney, let me help you by asking another question of Warren. Is there any other large casualty insurance operation in the world that you know of that you would trade for ours?

WARREN BUFFETT: Not remotely — no, no. Nothing close. I mean, we — however we lucked into it, we've got — we have an unbelievable insurance operation.

And, I mean, GEICO, you know, is fabulous. And, you know, if you think about — since 1936, the idea has been out there, but, you know, with all the strength that all the other companies had, and the agency plants and everything else, GEICO has now moved to where it's the third largest in the United States and gaining ground every day on the two ahead of them, and doing it very profitably.

GEICO's combined ratio — GEICO had an underwriting profit of close to eight points, as I remember it, in the first quarter. Now that's going to be, probably, the best quarter of the year, I should add, but it's a marvelous business.

Ajit [Jain] has built an insurance business from scratch in the reinsurance business, that, in many respects, you know, he operates all alone.

He may not see a lot of transactions in any given period of time, but there are certain things, where if somebody wants huge amounts of insurance and a quick answer, or even a slow answer sometimes — we'll give them a quick one — there's really nobody else to call. It's a little like Charlie mentioned on acquisition opportunities.

So he's — and he's done it. I mean, it didn't exist when he got there.

Tad Montrose has got a magnificent operation at Gen Re. It had to get shaken out to quite a degree, but Tad has got a very, very disciplined business there.

And then we have a group of smaller companies that some of them have some very unusual franchises.

So there really — you know, I didn't have anything to do with it, so I can brag about these people, but they have really done a job in building an insurance company that I don't think there's anything like it.

CHARLIE MUNGER: Some of you people that have been around a long time, you invested with an Omaha boy, and you ended up owning part of the best casualty insurance business in the world.

WARREN BUFFETT: If you go to 30th and Harney, you'll see a building there, National Indemnities. We paid 7 million for National Indemnity, a million-four for its sister company National Fire & Marine, and that's the same building that we operated out of in 1967, we're operating out of today.

The only difference is that today it's got more net worth than any insurance company in the world.

CHARLIE MUNGER: Yeah, so we — it's not that great a business as a business, casualty insurance.

It's a tough game. There are temptations to be stupid in it. It's like banking. (Laughter)

And — but if you're in it, I think we've got the best one.

11. Why See's Candies does well in inflationary times

WARREN BUFFETT: With those modest statements, we'll move onto Becky. (Laughs)

BECKY QUICK: This question comes from Mark Jordan (PH) in Charleston, South Carolina.

He writes, "In a period of high inflation, which particular businesses owned by Berkshire Hathaway will perform the best, and which will perform the worst and why?"

WARREN BUFFETT: Well, the businesses that will perform the best are the ones that require little capital investment to facilitate inflationary growth and that have strong positions that allow them to increase prices with inflation.

And, you know, we have a candy business, for example, and the value of the dollar since we bought that candy business has probably fallen at least 85 percent, I would say — 80 to 85 percent — and that candy business sells 75 percent more pounds of candy than it did when we bought it, but it has ten times the revenues and it doesn't take a lot more capital.

So that kind of a business — any business that can — that has enough freedom to price to offset inflation and doesn't commensurate invest — or huge investment — to support it, will do well.

Businesses like our utilities which get, in effect, a bond-like return but require — you know, if you're going to build a generating plant and it costs twice as much per kilowatt hour of capacity, and all you're going to get is a fixed return and yields on bonds go up, perhaps dramatically, to get high inflation, is not going to do that well in an inflationary period, just because it has certain aspects of a bond-like investment, and bonds generally are not going to do well in inflation.

Charlie?

CHARLIE MUNGER: Well, but like our insurance operations, our capital intensive railroad business is certainly one of the best railroads in the world. And our utility operations are certainly one of the best utility operations in the world.

And so it isn't all bad to be up there, world class, in your main businesses.

WARREN BUFFETT: Our railroad — the government has talked about building a high-speed rail system in California.

I think they're talking about 800 miles of track, and their estimated cost was about 43 billion, and estimated costs on construction and things like that go up dramatically much more often than they get reduced even by a minor amount.

And, of course, we paid 43 billion, counting debt assumed, for our rail system, which has 22,000 miles of main track and 6,000-plus locomotives, and 13,000 bridges, if you ever want to buy a bridge.

So that — the replacement value of that asset during inflation already is huge and it would grow dramatically, and the world — our country will always need rail transportation. So it — it is a terrific asset to own, I'll just leave it at that.

12. "May you live until the A stock splits"

WARREN BUFFETT: OK. Area 1 again.

AUDIENCE MEMBER: I'm Martin Greenberger, UCLA Anderson School, where I work in disruptive technologies, not finance.

WARREN BUFFETT: You're forgiven. Go ahead. (Laughs)

AUDIENCE MEMBER: My friend Walt would like to know if Berkshire has been considering splitting its Type A shares, like it did its Type B shares, and if so, what are the pros and cons, in your opinion? And what would be the short-term and longer-term effects?

WARREN BUFFETT: Yeah. Well, in effect, we've already split it, you know, 1500-for-one by having the B available.

And, you know, we have a situation where the company will never be sold, but if any transaction involves the A stock, the B shares are going to get treated exactly the same. So there's really no disadvantage to owning the B stock, except it has somewhat less voting power than the A stock.

But in every other way it's the same instrument, and so we already have a split stock available.

So I would tell Walt that he really should not count heavily on the A stock getting split.

Charlie?

CHARLIE MUNGER: Yeah, Warren used to cheer up his old friends by telling them, may you live until the A stock splits. (Laughter)

WARREN BUFFETT: And I would love to make that deal myself. (Laughs)

13. Buffett's best deal: hiring Ajit Jain

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from Matthew Palmer of North Andover, Massachusetts.

And he writes, "Mr. Buffett, you have praised [Berkshire Hathaway reinsurance chief] Ajit [Jain] as a possible successor. Since he may be in line as our next CEO, can you give us a concrete example of a policy that he's written that's impressed you, and can you talk a little about the way he thinks since we rarely get an opportunity to hear from him?"

WARREN BUFFETT: Yeah, Ajit is not exactly a publicity hound.

Ajit — (laughs) — he —

I can't think of any decision he's ever made that I think I could have made better.

And I've — I'm not privy to all of his transactions anymore. There just — there are lots of them that are not of huge size or of great interest, but he tells me about all the interesting things that come along and all the very big things that come along. And I would say this: you'd be better off voting with him than with me after listening to any proposition he brings up.

He is as rational a thinker as Charlie is, as anybody I've met. He loves what he does.

He's creative. He's very creative. We have moved into one area after another in reinsurance when people came in copying us in one area of business that we would be operating in. Ajit comes up with something else.

Lately we've been much more active in life reinsurance, but who knows tomorrow brings. I mean, if there happens to be a huge cat in the third quarter of this year or something of the sort, that might open up all kinds of opportunities in writing covers when — if capacity got strained.

But who knows what will happen. All I know is that Ajit's mind works like a machine, you know, day after day. And he does love what he does, which is an important part of doing well at any activity.

And I really — I don't know what his best deal was. I know what my best deal was, which was hiring him.

Charlie?

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

Well, Ajit is real interested in what he does. Many of you don't know this, but every Thanksgiving, Ajit flies to London because they don't have a Thanksgiving holiday. (Laughter)

WARREN BUFFETT: We give him Christmas off, though. (Laughter)

Ajit, we just — he — I say how invaluable he is, and I'm not exaggerating when we talk about him. He is — to an extraordinary degree, he thinks of Berkshire first.

Ajit, at various periods when insurance companies became popular for one reason or another, there was, you know, there was the big thing about Bermuda companies some few years ago, Ajit could have monetized himself to an incredible degree. Still could do it.

I mean, people would hand him a significant percentage of any company being formed with lots of money, so that immediately he could create, I would guess, in the hundreds of millions of wealth without lifting a finger, just by somebody putting up, you know, a couple billion dollars and saying you've got 20 percent of it or whatever it may be.

I mean, listen, he's smart. He knows that, and it doesn't cross his mind to do anything like that.

I mean, he — we have, in comp — he always thanks me for what I do at the end of the year, and I feel I've left off a zero, you know, when I get all through. (Laughs)

He's just a remarkable human being. And we are very, very lucky that, I think, he has a lot of fun in what he does at Berkshire.

He's got a cadre of about 30 people that work with him. There's many more that are settling claims and doing that sort of thing on runoff business, but it's — you won't find anything like it, in my view, not only in the insurance world, but really in almost any part of the business world. (Applause)

WARREN BUFFETT: Let's go —

CHARLIE MUNGER: You didn't answer the question. Maybe you avoided it on purpose.

WARREN BUFFETT: Oh.

CHARLIE MUNGER: He said, what are our worst businesses?

WARREN BUFFETT: What are our worst businesses?

Well, generally speaking — and this is general — I have — well, made certain mistakes in going into smaller businesses that really never had the potential of becoming big.

But I would say overall, probably, I would call retailing — you know, Dexter was our worst business, but I've — the Furniture Mart, obviously, is a terrific operation. But we have not made — despite being in numerous retailing — quite a few — retailing business for quite a while, we have not created major earning power there.

Wouldn't you agree on that, Charlie?

CHARLIE MUNGER: Yeah, but luckily it's a small part of the operation.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: But you're right. That's been the hardest game for us. And, you know, if we were a little smarter we could have figured that out better. (Laughs)

WARREN BUFFETT: Well, if we were a little smarter we could have done a lot of things. (Laughs)

Of course, See's is a retailing business, to some degree.

CHARLIE MUNGER: Yes.

WARREN BUFFETT: And we had enormous success there, so maybe we started thinking we were geniuses. We are like the duck on the pond when it was raining, and we thought we were rising in the world because of merit and it was just because it was raining. (Laughter)

14. "Forget about goodwill" when evaluating a business

WARREN BUFFETT: OK. We'll go to number 2.

AUDIENCE MEMBER: Joe Tellinghas (PH), Boston, Massachusetts.

What's the proper way to think about goodwill and return on capital?

Berkshire's manufacturing, service, and retail businesses earn pretax returns on tangible capital over 20 percent, which suggests either skilled managers or fantastic businesses. But the return on allocated equity is in the single digits, which looks drab.

Accountants treat intangibles similarly because they have different economics. (Inaudible)

For an indestructible brand like See's or Coca-Cola, I can see why the intangibles should not be amortized because it's worth more every year, and your comments on GEICO policyholders were one way to think about that.

But all the tobacco companies have billions of dollars of goodwill in unit sales of cigarettes to claim every year in developed countries, so perhaps they should be amortized. And for Time Warner- AOL, goodwill definitely needed to be amortized.

WARREN BUFFETT: Yeah, goodwill — you mention AOL-Time Warner or something of the sort, it should be written off, actually. It was just a mistake in purchase price.

Goodwill should not be used in evaluating the fundamental attractiveness of a business. There you should look at return on tangible assets, and even then there's some minor — some other adjustments you may want to make.

But basically, in evaluating the businesses we own, in terms of what the management are doing and what the underlying economics of the business are, forget about goodwill.

In terms of evaluating the job we're doing in allocating capital, you have to include goodwill, because we paid for it.

So if we buy — you know, Coca-Cola goes back to 1886 and John Pemberton at Jacobs Pharmacy in Atlanta, and there was not a whole lot of goodwill put on the books when he sold that first Coca-Cola.

If you were to buy the company now, the whole company, you'd be putting a figure, you know, of 100 billion or something like that on it.

You shouldn't amortize that, and you shouldn't, in judging the economics of the business, look at that.

But in terms of judging the economics of the business that purchased it — we'll call it Berkshire — then you have to allow for the goodwill, because we are allocating capital and paying a lot for it.

I don't think the amortization of goodwill makes any sense. I think write-offs of it, when you find out you've made the wrong purchase and the business doesn't earn commensurate with the tangible assets employed plus the goodwill, I think write-offs of it make sense.

But when looking at businesses as to whether they're good businesses, mediocre businesses, poor businesses, look at the return on net tangible assets.

Charlie?

CHARLIE MUNGER: Well, I think that's right. But as the gentleman says, when we buy a business, a whole business, we never get a huge bargain and, of course, we may get down toward 10 percent pretax earnings on what we pay.

That isn't so awful as you think when you — a lot of the money comes from insurance float that costs you nothing.

In other words, if you have 60 billion of float and God gives you 6 billion a year earnings, it's not all bad.

WARREN BUFFETT: Well, on Lubrizol we're paying close to 9 billion for the equity, and it earns — and you should make adjustments for debt but it's not an important factor there — and, you know, current rate of earnings is probably a billion pretax.

And now Lubrizol itself is employing far — you know, they're employing, you know, call it 2 1/2 billion of equity to earn that billion of pretax, so it's a very good business, in terms of the assets that are employed. But when we end up paying the premium we pay to buy into it, it becomes a billion pretax on something close to 9 billion.

You have to judge us based on close to a $9 billion investment. You have to judge James Hambrick in running the business based on the much lower capital that he has employed.

It can turn out to be a very good business, and we could turn out to have made at least a minor mistake if it isn't as good a business as we think it is now, but still is a very satisfactory business based on the tangible capital employed.

Charlie, can you make that clearer? (Laughs)

CHARLIE MUNGER: Well, it's just — we are not going to buy, in the climate we're in now, operating businesses that are at all decent for low prices. It's just not going to happen.

15. Munger really loves Costco

WARREN BUFFETT: Carol?

CAROL LOOMIS: In a book about Charlie, "Damn Right!" by Janet Lowe, Charlie talks about his view on teaching finance.

He says that he would use the histories of a hundred or so companies that did something right or wrong as a basis for teaching the course.

Could each of you — and since this concerned Charlie, could each of you — we'll start with Charlie — give us an example or two from either category, right moves or wrong moves?

WARREN BUFFETT: I predict Charlie is going to talk about Costco. Go ahead, Charlie. (Laughs)

CHARLIE MUNGER: Well, Costco, of course, is a — (laughter) — a business that became the best in the world in its category, and it did it with an extreme meritocracy and an extreme ethical duty, self-imposed, to take all its cost advantages as fast as it could accumulate them and pass them onto the customers. And, of course, that created ferocious customer loyalty.

And it's been a wonderful business to watch, and, of course, strange things happen when you do that and do that long enough.

Costco has one store in Korea that will do over 400 million in sales this year. These are figures that can't exist in retailing, but, of course, they do.

And so that's an example of somebody having the right managerial system, the right personnel selection, the right ethics, the right diligence and et cetera, et cetera, et cetera. That is quite rare.

And if you — if once or twice in a lifetime you're associated with such a business, you're a very lucky person.

And the more normal business is a business like, say, General Motors, which became the most successful business of its kind in the world and wiped out its common shareholders, what, last year?

That is a very interesting story, and if I were teaching in a business school, I would have Value Line-type figures that took people through the entire history of General Motors. And I would try and relate the changes in the graph and in the data to what happened in the business.

And to some extent, they faced a really difficult problem: heavily unionized business, combined with great success, and very tough competitors who came up from Asia and elsewhere, and to some extent from Europe. And that is a real problem, which, of course — to prevent wealth from killing you, your success turning into a disadvantage, is a big problem in business.

And so there are all these wonderful lessons in those graphs. And I don't know why people don't do it. The graphs don't even exist that I would use to teach.

I can't imagine anybody being dumb enough not to have the kind of graphs I yearn for. (Laughter)

But so far as I know there's no business school in the country that's yearning for these graphs.

Partly the reason they don't want it is if you taught a history of business this way you'd be trampling on the territories of all the little professors in subdisciplines. You'd be stealing some of their best cases.

And in bureaucracies, even academic bureaucracies, people protect their own turf. And, of course, a lot of that happened at General Motors. (Applause)

Yeah.

It's a — I really think the world — that's the way it should be taught. Harvard Business School once taught it much that way, and they stopped.

I'd like to make a case study as to why they stopped. (Laughter)

I think I can — I think I can successfully guess. It's that, of course, the history of business trampled on the territory of barons of other disciplines like the baron of marketing, the baron of finance, the baron of whatever.

And IBM is an interesting case. I mean, there's just one after another that are utterly fascinating, and I don't think they're properly taught at all because nobody wants to do the full sweep.

WARREN BUFFETT: Charlie and I were on a plane recently that was hijacked.

CHARLIE MUNGER: With what?

WARREN BUFFETT: It was hijacked. I'm telling about our experience on that hijacked plane when the hijackers picked us out as the two dirty capitalists that they really had to execute.

But they were a little abashed about it. They didn't really have anything against us, so they said that each of us would be given one request before they shot us, and they turned to Charlie and they said, "What would you like as your request?"

Charlie said, "I would like to give once more my speech on the virtues of Costco, with illustrations." (Laughter)

And the hijacker said, "Well, that sounds pretty reasonable to me."

And he turned to me and said, "And what would you like, Mr. Buffett?"

And I said, "Shoot me first." (Laughter)

CHARLIE MUNGER: Anyway.

16. Incentivizing kids

WARREN BUFFETT: OK. Number 3.

AUDIENCE MEMBER: Sumat Mehra (PH) from Kashmir in India. Mr. Buffett, hope you enjoyed your first trip to India.

WARREN BUFFETT: I sure did.

AUDIENCE MEMBER: Here's my question. One of the most important things that drive people are incentives, but if you live in a rich society it's very hard to get your kids to work hard and reach their full potential because they just don't need to.

So if you or Charlie decide to have a kid in the next five years — (Laughter)

CHARLIE MUNGER: It would be a star in the east.

WARREN BUFFETT: It will take more than a decision. (Laughter)

AUDIENCE MEMBER: How would you incentivize him or her —

WARREN BUFFETT: I thought you were going to say, "How would you?" (Laughter)

No, it's a good question. I apologize for interrupting.

AUDIENCE MEMBER: How would you incentivize him or her to compete among the hungry and highly motivated kids from emerging markets like China, Brazil, Russia, or India?

WARREN BUFFETT: I think certainly that if you are very rich and you bring up your kids to think that they are more important in society, or that they have some special privilege, simply because they came out of the right womb, that, you know, that's just a terrible mistake.

But Charlie has raised eight children that I know quite well, most of them, and I don't think any of them have that sense.

But it's — if you really are going to raise your kids to think that other people should do all the work for them and that they will be entitled to sit around and fan themselves for the rest of their lives, I mean, you know, you will probably not get a good result.

I — you know, in my — Charlie has been rich most of the time when his kids — many of his kids — were growing up — some of his kids were growing up,

I've been rich while my kids were getting — certainly when they got into high school and college — but I don't think — I certainly didn't want to give them the idea that they were special just because their parents were rich.

And I don't think you necessarily have to get a bad result or have children that don't have any incentives simply because their parents are rich.

The one thing I don't think you want to give them an incentive to do is try and outdo their parents at what their parents happen to be good at.

I don't think that makes sense, whether if you are a professional athlete, or a rich person, or whatever it may be, a great novelist, you name it.

But I really think if you're rich and your kids turn out to have no incentives, I don't think you should point at them. I think you should probably point at yourself.

Charlie?

CHARLIE MUNGER: Well, I don't think you can raise children in an affluent family and have them love working 60 hours a week in the hot sun digging fence post holes or something. That's not going to work.

So to some extent, you are destroying certain kinds of incentives. And my advice to you is to lose your fight as gracefully as you can. (Laughter)

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

CHARLIE MUNGER: Kids that really get interested in something will work no matter how rich they are.

But it's rare to have an Ajit-like intensity of interest.

You know, if you were a proctologist, you might not like your day as it went on and on. (Laughter)

WARREN BUFFETT: I think we better move along. Becky? (Laughter)

17. Compensation incentives for Berkshire's next CEO

BECKY QUICK: This question comes from a shareholder from central Iowa who asks, "Berkshire Hathaway does well, in part, because its managers want to be there for nonpecuniary reasons. But it seems likely that the next operations CEO will be best be filled by someone who insists on a salary of more than $100,000.

"What kind of compensation structure do you expect for the next generation of Berkshire leadership?"

WARREN BUFFETT: Well, I think the next CEO will make a lot of money and should make a lot of money.

I mean, the responsibility for running a company with a couple hundred billion dollars of market value should pay well.

I think that whatever the level the board decides then, in terms of a base salary, should be supplemented by, probably, an option system that incorporates a couple things that are perhaps unusual.

I don't think the option price — the original strike price — should be less than if the company were for sale, the assets would bring.

So the idea of giving somebody an option during some depressed part of the stock market at the market price, I think, is crazy because you wouldn't sell your business at that price and why sell part of it on that basis.

So I think the base price should be what the business is worth at the time you start, and then I think if, because of the compounding feature of leaving money there — you know, no management at all would produce some gain in value over time — so I think there should be an increase in the base price annually at some rate, and then minus the dividend that's being paid.

So, if you assume a 3 percent dividend was paid, and you wanted to have a hurdle rate of increasing at 7 or 8 percent a year, then you would have the option price accelerate, maybe, at 4 or 5 percent.

But with that kind of a structure, I think you can give a very large option because you — if somebody is creating excess value above a given rate on a very large sum, I think they deserve something quite significant in terms of that excess earned.

Now, they — the present compensation system has no relevance at all to what my successor should earn. The main thing is getting the right person with the right values who interacts well with the managers and who knows how to allocate capital.

And as you just heard a little earlier, our managers who accomplish a lot, if they — and if they're working with big operations so that it turns into a lot of dollars — they can make a lot of money with Berkshire.

They — nothing is worked off the eccentricities of Charlie and me at the top level.

So, you know, people make well into eight figures, sometimes, at Berkshire. But they earn it, and they don't get it because of any phony targets or anything of that sort. They get it because they really deliver incredible, in some cases, excess value to Berkshire.

Charlie?

CHARLIE MUNGER: Well, I hope it will be a long time in the future, and I don't regard it as absolutely inconceivable that Warren's spot will someday be occupied by a very rich man who has adopted Warren's system of pay.

I think somebody in America has to be the exemplar for not grabbing all that you can. I think it's a very important part of the whole scheme. (Applause)

WARREN BUFFETT: I don't think you better run an ad, though, after I go, that says CEO wanted, $100,000 pay plus pleasant surroundings. (Laughs)

18. Societal issues are important but don't affect investment decisions

WARREN BUFFETT: OK. We'll go to number 4.

AUDIENCE MEMBER: Hi, Mr. Buffett, Mr. Munger. My name is Vern Cushenbery and this question is on behalf of a group of investors that made the trip up today from Overland Park, Kansas.

Given your interest in renewable energy and natural resources, I wonder if you'd be willing to share your thoughts on how a world of limited and depleting clean water supplies and declining food stocks affects your investment strategies and thinking on the future.

WARREN BUFFETT: Yeah, I would say it's an important subject but it doesn't affect our investment strategy to any real degree.

In other words, you know, we would love to buy another GEICO. We would love to buy another BNSF. We'd love to buy another MidAmerican.

And we look at those businesses over a long time frame, but we are looking at what we expect their earning power to be three, five, 10, 15 years down the road compared to what we are paying.

So I would say that there are a number of societal issues that really do not enter into our investment or purchase of business-type decisions.

Charlie?

CHARLIE MUNGER: Well, I would advise not paying too much attention to the clean water issue. If there's enough energy, you can always get enough clean water.

Israel sometimes goes month after month making half its water from sea water. With enough energy, why, you have — the water problem goes away. And that's very helpful in considering the future.

And regarding the agricultural productivity, I think one of the main reasons for being restrained in the use of hydrocarbons is that modern agriculture won't work without them.

So I'm a great believer in being conservative, in terms of blowing all the hydrocarbons on heating houses and running cars. I think that — think of how happy we'd be if we'd taken a bunch of that dollar oil in the Middle East and just carted it here and put it in salt caverns.

I mean you could argue that we really screwed up the past, and you could argue all the people who think that our main solution is to drill, drill, drill. They're all nuts. (Laughter and applause)

It's probably quite wise to use up the other fellow's hydrocarbon while preserving our own.

It's not going away because we are not drilling it now.

But you can see that this will lead into unproductive discussion. (Laughter)

19. We wouldn't participate in an auction for any company

WARREN BUFFETT: OK. We'll move right onto Andrew.

ANDREW ROSS SORKIN: This next question, actually, just came in by email from someone in the audience from their BlackBerry, actually a prominent investor that asked that his name not be named.

And his question is the following: He writes, "Your purchase of Lubrizol was done in a negotiated transaction. The board of Lubrizol did not market the company for sale nor run an auction.

"According to the proxy, you did not permit the company to run a go-shop process, despite the requests you allow them to do so.

"Did the board of Lubrizol breach its fiduciary duty by not running a more competitive process to sell the company? And if not, why not?"

CHARLIE MUNGER: Let me do this.

WARREN BUFFETT: OK. Charlie will. (Laughter)

He volunteers —

CHARLIE MUNGER: The answer is no, the board at Lubrizol did not breach its duty because we were not going to participate in the transaction if they didn't do it our way. (Laughter and applause)

WARREN BUFFETT: Yeah, we basically don't participate in auctions.

And actually, just very, very recently we were asked to participate in one, and we're just not interested.

They may end up getting less money than they would have gotten from us. But if they want to auction it, the one thing I can guarantee them, you know, is that when they get all through, we will not pay them what we would have them paid originally if they stepped up.

So they get a very certain deal, they got a very significant price, in my view, and in the view of two advisors.

And if they had said we want to conduct an auction, we would have said good luck, and we'd have looked at something else.

CHARLIE MUNGER: Has anybody else got an easy question? (Laughter)

20. How to judge if Buffett is doing a good job of allocating capital

WARREN BUFFETT: OK. Number 5.

AUDIENCE MEMBER: Hi, Charlie. I think I have an easy question. My name is —

WARREN BUFFETT: Give it to me then. (Laughter)

AUDIENCE MEMBER: My name is Stuart Kaye from Matarin Capital Management in Stanford, Connecticut.

And, Warren, you've often described a big part of your job is allocating capital.

Going forward, by just looking at Berkshire's financial statements, how can we determine how good of a job you have done at allocating capital?

WARREN BUFFETT: Well, the real test will be whether the earnings progress at a rate that's commensurate with the amount of capital that's being retained. And over time, a market value test — but markets can be very volatile and capricious — but over time, obviously, we — unless the market value of Berkshire is significantly greater than the amount of capital that we have kept from you, retained, and used to buy businesses, you know — the verdict is against us if we ever start selling at a discount to that factor.

But you just have — and, you know, it is not a perfect measurement and certainly is not on any three-month or six months or even one-year basis, but over time, if we're going to keep your money, we have to earn a better-than-average return on that money we keep and that has to translate into the stock selling at a premium over the money we retain from you.

And so far we've done OK on that, but the job gets tougher every year.

Charlie?

CHARLIE MUNGER: Yeah. We have continued to beat the market averages. We just aren't beating our own past record. And I guarantee that will continue, at least the last half of it. (Laughter)

WARREN BUFFETT: Yeah. Only the last half of it, right?

CHARLIE MUNGER: Yeah.

21. Don't compare opportunities now to your best-ever deal

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: This question is from Mike Rifkin (PH). He wants to ask about five transactions you've made in recent years with very different terms.

Goldman, 5 billion at 10 percent plus warrants; GE, five billion at ten percent plus warrants; Dow Chemical, 3 billion at 8.5 percent convertible to common; Wrigley- M&M Mars, 4.4 billion at 11.45; Swiss Re 2.7 billion at 12 percent.

Now, why the different interest rates you set and how about why the warrants in some cases, and why did the rich Mars family need 4.4 billion to do a deal, and at 11.45 percent?

WARREN BUFFETT: Well, we'll let the Mars family speak for themselves.

But in terms of comparing those five deals, it was 3 billion with GE, and the Mars deal actually involved a $2.1 billion preferred stock, which has some usual characteristics, so you have to look at it as a package.

But the important thing is that every one of these deals was done at a different time, although the Goldman and the GE deals were done in close proximity with each other.

And market conditions — you know, you heard Charlie in the movie talk about opportunity costs. Our opportunity costs were different in every single one of those five transactions. And incidentally, we could have done a much better — I could have done a much better — job of allocating our money, you know, in terms of the post-panic period.

I was early on Goldman and GE, compared to the situation five months later. But, you know, we don't have — we not only don't have perfect foresight, sometimes it's pretty bad.

But each deal — when I did the Swiss Re deal, I was not thinking about the Dow Chemical deal, which was committed to, maybe, a year-plus earlier. I was thinking about what else I could do with $2.7 billion, and that's the way all the decisions are made.

So they are not related — they're not related to each other. They go through a mind that is looking at everything available that day, including the amount of cash we have, the likelihood of being able to do something else next week or next month, what else we can do that day. And past deals we've made don't really make any difference.

In fact, one of the things — one of the errors people make in business — and sometimes it can be a huge error — is that they try and measure every deal against the best deal they've ever made.

So they say, you know, I made this wonderful deal for, maybe, an insurance policy written, or it might be a company bought, it might be a stock bought, and they're determined that they're never going to make a deal that isn't that attractive in the future.

So they, in effect — sometimes they take themselves out of the game.

The goal is not to make a better deal than you've ever made before. The goal is to make a satisfactory deal that's the best deal you can make at the time. And Charlie relates it to marriage, and I'll let him expand on that. (Laughter)

CHARLIE MUNGER: No, those are — of course, we're going to make different deals at different times based on different opportunity costs. There's no other rational way to make deals.

22. You don't have to read quickly but you should read

WARREN BUFFETT: OK. We'll go to number 6.

AUDIENCE MEMBER: Keith McGowan, Norfolk, Massachusetts. Thank you, Mr. Buffett and Mr. Munger. Thank you for being a role model.

Your ethics, frugality, sense of humor, honesty, sharing your ideas on investing, sharing your ideas on business, make this world a better place for everyone. (Applause)

Charlie mentioned in a prior answer about continuous learning. Mr. Buffett, you read about five newspapers a day. You also read many annual reports and other business-related reports.

You have the ability to read much faster than the vast majority of people. Reading is a fantastic thing.

What advice would you give to children in high school, college, or adults who want to increase their ability to read faster?

WARREN BUFFETT: Well, you know that's an interesting question because I do read, as you described, the five papers and lots of 10Ks and 10Qs.

Unfortunately, I'm not a fast reader, and I'm not as fast as I used to be on reading.

But I don't know how effective various speed reading classes may be, but if they are effective, you know, I would — I would really suggest anybody that can improve their speed — I wish I could read a lot faster than I can.

Charlie can read faster than I can. And it's a huge advantage to be able to read fast.

And, you know, there's a that old Woody Allen story about how he took the speed reading course, and he met somebody, he was telling him how wonderful it was, and the guy said, "Well, give me an example."

And Woody Allen said, "Well," he said. "I read 'War and Peace' last night in 20 minutes. It's about Russia." (Laughter)

That's the problem I have when I try and read fast. I get all through reading the book, and I say, it's about business, you know, so —

I really don't know the effectiveness of speed reading-type courses, but if you know of any friends or — you can learn more about that, and there are effective techniques.

Obviously, the thing to do is to learn them very young because there really — there's nothing — there's hardly anything more pleasurable, you know, than reading and reading and reading and reading.

And Charlie and I do a lot of it. We continue do a lot of it. But I don't do it as fast as I would like to.

Charlie?

CHARLIE MUNGER: Well, I think speed is overestimated. I had a roommate at Caltech who had a very distinguished mind, and I could do problems faster than he could, but he never made a mistake, and I did. (Laughter)

So, I wouldn't be too discouraged if you have to go a little slower. What the hell difference does it make? (Laughter and applause)

Pass that peanut brittle, Warren.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Thank you. Thank you.

WARREN BUFFETT: You may have noticed we have a 15-pound box out for sale in the other room, but Charlie is looking for a 25-pound box.

23. Buffett: There shouldn't even be a debt ceiling

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Eric Wiseman (PH) who asks, "Are you worried about Congress playing politics with the raising of the debt ceiling? What would this do to Berkshire Hathaway stock and to the overall economy?"

WARREN BUFFETT: You mean if they didn't raise it?

BECKY QUICK: If they didn't raise it, right.

WARREN BUFFETT: Yeah, well. It would probably be the most asinine, you know, act that Congress has ever performed.

One time in Indiana back in the 1890s, I think they passed a bill — I know it was introduced — you can look it up on a search engine. They passed a bill to change the value of pi, the mathematical term pi, to an even 3 — (laughter) — because they said it would be easier for the school children to work with.

Well, that's the only bill I can think of that would give competition to a refusal to raise the debt ceiling.

I mean, it's extraordinary. I mean, it really is extraordinary that with our deficit running, you know, well over $100 billion a month, and all kinds of items that can't be changed — I mean, there's — having a debt ceiling to start with is a mistake.

I mean, it doesn't — the United States of 2011 has a different debt capacity than the United States of 1911, and we're always — it's going to be a growing country, and we're going to have a growing debt capacity.

That doesn't mean I think it's a great idea at all to have debt growing, as a percentage of GDP.

But this — the debt ceiling's on — so that these games get played and all the time that gets wasted and everything, and, you know, the amount of — number of — silly statements that you hear. It just seems such a waste of time for a country that's got a lot of things to do.

But in the end, they won't, in my view — there's no chance that they don't increase the debt ceiling and I would love to see them — well, I'd love to see them eliminate the idea, because it results in these periodic kind of stalemate operations where everybody uses it for posturing purposes and everything of the sort.

The United States is not going to have a debt crisis of any kind as long as we keep issuing our notes in our own currency. You know, the difference between being able to borrow in your own currency and having to borrow in another currency is night and day.

The only thing we have to worry about is the printing press and inflation. And if you're a member of the euro, European Monetary Union, you have to worry about — you can't print money. You can go and get your co-members to try and help you out.

But giving up the right to issue debt in your own currency is a huge step. And the United States has not done it. I don't know whether we've ever issued U.S. bonds in any other currency but we certainly haven't made a habit of it.

And the Japanese, incidentally, which have a very ratio of debt-to-GDP, also have consistently borrowed in their own currency.

And believe me, when it's time to pay somebody back, and you have a choice of paying — and you're forced to pay somebody else's currency versus paying in your own — it's entirely a different proposition.

As a matter of fact, Charlie and I, we were trying to buy that bank back in —

CHARLIE MUNGER: Chicago.

WARREN BUFFETT: Yeah, in Chicago in the late 1960s, and this was a time of really tight money.

And tight money was different then than tight money is today. I mean, tight money meant no money.

And somebody — we wanted to buy this bank, and they wanted — the only place we could find some money, I think, was in Kuwait in dinars, wasn't it?

CHARLIE MUNGER: Kuwaiti dinars. (Laughter)

WARREN BUFFETT: And I thought to myself, and Charlie concurred, who the hell knew what they were going to say the value of the dinar was when we went to pay it back. It was not something over which we had a lot of control. So we decided not to borrow the money in dinars even though I kind of wish we'd bought the bank.

Charlie, do you have anything to say on that?

CHARLIE MUNGER: No. (Laughter)

I do think — I do think — you know, I remember an era when we had a bipartisan foreign policy and all that, and I liked that era. And that was the Marshall Plan, and a lot of wonderful constructive things were done, and they were generous things.

Now, it seems to me that both parties are trying to compete to see who can be the most stupid — (laughter) — and they keep topping one another. (Laughter and applause)

WARREN BUFFETT: You can tell Charlie is a fellow who has always filed an accurate income tax form. (Laughter)

He's not worried.

24. Nuclear power is "important" and "safe"

WARREN BUFFETT: Number 7.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I'm John Gorrie (PH) from Iowa City, Iowa, where I'm a happy customer of MidAmerican Energy.

Around 2004, Mr. Buffett, you told us of a great attention you had given to limiting Berkshire's exposure to mega-catastrophes so that one could not break Berkshire.

Today, MidAmerican Energy is seeking approval to build a nuclear power plant in eastern Iowa. At the same time, another utility company, Tokyo Electric and Power, faces claims that Merrill Lynch has estimated as exceeding 12 trillion yen, or $140 billion, to compensate residences and businesses that have been displaced and farmers that cannot produce.

Do you believe that the bond-like return that MidAmerican Energy might receive from a nuclear power plant can justify the mega-catastrophe risk that it would pose to Berkshire?

WARREN BUFFETT: Yeah, I don't think it does pose — I don't know the details of it, and Greg Abel can speak to it better than I can, but I don't think there's anything like the exposure that you refer to.

I think nuclear power is an important part of the world's equation, really, in dealing with its problems on — it's very long term because you're not going to change the installed base in any hurry.

And as you know, France has a very high percentage of nuclear power. And, actually, 20 percent of the electricity generated in the United States comes from nuclear power.

I probably am getting some of mine from — we have — at Fort Calhoun, we have a nuclear facility — not we, but Omaha Public Power District has a nuclear facility I've actually been in.

But I think nuclear power is important, and I think it's safe. I think that — I know — I don't think nuclear power is going to go any place in the United States for a while — maybe quite a while — because of the reaction to what happened in Tokyo — with Tokyo Electric Power.

But that doesn't change my view as to the advisability of continuing to develop nuclear power, not only in the United States, but around the world.

I think some people misinterpreted what I said when I was interviewed, when I said that I thought it would have a major setback in its development, just because of the popular reaction to what happened in Japan.

But that does not change my view that nuclear power is important for the future of this country and the world.

Charlie? (Applause)

CHARLIE MUNGER: Yeah, we can't be so risk averse that things that have a very tiny chance of making a big dent in one subsidiary are unendurable for us. We have to have a certain reasonable amount of courage in operating this company.

WARREN BUFFETT: We have pipelines — we have gas pipe — you can dream of all kinds of worst-case situations.

We have to carry toxic materials. We're required by law to carry those on the railroad, and, you know, you can picture the wrong place, the wrong time, the wrong everything. But we are not bearing any risks, in my view, ever, that threaten the enterprise.

I mean, that is one thing I think about all the time. I regard myself as the Chief Risk Officer of Berkshire, and that is not something to be delegated to a committee, in my view, at all.

So I think about — whether I think about derivative positions, whether I think about leverage, whether I'm thinking about nuclear power plants or anything, I mean, we are not doing anything that I know of that — pressing my imagination as far as I can — threatens me losing a night's sleep over Berkshire's well-being.

CHARLIE MUNGER: And I think you'd also count on any new nuclear plant built in Iowa will be a hell of a lot safer than the ones we already have. We are learning as we go along here. (Applause)

WARREN BUFFETT: Yeah. Obviously, more people — more people have lost their lives, by far, in coal mine accidents, you know, than ever in the United States — have suffered no losses from anything involving nuclear — with it producing 20 percent of the electricity used by 309 million people.

CHARLIE MUNGER: And if a tsunami gets to Iowa, it will a hell of a tsunami. (Laughter)

WARREN BUFFETT: Yeah. And our railroad won't do so well, either. (Laughter)

25. Charity program fell victim to pressure groups

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from Mary and Jim Beaumont (PH) from Springfield, Illinois. They've been Berkshire shareholders since 1971, and I should note that we received several questions from some long-term shareholders along these lines, and this one reads:

"Would Berkshire ever consider reinstating its shareholder-directed charitable giving program now that you have a big cash position and are urging people to give away their wealth to worthy causes?

“When you had that program, we were able to support many local schools and charities over the years.”

WARREN BUFFETT: Yeah, I love that program, which we had for, maybe, 20 or so years. Charlie loved it. A lot of the shareholders loved it.

And it was interesting because it was a tax-efficient way to let shareholders give away some money to whatever they chose, as long as it was a 501(c)(3), and they could pick up to three charities.

And some families, for example, used it as a learning device. When they would get the form from us, they’d get their kids around the table and they’d talk about philanthropy and why they were choosing what they did.

Two things — well, one thing that was very interesting about it is nobody else copied it. I mean, the rest of corporate America was not interested in having their shareholders direct contributions. They were much more interested in having the CEO direct contributions. So it did not catch on, despite a fair amount of publicity.

We always had a small backlash of sorts from people who didn’t like the charities that our shareholders were choosing.

So Berkshire’s name was on the check. The shareholders would tell us we want $20 a share, let’s say — and they own ten shares, so they can direct $200 — they’d say, we want our $200 to go to more —churches and synagogues, actually, were number one — but there were schools and there were all kinds of things.

And we would always get some letters where Berkshire would be contributing to, say, Planned Parenthood of California, and people would say, “Well, we’re not going to buy See’s Candy because Berkshire is supporting Planned Parenthood in California.”

And sometimes I would write the people a letter and tell them that when See’s bought almonds or milk or anything like that we didn’t get into the charitable preferences of the person supplying us, but it never really amounted to anything.

Then we bought the Pampered Chef, and that was a different situation because with the Pampered Chef we operated through 50,000-plus independent contractors.

These are women, largely, women, who sometimes, to supplement their income — we have at least one in the office that — a woman that sells Pampered Chef products — sometimes as a main source of income — were — these 50,000 were independent contractors, and a campaign developed where people said that because Berkshire Hathaway gives money, probably primarily to pro-choice organizations, and that was at the direction — we had other people giving them to pro-life organizations.

I mean, these reflected the views of our shareholders, not of Berkshire management — but that they were going to boycott these independent contractors.

And these were people who depended on the income, who had nothing to do with Berkshire's policies, and they were being hurt, in terms of their livelihood, and in some cities it became a radio campaign, and in some cities people regularly started interfering with the parties arranged for our Pampered Chef consultants.

And it was hurting a whole lot of innocent people who had nothing to do with Berkshire's policies, who had nothing to do with Berkshire.

And at that time, reluctantly, we decided to end the program.

I did not — I didn't mind at all losing some See's Candy business or whatever to some people.

But when we start affecting individuals — most of these are not high-income individuals — and we're cutting off their livelihood because of something Berkshire is doing, it became — it just became apparent to me that it was unfair to continue it, and reluctantly, we stopped it, and I think it's too bad.

Charlie?

CHARLIE MUNGER: We don't want the parent company involved in distracting arguments about the social issues of the times.

WARREN BUFFETT: Well, we certainly don't want it where it affects —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — people who are just bystanders, basically, who have counted on us over the years to work with them. And it was literally affecting the income of thousands, primarily women, concentrated in certain communities around the country. OK.

CHARLIE MUNGER: A lot of stock — Berkshire stock — is given away every year. It isn't like we've lost the flow of charity totally.

WARREN BUFFETT: No, a huge amount is given away. Partly that's because Charlie and I started our partnerships back in the 50s and 60s, and we've got a number of partners that are now in their 80s, and some of them have given away some exceptional amounts of money.

You had a question earlier from Dick Holland, for example, and Dick Holland — I think it's a matter of record as to exact numbers — but he's given away huge amounts of money over the years and continues to.

And we've got dozens like that that I would say are going to end up giving back 90 percent or more of all the money they've made in Berkshire.

26. Why we hate projections

WARREN BUFFETT: OK. (Applause)

Number 8.

AUDIENCE MEMBER: Tanya Laneva (PH), Boston, Massachusetts.

When you think about long-term cash flows, do you try to forecast growth? Or do you just think about certainty?

If you have an indestructible company like Coca-Cola or Burlington Northern, do you try to estimate growth?

WARREN BUFFETT: Well, we think — are you finished on that?

AUDIENCE MEMBER: Yes, thank you.

WARREN BUFFETT: We — growth is part of the investment equation, and obviously, we love profitable growth. So we would love to figure out a way to, say, take a See's Candy, to move it geographically into new areas, all kinds of things.

I mean, if we could find areas for growth with See's, it would be likely to be very, very profitable.

If Coca-Cola, which is in 200 countries, I mean they have pursued that policy successfully now for 125 years. And some products travel way better than others.

But when we look at a business and we're looking out in the future, obviously, if we see growth in that picture and it's growth which is — produces a high return on incremental capital involved, we love it, but we do not rule out companies where we think there will be little or no growth, if the price is attractive relative to the earning power.

You know, there will be some growth, over time, in something like lubricants, you know, at Lubrizol, but it won't be dramatic growth.

Would we love it if it, you know, if it were going to grow ten percent a year in units or something of the sort? Sure. But that's not going to happen.

So it's a factor in every investment decision because we're really looking out to the future as to future earning power, but also future capital requirements.

And we think plenty about whether any business we go into is likely to grow profitably, and sometimes we're right and sometimes we're wrong. But we don't rule out companies that have very slow growth or no-growth possibilities.

Charlie?

CHARLIE MUNGER: Yeah, well, the interesting thing is that in our country, the business schools teach people to make these projections way in the future, and they program these computers to grind these projections out. And then they use them in their business decision making, et cetera, et cetera.

I've always regarded those projections as doing more harm than good. And Warren has never prepared one that I know of, and where an investment banker prepares one, we tend to throw them aside without reading them.

WARREN BUFFETT: We them upside down, actually.

CHARLIE MUNGER: What?

WARREN BUFFETT: We turn them upside down.

CHARLIE MUNGER: Yeah, yeah. And I think an enormous false precision gets into things when you program computers to make forward projections for a long period of time.

We make rough projections in our head all the time.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: And we don't do any of those formal projections, because the fact that they're there on paper and came out of a computer makes some people think they must be significant. I really think they do more damage than they do good.

WARREN BUFFETT: When we bought Scott Fetzer, which was back in about 1985, it had been shopped by First Boston to more than 30 parties. They never got around to calling us.

So after shopping it to about 30 parties, Scott Fetzer, finally, was working on a deal with an ESOP after something else had fallen through, I forget the exact details.

And I sent a letter to Ralph Schey. I'd read about it in the paper. I'd never met him, never talked to the guy. But I sent him a letter.

I figured I'd gamble 21-cents, or whatever the first class rate was then, and I said, "We'll pay $60 a share. If you like the idea, I'll meet you in Chicago Sunday, and if you don't like the idea tear up the letter."

So that took place and Ralph met me, and we made the deal, and we paid the $60 a share or whatever it was.

And Charlie and I went back to sign up the deal, and the follow from First Boston was there, and he was a little abashed since he had not sent us — contacted us at all — when they were looking for something. But naturally he had a contract that called for a few million dollars of commission even though he'd not bothered to ever contact us and we made the deal by ourselves.

So, in a moment of exuberance while he was collecting his few million dollars, he said to Charlie, he said, "Well, we prepared this book in connection with Scott Fetzer, and since you're paying us a couple million dollars and have gotten nothing so far," he said, "maybe you would like to have this book."

And Charlie, with his usual tact, said I'll pay you $2 million if you don't show me the book. (Laughter)

And I should mention, this will — in connection with Lubrizol, Dave Sokol met James Hambrick, I think on whatever it was, January 25, or whatever the date, and he — Lubrizol had already made projections publicly out to 2013.

And Dave told me that they had — they — that James had also given him some projections, I guess out to 2015 or something, and did I want to see them? And I told him no.

I mean, I don't want to look at the other follow's projections. I've never seen a projection from an investment banker that didn't show the earnings going up over time, and believe me, the earnings don't always go up over time.

So, it's just — you know, it's the old story: don't ask the barber whether you need a haircut, you know.

You do not want to ask an investment banker what he thinks the earnings are going to be in five years of something he's trying to sell.

So I pay no attention to that sort of thing.

But we do, as Charlie says, we are doing projections in our head, obviously, when we look at a business. I mean, when we look at any company to buy, or any stock to buy, we are thinking in our mind, we've got a model in our mind, of what that place is likely to look like over some period of years. And then we also have some model in our mind of how far off we can be.

I mean there's some things we can be way off on, there's other things we're likely to be in a fairly narrow range on.

So all that is taking place, but we sure don't want to listen to anybody else's projections.

CHARLIE MUNGER: Those of you about to enter business school, or who are there, I recommend you learn to do it our way, but at least until you're out of school you have to pretend to do it their way. (Laughter and applause)

27. Buffett owns a few stocks and lots of bonds

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: On Berkshire's quarterly 13F filings at the SEC, three stocks are held only by the entity recorded on the form as Warren E. Buffett, and not by a Berkshire subsidiary company.

Please clear up some confusion on this matter. Are these holdings your own personal investments outside of Berkshire, or do they belong to Berkshire Hathaway?

WARREN BUFFETT: Well, you'll have to tell me what the names are.

CAROL LOOMIS: Unfortunately, the questioner didn't include those. But these are the three, I think, that are — that say Warren E. Buffett is the owner.

WARREN BUFFETT: Yeah. Well, Marc Hamburg prepares those forms. Marc, do you have a microphone that you can — you could —

MARC HAMBURG: I think —

WARREN BUFFETT: Yeah. Go ahead.

MARC HAMBURG: Well, those are securities that are owned by certain employee benefit plans and so that — Warren is directed into those plans, but it doesn't — they're not owned by Warren, or there's no indication that they're owned by Warren.

Warren is part of the filing because he's considered to be a controlling shareholder of Berkshire. So every security listed on there shows Warren as one of the — one of the owners.

WARREN BUFFETT: Yeah. Do we file stocks owned by pension plans?

MARC HAMBURG: To the extent that you direct — have directed —

WARREN BUFFETT: I got you, yeah.

MARC HAMBURG: Right.

WARREN BUFFETT: Yeah. No, I don't — I don't think I — well, Marc knows the rules on it better than I do. I own very, very few securities.

I really spend my time thinking about Berkshire, so I've got a lot of the very security I've been telling you not to buy, which is government bonds, but that's not because it's a good investment. It's a place to have some money and forget about it, and I'll work on Berkshire.

28. Evaluating a company outside the U.S.

WARREN BUFFETT: Area 9.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, it's an honor and a pleasure. My name is Ben Anderson (PH), I'm from Los Angeles.

When you're looking at an investment in China, where the business culture is a lot different than it is here in the U.S., and successful business practices are, again, very different than they are here, what are the characteristics you look for when placing investment in that company, and is that any different than the general principles at Berkshire?

WARREN BUFFETT: We follow the same principles, but we recognize that we know less about tax laws, about customs, about attitudes towards shareholders, any time we get outside the United States, than we know in the United States. Now, to varying degrees, we weigh in that uncertainty.

At the time I bought PetroChina stock, which, I don't know, was probably 2003 or thereabouts, it was extraordinarily cheap, in relation to any calculation of reserves or refining capacity or cash flow or you name it. And at the same time, Yukos in Russia was similarly very, very cheap, and they were both huge.

And I'm no geopolitical expert or anything of the sort, but I decided I was more comfortable buying PetroChina than I was buying Yukos. Now, was I as comfortable buying PetroChina as I would have been buying, you know, some domestic company of similar size?

No, because I don't know as much — I didn't know then, and I don't know as much now, about all the intricacies of Chinese tax law and what the policies might be.

But I was fairly impressed — quite impressed — when I read the report of PetroChina.

For one thing, they said they were going to pay out 45 percent of — as I remember — 45 percent of their earnings in dividends. That's more than any company — oil company — in the United States would tell me.

So I regarded it as a plus and an indication of intent that I thought would be fulfilled, and it has been fulfilled.

So we do make allowances for our lack of understanding, as well as we might in the United States, various key factors.

But the basic principles of trying to value the business, trying to find managements in which we have confidence, in both their ability and integrity, and then finding attractive purchase price, those principles apply wherever in the world we would be investing.

Charlie?

CHARLIE MUNGER: Well, we make so few investments in China that trying to draw general lessons from us would be hard.

It reminds me of the time a professor went west for the summer and came back to his faculty and he said, “I’ve learned that Indians always walk single file.” And they said, “How did you figure that out?” And he said, “I saw one and he did.” (Laughter)

WARREN BUFFETT: How did we get from there to China? (Laughter)

CHARLIE MUNGER: Well, we only had a couple of things in China. They’re like the one Indian. You can’t draw general lessons from them.

WARREN BUFFETT: But we’re willing to look tomorrow.

I mean, obviously, if we had a call on some — that could be a significant size investment because we — it just doesn’t make any sense for us to look at things we can just put a couple of hundred million dollars in — but we, you know, I love the idea of looking at various ideas.

I mean, I find it a fascinating game to hear about companies or businesses that are new to me. And the problem now is that the universe has gotten much smaller because of our size. But we welcome a call from a lot of countries.

There’s some countries that are just too small. They’re not going to have businesses that could move the needle at a place like Berkshire, and so those are off the list, but —

CHARLIE MUNGER: China has at least one private company that makes over $3 billion a year after taxes. There’s some big things out there.

WARREN BUFFETT: I’ll get the name from him later, but I don’t want you to hear. (Laughter)

29. Where Berkshire’s short-term cash goes

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Ed Schmidt (PH) in Alaska. He's asking about Berkshire's cash.

He writes, "Where is that money held? All in Treasury bills or notes? If so, what will happen in June when the biggest buyer, the Fed, quits buying? Where is all that money on the sidelines? Is it under the mattress we saw two years ago?

"I don't see how any significant amount of money can be in banks that aren't paying interest, corporate bonds that are risky and not paying much interest, or government bonds that seem less and less sound as each day passes."

WARREN BUFFETT: Well, he's certainly right that all of the choices are lousy for short-term money now, but we don't play around with short-term money. So we did not own commercial paper in 2008 before problems occurred. We did not own money market funds.

When I say we didn't own them, maybe small amounts at various subsidiaries, but in terms of the big money, which we run out of Berkshire, we basically keep it in Treasurys.

And we get paid virtually nothing now for it, and that's irritating, but the last thing in the world we would do at Berkshire is to try and get 5 or 10 or 20 or 30 basis points more by going into some other things with our short-term money.

It is a parking place. It's an unattractive parking place, but it's a parking place where we know we'll get our car back when we want it.

You know, when we need — certainly the case — in September of 2008, we had committed for some time to put $6.5 billion in Wrigley when the Mars/Wrigley deal occurred, and we certainly didn't contemplate at the time we made that commitment, which was probably in the summer, that the events would take place like they did in September and — but we had the money.

I knew I had to show up with 6 1/2 billion dollars — I think it was on October 6 — and, you know, I had to show up. (Laughs)

I couldn't show up with a money market fund or some commercial paper or anything of the sort. I had to show up with cash.

And the only thing I feel — virtually the only thing I feel good about, in terms of having large amounts of ready cash is Treasury bills, and that's where we've got — if you look at our March 31st statement, I think you'll see 38 billion, and overwhelmingly that will be in Treasurys.

Charlie?

CHARLIE MUNGER: Well, of course, I've watched a lot of people struggle who thought it was their duty in life to get an extra 10 basis points on the short-term money.

I think it's really stupid to try and maximize returns on short-term money if you're in an opportunist game the way we are, where we want to suddenly deploy money.

Some of those pipelines we bought, they came for sale on Saturday, and we had to close on Monday or something?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Why fool around with some dubious instrument when we had sudden needs for money like that?

WARREN BUFFETT: We bought one pipeline where the seller was worried about going bankrupt the following week. And there's a Hart-Scott-Rodino clearance required through the FTC, and they needed the money right away, and we — I wrote a letter, as I remember, to the FTC, and I said that we will do whatever you tell us to do later on.

You can look at this all you want. We'll give you all the data you want. And if you tell us, you know, to unwind the deal, whatever you tell us, we will do.

But these guys need the money, and so we closed it earlier. And our ability to come up with cash when people need it and when the rest of the world is petrified for some reason, has enabled several deals to get done.

We don't know whether — that could happen tomorrow. I mean, if — you know, Ben Bernanke runs off to South America with Paris Hilton or something — (laughter) —I mean, who knows what will happen. And we want to be able, at that moment, to have our check clear.

So, we figure we never know what tomorrow will bring, although it won't bring that, I want to — leave that off the transcribed part of the report. (Laughter)

But we are — when somebody comes to us and they say, we need a deal right now, we can do it, and they know we can do it, and it can be big. It just has to be attractive.

30. Wind power needs government subsidies

WARREN BUFFETT: OK. Area 10.

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. Thank you very much for taking the time to have a terrific shareholders meeting.

Four years ago we announced that we're naming our son after you, so we're happy to say hi to both you and Charlie.

Charlie, since Berkshire bought Wesco, we wanted to see if you can take some time to host a meeting of your own? It can be anywhere, anytime.

CHARLIE MUNGER: We're going to do that.

AUDIENCE MEMBER: Great.

CHARLIE MUNGER: We won't call it a Wesco meeting. We'll call it, "An Afternoon with Charlie."

AUDIENCE MEMBER: Great.

CHARLIE MUNGER: It's only for hard-core addicts. (Laughter)

AUDIENCE MEMBER: Warren, MidAmerican Energy is investing over a billion dollars in wind power. How do you feel about wind power as a source of renewable energy and its economics? Will this scale of investment continue and what type of returns do you expect to come from wind power?

WARREN BUFFETT: Yeah, it's terrific, but wind power is terrific, but only when the wind blows. And the wind blows about — as I remember— about 35 percent of the time in Iowa.

So you never can count on wind power, obviously, for your base load. And, you know, that is a real limitation.

On the other hand, wind power, you know, is basically, I guess, the cleanest energy you can come up with, except for the fact that it can't be relied on. It — the economics only make sense with an incentive credit — tax credit — provided by the federal government, which they've been doing for a considerable period of time.

It does not — standing on their own, the investment will not return anything like an adequate return on capital. So there is a tax credit that your government has made a decision that it wants to subsidize, in effect, wind power.

And Iowa has been — Iowa is a good wind state. This whole central belt is good and — central part of the country is good — so it's made sense to locate a lot of megawatts of generating capacity in Iowa, and we have more under construction now, and I think we're now, I think, number one in the country in respect to wind power.

So we'll be doing more. It is dependent, in terms of the price you can get, the percentage of the time that you're generating capacities actually get used and everything, it only makes sense with the tax credits.

And one thing that is kind of interesting — one of the assets of Berkshire is that it pays a lot of taxes. That doesn't sound like much of an asset, but in these days, a lot of utilities, when you get both a hundred percent depreciation, which has been put in now by the federal government for a short period of time, and you get these sort of tax credits on wind, they really don't have the tax paying capacity to be able to use the tax credits.

So they are in a different position than Berkshire, which pays a lot of taxes. We've probably paid something like 2 percent of all the corporate taxes in the United States, maybe, over the last five years. I want to check that, but it's not — I don't think that's way off.

So we have a lot of tax paying capacity. We can use it to build more wind projects. And I think it's very likely we will continue to do it.

It helps our Iowa customers. Because these projects are successful, it's enabled us to keep rates — among other reasons — it's helped to keep rates absolutely unchanged now for more than a decade, which is very unusual among electric utilities in the United States.

Charlie?

CHARLIE MUNGER: No, I've got nothing to add.

31. We would not have let NetJets go bankrupt

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Well, this is not a David Sokol question, but it relates to him. It's actually a NetJets question.

This shareholder asked, "I was struck by your statement when you praised Sokol for, quote, 'having resurrected an operation that was destined for bankruptcy.'

"This really got my attention because I don't recall you or Berkshire Hathaway saying earlier that NetJets was on the verge of bankruptcy at the time that his predecessor, Richard Santulli, had stepped down.

"In fact, at the time, the company seemed to give the impression it was dealing with a few short-term problems but that it was fundamentally sound. In truth, how close was it to bankruptcy? And if that was the case, why didn't you tell us?

"And finally, was it ethical for NetJets to be asking perspective clients to part with their money at a time when it was, in the eyes of its main shareholder, quote, 'destined for bankruptcy?'"

WARREN BUFFETT: Yeah, I think I said it was — maybe we can find the exact words here — but I think I said it was destined for bankruptcy, absent the fact that Berkshire Hathaway owned it, if it had been a standalone entity.

And Berkshire never had any intent, never would have had any intent of any kind, to bankrupt NetJets.

But if it had been owned as a standalone by somebody else, the public, that's what would have happened to it.

With Berkshire's ownership, Berkshire has had two insurance companies that would have gone bankrupt as standalone insurance companies. And we — it never crossed our mind that we would let them do it.

So we put money into companies that were bankrupt that Berkshire owned to make them whole, basically. And, essentially, we were doing the same thing with NetJets when we put in — we got it up to 1.9 billion.

But NetJets, in my opinion — well, it would have been bankrupt, absent somebody like Berkshire owning it. I'm almost positive that I said that, that absent Berkshire's ownership, or some words to that effect — let's see if I can find it.

Maybe Charlie can be commenting while I'm looking for this.

In any event — (Laughter)

Well, I'm not finding it immediately where I even discussed it, but I know I talked about it on the bankruptcy thing, but I also know that I conditioned it on not being owned by Berkshire.

Charlie?

CHARLIE MUNGER: No comment.

WARREN BUFFETT: No comment. (Laughter)

We've pointed that out to Standard & Poor's and Moody's. We look at — Berkshire has a lot of different companies, but we feel that it's one entity and, you know, Moody's or Standard and Poor's has to look at each one separately and all of that, but Charlie and I did not — have not been running this business to walk away from some company.

We had one in Louisiana, Southern Casualty, and we had another one in Chicago, both of which, if left to their own devices, would have gone bankrupt, and we didn't even think about not making them whole.

32. Buffett's advice: invest in your own skills

WARREN BUFFETT: Area 11?

AUDIENCE MEMBER: Good afternoon. My name is Christopher David (PH). I'm an entrepreneur from Arlington, Virginia. My question is about the youth.

I work with a lot of high school and college students and recent graduates who are facing a job market with 20 percent youth unemployment, and at the same time one of the most favorable entrepreneurial environments. It's easier than ever to start a business or get involved with a startup.

So considering that these kids are politically savvy, they like studying economics, they're brilliant and they're willing to learn, what advice can you give them from an investment perspective that could help them chart their own course, as opposed to get a nine-to-five job?

WARREN BUFFETT: Well, the main thing you could do — and people do it different ways. I used to do it by doing a lot of reading — I was — practically lived at the Omaha Public Library for three or four years in pre- — when I was 9 or 10 or 11.

I mean, anything you do to improve your own skills, you know, you never know where it's going to pay off later on.

I only — I have one diploma hanging in my office, and I got a couple of others, but the one diploma I have hanging up there is one I got from a Dale Carnegie course, which cost me a hundred bucks back in 1951, and I can't — it's incalculable how much value I got from that hundred dollars.

There's nothing like working to improve your own skills, and I would say communications skills are the first area I would work on to enhance your value throughout life, no matter what you do.

I mean, if I had stayed in the same position I was in, in terms of communicating, back in 1950 or '51, my life would have turned out differently. I mean, I started selling securities. If you can't talk to people, you've got a real problem selling securities.

The — so I — you know, I think people — I think the — if you get lucky, you find your passion early on, but you want to work at something you're passionate about, and then you want to work to improve your skills in that. And I think if you do both of those things, I think you're likely to do very well.

Charlie?

CHARLIE MUNGER: Yeah, I think economics is a really tough subject, and I think it's easy to teach the basic microeconomics and certain of the basic ideas, but the minute it gets into the full range of complexity, you have the difficulty that the experts disagree.

So, I don't think I would hurry if I were trying to learn something into the parts of the fields where none of the experts can agree among themselves. I would master the easy stuff first.

WARREN BUFFETT: Yeah, I don't think — yeah, I would not advise taking lots of courses in economics to somebody going to school.

I'm just trying to think back. It's been a long time since I took my economics courses at Wharton, but I don't regard them as the ones that pushed me forward in any significant way.

33. Reinsurance is a lot harder than it looks

WARREN BUFFETT: Carol?

CAROL LOOMIS: Question from Jon Brandt. Does Berkshire's equity ownership in Munich and Swiss Re reduce the amount of catastrophe-exposed insurance business you are willing to write directly?

If so, assume that prices return to being attractive, would you then limit the quantity of other reinsurance stocks you buy so that you could do more direct business?

WARREN BUFFETT: We have invested in Munich and Swiss Re less than — well, let's see what it would be — it's less than $4 billion, so we're talking 2 1/2 percent of our net worth.

So those investments, in aggregate, are not of a magnitude that would cause me to change at all what we're willing to do — the risks we're willing to bear — in the reinsurance field.

We're way below, sort of, capacity, in terms of risk that we will tolerate in insurance. I mean, I put in the report, you know, I expect our normal earning power to be in the $17 billion or something pretax range.

Well, that is so unlike any other reinsurance company in the world. We went through the worst quarter in reinsurance history, except for Katrina's quarter, you know, and we end up earning, you know, very substantial sums.

So those investments are no constraint at all on our willingness to write insurance. We would love to have a lot more attractive reinsurance business on the books, we just — we just can't find it at prices that we think are commensurate for the risk. But it's not because of an aversion to risk overall.

Charlie?

CHARLIE MUNGER: Yeah, it's — insurance, and particularly reinsurance, it's not that easy a business. It's taken you a long time to do as well as you do. And if it weren't for Ajit, why, we wouldn't — we'd be a lot smaller business.

WARREN BUFFETT: Well, it should be pointed out, we really didn't succeed at all in the reinsurance business in the first 15 years.

We started in reinsurance around 1970, and we had a fellow that I thought the world of running it, George Young, but net, counting the value of float, it was not a good business for us for 15 years until Ajit came along. It is not an easy business. It looks easy most of the time. I mean —

CHARLIE MUNGER: That's the trouble with it. It looks easier than it is.

WARREN BUFFETT: It looks way easier than it is.

And, you know, it's like having a pair of dice, and, you know, accepting bets on boxcars or something like that, and, you know, it's going to come up once in 36 times, so you can win a lot of bets by giving the wrong odds, but if you keep do it long enough, you lose a lot of money.

So these infrequent events, you better have factored in to your pricing, and not fool yourself by whether you make money in a given year or two years or even three or four years. And most people have a little trouble with that, and we had a little trouble with it for about 15 years.

CHARLIE MUNGER: And incidentally, the investment bankers of the world, now that they trade so much for their own account and derivatives, they have sold some of these products where most of the time the customer wins but when the customer loses, he really loses big.

In other words, they're smarter than the customers, and they have caused some of the most horrendous losses to ordinary businessmen. It happened in Korea, it happened in Mexico, it happened —

Just beware of the salesman who's selling a new derivative product.

WARREN BUFFETT: Or an old one. An old one, too.

CHARLIE MUNGER: Yeah, but new ones are worse.

WARREN BUFFETT: Yeah.

34. How Buffett first met Todd Combs

WARREN BUFFETT: OK. Area 12.

AUDIENCE MEMBER: Hi, my name is Bottle Pondy (PH). I'm from Philadelphia, Pennsylvania.

Question's about Todd Combs, the young money manager you hired late last year.

For Mr. Munger, I understand you introduced him to Berkshire. Could you talk a little bit about that — how that relationship started, and how we as shareholders, are we going to be able to assess his progress?

CHARLIE MUNGER: Well, I hate doing this because I may get more letters than I want, but he sent me a letter. That's how it happened. It was like Warren's letter to the guy at — Ralph Schey.

And at any rate, I had a meal with him, and then I called Warren and I said, "I think this is the guy you should talk to." We have a very complicated business and very elaborate procedures, as you can tell. (Laughter)

WARREN BUFFETT: And his results will be known over a five-year period or something. I mean, you cannot judge an investor by what they do in six months or a year.

CHARLIE MUNGER: Todd has the advantage that he's been thinking about financial companies like Berkshire for a great many years. That's useful for us to have around.

WARREN BUFFETT: And as we put in the annual report, it's more likely than not, but not a sure thing, that over time, we have more than one investment manager.

You know, there's a lot of money at Berkshire to be managed. And it would not be a bad idea, but we have to find the right people, and the right people just does not mean a given IQ or a given past record, it means a lot of things.

And if we end up with two or three, you know, that — that's a plus. But it's not — we don't mandate that sort of a result.

35. Acquisitions and stock

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes in from Scott Wilkin, and he's from Chicago, but he's sitting in the audience right now.

Johnson & Johnson is one of Berkshire's biggest holdings, and he asks for your thoughts, Warren, on Johnson & Johnson's recent acquisition of Synthes for $21 billion.

You were quite outspoken in your opposition of Kraft's deal for Cadbury, particularly because of their use of stock. J&J's deal also is primarily with stock, and do you support this deal?

WARREN BUFFETT: I have not talked to anybody in the Johnson & Johnson management, and I have no specific knowledge of the company, but basically, I would like the deal a whole lot better if it was all for cash.

The idea — when a management trades away — I think this deal is about two-thirds stock, roughly, and one-third cash. And Johnson & Johnson has plenty of ability to pay cash for a $22 billion deal. And when they trade away their present businesses for some other business, they're either saying their own businesses are pretty fully valued, or they're saying the guy is making a hell of a mistake that's selling to them.

So I would — like I say, if it was all for cash, I would like it a lot better. And I think that it is — by using a lot of stock for a deal like this, that it certainly — you can — you can draw the inference that J&J is not valuing its own businesses, you know, as attractively as you might think they should be evaluated.

And if you use your own company stock to pay 20 percent or more than market for some other company and, you know, there probably are not a lot of synergies involved or anything in the management. There may be some, but there's usually some offsets too.

But like I said, I would have much preferred it if they'd done it for cash.

Charlie?

CHARLIE MUNGER: Yeah, you also have the disadvantage in (inaudible) that you know a hell of a lot more about chocolate and pizza than you know about medical devices.

WARREN BUFFETT: You think I know more about chocolate?

CHARLIE MUNGER: Well, you — (Laughter)

But at Kraft, I mean, you're talking about businesses that Warren knew a lot about, and neither of us knows much about medical devices.

WARREN BUFFETT: Yeah, the pizza has business has done pretty well since it was sold by Kraft. (Laughs)

36. Why we won't issue stock to make an acquisition

WARREN BUFFETT: We go to 13 in the other room.

AUDIENCE MEMBER: Hi, I'm Glenn Tongue from New York. First off, thank you for a terrific day.

My question deals with acquisitions. Pre-Lubrizol, we estimated Berkshire's year-end 2011 cash balance could approach $60 billion.

I believe you commented recently on an elephant that you thought was too big.

What is your acquisition appetite? What size is too big? Has the phone been ringing lately? And what if anything can we, as shareholders, do to help?

WARREN BUFFETT: I got through college answering fewer questions than that. But the — (Laughter)

But anything you can do to help, I appreciate, Glenn.

The — you know, it's hard to name a precise figure. This one, you know, was way too big unless we used a lot of stock, which, like I say, we wouldn't do.

Our appetite is always there. We are not going to borrow a lot of money. We're not going to issue shares, except perhaps in some minor amount to make a deal that couldn't get made otherwise.

But — and, obviously, we'll never sell a business to buy some other business. So, you know, our cash balances will tend to build month to month unless we do something.

And we can, and will, sell some portfolio securities. But doing Lubrizol requires close to $9 billion of cash, and obviously we could do another one of that size.

In fact, we're looking at a couple, but they're no more than a gleam in the eye, but they would take sums roughly similar to Lubrizol, and, you know, we would be comfortable doing those, and they would add significant — significantly to Berkshire's earning power. They're worth doing.

But we can't do a really — a really big elephant now, and we won't — you know, we won't stretch. We never — we've never really taken any risks because we don't need to, and we will not trade something that we have and need for something that we don't have and don't need, even if we'd kind of like to have it.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with all that.

We are very reluctant to issue shares. And in that, we're different from most places.

I have a friend that sold out to a socialist country, and they issued shares in a controlled corporation, and the socialist executive said, "Isn't this wonderful we're getting this business for nothing."

WARREN BUFFETT: Some people really have that, and, of course, there are some companies — and we talked about the wave that took place in the late '60s, but periodically — one certainly happened during the internet period — companies just couldn't issue shares fast enough, because they basically were trading confetti for real assets. And that is a business model that has been applied successfully for some periods of time by certain companies in the past.

It usually ends in some kind of a fiasco, but — well, I shouldn't say it usually does, but it runs out of gas at some point.

But, you know, essentially, we've never been in that game.

We hate issuing shares and the idea of selling our — when we issue shares we're divesting ourselves of a portion of every wonderful business we have, from GEICO to ISCAR to you name it. And we don't like doing that. We like owning those businesses. We'd like to own more of them.

We — you know, we have a deal, for example, on Marmon where we bought some more of it this year, and we will buy the rest of it a few more years, and we feel good about that. We pay a fair price for it, but we get a business we know, a management we like, and that's really what we'd like to continue doing at Berkshire. In fact, we will continue doing it.

37. Housing market is terrible, but we'll profit on the rebound

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from Larry Pitkowsky, who is a long-time shareholder, I think he's in the audience, from the GoodHaven Fund.

He asks, "Over the years, you built or acquired a significant number of businesses that are related to the residential and commercial real estate markets, including such segments as brokerage servicing, insulation, carpeting, construction products, painted furniture.

"Berkshire's ownership with these businesses would seem to give you a unique window through which to view current conditions. Could you give us some insight into the current state of the housing and commercial real estate market and what we might expect to see in these businesses over" — and this might be a long shot — "over the next decade."

WARREN BUFFETT: Well, the immediate situation is it's terrible. It's been flatlined now for a long time, and it affects Shaw, it affects MiTek, it affects Acme Brick, it affects Johns Manville, it affects our HomeServices operation.

And there has been no bounce, at all, but you see that in the housing start figures, too.

I'm not telling you anything you don't see, except I see it with pain as I look at the monthly earnings figures.

But those are good businesses. And as I mentioned in the annual report, we bought the largest brick operation in Alabama. And I think Alabama uses more brick per capita than any state in the union, but that doesn't mean much currently, because nobody is using any brick to speak of.

But we bought it. We wrote a check for cash, and we like improving our position.

MiTek has bought operations. Shaw is spending a couple hundred million dollars this year, partly because of a change in the nature of the carpet business.

This country, over time, will build houses at a rate, overall, in total, commensurate with household growth, and I think we're going to see plenty of household growth in future decades, and I think that our companies are well-positioned to make significant money when we get to a normalized level of home building.

I said in the annual report I thought it would — we would be seeing the upswing by year-end. I've seen nothing since I wrote the annual report that makes it look like I'm certain to be correct or anything, that there's been no movement that I've seen so far in the two months since I wrote the report.

I would think it would start occurring by then, but if it doesn't, you know, it may be a year later. I don't think anybody knows the answer on that.

If I had to bet one way or another, though, I think it will be turning up by year-end.

It really isn't that important to us. When I made the decision to buy the brick company in Alabama, it was not because I thought brick was going to turn in two months or six months or a year.

I thought that over time, being a very important brick manufacturer and distributor in Alabama adjacent to our strong operation in Texas, it would be a good investment at the price that we paid. And I feel good about the decision, but I won't feel good about our brick results in the next six months. I can be sure of that.

Charlie?

CHARLIE MUNGER: Well, one advantage of buying these very cyclical businesses is a lot of people don't like them. And what difference does it make to us if the earnings average, say, 300 million a year, if it comes in in a very lumpy fashion?

In the big scheme of things, what do we care if it's lumpy, as long as it's a good business? And we have an advantage on that stuff. Nobody else was bidding for a brick plant in Alabama with no customers to speak of. (Laughter)

WARREN BUFFETT: We'll be there if you need brick in Alabama. (Laughter)

You know, See's Candy, a wonderful business, loses money roughly eight months of the year.

Now, it just so happens we know the seasonal pattern, so we don't worry in July that somehow Christmas won't come, you know. We've got a couple thousand years on our side. (Laughter)

So the — but that's — you know, that's easy to see. If you just looked at one month of See's earnings or looked at one quarter, you'd think, what are these guys doing in this business?

Now, obviously, cyclical businesses, you know, are not going to behave exactly the same as seasonal businesses, but why look at it any differently?

I mean, if you take the next 20 years, there will be, you know, three or four terrible years for residential housing, and there will be a lot of them that are pretty good, and there will be a few that are terrific.

And I don't know the order in which they're going to appear, but I know if I can buy the assets cheap enough to participate in those 20 years, that we'll do OK over that time. So that's why we're in the brick business.

38. Short adjournment before formal business meeting

WARREN BUFFETT: Now let's see. Yeah, we're at 3:30, so we will adjourn for about five minutes, and then we will conduct the business meeting of Berkshire Hathaway, and we can turn the lights up, and we'll rejoin you in just a couple of minutes. (Applause)

39. Berkshire formal annual meeting begins

WARREN BUFFETT: OK. If you'll settle down, we'll conduct a little business.

This morning I introduced the Berkshire Hathaway directors that are present.

Also with us today are partners in the firm of Deloitte & Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors and the motions voted upon at this meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: Yes, I do.

As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 2, 2011, being the record date for this meeting, there were 942,559 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 1,059,055,810 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/10,000th of one vote on motions considered at the meeting.

Of that number, 663,042 Class A shares, and 659,697,109 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 28th.

WARREN BUFFETT: Thank you. That number represents a quorum and we will therefore directly proceed with the meeting.

The first order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: Second.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions?

We will vote on this motion by voice vote. All those in favor, say aye. Opposed? The motion is carried.

40. Election of directors

WARREN BUFFETT: The next item of business is to elect directors.

If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, you may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to one of the meeting officials in the aisles, who will furnish a ballot to you.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott be elected as directors.

Are there any other nominations? Is there any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxyholders in response to proxies that were received through last Thursday evening, cast not less than 701,770 votes for each nominee. That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott have been elected as directors.

41. Shareholder advisory vote on Berkshire’s executive compensation

WARREN BUFFETT: The next item on the agenda is an advisory vote on the compensation of Berkshire Hathaway's executive officers.

I recognize Mr. Walter Scott to place a motion before the meeting on this item.

WALTER SCOTT: I move that the shareholders of the company approve, on an advisory basis, the compensation paid to the company's named executive officers, as disclosed pursuant to Item 402 of Regulation S-K, including compensation discussion and analysis, the accompanying compensation tables, and related narrative discussion, in the company's 2011 annual meeting proxy statement.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that the shareholders of the company approve, on an advisory basis, the compensation paid to the company's named executive officers.

Is there any discussion?

The motion is ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the motion and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxyholders in response to proxies that were received through last Thursday evening, cast not less than 720,883 votes to approve, on an advisory basis, the compensation paid to the company's named executive officers.

That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

The motion to approve, on an advisory basis, the compensation paid to the company's named executive officers has passed.

42. Shareholders decide to hold a compensation vote every three years

WARREN BUFFETT: The next item is an advisory vote on the frequency of a shareholder advisory vote on compensation of named executive officers.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to this item.

WALTER SCOTT: I move that the shareholders of the company determine, on an advisory basis, the frequency, whether annual, bi-annual, or tri-annual, with which they shall have an advisory vote on the compensation of the company's named executive officers, set forth in the company's proxy statement.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: If has been moved and seconded that the shareholders of the company determine the frequency with which they shall have an advisory vote on compensation of named executive officers, with the options being every one, two, or three years.

Is there any discussion?

The motion is ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the motion and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxyholders in response to proxies that were received through last Thursday evening, cast 112,395 votes for a frequency of every year; 4,615 votes for a frequency of every two years; and 609,699 votes for a frequency of every three years, of an advisory vote on the compensation of named executive officers.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

The shareholders of the company have determined, on an advisory basis, that they shall have an advisory vote on the compensation paid to the company's named executive officers every three years.

43. Shareholder motion on reduction of greenhouse gases

WARREN BUFFETT: The next item of business is a motion put forth by Miss Coward, a Berkshire shareholder represented by Mr. Bruce Herbert and Mr. Larry Dorrs (PH).

The motion is set forth in the proxy statement.

The motion requests Berkshire Hathaway to establish goals for the reduction of greenhouse gas at its subsidiaries' power plants, and prepare a report for shareholders on how it will achieve these goals.

The directors recommend that the shareholders vote against the proposal.

I will now recognize Mr. Herbert to present the motion. To allow all interested shareholders to present their views, I ask Mr. Herbert to limit his remarks to five minutes.

The microphone at, well, let's have Mr. Herbert first, if we can turn up the lights.

BRUCE HERBERT: Thank you.

Good day, ladies and gentlemen. My name is Bruce Herbert and I'm chief executive of Newground Social Investment in Seattle, Washington.

It is such a pleasure to be here today, representing a life-long owner of Berkshire Class A shares. And I stand to present the resolution found on page 12 of the proxy, that asks our company to set goals for reducing greenhouse gas emissions at its energy holdings.

This is because serious investors know, and studies show, that climate change creates financial liability.

The Investor Network on Climate Risk, whose members manage more than $10 trillion, and the Carbon Disclosure Project, representing more than $70 trillion in assets globally, call on companies to disclose risks related to climate change, as well as the actions taken to mitigate those risks.

In 2010, 66 percent of U.S. electric utilities had already set greenhouse gas emission reduction goals. Sixty-six percent. Unfortunately, Berkshire MidAmerican was not among them.

Now, investors have cause to be concerned. Just last year, the SEC announced that climate risks are material, and that they must be disclosed.

We do applaud MidAmerican for having the largest wind energy portfolio of any utility in the United States.

However, it is also true that MidAmerican generates close to three-quarters of its power burning coal. Investors, globally, want to reduce risk through cleaner generation, and 66 percent of public utilities have already published their plans for doing so.

But MidAmerican offers no such plan, despite the public proclamation via its website, that, quote, “We will set challenging goals and assess our ability to continually improve our environmental performance,” unquote.

There is no more important environmental goal for a coal-burning utility than to reduce pollution. But more than this, Berkshire is uniquely vulnerable, in that the financial burdens of climate change are pushed onto insurance companies, and as a major insurer, this has serious financial ramifications for our company.

Berkshire enjoys a remarkable and well-earned reputation, earned over many decades, for being practical visionaries. Addressing climate change offers an opportunity for our company both to uphold and to enhance this reputation.

So in closing, the world’s largest institutional investors call on companies to set greenhouse gas reduction goals. Such goals are key tools for managing the extraordinary business risk of climate change.

Two-thirds of utilities in the United States have already set these types of reduction goals, and this resolution, importantly, gives Berkshire managers the freedom to determine what those goals should be and to shape the process for meeting them.

And the major proxy advisory firms have repeatedly recommended voting for similar resolutions.

So I will close with a request and a question. The request is for all of you here to please join us in supporting this common sense proposal.

And the question, gentlemen, is, have you evaluated the business risk of climate change to our companies and what did you find out? Thank you.

WARREN BUFFETT: Thank you, Mr. Herbert.

We have a microphone at zone 1. It’s available for anyone wishing to speak for or against the motion. You’ve seen where zone 1 is there.

I’ll wait just a minute or two in case anybody would like — is there an additional speaker there that —?

I’ll ask that, for the benefit of those present, I ask that each speaker for or against the motion limit themselves to two minutes and confine your remarks solely to the motion.

So go ahead.

AUDIENCE MEMBER: Hi, I'm Paul Herman, founder of HIP Investor. HIP stands for Human Impact and Profit. We're a registered investment advisor in the states of California, Illinois, and Washington.

Climate change is obviously one of the risks to Berkshire Hathaway conglomerate companies, including MidAmerican Energy and Burlington — the Burlington railway — which transports coal, much of which is getting exported to China.

So we are concerned about, also, about the disclosure, quantification, and impact on profit, of greenhouse gases, as well as the quantification of the asset of the carbon credits that might be available for eco-efficient companies.

So we strongly support this resolution for increased disclosure, increased transparency and evaluation of the financial returns that are possible, or the financial liabilities, especially with your expertise in reinsurance, because reinsurance companies typically put a quantification of potential carbon exposure and liabilities, whereas traditional insurance companies may not do so.

So we strongly advocate for transparency, disclosure, and quantification as to the potential risks and liabilities. The SEC has encouraged this type of disclosure, though they have not mandated it. So Berkshire Hathaway would be a leader in doing this, as companies like GE, which their Ecomagination initiative, the 10 percent of revenue that they generate from their Ecomagination products, and other leaders from Jeff Immelt to the leaders of Duke Power that take a positive position on the financial returns that are possible for addressing climate change and carbon efficiency. Thank you.

WARREN BUFFETT: Thank you.

We have some more speakers there?

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger. My name is Jefferson Lilly (PH), a long-term Berkshire shareholder. It's my personal opinion that it's the previous two speakers that are the hot air in the problem around global warming, and that we — (applause) — that we not regulate Berkshire Hathaway to force it to have carbon disclosure or other silly rules.

It's fine if the managers of the individual businesses choose to do that on their own, but it's completely inappropriate to bring this false religion of global warming to try and regulate Berkshire Hathaway.

You guys are doing a great job on your own. (Applause)

WARREN BUFFETT: Are there any other speakers there that —?

AUDIENCE MEMBER: Mr. Munger and Warren Buffett. I would just like to say one thing, which I think is really important.

Berkshire Hathaway can be a leader in the environment. And I'm for transparency, as I know these two gentlemen are, and John Doerr, who is very passionate about the environment, and I know if he was here today, he would have the same sentiments as these two gentlemen.

And it's important that as American citizens, we care about the environment. And not keep polluting the environment. And I'm with these two gentlemen 100 percent.

WARREN BUFFETT: Thank you. (Applause)

Do we have any others that haven't spoken?

AUDIENCE MEMBER: Yes. My name is Eric Shlime (PH). I am not for this, so against the motion.

I think Berkshire Hathaway has a pretty good reputation at being clean, being environmentally responsible. I don't think anyone is saying that either Mr. Buffett or Mr. Munger is somehow — doesn't care about the environment.

I think most people care about the environment. But it doesn't mean that we should for Mr. Buffett and Mr. Munger, or any of the CEOs, to tell them how to run their business.

You guys care a lot about Berkshire's reputation. If Berkshire's subsidiaries are just polluting oceans and ponds and destroying the reputation in different towns and cities, I don't think that would be too cool with either Buffett or Munger.

So, doesn't mean you don't care about the environment just because you're not going to somehow regulate and tell other people how to run their business. Let's just do things voluntarily, do things to make money, and be responsible. At the end of the day, that's what wins. Thank you.

WARREN BUFFETT: Thank you. (Applause)

Anyone additional?

AUDIENCE MEMBER: Yeah, my name's Larry Dorrs (PH) and I support this resolution.

I don't think anybody is saying anything other than you're gentlemen of great integrity. But this is a dollars and cents issue. And the EPA is releasing new rules that are calling for more regulation of greenhouse gas emissions.

So this — you know, we're really approaching this from a point of view of a conglomerate that has insurance holdings, and it really is insurance companies that are bearing the great costs.

So I’m looking very much forward to your point of view on this. Thank you.

WARREN BUFFETT: Thank you.

Anyone else?

AUDIENCE MEMBER: Yes, thank you. David Hughes (PH), a shareholder.

It’s my opinion that this is the right thing to do and I think that it makes sense to do it, as an organization, prior to being forced to do it.

And if this gives you the tools to set the rules your way, as you see fit, then I think that’s far more powerful and sets a precedent, as Berkshire has done in the past, so I am for the resolution.

WARREN BUFFETT: Thank you. (Scattered applause)

Anyone additional?

AUDIENCE MEMBER: Hello. My name is Thomas Dankenburter (PH) and my background was in biochemistry, and I’m very passionate about the environment, and I think it’s very important for Berkshire to work to be a leader, and so I’m very much in support of this proposition.

WARREN BUFFETT: Thank you. (Scattered applause)

Got somebody else there?

AUDIENCE MEMBER: Hi. My name is Sarah Cleveland. I’m from Portland, Oregon.

I want to just also put a voice in favor of this resolution, and I think it’s not about rights or wrong. It’s about a willingness to take a look at risks and opportunities. And also for Berkshire Hathaway to be a leader. And also work with the subsidiary companies on specific possibilities.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: Hi.

WARREN BUFFETT: You’re on.

AUDIENCE MEMBER: My name is Sam Roy (PH). This is my first meeting.

Mr. Munger and Warren Buffett, I’m so impressed how you run your business, but I think you will care for the environment as well. I don’t know whether we should impose a route, but at least you will, by your act, how the local businesses are run, and all the operating goes out and appears, and there is no question that we do everything possibly that we never pollute the air that cannot be changed.

It is not hot air, but it is something I'm very passionate about. You can do anything with your environmental, but if you are not taking charge right now, we don't know what the implications would be for our kids and grandkids.

I request you give it total investigation, and I think you will do that. Thank you for this opportunity.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: Yes. Mr. Buffett and Mr. Munger, my name is Bob Stein (PH). I'm a registered, professional engineer, and I have a couple comments, and I'm a Berkshire stockholder.

One, I think we all support very sound environmental protection. But the science before this — that's being used by EPA for greenhouse gases is not necessarily sound, and is not necessarily in the best interests of Berkshire Hathaway shareholders.

Also, everything that the EPA has proposed is not practical and has caused a lot of problems making U.S. competitive in the world industrial market. Thank you.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: Jason Bang (PH), Palo Alto, California. For me, one thing that's been very interesting about the issue is that it is something that deserves the passion that people bring to it. And I actually side with many of these people on the science of the issue.

What concerns me is, not necessarily that Berkshire agrees to the motion, I'm actually against it, but that the enterprises under Berkshire are about to help evangelize the true science behind what's actually going on and help the American public get a better understanding, so they can also bring about change, rather than have it all occur from the executive level.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Good afternoon. My name is Bill Guenther. I'm a shareholder from Newfane, Vermont.

I work as a state forester back home and I want to say for folks that don't believe global warming is reality, I wish you would follow me around in the woods. It definitely is.

I want to support this resolution and I hope that the rest of the shareholders will feel it important enough to see it through. Thank you.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: Good afternoon. I'm (inaudible). I care about energy. I care about energy and environment more than anybody else because I'm currently still studying energy and environment issues.

But I truly believe the power of private sector, the power of free markets. And I think it's not your responsibility to put the resources of the shareholder for this issue. It's not your expertise.

I can personally do a better job to provide (inaudible) to do environmental advocacy than you do. So actually, against this resolution. Thank you.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: Sorry, I have a friend to say something. I can translate it.

(OFF-MICROPHONE SPEAKING)

OK. He says the development of the solar panel has great impact on China. And the question — and he also thinks that, actually, Berkshire should do something, as should think about the implication of that.

WARREN BUFFETT: Thank you. (Scattered applause)

OK. Whoops, we have one more.

AUDIENCE MEMBER: Hi, I'm Kevin Thompson (PH). I'm a shareholder.

I'm for the motion. I am a career engineer that works with an oil company. And what we found when we started looking at greenhouse gas emissions was that what we thought was going to end up costing the company more money actually created more revenue for the company.

And those are some of the stories that generally don't get told, but they are out there. And I would recommend that you take a look at it, because in actuality, what you may be dismissing may actually be revenue for your shareholders. Thank you.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: Hello, Mr. Buffett. I'm Mike from (inaudible) and there's obviously a fine line between, like, cutting down the Amazon forest and, like, just burning some coal.

So sometimes you can give up a little but you can't really give up that much. So that's why I don't support the motion.

WARREN BUFFETT: Thank you. (Scattered applause)

AUDIENCE MEMBER: You're welcome.

MEETING OFFICIAL: There do not appear to be any further comments.

WARREN BUFFETT: OK, thank you. (Applause)

Democracy in action at Berkshire.

The — a couple of questions that were raised. In terms of material information, or material risks, in respect to Berkshire and specifically to our insurance operation, annually in the 10-K, there's a recitation of risk. And, in my own opinion, in terms of our insurance operation, this question does not pose material risk to Berkshire's insurance operations.

The question one gentleman, toward the end, mentioned the fact that it might even be more profitable for Berkshire, in terms of what might happen if we followed the motion. Ironically, he could well be right if it were in our determination, but just take our three major states in electric utility operation, where we serve almost two million customers, Iowa, Utah, and Oregon, but it's true of other states as well.

We operate under the dictates of the utility commissions in those three states, all of which — or each of which — sets their own rules regarding operation, and each of which we end up obeying.

If we were to unilaterally, for example, decide to close down significant coal generation, we would be told to depreciate those plants over a shorter period, and that would translate, not in the cost to Berkshire, it would translate into higher rates for electricity there.

We are entitled to a return on our investment and the faster the depreciation, the higher the rates have to be in order to achieve allowed returns.

So there was a woman from Oregon speaking, for example. And the burden of any unilateral attempt by us — and we couldn't do it without the approval of the utility commissions — but the burden would fall on customers.

And it is true, actually, that we would recoup accelerated depreciation and we would probably have a much larger investment on which we would be allowed a return in other generating facilities.

But this is a question — this is not something that the stockholders of Berkshire end up incurring the costs of. It's something that the rate, or the users of electricity in these various states, will pay for. And that judgment, quite properly, should be made by the public utility commissions of those various states. And whatever they decide, you know, we will follow.

And over time, there's no question, just like we've talked about our wind generation in Iowa, this country will move toward a different composition of electricity generation.

And as I stated earlier, I personally favor more nuclear over time, but that will be determined both at the state level, and in some ways, at the national level.

So it's our recommendation that the motion be voted down. And I think the motion is now ready to be acted upon.

If there are any shareholders voting in person, they should now mark their ballots on the motion and allow the ballot to be delivered to the inspector of elections.

Miss Amick, when you are ready you may give your report?

BECKI AMICK: My report is ready.

The ballot of the proxyholders in response to proxies that were received through last Thursday evening cast 67,733 votes for the motion, and 608,576 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

The proposal fails.

44. Formal meeting adjourns

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move this meeting be adjourned.

WARREN BUFFETT: Is there a second?

VOICE: I second it.

WARREN BUFFETT: A motion to adjourn has been made and seconded. We will vote by voice.

Is there any discussion? If not, all in favor say aye.

All opposed say no.

Morning Session - 2012 Meeting

1. Welcome

WARREN BUFFETT: Good morning. I'm Warren, and this hyperkinetic fellow is Charlie.

And we're going to conduct this pretty much as we have in the past. We'll take your questions, alternating among the media and analysts in the audience until 3:30, with a break around noon for an hour.

And then we'll have the regular meeting of the shareholders beginning at that time. Feel free to drift away and shop in the other room. We have a lot of things for you there.

2. See's Candy lollypop group photo

WARREN BUFFETT: We only have one scripted part of this meeting, and See's Candy has placed on all of the seats a little packet.

And what we'd like you to do, we're going to like — we'd like to videotape everyone eating their pop at the same time for posting on Facebook and for use by the media in today's meeting.

So, if each of you will open up the lollipop now.

Now, first of all, you've got them open. We'd like you to hold them up above your head. We're going to get a shot of 18,000. Dennis, here we come. And we'll get a few shots of that.

We got it all, Mele?

OK. And now you can take off the cover and the good part comes, and Charlie and I have — we have fudge up here and we have peanut brittle.

And I said the meeting would run until 3:30. If we've consumed 10,000 calories each, we sometimes have to stop a little early at that point. (Laughter)

3. Q1 earnings

WARREN BUFFETT: The only slide we have at this point is we did put out our earnings — first quarter earnings — yesterday.

And in general, all of our companies are — with the exception of the ones in the residential construction business, which was the case last year and it's the case this year — that all of the companies, except those in that area, pretty much have shown good earnings.

And in the case of the bigger ones, the five largest non-reinsurance companies earned — all had record earnings last year, aggregating of those five companies something over 9 billion pretax.

And in the annual report I said I thought they would — if business didn't take a nosedive this year — that they would earn over $10 billion pretax this year. And certainly nothing we've seen so far would cause me to backtrack on that prediction.

The insurance — if you read our 10-Q and turn to the insurance section, you will see that there was an accounting change mandated for all property-casualty insurance companies, which — rather technical and I won't get into the details of it — it changed something that's called the deferred policy acquisition cost, called DPAC.

It has no effect on the operations at all, on the cash, but it did change the earnings downward by about $250 million pretax for GEICO in the first quarter. It's based on whether you defer some advertising.

It has — GEICO had a terrific first quarter, had a real profit margin of almost 9 percentage points, and the float grew, and everything good happened at GEICO in the first quarter. We had good growth.

But we did make that accounting change. That accounting change also affects, to a lesser degree, the second quarter, and it may even trail just a bit into the third.

But the underlying figures are somewhat better than the figures that we've presented there.

And so, overall, we feel good about the first quarter. We feel good about the year.

4. Berkshire directors introduced

Maybe we should — even though we'll do it again at the meeting — but we should probably introduce the directors. And I don't know whether the audience can see the people here but if you can turn up the lights or something so they can.

We'll start off, of course, with Charlie, Charlie Munger. And then alphabetically — if the directors would just — (Applause)

I was going to suggest that you withhold your applause until the end, but I know he's sort of irresistible, so we'll make an excuse for him. (Laughter)

For the remainder of the directors, if they stand and remain standing, and then you can applaud them at the end, if you will.

We've got Howard Buffett, Stephen Burke, Susan Decker, Bill Gates, David Gottesman, Charlotte Guyman, Don Keough, Tom Murphy, Ron Olson, and Walter Scott, Jr.

Now you can go wild. (Applause)

5. Q&A begins

WARREN BUFFETT: Now we'll start with the questions. And what we will do is we'll start over here with the media —with one of them — move to one of the analysts, and then move to one of the shareholders, and we'll go by stations with the shareholders.

And if we get — sometimes we've had as many as 60 or 62 questions.

If we get to 54, at which point each person on the panel here has had a shot at 6 questions, then from that point on we'll do nothing but the — but from the shareholders from 54 on.

So we'll see how that goes.

6. Buffett: My successor will also be the "chief risk officer"

WARREN BUFFETT: And with that, we'll start off with Carol Loomis of Fortune Magazine.

CAROL LOOMIS: Good morning. I'll make my mini speech, which the most important point is that neither Warren nor Charlie have an idea of what we're going to ask.

The other thing is that we received hundreds, if not thousands, of questions. We don't know the exact count, so we certainly couldn't use every one. If we didn't use yours, we're sorry.

So for the first question, Warren, two shareholders wrote me about the heavy responsibilities that will fall on your successor and his or her ability to deal with them. So I'll make this a two-part question.

From Chris Inge (PH), "Mr. Buffett, you have stated that you believe the CEO of any large financial organization must be the chief risk officer as well.

"So, at Berkshire, does the leading CEO candidate for successor, as well as the backup candidates, possess the necessary knowledge, experience, and temperament to be the Chief Risk Officer?"

The related question is about the Goldman Sachs, GE, and Bank of America deals, all giving Berkshire warrants, that you have negotiated.

Shareholder Jacques Cartier — Catere (PH), excuse me — asked whether these specific transactions could have been done with similar terms without your involvement.

If not, what implications would that have for Berkshire's future returns?

WARREN BUFFETT: Yeah. The — I do believe that the CEO of any large, particularly financial-related, company should — it really should apply beyond that, but certainly with a financially-related company — should be the chief risk officer.

It's not something to be delegated. In fact, Charlie and I have seen that function delegated at very major institutions, and the risk committee would come in and report every week, every month, and they'd report to the directors, and they'd have a lot of nice figures lined up, and be able to talk in terms of how many sigmas were involved and everything, and the place was just ripe for real trouble.

So I do — I am the chief risk officer at Berkshire. It's up to me to understand anything that could really hit us in any catastrophic way.

My successor will have the same responsibility, and we would not select anybody for that job that we did not think had that ability.

It's a very important ability. It ranks right up there with allocation of capital and selection of managers for the operating units.

It's not an impossible job. I mean, it — the basic risks could involve excessive leverage and they — and then the — they could involve excessive insurance risk.

Now, we have people in charge of our insurance businesses that themselves worry very much about the risk of their own unit and, therefore, the person at the top really has to understand whether those three or four people running the big insurance units are correctly assessing their risks, and then also has to be able to aggregate and think how they accumulate over the units.

That's where the real risk is, unless you're engaging in a lot of leverage in your financial structure, which isn't going to happen. Before I answer the second, Charlie, would you like to comment on that?

CHARLIE MUNGER: Well, not only was it — this risk decision frequently delegated in America, but it was delegated to people who were using a very silly way of judging risk that they've been taught in some our leading business schools. (Laughter)

So this is a very serious problem this man is raising. The so-called "Value at Risk" and the theories that outcomes in financial markets followed a Gaussian curve, invariably. It was one of the dumbest ideas ever put forward. (Laughter)

WARREN BUFFETT: He's not kidding, either. We've seen it in action.

And the interesting thing is we've seen it in action with people that know better, that have very high IQs, that study lots of mathematics. But it's so much easier to work with that curve, because everybody knows the properties of that curve, and can make calculations to eight decimal places using that curve.

But the only problem is that curve is not applicable to behavior in markets, and people find that out periodically.

The second question: we're well equipped, Carol, to answer that question. We would not have anybody — we're not going to have an arts major in charge of Berkshire. (Laughter)

The question about negotiated deal, there's no question that partly through age, partly through the fact we've accumulated a lot of capital, partly the fact that I know a lot more people than I used to know, and partly because Berkshire can act with speed and finality that is really quite rare among large American corporations, we do get a chance, occasionally, to make large transactions.

But that takes a willing party on the other side. When we got in touch with Brian Moynihan at the Bank of America last year, I had dreamt up a deal which I thought made sense for us, and I thought it made sense for the Bank of America, under the circumstances that existed.

But I'd never talked to Brian Moynihan before in my life. I had no real connection with the Bank of America.

But when I talked to him, he knew that we meant what we said, so that if I said we would do 5 billion and — I laid out the terms of the warrants — and I said we'd do it.

And he knew that that was good and that we had the money.

And that ability to commit, and have the other person know your commitment is good for very large sums and, maybe, complicated instruments, is a big plus.

Berkshire will possess that subsequent to my departure. I don't think that every deal that I made would necessarily be makeable by a successor, but they'll bring other talents as well.

I mean, I can tell you the successor that the board has agreed on can do a lot of things much, much better that I can do.

So, if you give up a little on negotiated financial deals, you may gain a great deal, just in terms of somebody that's more energetic about going out and making transactions.

And those deals have not been key to Berkshire. If you look at what we did with General Electric and Goldman Sachs, for example in those two deals in 2008, I mean, they were OK, but they are not remotely as important as, you know, maybe buying Coca-Cola stock, which was done in the market over a period of six or eight months.

We bought IBM over a period of six or eight months last year in the market. We bought all these businesses on a negotiated basis.

So the values in Berkshire that have been accumulated by some special security transaction are really just peanuts compared to the values that have been created by buying businesses like GEICO or ISCAR or BNSF, and the sort.

It's not a key to Berkshire's future, but the ingredients that allowed us to do that will still be available and, to some extent, peculiar to Berkshire, in terms of sizable deals.

If somebody gets a call from most people and they say, you know, we'll give you $10 billion tomorrow morning, and we'll have the lawyers work on it overnight, and here are the terms and there won't be any surprises, they're inclined to believe it's a prank call or something of the sort. But with Berkshire, they believe it can get done.

Charlie?

CHARLIE MUNGER: Yeah, and in addition, a lot of the Berkshire directors are terrific at risk analysis.

Think of the Kiewit Company succeeding, as it has over decades, in bid construction work on oil well platforms and tunnels and remote places and so on.

That's not easy to do. Most people fail at that eventually, and Walter Scott has presided over that bit of risk control all his life and very routinely.

And Sandy Gottesman created one of my favorite risk control examples. One day he fired an associate, and the man said, "How can you be firing me when I'm such an important producer?"

And Sandy said, "Yes," he says. "But I'm a rich old man and you make me nervous." (Laughter)

WARREN BUFFETT: Yeah. We do not have anybody around Berkshire that makes us nervous.

7. We "reserve conservatively" at insurance operations

WARREN BUFFETT: OK. Now we go to our new panel.

Cliff Gallant of KBW, we're getting the first question here from an analyst.

I don't think that is on.

CLIFF GALLANT: Oh, can you hear me?

BUFFETT: Yeah.

CLIFF GALLANT: OK, sorry. Thank you again for the opportunity. The subject, generally, still is mortality.

In your 2011 annual report, Berkshire disclosed that Berkshire Hathaway Reinsurance Group made changes in its assumptions for mortality risk, which resulted in a charge, specifically saying that mortality rates had exceeded assumptions in the Swiss Re contract.

Conversely in Gen Re's Life/Health segment, they reported lower than expected mortality, and I believe these trends continued into the first quarter that we saw in the report last night.

What was the surprise in the Swiss Re contract? And is there a difference in basic assumptions and trends for things like mortality rates among Berkshire's different businesses?

In the property-casualty businesses, for example, are the same assumptions and reserving philosophies applied companywide?

WARREN BUFFETT: Starting off with the Swiss Re example, we wrote a very, very large contract of reinsurance with Swiss Re — I would say, I don't know, a year-and-a-half ago now, or thereabouts — and it applied to their business written, I think, in 2004 and earlier. And they had a lot of business. It was American business.

And we started seeing — we got reports quarterly — and we started seeing mortality figures coming in quarterly that were considerably above our expectations and what looked like should be the case — should have been the case — looking at their earlier figures.

So at the end of last year — we have a stop-loss arrangement on this — so we set up a reserve that really reserves it to the worst case, except we present-value that.

But until we get — until we figure out what can be done about that contract — and we have some possibilities in that respect — we will keep that reserved at this worst case. And so we took a charge for that amount.

We do — we are reinsuring Swiss Re, and then they are reinsuring a bunch of American life insurers, and there is ability to reprice that business as we go along, but the degree to which we and Swiss Re might want to reprice that may be a subject of controversy, we'll see, so we just decided to put it up on a worst-case basis.

Getting to the question of how GEICO reserves, how Gen Re reserves, I would say that — it's described to some extent in our annual report — but I would say that the one overriding principle is that we hope, and our plan is, to reserve conservatively.

I mean, it's a lot different reserving in the auto business, where on short-tail lines and physical damage and property damage, you know, you find out very quickly how you're doing.

And if you look at GEICO's figures, you know, we've had redundancies year after year after year.

Gen Re was under reserved at the time we bought it, and back in those 1999/1998 years, those developed very badly. Now they've been developing very favorably for some time. I think with Tad Montross, we've got a fellow that — where I feel very good about the way he reserves.

But he is not — there's no coordination between him and Tony [Nicely] at GEICO, nor with Ajit [Jain] at Berkshire Hathaway Reinsurance. They all have, I think, the same mindset, but they don't — they're three very different, different businesses.

Charlie?

CHARLIE MUNGER: There's always going to be some contract where the results are worse than we expected. Why would anybody buy our insurance if that weren't the case? (Scattered laughter)

WARREN BUFFETT: It's interesting how — I mean, just take 9/11. You know, it's very hard to reserve after something like 9/11, because to what extent is business interruption insurance — when you close the stock exchange for a few days, are you going to be able to collect on insurance?

And, you know, when you close restaurants at airports, you know, 2,000 miles away, because the airport is closed for a few days, is that business interruption insurance? There's — a lot of questions come up.

We turned out to be somewhat over-reserved for 9/11, as it turned out.

You've got the same situation going on in both Thailand and Japan because, as you know, the supply chain for many American companies was interrupted by the tsunami in Japan and the floods in Thailand.

And if you're a car manufacturer in the United States and you aren't getting the parts, you know, does your business interruption insurance cover the fact that there were floods for your supplier in Thailand or the tsunami hit in Japan? Sometimes that stuff takes years and years to work out.

On balance, I think you will find that our reserves generally develop favorably.

8. "It's amazing how little influence we've had"

WARREN BUFFETT: OK. We go to the audience now up at post number 1, and there he is.

AUDIENCE MEMBER: There he is. Good morning, Mr. Chairman, Mr. Vice Chairman. My name is Andy Peake (PH), and I'm from Weston, Connecticut.

In the past, you've made a few investments in China: PetroChina and BYD, to name two.

Given the growing importance of China in the world, what advice would you give the new Chinese leadership and corporate CEOs such that you would make more investments in China? Xièxiè.

WARREN BUFFETT: Well, Charlie has made the most recent investment in China, so I'll let him handle that one.

CHARLIE MUNGER: Yeah, we're not spending much time giving advice to China. (Laughter)

WARREN BUFFETT: That's not because they're not hungry for our advice. (Laughs)

CHARLIE MUNGER: If you stop to think about it, China has been doing very, very well from a very tough start. To some extent, we ought to seek advice there instead of give it.

WARREN BUFFETT: We have — I would say that we've found it almost useless in 60 years of investing to give advice to anybody in business.

CHARLIE MUNGER: We have found that we have a lot of control — it's kind of like controlling affairs by pushing on a noodle.

It's amazing how little influence we've had when we had 20 percent of the stock.

And people have this illusion of mass control at headquarters. The beauty of Berkshire is that we created a system that doesn't require much control at headquarters.

WARREN BUFFETT: But we — if you look at our four largest investments, which are worth, we'll say — they're certainly worth $50 billion today.

We've had some of them for 25 years — one of them — and another one for 20 years.

The number of times that we have talked — unless we were on the board, which I was at Coca-Cola — but the number of times we've talked to the CEO of those companies, where we have $50 billion, I would say doesn't average more than twice a year, and we are not in the business of giving them advice.

If we thought that the success of our investment depended upon them following our advice, we'd go onto something else. (Laughter)

9. No warnings when Berkshire shares are overvalued

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from a shareholder named Ben Noll (PH), and I've got several different emails that were very similar to this one but I'm choosing Ben's question.

He writes that while pleased by your announcement to buy back stock at 110 percent of book value, he feels like a bit of a chump for sometimes having paid nearly 200 percent of book in the past few years.

Since you've stated repeatedly that it's as bad to be overvalued as to be undervalued, why didn't you warn us previously when the price-book relationship was very different, or have you not felt that Berkshire was trading above intrinsic value over the last decade?

WARREN BUFFETT: Yeah, we've written in the back of the report how we prefer to — not to see our shares sell at the highest possible price.

I mean, we've got a whole different view on that than many managers.

If we could have our way, we would have the stock trade once a year, and Charlie and I would try to come up with a fair value for intrinsic business value, and it would trade at that.

That's incidentally what some private companies do, but you're not allowed that luxury in the public market, and public markets do very strange things.

If Charlie and I think Berkshire is overvalued, then it would be a very interesting proposition to have us announce, you know, a half an hour before the market opens someday, and have us both saying, gee, we think your stock is overpriced.

I mean, we would have to do that with every shareholder simultaneously, and they would — who knows how they would react. We have never — I don't think — certainly never consciously done anything to encourage people to buy our stock at a price we thought was above intrinsic value.

The one time we sold stock, under some pressure back in the mid-1990s when somebody was going to do something with the stock that we thought would be injurious to people, we created a stock and we thought the stock was a little on the high side then and we put on the cover of the prospectus something that I don't think has ever been seen, which we said that neither Charlie nor I would buy the stock at the price, nor would we recommend that our family did it. (Scattered laughter)

And if you want a collector's item for a proxy material — offering material — get that because I don't think you'll see that one again.

We think that if we are going to repurchase shares from people, that we ought to let them know what — that we think we're buying it too cheap.

I mean, we wouldn't buy out — if we had two or three partners and somebody wanted to sell out — but we'd probably try to arrive at a fair price — but if it was established by a market and they were going to sell too cheap, we'd tell them we thought they were selling it too cheap.

We are not selling it. We are not saying that 111 percent — we're using 110 percent of book — 111 percent or 112 percent is intrinsic business value — we know it's significantly above 110.

And I don't think we will ever announce — because I don't see how we would do it — I don't think we'll ever announce that we think the stock is selling considerably above intrinsic business value, but we will certainly do nothing to indicate that we think the stock is attractively priced, if that comes about.

Charlie?

CHARLIE MUNGER: I've got nothing to add. (Laughter)

10. We'll buy "significantly" undervalued Berkshire shares

WARREN BUFFETT: Jay Gelb from Barclays.

JAY GELB: Thank you. My question is also on share buybacks.

Warren, in last year's annual letter, you said not a dime of cash has left Berkshire for dividends or share repurchases during the past 40 years.

In 2011, Berkshire changed course and announced a share repurchase authorization.

What I'd like to focus in on is, what is Berkshire's capacity for share buybacks, based on continued strong earnings power? How attractive is deploying excess capital and share buybacks compared to acquisitions, even above 1.1 times book value? And what are your latest thoughts on instituting a shareholder dividend?

WARREN BUFFETT: The 1.1 is a figure that we feel very comfortable with. So, we would probably feel comfortable with a figure somewhat higher than that, but we wanted to be dramatically — or very significantly — undervalued to do buybacks, and we want to be very sure that every shareholder that sells to us knows that we think that it's dramatically — or significantly — undervalued when we do it.

But we have a terrific group of businesses.

The marketable securities that we own, we think, are going to be worth more in the future, but we carry them at what they're selling for today. So they're not — that's not an undervalued item, you know, in the balance sheet.

But some of the businesses we own are worth far more money than we carry them, and we have no significant business that's worth any significant discount from the carrying value.

So we would — from strictly a money-making viewpoint — we would love to buy billions and billions and billions of dollars' worth of stock at — we'll move that up to tens of billions — at 110 percent of book.

You know, I don't think it will happen, but it could happen. You never know what kind of a market you'll run into.

And if we get the chance to do it, as long as we don't take our cash position below 20 billion, we will — we would buy very aggressively at that price. We know we're making significant money for remaining shareholders.

The value per share goes up when we buy at 110 percent of book, and therefore — and it's so obvious to us that we would do it on a big scale if given the chance to, and if it did not take our cash position down below a level that leaves us comfortable.

Charlie?

CHARLIE MUNGER: Well, some people buy their own stock back regardless of price. That's not our system.

WARREN BUFFETT: Well, we think it's — we think a lot of the share repurchases are idiotic.

CHARLIE MUNGER: I was trying to say that more gently.

WARREN BUFFETT: You've never done it before. (Laughter)

The — it's — I mean, it's for ego. I've been in a lot of board rooms where share repurchase authorizations have been voted, and I will guarantee you it's not because the CEO is thinking the way we think at all.

They like buying their stock better at higher prices, and they like issuing options at lower prices. You know, it's just exactly the opposite than the way we would think.

We will only do it for one reason, and that's to increase the per-share value the day after we've done it.

And if we get a chance to do that, we both, you know, in a big way, we'll do it in a big way.

I don't — strictly operating as a financial guy, I would hope we get a chance to do a lot of it. Operating as a fiduciary for hundreds of thousands of people, I don't want to see them sell —

CHARLIE MUNGER: We hope the opportunity never comes.

WARREN BUFFETT: Yeah. But if it does, we'll grab it.

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

WARREN BUFFETT: OK. Station two, shareholder?

AUDIENCE MEMBER: Hello, Mr — Hi, Mr. Buffett. My name is Bernard Fura (PH) from Austria, Vienna.

My question is about banks. What's your view on the European banks? What's your view on the U.S. banks? And what must happen that you invest in European banks? Thank you.

WARREN BUFFETT: Well, I have a decidedly different view on European banks than American banks.

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

They've buttressed their capital in a very big way. They've got liquidity coming out their ears at the bigger banks. The American banking system is in fine shape.

The European banking system was gasping for air a few months back, which is why Mr. Draghi opened up his wallet at the ECB and came up with roughly a trillion euros of liquidity for those banks.

Now a trillion euros is about $1.3 trillion, and $1.3 trillion is about one-sixth of all the bank deposits in the United States.

I mean, it was a huge act by the European Central Bank, and it was designed to replace funding that was running off from European banks. European banks had more wholesale funding than American banks, on average.

If you look at the Bank of America or Wells Fargo, they get an enormous amount of money from a natural customer base. European banks tended to get much more of it on a wholesale basis, and that money can run pretty fast.

So the European banks need more capital in many cases. They've done very little along that line.

One Italian bank had a rights offering here three or four months ago, but basically they have not wanted to raise capital, probably because they didn't like the prices at which they would have had to do so, and they were losing their funding base.

The problem on the funding base has been solved by the ECB because the ECB gave them this money for three years at 1 percent.

I'd like to have a lot of money at three years at 1 percent, but I'm not in trouble, so I can't get it. (Laughter)

But I just — if you look at our banking system, it's really remarkable what's been accomplished.

I thought at the time that the Treasury and the Fed were maybe a little overdoing it when they brought those bankers to Washington and banged their heads together and said you're going to take this money whether you like it or not.

But overall, I think that policy was very sound for this country's economy. And if some banks were forced to raise capital that they didn't need, you know, which I might not have liked as a shareholder at one of them, overall, I think that our society benefited enormously.

And I think the Fed and the Treasury has handled things quite sensibly during a period when if they hadn't handled this sensibly, that our world today would be a lot different.

Charlie?

CHARLIE MUNGER: Yeah. Europe has a lot of problems we don't. We've got this full federal union, and the country that runs the central bank can print its own money and pay off its own debt and so on.

And in Europe, they don't have a full federal union and that makes it very, very difficult to handle these stresses. So we're more comfortable with the risk profile in the United States.

WARREN BUFFETT: It's night and day. I mean, it — in the fall of 2008, when essentially Bernanke and Paulson, and implicitly, the President of the United States, said we'll do whatever it takes, you knew that they had the power, and the will, to do whatever it took.

But when you get 17 countries that have surrendered their sovereignty, as far as their currency is concerned, you know, you have this problem. Henry Kissinger said it a long time ago. He said, "If I want to call Europe, what number do I dial?"

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

So I would put European banks and American banks in two very different categories.

12. Munger: "Idiotic" to use natural gas instead of coal

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Thank you Warren. This question comes from a shareholder who works at a coal mining company and he asked the following:

"Burlington Northern and MidAmerican are two key links in a critical supply chain. Can you describe your views on coal and natural gas investments, and can you discuss how the current low-price environments impact the prospect for each of these businesses?

"You seem to have created an elegant hedge. As Burlington Northern suffers from the decline in coal, MidAmerican may benefit from the fire sale in its fuel sources."

WARREN BUFFETT: Yeah. Well, MidAmerican will never really benefit or be penalized too much by the price of coal, because if coal is cheap, the benefit is going to be passed on to customers, and if it's expensive, the costs are going to be passed on.

You know, MidAmerican really is a — it's a regulated public utility. It has several — we have two MidAmericans. We have a MidAmerican Holding and a MidAmerican that operates in Iowa, then we have utilities on the West Coast.

But those utilities are pass-through organizations. They need to be operated efficiently in order to achieve their rate of return, but if they are operated efficiently and in the public interest, whether coal or labor, whatever it is, may go up or down, really doesn't affect them, although it affects their customers.

Coal traffic is important to all railroads in the United States, and coal traffic is down this year.

This may interest you. This year, in the first quarter, kilowatt hours used in the United States went down 4 percent — 4.7 percent. That is a remarkable decrease in electricity usage, 4.7 percent, and that affected, of course, the demand for coal.

But the other thing that's happening, as you mentioned, natural gas got down under $2 — it's a little higher now — but it got down under $2 at the same time oil was $100.

And if you told Charlie or me five years ago that you'd have a 50-to-1 ratio between oil and natural gas, I think we would have asked you what you were drinking.

Did you ever think that was possible, Charlie?

CHARLIE MUNGER: No. And I think what's happening now is, to use your word, it's idiotic.

We are using up a precious resource, which we need to create fertilizer and so forth, and sparing a resource which is precious but not as precious, which is thermal coal.

If I were running the United States, I would use up every ounce of thermal coal before I'd touch a drop of natural gas. But that's — conventional view is exactly the opposite. I think those natural gas reserves we just found are the most precious things we could leave our descendants.

I'm in no hurry to use it up, and the gas is worth more than the coal.

WARREN BUFFETT: Despite the wild things we've seen in pricing, particularly this ratio of natural gas prices to oil, you can't change — I mean the installed base is so huge when you get into electricity generation — that you can't really change the percentages too much, although there has been a shift in recent months.

Where gas generation is feasible, it has supplanted some coal generation. And certainly in the future, you're going to see a diminution in the percentage of electricity generated from coal in this country.

But it won't be dramatic because it can't be dramatic. You just can't — the megawatts involved are just too huge to have some wholesale change.

It's going to be very interesting to see how this whole gas-oil ratio plays out, because it has changed everyone's thinking, and it's changed in a very short period of time. I mean, three years ago, people wouldn't have said this was possible.

CHARLIE MUNGER: Yeah. The conventional wisdom of the economics professors is if it happens in a free market it must be OK. It will work out best in the end.

That is not my view with 100 percent accuracy. I think there are exceptions to that idea. And I think it's crazy to use up natural gas at these prices.

13. GEICO has no plans to use driver tracking technology

WARREN BUFFETT: OK. Gary Ransom of Dowling.

GARY RANSOM: Telematics is the latest pricing technology in the auto insurance business whereby you put a little device in your car and you can either get a discount or some other determination of your pricing based on actual driving behavior.

What is GEICO doing to keep pace with that change, and are there any other initiatives that GEICO has in place to maintain its competitive advantages in pricing?

WARREN BUFFETT: Yeah. Progressive, as you know, has probably been the leader in what you just described. And we have not done that at GEICO, but it — if we think there becomes a superior way to evaluate the likelihood of anybody having an accident, you know, I think we have 50 — I think you have to answer 51 questions — which is more than I would like, if you go to our website to get a quote.

And every one of those is designed to evaluate your propensity to get in an accident.

Obviously, if you could you could ride around in a car with somebody for six months, you might learn quite a bit about the propensity, particularly if they didn't know you were there, you know, like with your 16-year-old son.

But I do not see that as being a major change, but if it becomes something that gives you better predictive value about the propensity of any given individual to have an accident, we will take it on, you know, and we will try to get rid of the things that don't really tell us that much all the time.

But we're always looking for more things that will tell us if we look around at these — the people in this room, one by one, you know — what tells us their likelihood of having an accident in the next year.

We know that youth is, for example. I mean, there is no question that a 16-year-old male is much more likely to have an accident than some guy like me that drives 3500 miles a year and is not trying to impress a girl when he does it, you know. (Laughter)

So, you know, that one is pretty obvious. Some of these others — some things are very good predictors that you wouldn't necessarily expect to be. Credit scores are, but — and they're not allowed in all places — but they will tell you a lot about driving habits.

We'll keep looking at anything, but I do not see any — I don't see in this new experiment — anything that threatens GEICO in any way. GEICO, in the first quarter of the year — now the first quarter is our best quarter — but we added a very significant number of policies.

I forget what the exact number was, but February turns out to be the best month for some reason. We were up there getting pretty close to 300,000 policies.

So our marketing is working extremely well, and our risk selection is working extremely well, and our retention is working well. So GEICO is quite a machine.

That's one of the — that's the business that we carry, as I've mentioned in the past — I think we carry it at a billion dollars — roughly a billion dollars over its tangible book value. You know, it's worth a whole lot more than that.

I mean, based on the price we paid, that figure would come up these days to, you know, certainly something more like $15 billion more than carrying value.

And we wouldn't sell it there. We wouldn't sell it at all, but that would not tempt us in the least.

Charlie?

CHARLIE MUNGER: Nothing to add.

14. Business schools are improving but still teach "nonsense"

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Hi, Charlie and Warren. My name is Chris Reese. I'm here with a group of MBA students from the University of Virginia in Charlottesville.

In recent years, business schools have taken a lot of blame for some of the recent state of the economy.

What would you suggest to change the way that business leaders are trained in our country?

WARREN BUFFETT: Well, I wouldn't — I don't know. Charlie, I wouldn't blame business schools particularly for most of the ills — would you?

I think they've taught to students a lot of nonsense about investments, but I don't think that's been the cause of great societal problems. What do you think?

CHARLIE MUNGER: No, but it was a considerable sin. (Laughter)

WARREN BUFFETT: Well, you want to elaborate on what was the more sin —

CHARLIE MUNGER: No, no. I think business school education is improving. (Laughter)

WARREN BUFFETT: Is the implication from a low base or —

CHARLIE MUNGER: Yes. (Laughter)

WARREN BUFFETT: I'd agree with that. (Laughter)

No, in investing, I would say that probably the silliest stuff that we've seen taught at major business schools probably has been — maybe it's because it's the area that we operate in — but has been in the investment area.

I mean, it is astounding to me how the schools have focused on sort of one fad after another in finance theory, and it's usually been very mathematically based.

When it’s become very popular, it’s almost impossible to resist if you’re — if you hope to make progress in faculty advancement.

Going against the revealed wisdom of your elders can be very dangerous to your career path at major business schools.

And you know, really, investing is not that complicated. I would have — you know, a couple of the courses. I would have a course on how to value a business, and I would have a course on how to think about markets.

And I think if people grasped the basic principles in those two courses that they would be far better off than if they were exposed to a lot of things like modern portfolio theory or option pricing. Who needs option pricing to be in an investment business?

You know, when people — you know, when Ray Kroc started McDonald’s, I mean, he was not thinking about the option value of what the McDonald’s stock might be or something. He was thinking about whether people would buy hamburgers, you know, and what would cause them to come in, and how to make those fries different than other people’s, and that sort of thing.

It’s totally drifted away — the teaching of investments.

I look at the books that are used, sometimes, and there’s really nothing in there about valuing businesses, and that’s what investing is all about.

If you buy businesses for less than they’re worth, you’re going to make money.

And if you know the difference between the businesses that you can value and the ones that you can’t value, you know, which is key, you’re going to make money.

But they’ve tried to make it a lot more difficult and, of course, that’s what the high priests in any particular arena do. They have to convince the laity that the priests have to be listened to.

Charlie?

CHARLIE MUNGER: The folly creeps into the accounting, too. A very long-term option on a big business you understand — the stock of a big business that you understand — or even a stock market index — should not be — the optimal way to price it is not by using Black Scholes, and yet the accounting profession does that.

They want some kind of a standardized solution that requires them not to think too hard, and they have one. (Laughter)

WARREN BUFFETT: Is there anybody we’ve forgotten to offend? (Laughter)

If you'll send a note up. (Laughs)

15. Buffett Rule: minimum tax for "very, very high earners"

WARREN BUFFETT: Carol?

CAROL LOOMIS: Well, talking about not offending, "The talk of the "Buffett Rule" is all over newspapers and TV.

"But I believe your concept of what should happen to taxation of very high earners is different from what is now promulgated as the 'Buffett Rule.'

"Could you clear us up on this?" This is a question from Leo Slazeman (PH) from the Kansas City metropolitan area.

WARREN BUFFETT: Yeah. I would say this: it has gotten used in different ways.

I think, intentionally, in some cases, because it was more fun to attack something that I hadn't said than try to attack what I had said.

Basically the proposal is that people that make very large incomes pay a rate that is commensurate with what people think is paid by people of those incomes.

I mean, I think most people believe, when they look at the tax rates and all that, that if you're making 30 or 40 or $50 million a year, that you're probably paying tax rates in the 30 percent area, at least. And many people are.

But the figures are such that if you look at the most recent year, and you aggregate both payroll and income taxes, because they both go to the federal government on your behalf, if you take the 400 largest incomes in the United States, they average $270 million each.

That's per person, 270 million each. 131 of those 400 paid tax rates that were below 15 percent. Now — counting payroll taxes, too.

In other words, they were paying at less than what the standard payroll tax was — up till we've had this giveback here recently — but payroll tax was 15.3 percent for most of the last decade.

So, under the "Buffett Rule," we would have a minimum tax — only for these very, very high earners — that, essentially, would restore their rate to what it used to be back in 1992.

When the average income of the top 400 was only 45 million, there were only 16 of the 400 that were at 15 percent or below. But now there's 131.

There's still plenty of them that are paying in the 30s. I wouldn't touch them.

But I would say when we're asking for shared sacrifice from the American public, when we're telling people that we formally told — were given promises on Social Security and Medicare and various things — and we're telling them we're sorry but we kind of overpromised so we're going to have to cut back a little, I would at least make sure that the people with these huge incomes get taxed at a rate that is commensurate with the way they used to be taxed not that long ago and probably — and is commensurate also with the way that two-thirds of the people in that area get taxed at higher rates.

So it's gotten butchered a little bit, but it would affect very, very, very few people. It would raise a lot of money. (Applause)

CHARLIE MUNGER: Warren, isn't the suggestion that you can give about half of a 30 percent to charity instead of the government?

WARREN BUFFETT: Well, but the tax rates, still, after the charitable deduction, after the charitable deduction, you have to give — if you're going to give 50 percent and get a deduction — it has to be all cash. If you start giving appreciated securities —

And then if you give to a private foundation, you're down to 20 percent. Yeah. But —

CHARLIE MUNGER: But there is some exception in this proposal now isn't it — Obama's proposal — that charitable contributions help you?

WARREN BUFFETT: Well, there is a — there's a bill, actually, by Senator [Sheldon] Whitehouse of Rhode Island. I mean, that is the only actual bill. That was voted on, and it did not get the vote. It got 51 votes in the Senate and needed 60. I can't tell you the exact precision on what it included there.

I don't have any — you know, there can be all kinds of other ways of getting at the same proposition. I just think that people like me that have huge incomes — and I have no tax planning, I don't have any gimmicks, I don't have Swiss bank accounts, I don't have any of that kind of stuff.

But when I get all through, you know, I've made the calculation four different — three different times — 2004, 2006, and 2010 — and in all three of those years, when my income was anywhere from 25 to 65 or so million, I came in with the lowest tax rate in our office. And we had maybe 15 to 22 or so people in the office at different times, and everybody in the office was surprised.

They were all in the 30s. And I was, several times, you know, in this area of 17 percent, and that's because the tax law has gotten moved over the years in a way to favor people that make huge amounts of money.

Imagine having 270 million of income and there were — I believe there were — 31 of the 400 that were below 10 percent on tax rates, and that counts payroll taxes as well.

And like I say, you know, my cleaning lady — incidentally, I've been asked to explain — I keep talking about my cleaning lady.

Well, my wife wants it very clear, she doesn't have a cleaning lady. This is the cleaning lady at the office, Mary that I — (laughter) — my wife has gotten very — she does not have a cook, she does not have a cleaning lady, and she got a little tired of me implying that she had one.

So it's my cleaning lady at the office has been paying 15.3 percent on Social Security taxes, at the same time that an appreciable number of people making hundreds of millions of dollars a year are paying less than 10 percent.

I think it's time to take a look at that. OK — (applause)

16. Catastrophe insurance: "nobody knows for sure what the right rate is"

WARREN BUFFETT: Cliff.

CLIFF GALLANT: Over the past two years, the world has witnessed a number of surprisingly large financial losses from major catastrophes, including earthquakes in Chile, and Japan, New Zealand, as well as floods in Thailand.

Near term, what do you expect the impact on reinsurance pricing will be for catastrophe risk? And longer term, does this trend of increased frequency of major catastrophes affect Berkshire's view on the global reinsurance business?

WARREN BUFFETT: It's very hard, because of the random nature of quakes and hurricanes and that sort of thing, very hard to know when you really have had a trend.

We've had that situation with global warming. I mean, it has been ungodly warm here in the last few months. A few years ago, it was extremely cold.

Anything that moves as slowly as the things affecting our globe, separating out the random from new trends is really — is not easy to do.

We tend to sort of assume the worst. I mean, if we see more earthquakes in New Zealand than have existed, you know, in the last few years than existed over the last 100 years, we don't say that we'll extrapolate the last couple of years and say that's going to be the case, this huge explosion of quakes. But we also don't take the 100-year figure anymore.

We have written — in the last few months — we have written far more business in Asia, and by that I mean New Zealand, Australia, Japan, and Thailand.

We've written quite a bit more — a lot more business — than we wrote a year ago, or two years ago, or three years ago, because they've had some huge losses, and they have found that the rates they had been using were really inadequate. And they are looking for large amounts of capacity in some cases, and we are there to do that if we think the rate is right.

But nobody knows for sure what the right rate is.

I mean, we can tell you how many 6.0 or greater quakes have happened in California in the last hundred years and how many Category 3 hurricanes have hit, you know, both sides of Florida, whatever.

There's all kinds of data available on that, but the question is, how much does it tell you about the next 50 years?

And so we — if we think we're getting a rate that — if a fairly negative hypothesis would indicate — then we move ahead, and we've done that in the Pacific.

I don't know whether you know it, but if you — last year, we had two or three quakes in Christchurch, New Zealand, but I believe it was — the second one caused, like, $12 billion of insured damage.

And if you think of that in relationship of a country of 4 or 5 million and you compare that to the kind of cats we've had in the United States, that's ten Katrinas. You know, there's been some really severe —

And Thailand was the same way with the floods.

It was — the losses were just huge in respect to the entire premium volume in the country.

So when that happens, everybody reevaluates the situation, and we are perfectly willing to take on very big limits if we think we're getting the right price.

We have propositions out for as much as 10 billion of coverage, you know. Now, we don't want that 10 billion to correlate with anything else, and we want to be sure we get the right price. But — and we may write some at some point.

It's certainly — the market for cat business in some parts of the world is significantly better from our standpoint than it was a year or two ago, but that's not true every place.

17. Wind power wouldn't "make sense" without subsidies

WARREN BUFFETT: OK. Station 4.

AUDIENCE MEMBER: Good morning, Mr. Buffett, Mr. Munger. My name is Verne Fishenberry (PH), and I ask this question on behalf of a group of investors that made the trip up from Overland Park, Kansas.

MidAmerican has a large investment in wind and solar power. What effect do subsidies and incentives have on that business, and could you share your thoughts on a sustainable energy policy?

I gather we should be conserving our natural gas. What is the most appropriate use of that resource?

WARREN BUFFETT: Yeah. Well, I believe the — on wind — and we're much bigger in wind than solar, although we've entered solar in the last six months or so. We've got two solar projects that we own about a half of each one of them.

But we've been doing wind for quite a while, and I think the subsidy is 2.2 cents for ten years per kilowatt hour, and that's a federal subsidy.

And there's no question that that makes wind projects — in areas where the wind blows fairly often — that makes wind projects work, whereas they wouldn't work without that subsidy. The math just wouldn't work out.

So the government, by putting in that 2.2 cents subsidy, has encouraged a lot of wind development. And I think if there had been none, my guess is there would have been no wind development. I don't think any of our projects would make sense without that subsidy.

In the case of solar, the projects we have have got a commitment from Pacific Gas and Electric to a very long-term purchase commitment.

How that ties in with their particular obligations or anything, I mean, there may be some subsidy involved in why they wish to buy it at the price they do from us. I'm sure there is; I don't know the specifics of it.

But neither one of those projects, neither solar nor wind — if Greg Abel is here and wants to go over to a microphone and correct me on this, it would be fine — but I don't think any solar or wind would be working without subsidy.

And, of course, you can't count on wind for your base load. I mean, it works and it's clean, but if the wind isn't blowing, you know, it does not mean that everybody wants to have their lights off.

So it's a supplementary type of generation, but it can't be part of your base generation.

Charlie, do you have any thoughts on that? And Greg, do we have Greg up here? Go ahead, Charlie.

CHARLIE MUNGER: Well, I think, of course, it — eventually we're going to have to take a lot of power from these renewable sources and, of course, we're going to have to help the process along with subsidies.

You know, I think it's very wise that that's what the various governments are doing.

WARREN BUFFETT: Yeah, you could say the future is subsidizing, you know, oil and natural gas now, in a sense.

Is Greg up there?

CHARLIE MUNGER: He needs a mic.

WARREN BUFFETT: He needs a mic.

GREG ABEL: Zone 7. Yeah.

WARREN BUFFETT: Yeah.

GREG ABEL: Just to touch on the — both the wind projects and the solar, Warren, you were exactly right. Obviously the subsidy associated with the wind has allowed us to build, now, 3,000 megawatts across our two utilities.

And you are absolutely correct, we would have not moved forward without that type of subsidy.

On the solar, there's actually a couple other incentives that are in place. You get a very large incentive associated with constructing the assets.

We get — we recover 30 percent of the construction costs as we build it.

Significant advantage there, relative to Berkshire being a full taxpayer, where a lot of other entities in the U.S. are not — or the corporate entities that are competing for those projects relative to ourselves often don't have the tax appetite for those type of assets.

So we do benefit from the ongoing tax structure, there's no question, both in wind and in solar.

WARREN BUFFETT: Greg has hit on a point that people don't — often don't — understand about Berkshire.

We have a distinct competitive advantage. It's not unique, but it's a distinct competitive advantage in that Berkshire pays lots of federal income tax.

So when there are programs in the energy field, for example, that involve tax credits, we can use them because we have a lot of taxes that we're going to pay, and therefore, we get a dollar-for-dollar benefit.

I don't have the figures, but I would guess that perhaps 80 percent of the utilities in the United States cannot reap the full tax benefits, or maybe any tax benefits, from doing the things that we just talked about because they don't pay any federal income taxes.

They've used bonus depreciation, which was enacted last year and where you get 100 percent write-off in the first year. They wipe out their taxable income.

And if they've wiped out their taxable income through such things as bonus depreciation, they do not — they cannot — have any appetite for wind projects where they get a tax credit or — in the solar arrangement.

So, by being part of Berkshire Hathaway, which is a huge taxpayer, MidAmerican has extra abilities to go out and do a lot of projects without worrying about whether they sort of exhausted their tax capacity. It's an advantage we have.

18. Political views shouldn't affect investing decisions

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from John in Brunswick, Georgia.

He says, "You are clearly entitled to speak your mind on any and all subjects as an individual, but the recent publicity around the Buffett tax has become quite loud.

"And as a shareholder, I fear it is limiting, to some degree, the interest in the Berkshire stock, on principal, for some people.

"For instance my 84-year-old father is not interested in investing in Berkshire because of his opposition to this tax position, and otherwise, he likely would.

"While being a public company CEO, should some of the political dialogue be somewhat muted for the betterment of the company and its share price?"

WARREN BUFFETT: Yeah. That's a question that's raised frequently. (Applause)

But I really — in the end, I don't think that any employee of Berkshire, I don't think that the CEOs of any of the companies that we own stock in, should in any way have their citizenship restricted.

We did not — (Applause)

When Charlie and I took this job, we did not decide to put our citizenship in a blind trust. People are perfectly willing — it's fine if they disagree with us. I think it's kind of silly.

I don't know the politics of — necessarily — of [American Express CEO] Ken Chenault or [Coca-Cola CEO] Muhtar Kent or [Wells Fargo CEO] John Stumpf. I got a pretty good idea with [banker Richard] Kovacevich at one time. (Laughs)

But they run these businesses in which we have ten — [IBM CEO] Ginni Rometty, I mean, we've got 11 or $12 billion with her. I don't know what her politics are, and, you know, I don't know what her religion is.

She's got all kinds of personal views, I'm sure, that probably are better than mine, but it doesn't make any difference. I just want to know how she runs the business.

And I really think that that 84-year-old man making a decision on what he invests in based on who he agrees with politically, sounds to me like you ought to own FOX. (Laughter and applause)

Charlie?

CHARLIE MUNGER: Well, I want to report that Warren's view on taxes for the rich has reduced my popularity around one of my country clubs. (Laughter)

WARREN BUFFETT: If it keeps him from hanging around the country club, I'm all for it.

CHARLIE MUNGER: And it's a disadvantage I am willing to bear in order to participate in this enterprise. (Laughter)

WARREN BUFFETT: Charlie and I, we don't disagree on as many things as you might think, but we've certainly disagreed on some things over 53 years. It's never — we've never had an argument in 53 years. Maybe you can get one started here if you work on it. (Laughter)

But it — it's just — it's irrelevant. I mean, you know, roughly half of the country is going to feel one way this November and the other half is going to feel a different way.

And if you start selecting your investments, or your friends, or your neighbors, based on trying to get people that agree with you totally, you're going to live a pretty peculiar life, I think.

19. Size of potential deals limited by commitment to not use stock

WARREN BUFFETT: OK. Jay.

JAY GELB: Warren, this question is on acquisitions. Would you consider an acquisition in excess of $20 billion?

And if so, would it be funded in terms of existing cash, as well as issuing debt and equity, or perhaps even selling existing investments?

WARREN BUFFETT: Yeah. We considered one here just a month or two ago which we would have liked — I wish we could have made it. There was probably about 22 billion.

I mean, it gets — above 20 billion it gets to be more and more of a stretch, particularly because we won't use our stock at all.

We used stock in the Burlington Northern acquisition, and we felt that it was a mistake, but we were using it for what, in effect, turned out to be about 30 percent of the deal, and we felt that we were doing well enough with the cash that overall that the mix was OK.

But we would not use our stock now, and we wouldn't even use it for 30 or 40 percent of some deal. It's hard to imagine. So we really —

CHARLIE MUNGER: It's hard to imagine, but it could be conceivably happen.

WARREN BUFFETT: It could happen, it could happen.

But I don't think it will happen. (Laughs)

CHARLIE MUNGER: I don't either.

WARREN BUFFETT: So, we looked at this 22 or $23 billion-dollar deal, and we would have done it if we could have made the deal.

But it would have stretched us, but we would not have pushed it to the point where it would have taken our cash below 20 billion.

We would have sold securities, we would have done whatever was necessary to have a $20 billion cash balance when we got done with the deal.

But I would have had to sell some securities I didn't want to sell. I liked the deal well enough so I would have done it.

Now, if that had been 40 billion, I don't think we, you know, no matter how well I liked it, I don't think I would have wanted to peel off 25 billion or so of marketable securities trying to get it done, and I certainly wouldn't want to be in limbo not knowing exactly where the money was going to come from, and therefore, be subject to some terrible shock in the world, in the market.

If you have a $20 billion-dollar deal, though, I've got an 800 number, so — (Laughter)

But you've actually sort of hit the point where we start squirming a little bit as to where we would come up with the money.

On the other hand, the money is building up month by month so I — we will — if we can make the right $20 billion deal, we'll do it. And next year, if we haven't made a deal, I'll probably say if we can find the right $30 billion deal, we would do it.

20. We can't bring jobs back to the U.S. because they never left

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: Glenn Mollenhour (PH), Westlake, Ohio. First of all, I want to thank you for having us here today. Very nice. Now Warren, I'd like to have dinner with you tomorrow night at Gorat's.

WARREN BUFFETT: They'll have a bidding at Glide here in June. It went for two million-six last year. (Laughter)

AUDIENCE MEMBER: My question is about jobs coming back to the U.S. I notice a number of companies have started to bring jobs back here.

Is Berkshire Hathaway looking at doing that for any job they've shipped out of the United States?

WARREN BUFFETT: Well, I have to finish my fudge here — the — I would say that of the 200 — the number of jobs we have is listed in the back of the report — I think it's about 270,000 — 270,858 at year-end.

I'm just trying to think.

We probably — I don't think we have more than 15,000 on the outside — of those 270 — outside the United States.

So as I put in the annual report, we invested in plant equipment — not in stocks, but in plant equipment, and not in acquisitions — over $8 billion last year, and 95 percent or so of that was in the United States.

So we don't really have a lot around the world. (Applause)

I'm not opposed to it. I mean, our ISCAR operation, which is based in Israel, operates throughout the world.

I mean, they — I've been to their plants in Japan, I've been to their plants in Korea, I've been to their plants in India.

The product they sell is going to be sold throughout the world. The U.S. is an important market for them, but it's not a majority of their business or anything like it.

So that company has about 11,000 employees or so, and relatively few of theirs are going to be in the United States.

We'd like to do more business in the United States, but we'd like to do more business in Korea and Japan and India and you name it.

We have utility operations in the UK, but other than — we have — we just bought a business in Australia at Marmon here, recently.

Well we bought — just the last day or so it's been announced — we're buying a — for CTB, which we've had a terrific history with. Vic Mancinelli has been a great man to manage businesses.

And just in the last day or two, we bought an operation based in The Netherlands [poultry-processing device maker Meyn Holding], although they have employment here.

But I would say that it's extremely likely that 10 years from now, when you look at the breakdown of our employees, that we have many, many more employees, you know, maybe hundreds of thousands more employees. And some of those will be outside this country, but most of them will be in this country.

We find — there's lots of opportunity in the United States. There is no shortage of opportunity.

In that 8.2 billion, or whatever it was last year, we loved putting that money out, and we'll put out more this year.

And this is — I mean it's a real land of opportunity. That's not to knock opportunities elsewhere. But we find lots of things to do that make a — we think — make a lot of sense in this country.

Charlie?

CHARLIE MUNGER: You can't bring a lot back if it never left. (Laughter)

WARREN BUFFETT: That's the long version of my answer. (Laughter)

21. Buffett: prostate cancer treatment is "nonevent"

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Well, Warren, I should say I was not planning to ask you this question, but in the past hour, I've received probably two dozen emails from shareholders in this room who want the question asked, so I will ask it, and it's a very simple question. How are you feeling?

WARREN BUFFETT: I feel terrific. And — I always feel terrific, incidentally. That's not news. (Applause)

I love what I do. I work with people I love. It's more fun every day.

And it — basically, I seem to have a good immune system. You know, I mean, my diet is such that, you know, as any fool can plainly see, I'm eating properly. (Laughter)

All I can say is it works.

And I have four doctors, at least a few of them, I think, own Berkshire Hathaway.

Not a screen I put everybody through, but —

And my wife and my daughter and I listened to the four of them for an hour and a half about two weeks ago.

And they described various alternatives, and none of them — well, not that — the ones that they recommend, you know, do not involve a day of hospitalization.

They don't require me to take a day off from work. The survival numbers are way up. I read one where it's 99 1/2 percent for 10 years.

So, you know, maybe I'll get shot by a jealous husband, but — (laughter) — this is not — this is a really minor event, and Charlie will tell you how minor it is.

CHARLIE MUNGER: Well, as a matter of fact, I rather resent all this attention and sympathy Warren is getting. (Laughter)

I probably have more prostate cancer than he does. (Laughter)

WARREN BUFFETT: He's bragging.

CHARLIE MUNGER: I don't know because I don't let them test for it. (Laughter and applause)

WARREN BUFFETT: He's not kidding. (Laughs)

CHARLIE MUNGER: At any rate, I want the sympathy. (Laughter)

WARREN BUFFETT: My secretary was getting too much attention, so I decided I had to throw the spotlight back on myself. (Laughter)

In all seriousness, it is a nonevent, yeah.

The Med Center is about two minutes from the office, and for two months, I'll have to drop over there every afternoon and it will take a few minutes. And I may have a little less energy, but that may mean I do fewer dumb things, who knows? (Laughter)

22. We'll take on runoff annuity liabilities at the right price

WARREN BUFFETT: OK. Gary?

GARY RANSOM: Yes. Your insurance operations have taken on a good chunk of some runoff property-casualty businesses.

There's another business that has an increasing amount of runoff, and that's the annuity business, Hartford, ING, Cigna, et cetera.

Is there a time, or are there conditions, under which you might consider taking on some of those liabilities?

WARREN BUFFETT: Sure. In effect, in some of our businesses, we're taking on some annuity, but not like — I mean, it's generally classified as property-casualty.

But we would take on annuity books. The problem is there, we're not going to assume anything much better than the risk-free rate in making a bid for that sort of thing.

I mean, we do not like the idea of taking on long-term liabilities and paying 150 basis points, you know, above Treasuries or something, to do that.

And there are people that will do that. They may not be quite as likely to fulfill those promises in the years to come as we would.

But we want to get money on the liability side at attractive rates. Now, the most attractive is if we can write property-casualty business at an underwriting profit and get it for nothing.

But we're willing to pay for annuity-type liabilities, and I don't think it's impossible you'll see us do a little of that.

We've done some in the UK. We've actually taken on a little bit, but it's not huge. But we're beginning to take on more.

23. What Buffett would have done differently

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Good morning, Warren and Charlie. Glad you're feeling well.

My name is Ryan Boyle, and I'm 26 and working for a private equity firm in Chicago.

If you were me and had the chance to start over, what areas would you look to get into?

And do you think that my generation will have the same number of opportunities as yours? And if not, would you look to focus on emerging markets?

WARREN BUFFETT: Oh, I think you have all kinds of opportunities.

I would probably do very much what I have done in life, except I'd do it — I'd try and do it a little earlier, and I would have tried to be a little bit better when I was running a partnership, in terms of aggregating the money faster.

I used to work with $5,000 contributions from partners and, you know, I would try to develop an audited record of performance as early as I could.

I would try to attract some money, and then when I'd build up a fair amount of money out of investing, I would try to get into something much more interesting, which would be buying businesses to keep.

You mentioned private equity, which very often is buying businesses to sell. I don't want to be buying and selling businesses. I mean, if I establish relationships with people that come to me with their business, and they want to join Berkshire, I want it to be for keeps.

And that's been enormously satisfying. But it takes some capital to get into that business, and I didn't have any capital when I started out, so I built it through managing money for myself and other people, combined.

And like I say, I would get us through that process as fast as I could and then into a game where I could buy businesses of significance and interest to me. And I'd spend the rest of my life doing it, just as I've done.

Charlie?

CHARLIE MUNGER: Well, I've got nothing to add to that, either.

WARREN BUFFETT: And I'd do it with Charlie, incidentally. (Laughs)

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

WARREN BUFFETT: Carol.

CAROL LOOMIS: This comes — this question comes from a man who believes the stock — that Berkshire stock — is being held down some by your talking about the Buffett Rule.

I know you said you doubt that, but he suspects that at least 95 percent of the people in this arena believe that Berkshire Hathaway stock is undervalued.

If you don't think it's the Buffett Rule, could each of you give us your opinions about why the stock stays stuck at these levels?

WARREN BUFFETT: Yeah. We've run Berkshire now for 47 years. There have been several times — oh, four or five times — when we've thought it was significantly undervalued.

We saw the price get cut in half at least four times — or roughly in half — in fairly short periods of time.

And I would say this: if you run any business for a long period of time, there are going to be times when it's overvalued and sometimes when it's undervalued.

Tom Murphy ran one of the most successful companies [Capital Cities] the world has ever seen, and in the early 1970s, his stock was selling for about a third of what you could have sold the properties for.

And, you know, Berkshire, back in 2000/2001, whenever it was that I wrote in the annual report that we were also going to repurchase shares, was selling at what I thought was a very low price, and we didn't get any repurchase.

But that — stocks — the beauty of stocks is they do sell at silly prices from time to time. That's how Charlie and I have gotten rich. You know, Ben Graham writes about it in Chapter 8 of the Intelligent Investor.

You know, next to — well, Chapters 8 and Chapters 20 are really all you need to do to get rich in this world.

And Chapter 8 says that in the market you're going to have a partner named "Mr. Market," and the beauty of him as your partner is that he's kind of a psychotic drunk — (laughter) — and he will do very weird things over time and your job is to remember that he's there to serve you and not to advise you.

And if you can keep that mental state, then all those thousands of prices that Mr. Market is offering you every day on every major business in the world, practically, that he is making lots of mistakes, and he makes them for all kinds of weird reasons.

And all you have to do is occasionally oblige him when he offers to either buy or sell from you at the same price on any given day, any given security.

So it's built into the system that stocks get mispriced, and Berkshire has been no exception to that.

I think Berkshire, generally speaking, has come closer to selling around its intrinsic value, over a 47-year period or so, than most large companies.

If you look at the range from our high to low in a given year and compare that to the range high and low on a hundred other stocks, I think you'll find that our stock fluctuates somewhat less than most, which is a good sign.

But I will tell you, in the next 20 years, Berkshire will someday be significantly overvalued, and at some points significantly undervalued.

And that will be true for Coca-Cola and Wells Fargo and IBM and all of the other securities that — I don't — I just don't know in which order and at which times.

But the important thing is that you make your decisions based on what you think the business is worth.

And if you make your buy and sell decisions based on what you think a business is worth, and you stick with businesses that you think — you've got good reason to think — you can value, you simply have to do well in stocks.

The stock market is the most obliging, money-making place in the world because you don't have to do anything.

You know, you sit there with thousands of businesses being priced at the same price for the buyer and the seller, and you don't — and it changes every day, and you've got lots of information about most of those businesses, and you don't have to do anything.

Compare that to any other investment alternative you've got. I mean, you can't do that with farms.

If you own a farm and the guy has the farm next to you and you'd kind of like to buy him out or something, he's not going to name a price every day at which he'll buy your farm or sell you his farm, but you can do that with Berkshire Hathaway or IBM.

It's a marvelous game. The rules are stacked in your favor, if you don't turn those rules upside down and start behaving like the drunken psychotic instead of the guy that's there to take advantage of it.

Charlie?

CHARLIE MUNGER: Well, what's interesting about this place is I think we've had a lot more fun and we got rich enough so we bought businesses and stocks to hold instead of to resell.

It's an enormously more constructive life. So as fast as you can work yourself into our position, the better off you'll be. (Laughter)

WARREN BUFFETT: And you should be very encouraged by the fact he's only 88 and I'm only 81. Just think, it may take you a little while. (Laughs)

25. We ignore headlines and macro factors

WARREN BUFFETT: Cliff?

CLIFF GALLANT: I guess along those lines, you talk about the drunken market, have systemic fear — systemic risk fears — ever caused you to pause in your eagerness to buy equities?

You know, back in 2008/2009, you know, why weren't you more aggressive back then?

WARREN BUFFETT: You'll probably find this interesting. Charlie and I, to my memory, in 53 years, I don't think we've ever had a discussion about buying a stock or a business, or selling a stock or a business, that has been — where we've talked about macro affairs.

I mean, if we find a business that we think we understand and we like the price at which it's being offered, we buy it. And it doesn't make any difference what the headlines are, it doesn't make any difference what the Federal Reserve is doing, it doesn't make any difference what's going on in Europe. We buy it.

You know, there's always going to be good and bad news out there, and which gets emphasized the most, you know, depends on the moods of people or newspaper editors or whomever.

And there's — you know, there's a ton of bad — I bought my first stock, you know, in June of — in June of '42, and what had happened?

You know, we were losing the war, until the Battle of Midway. I mean, so here was a country that — you know, all my older friends had gone, you know, disappeared.

We weren't going to make any kinds of goods that were — people wanted. We were going to build battleships and things to drop in the sea, and we were losing.

But stocks were cheap.

And I wrote that article in October of 2008 in the Times. I should have written it a few months later, but in the end, I said we've just had a financial panic and it's going to flow over into the economy, you know, you're going to read all kinds of bad news, but so what, you know?

America is not going to go away. Stocks are cheap.

You've got to — we look to value, and we don't look to headlines at all. And we really don't — everybody thinks we sit around and talk about macro factors. We don't have any discussions about macro factors.

Charlie?

CHARLIE MUNGER: Yeah, but we did keep liquid reserves at the bottom of the panic that, if we'd known it was not going to get any worse, we would have spent, but we didn't know that.

WARREN BUFFETT: Yeah. We know what we don't know.

We all — we know we don't want to go broke. I mean, we start with that.

And we know you can't go broke if you've got a fair amount of liquid reserves around and you don't have any near-term debts and so on.

So our first rule is always to play it tomorrow, no matter what happens. But if we've got that covered, and we can find things that are attractive, we buy it.

Well Charlie has a little company called the Daily Journal Company and he sat there with a whole lot of cash. And when 2008 came along, he went out and bought a few stocks. He won't tell me the names of them, but —

You know, that was the time to use the money, not to sit on it.

Was that the name of the stock, Charlie? (Laughter)

You don't get anything out of him. (Laughter)

26. Big Berkshire subsidiaries have "done well" over past 5 years

WARREN BUFFETT: Station 7.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, thank you for your inspiration and insight.

When you look at the stable of businesses that Berkshire owns, which business has greatly improved its competitive position over the last five years, and why?

And then conversely, perhaps you might name a business that was not so lucky.

WARREN BUFFETT: Yeah. We don't like to dump on the ones that aren't — that haven't done as well. But there's no question — and fortunately, the big ones have done well.

There's no question, even though we didn't — well, we didn't own all of it, but we actually have owned a significant piece of Burlington Northern over the last five.

But the railroad business for very fundamental reasons, which I should have figured out earlier, has improved its position dramatically over the last, really, 15 or 20 years, but it continues to this day.

I mean, it is an extremely efficient and environmentally-friendly way of moving a whole lot of things that have to be moved.

And it's an asset that couldn't be duplicated for, you name it, three, four, five, six times, you know, what it's selling for. So that it's a whole lot better business than it was five or 10 years ago.

Now, GEICO is a whole lot better business than it was five or 10 years ago, although I think you could have predicted that the chances were good that that was going to happen.

But, you know, we have — we're approaching 10 percent of the market now. And you go back to 1995, we had 2 percent of the market.

We had the ingredients in place to become much larger, and then fortunately, we had [CEO] Tony Nicely who absolutely maximized what was there to be done.

And GEICO's worth billions and billions and billions of dollars more than when we bought it.

And the Burlington is worth considerable billions more than when we bought it, even though it was recently.

MidAmerican has done a great job. We bought that stock at 34 or so dollars a share in 1999, and I think we appraise it now at around $250 a share, and that's in the utility business.

So ISCAR has been wonderful since we bought it. We bought that six years ago. And they just don't stop. You know, they do everything well. And I would not want to compete with them.

So we've — there are a number of them. And —

CHARLIE MUNGER: We have 80 percent or so of our businesses, by value, at least, increased their market strength.

WARREN BUFFETT: Yeah. By value, I would say more than 80 percent.

CHARLIE MUNGER: More than, yeah.

WARREN BUFFETT: But not by number, but by value.

CHARLIE MUNGER: By value. We are not suffering at all. We're never going to get the rate to 100 percent.

WARREN BUFFETT: And the mistakes have been made in the purchasing. I mean, it's where I misgauged the competitive position of the business.

It isn't because of the faults of management. It's because I just — either because I had too much money around or because I was — been drinking too much Cherry Coke or whatever it was — I assessed the future competitive position in a way that was really inappropriate.

But it wasn't because it really changed on me so much. And, you know, we've done some of that.

But the big ones — the big ones have worked out very well.

Gen Re, which took, like, real problems for some years. I mean, Tad [Montross] is running a fabulous operation there.

Ajit [Jain] has created something from nothing that's worth tens of billions of dollars. You know, he created that out of walking into the office in 1985 and entering the insurance business for the first time, but he just brought brains and energy and character to something, and we backed him with some money, and he's created a business like nobody I've ever seen.

Charlie?

CHARLIE MUNGER: Well, we've been very fortunate. And what's interesting is the good fortune is not going to go away merely because Warren happens to die. (Laughter)

It won't help him but — (Laughter)

WARREN BUFFETT: You'll have an explanation of that in the second half of this. (Laughter)

27. Derivatives are "not going to be a huge factor at Berkshire"

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Joel Bannister (PH) in Dallas, Texas, who says, "Warren, you personally run the derivative book.

"Who will manage these weapons of mass destruction after your tenure? We don't want to end up like AIG under someone else's watch."

He also adds, "P.S. I am wearing the wedding ring you sold my wife last year at the annual meeting at Borsheims."

WARREN BUFFETT: Well, obviously a man of intelligence. (Laughter)

Yeah, I don't think there will be much of a derivatives book after I'm around. In fact, there won't be much of a derivatives book when I am around. I mean, it's not that big of a deal.

But there will be — there could well be — well, I'll go back to will be, because it's almost required in certain of our utility operations that they engage in certain types of derivative activities. The utility boards that they respond to want them to hedge out certain types of activities.

And then they engage in swaps of generation. And there's a number of activities that there's some derivatives that fit into doing that, but it's not of a huge scope.

The railroad formerly hedged diesel fuel, for example. They may do that in the future; they may not. I mean — so there's a few operating businesses that will have minor positions.

I don't think that — I think it's unlikely that whoever follows me — well, they'll be in — there will be several investment guys that follow me, at least two, and they're on board now, Todd Combs and Ted Weschler.

We hit a home run with both of them. We got better than we deserved, but Charlie and I like that.

And they — it's unlikely they do anything — very unlikely they do anything — in derivatives, although I wouldn't restrict them from doing it because they're smart people and sometimes derivatives get mispriced.

But it's not going to be a huge factor at Berkshire. I think we're going to do really, probably, quite well with the derivative positions that we have. We've done fine with the ones that have expired so far, and I like the positions.

But the rules have changed in relation to collateralizing, and I don't like ever exposing us to anything that would cause me to worry about Berkshire's financial condition if the Federal Reserve were hit by a nuclear bomb tomorrow, or anything of the sort, or Europe, you know, something terrible happened.

We just — we think about worst cases all of the time around Berkshire. Charlie and I probably think about worst cases more than any two managers you'll ever find, and we are never going to expose ourselves to a worst case.

And a requirement to collateralize things means that you are putting yourself in a position where you may have to come up with some cash tomorrow morning, and we're never going to do that on any significant scale, because we don't know what tomorrow morning will bring.

Charlie?

CHARLIE MUNGER: We wouldn't — the derivatives have bothered some people. We never would have entered if we'd had to sign normal contracts.

We had better credit than anybody else, and we got better terms. And I think by the time that has all run off, we will have made at least $10 billion, maybe a lot more.

In other words, we're going to be very lucky we did those contracts.

28. Different valuation methods for different companies

WARREN BUFFETT: Jay?

JAY GELB: Warren, when you discuss Berkshire's intrinsic value, why do you value the insurance business at only cash plus investments per share?

And what's a reasonable multiple to apply to the pretax earnings of the noninsurance businesses?

WARREN BUFFETT: I would — I don't value the insurance business quite the way you say it. I would value GEICO, for example, differently than I would value Gen Re, and I would value even some of our minor companies differently.

But basically, I would say that GEICO is worth — has an intrinsic value — that's greater — significantly greater — than the sum of its net worth and its float. Now, I wouldn't say that about some of our other insurance businesses.

But that's for two reasons. One is, I think it's quite rational to assume a significant underwriting profit at GEICO over the next decade or two decades, and I think it's likely that it will have significant growth.

And both of those are value — items of enormous value. So that adds to the present float value, but I can't say that about some other businesses.

But in any event, once you come up with your own valuation on that, in terms of the operating business, obviously different ones have different characteristics.

But I would love to buy a new bunch of operating businesses that had similar competitive positions in everything.

Under today's conditions, I would love to buy those at certainly nine times pretax earnings, maybe 10 times pretax earnings. I'm not talking about EBITDA or anything like that, which is nonsense. I'm talking about regular pretax earnings.

If they have similar characteristics, we'd probably pay a little more than that, because we know so much more about them than we might know about some other businesses.

What would you say, Charlie?

CHARLIE MUNGER: When you used the word EBITDA, I thought to myself, I don't even like hearing the word. (Laughter)

There's so much nutcase thinking involving EBITDA. Earnings before what really counts in costs. (Laughter)

WARREN BUFFETT: Yeah. We prefer EBE, which is earnings before everything. (Laughter)

CHARLIE MUNGER: Right.

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

It's like Charlie's friend that used to sell fishing flies, Charlie, right?

CHARLIE MUNGER: Right. They don't sell these lures to fish. (Buffett laughs)

29. Buffett's negativity on gold "arouses passions"

WARREN BUFFETT: Station 8.

AUDIENCE MEMBER: Oh, hi, thanks. Neil Steinhoff (PH) from Phoenix. Thanks for holding the meeting today.

You mentioned a while ago that you were concerned about you and Charlie exposing yourself. Well, I for one am glad that you're not doing that. (Laughter)

Since 1999, the Berkshire Hathaway stock has — we have not gone up appreciably, whereas gold has gone up multiple times. I don't own your stock for the glamour. I own it to earn money. What happened?

WARREN BUFFETT: Well, I would say this: when we took over Berkshire, gold was at $20 and Berkshire was at $15 so — gold is now at $1600 and Berkshire is at $120,000. So you can pick different starting periods. (Applause)

Obviously, you can pick anything that's gone up a lot in the last, you know, month or year. I mean, it will beat 90 percent of — or 95 percent — of other investments.

But the one thing I would bet my life on, essentially, is over a 50-year period, not only will Berkshire do considerably better than gold, but common stocks as a group will do better than gold, and probably farmland will do better than gold.

I mean, if you own an ounce of gold now and, you know, you caress it for the next hundred years, you'll have an ounce of gold a hundred years from now.

If you own a hundred acres of farmland, you'll also have a hundred acres of farmland a hundred years from now and you'll have taken the crops for a hundred years and sold them and presumably bought more farmland in the process.

It's very hard for an unproductive investment to beat productive investments over any long period of time, and I recognize that —

It's very interesting. I can say bonds are no good and [Federal Reserve Chairman Ben] Bernanke still smiles at me. You know, and I can say some stock is no good, and people —

But if you say anything negative about gold, I mean, it arouses passions with people, which is kind of fascinating, because usually if you thought through something intellectually, it shouldn't really make much difference what people say. It should be that, well, you know, the question is whether your facts are right and your reasoning is right.

But when you run into people that are really excited about gold — and I came from a family where my dad loved gold.

And he was tolerant. He could take a discussion of it. I find many people have trouble with it.

Charlie?

CHARLIE MUNGER: Well, I have never had the slightest interest in owning gold. It's a much better life to work with businesses and people engaged in business. I can't imagine a worse crowd to deal with than a bunch of gold bugs. (Laughter)

30. Buffett: "my best ideas are all in Berkshire"

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: We got a couple of questions on this topic.

"You said in an interview on CNBC that you had bought shares in J.P. Morgan for your personal account.

"Can you explain how you decide to make a personal investment versus one in your role as a fiduciary for us as shareholders of Berkshire?

"And while you're at it, could you please share some names of stocks you've recently bought for your own account?" (Applause)

WARREN BUFFETT: The truth is I like Wells Fargo better than I like J.P. Morgan but I — but I also — we bought, and we're buying, Wells Fargo stock, and that takes me out of the business of buying Wells Fargo. So therefore, I go into something that I don't like quite as well but that I still like very much.

And that's one of the problems I have, is that I can't be buying what Berkshire is buying, and I've got some money around, and therefore, I go into my second choices, or into tiny little companies like I did with Korean companies and that sort of thing.

But my best ideas are all in Berkshire. That I can promise you.

Charlie? Charlie's bought real estate, too, and different things to avoid that problem.

CHARLIE MUNGER: Yeah. But basically the Munger family is in two or three things only.

Diversification is my idea of — not something I have practically no interest in, except as it happens automatically in a big place like Berkshire.

I rejoiced the day I got rid of a quote — you know, a stock quoting machine.

And I like this buy and hold investing. It's a lovely way to live a life and you deal with a better class of people, and it's worked pretty well for all of us.

And I don't think you need to worry about Warren's side investments. His investments in Berkshire are so huge and those are so small, relevantly, that if that's your main problem in life, you have a very favored life.

WARREN BUFFETT: Well, if you have 98 1/2 percent of your money in Berkshire and you really are trying to do your thinking about what's best for the 1 1/2 percent, you're a little bit crazy. (Laughs)

You should be thinking about Berkshire, which I can assure you I do. But, there could be —

CHARLIE MUNGER: And he does like Wells Fargo better than J.P. Morgan.

WARREN BUFFETT: Yeah, I do, yeah. And we have 400 and some million shares of Wells Fargo in Berkshire.

I like J.P. Morgan fine, obviously, but I know Wells better. It's easier to understand.

So, you know, we — well, we bought Wells Fargo in the first quarter. We bought Wells Fargo last year. We've bought it an awful lot of years.

And if I wasn't managing Berkshire, you know, but instead was sitting with my own money, I'd have a lot of money in Wells Fargo and I'd probably have some money in J.P. Morgan, too.

31. Why is BNSF a subsidiary of National Indemnity?

WARREN BUFFETT: Gary?

GARY RANSOM: When Berkshire bought BNSF, it raised the surplus of the property-casualty industry by about 4 percent. It's unusual to have a property-casualty company own such a large non-operating company.

I'd also characterize your whole organization chart as challenging, a lot of different pieces to it, which gives rise to the issue of capital efficiency.

And I'm just wondering, are there any parts of your organization structure that have any hindrance, whether it's regulatory or otherwise, to making use of the capital in the best way, generally, and in particular for BNSF?

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

So — and we've got a fair amount of money in life companies, and that money cannot be used as effectively over a period of years, in my view, as money we have in the property-casualty business. It's a disadvantage to being in the life business versus the PC business.

And the best place — obviously, the number one place where we like to have money is in the holding company. And we've got about 10 billion in the holding company right now. That, you have the ultimate flexibility with.

Most of our operating businesses keep more cash around than they need, but it's there. And I'm — as long as I have 20 billion someplace, I feel comfortable. We'll never have anything that can come up, remotely, that would cause me to lose any sleep as long as I start with the 20 billion.

That's probably considerably more than we need, but it just leaves us comfortable, and it makes us feel we can do other things aggressively, as long as we know the downside is protected.

The — having the railroad in National Indemnity was just something we thought was nice to have a huge asset like that there that should make the rating agencies and everyone feel comfortable, and there's no disadvantage to us.

Very interesting, the rating agencies — at least one rating agency — said they didn't want to give us any credit for that asset in there, although if we had 20 percent, like we had had earlier, they would have given us full credit for the market value. I didn't push them too hard on that.

But there's a fair amount of logic, I think, to where things are placed. If we were to make a big acquisition, it might require shifting some funds from one place to another, but we'll always leave every place more than adequately capitalized.

And if you can figure out a way that I could use the life funds more like I can use the property-casualty funds, call me. I've got an 800 number. (Laughs)

CHARLIE MUNGER: Well, two things are peculiar about that casualty operation. One is that it has so much more capital, in relation to insurance premiums, than anybody else. And the other is that it has, among the assets in that great surplus of capital, is something like the Burlington Northern Railroad, which makes it immensely stronger from the viewpoint of the policyholder.

It's a huge advantage you're talking about, not a disadvantage.

WARREN BUFFETT: Yeah. Here's a property-casualty company that has an asset in it that, unrelated to insurance, will probably make $5 billion pretax or more.

So if we're writing — well, in that entity, we're writing less than that — but let's say we're writing 25 billion of premiums. That means we can write at 120, and just our railroad operation will bring us an underwriting neutrality. I mean, it's a terrific — it's like having a royalty or something.

CHARLIE MUNGER: It's a wonderful position we have.

WARREN BUFFETT: And nobody else has it.

CHARLIE MUNGER: And nobody else has it. And they wouldn't let us do it if we weren't so strong.

32. We don't want Berkshire's stock to be too high or too low

WARREN BUFFETT: Station 9.

AUDIENCE MEMBER: Yes. John Horton, Water Street Capital, Jacksonville, Florida.

Since Berkshire will likely need to offer a stock component for very large acquisitions like Burlington Northern, wouldn't Berkshire lower its cash outlay by increasing the price of its stock to near fair value, perhaps by offering a 2 to 3 percent dividend or a promised percentage of cash earnings?

Might this have the effect of actually lowering the cash outlay needed for such acquisitions? As 30-year shareholders with almost $1 billion of exposure, we like this approach. Thank you.

WARREN BUFFETT: Yeah. We would obviously prefer to have our stock sell at exactly intrinsic business value, even though we don't know that precise figure, but Charlie and I would have a range that would not differ too widely.

And if it's over intrinsic business value, and we could use it as part of a consideration for buying something else at intrinsic business value, and then use cash for the balance, you know, we would like that situation.

And that — that's very likely to occur in the future. It's occurred in the past. Berkshire, without paying a dividend, has sold, probably, at or above intrinsic value as much of the time in the last 35 or so years as it has below.

I mean, it will bob around. And I do not think a dividend would be a plus, in terms of having it sell at intrinsic value most of the time. I think it might be just the opposite.

I mean, here we are, we're willing to pay, you know, 110 cents on the dollar for what's in there.

So the idea of paying out money, which we think is worth at least 110 cents on the dollar within the place, and have it turn into 100 cents on the dollar when paid out, just is not very attractive to us, unless we find we can't do things in the future that make sense.

But our goal — and we put it in the annual report. Our goal is to have the stock sell at as close to intrinsic business value as it can.

But with markets — you know, the way markets operate, most of the time it will be bobbing up or down from that level. And we've seen that now for 40-plus years, and we've tried to, at least in a way, point out what we think is going on.

And if it ever — if it — and it will. I mean, when it trades at intrinsic business value or higher, there may be times when we will use it.

We'd still prefer using cash, though. Cash is our favorite medium of purchase just because we're going to generate a lot of it. And we hate giving out shares.

We do not like the idea of trading away part of See's Candies or GEICO or ISCAR or BNSF. The idea of leaving you with a lower percentage interest in those companies because of any acquisition ambitions of ours is anathema to us.

Charlie?

CHARLIE MUNGER: Well, what he suggested is a very conventional approach, and we think it's better for the shareholders to do it the way we're doing it. (Applause)

WARREN BUFFETT: I should point out, I'm in the position — giving away all of my stock between now and 10 years after my death when my estate is settled — but I'm giving it away every year.

You know, it will do more good, in terms of its philanthropic consequences, if it's at a higher price than lower price. I mean, there's nobody here that has more of an interest in the stock selling at what I'll call a fair value, as opposed to a discount value, than I do.

I know I'm not a seller, but I'm disposing of the stock, and I would rather have it buy, you know, X quantity of vaccines than 80 percent of X.

So it isn't like we've got some great desire to have the stock sell cheap. If it does sell cheap, we'll, you know, we'll buy it in, but our interest is really in having it sell at, more or less, the fair value.

And we think if we perform reasonably well, in terms of running the business, and if we tell the truth about the business, and explain to a selected group of shareholders who are interested in that aspect of investing, that over time, it will average that.

And that's happened over the years, but it doesn't happen every year. If people get excited enough about internet stocks, they're going to forget about Berkshire. When they get disillusioned with internet stocks then — I'm going back 10 or 12 years on that.

But there have been times when people have gotten very excited about Berkshire, and there have been times when they've gotten very depressed.

Charlie, anything?

33. Buffett sees value in local newspapers

WARREN BUFFETT: OK. Carol.

CAROL LOOMIS: This question comes from Kevin Getnowski (PH) of Yutan, Nebraska. And to it, I've added one question at the end, which came from another shareholder writing about the same subject.

"You've described the newspaper business in the past as chopping down trees, buying expensive printing presses, and having a fleet of delivery trucks, all to get pieces of paper to people to read about what happened yesterday.

"You constantly mention the importance of future intrinsic value in evaluating a business or company. With all of the new options available in today's social media and the speculation of the demise of the newspaper media, why buy the Omaha World-Herald?"

"Was there some" — this is a question from the other one — "Was there some self-indulgence in this?"

WARREN BUFFETT: No, I would say this about newspapers. It's really fascinating, because everything she read is true, and it's even worse than that. (Laughter)

The newspapers have three problems, two of which are very difficult to overcome, and one, if they don't — the third — if they don't overcome it, they're going to have even worse problems, but maybe can be overcome.

Newspapers — you know, news is what you don't know that you want to know. I mean, everybody in this room has a whole bunch of things that they want to keep informed on.

And if you go back 50 years, the newspaper contained dozens and dozens and dozens of areas of interest to people where it was the primary source. If you wanted to rent an apartment, you could learn more about renting apartments by looking at a newspaper than going anyplace else.

If you wanted a job, you could learn more about that job. If you wanted to know where bananas were selling the cheapest this weekend, you could find it out. If you wanted to know how — whether Stan Musial, you know, went two for four, or three for four, last night, you went to the newspapers.

If you wanted to look at what your stocks were selling at, you went to the newspapers.

Now, all of those things, which are of interest to many, many people, have now found other means — they've found other venues — where that information is available on a more timely, often cost-free, basis.

So newspapers have to be primary about something of interest to a significant percentage of the people that live within their distribution area.

And the — there were so many areas where they were primary 30 or 40 years ago that you could buy a newspaper and only use a small portion of it and it still was valuable to you.

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

So they've lost primacy in all of these areas that were important.

They still are primary in a great many areas. The World-Herald tells me, every day, a lot of things that I want to know that I can't find someplace else.

They don't tell me as many things as they did 20 or 30 or 40 years ago that I want to know, but they still tell me some things that I can't find out elsewhere.

Most of those items — overwhelmingly — those items are going to be local. You know, they're not going to tell me a lot about Afghanistan or something of the sort that I want to know but I don't know. I'm going to get that through other medium.

But they do tell me a lot of things about my city, about local sports, about my neighbors, about a lot of things that I want to know. And as long as they stay primary in that arena, they've got an item of interest to me.

Now, the problem they have, they are expensive to distribute, as the questioner mentioned. And then the second problem is that, throughout this country, we had 1700 daily newspapers. We have about 1400 now.

The — in a great many cases, they are going up on the web and giving free the same thing that they're charging for in delivery. Now, I don't know of any business plan that has sustained itself for a long time, maybe you can think of — maybe Charlie can think of one — but that has charged significantly in one version and offers the same version free to people, that had a business model that would work over time.

And lately, in the last year even, many newspapers have experimented with, and to some extent succeeded, in those experiments, in getting paid for what they were giving away on the net that otherwise they were trying to charge for in terms of delivery.

I think there is a future for newspapers that exist in an area where there's a sense of community, where people actually care about their schools, and they care about what's going on in the given geographic area. I think there's a market for that.

It's not as bullet proof, at all, as the old method when you had 50 different reasons to subscribe to the newspaper.

But I think if you're in a community where most people have a sense of community, and you don't give away the product, and you cover that local area in telling people about things that are of concern to them, and doing that better than other people, whether it be high school sports, you know.

I've always used the example of obituaries. I mean, people still get their obituaries from the newspaper. It's very hard to go to the internet and get obituaries.

But I'm interested in Omaha and knowing who's getting married, or dying, or having children, or getting divorced, or whatever it may be.

When I lived in White Plains, New York, I really wasn't that interested in it. I did not feel a sense of community there.

So we have bought — and we own a paper in Buffalo where there's a strong sense of community, and we make reasonable money in Buffalo. It's declined, and we have to have a internet presence there where people have to pay to come on. We have to develop that.

But I think that the economics, based on the prices we paid — and we may buy more newspapers — I think the economics will work out OK. It's nothing like the old days, but it still fulfills an important function.

It's not going to come back and tell you what your — and tell you on Wednesday what stock prices closed at on Tuesday and have you rush to the paper to find out.

It's not going to tell you what happened in basketball last night when you've gone to ESPN.com and found out about it. But it will tell you a whole lot about what's going on, if you're interested in your local institutions. And we own papers in towns where people have strong local interest.

Charlie?

CHARLIE MUNGER: Well, we had a similar situation years ago when World Book's encyclopedia business was about 80 percent destroyed by Bill Gates. (Laughter)

He gave away a free computer with every bit of software.

WARREN BUFFETT: He charged $5, I think, Charlie —

CHARLIE MUNGER: And well, whatever it was. But we are still selling encyclopedias and we still make a reasonable profit but not nearly as much as we used to.

WARREN BUFFETT: Right.

CHARLIE MUNGER: Some of these newspapers, we hope, will be the same kind of investments. They're not going to be our great lollapaloozas.

WARREN BUFFETT: The prices were — well, we actually may be doing more in newspapers, and we will be going where there's a strong sense of community.

But if you live in Grand Island, Nebraska, where we have a paper, or North Platte, and your children live there and your parents probably live there, your church is there, you are going to be quite interested in a lot of things that are going on in North Platte, and in the state of Nebraska, that you won't find readily on television or the internet.

And you'll be willing to pay something for it, and advertisers will find it a good way to talk to you, but it won't be like the old days.

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

WARREN BUFFETT: Cliff?

CLIFF GALLANT: Thank you. Just on that general topic, it is true that in the past some of your investments have been fairly affected by technology, in newspapers or World Book.

Are there other businesses where you're concerned about technology affecting them, for example, you know, Amazon or online grocery stores? Could they affect a business indirectly, like McLane?

WARREN BUFFETT: Amazon is a tough one to figure. I mean, Amazon — it could affect a lot of businesses that don't think they're going to be affected today in the retailing area. It's huge. It's a powerhouse.

I don't think it's going to affect a Nebraska Furniture Mart, but I think it could affect some of the other retailing operations THAT we have. It won't affect the Nebraska Furniture Mart.

I should report to you that in the first four days: Tuesday, Wednesday, Thursday, and Friday of this week, our business at the Furniture Mart is up about 11 percent over last year, so you people are doing your part there.

We had — on Tuesday we did over $6 million of business. Now, those of you who are in the retailing business, thinking about a Tuesday and 6 million-plus of volume, we'll do more probably today, but those are huge, huge volumes.

And we're going to go to Dallas here in a couple of years. We've got a 433-acre plot of ground down there, and I think we're going to have a store that will make any records we've set in the past look like nothing.

Going back to Amazon, though, in terms — GEICO was very affected by the internet, and at first, we missed that.

I mean, we — GEICO's got an interesting history. It was mail originally, if you go back into the late '30s and early '40s, and it was very successful. And then it moved — not leaving mail totally behind — but it moved to television big time.

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

But it just changed dramatically, you know, to the internet.

So, things do change very significantly, and if the consumer finds something they like to do better in some new way — and Amazon has been an incredible success. It's very hard to find people who have done business with Amazon that are unhappy about the transaction. They have happy customers.

And a business that has millions and millions of happy customers can introduce them to new items and then, you know, and it will be a powerhouse, and I think it could affect a lot of businesses. It's hard for me to figure out.

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

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

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

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

CHARLIE MUNGER: I won't be buying the stuff because I'm habit bound. Besides, I almost never buy anything. (Laughter)

But I think it will hugely affect a lot of people. I think it's terrible for most retailers. Not slightly terrible, really terrible.

WARREN BUFFETT: Well, with that cheerful assessment, we'll go to station 10. (Laughter)

35. “Almost impossible” to copy Berkshire

AUDIENCE MEMBER: Hi. This is Hector from (inaudible) Industry Fund Management Company in China.

My question is, you mentioned acquiring insurance float with zero, or even negative cost, is one of the key competitive advantages of Berkshire Hathaway. And we also found that an average leverage of Berkshire always about 100 percent.

I guess the net asset growth will significantly decline without using that leverage.

Therefore, to own an insurance company acquiring insurance float would be an important strategy if (inaudible) want to copy Berkshire business model. Would you please give me a comment?

WARREN BUFFETT: Charlie, I didn’t get all that so you —

CHARLIE MUNGER: I didn’t get it all, either. (Laughter)

But, we have a very peculiar model, and it works very well for us. I think it’s very hard for other people to get the same result.

WARREN BUFFETT: Yeah, I think it’s almost impossible. Besides, I mean, it’s taken a long, long time to get here. It’s taken a great amount of consistency, and that consistency has been allowed because, basically, we’ve had a controlling shareholder during that time.

So we’ve not had to bow to any of the urgings of Wall Street or, you know, whatever may be the fad of the day. But we have had a culture that — where we could write out 13 or 14 principles more than 30 years ago, and we’ve been able to stick with them.

And that’s very hard to do for most American corporations, and I think it’s very hard to do when managers come and go and they have small shareholdings. I think it takes a very unusual structure to be able to do it.

And, you know, it took a long time to get to the point where people with large private businesses in this country really cared about where those businesses were lodged after they gave up their stewardship. Took a long time to have it get so that a great many of those people would think of Berkshire first.

And the nice thing about it is, if they think of Berkshire first they don’t think of anybody second, so we get the call.

We don’t do well buying businesses at auction. I mean, if somebody’s only interest is to get the top price for their business, you know, seldom we’ll get one.

We did buy one at auction, I mean, but it was an add-on. The Dutch company we bought yesterday, we bought at auction. But that sometimes happens with our smaller acquisitions.

But the big private acquisitions are going to come to Berkshire because they want to come to Berkshire. And that's a significant competitive edge, and I don't see how anybody really challenges us on that.

CHARLIE MUNGER: Well, not only do I think other people will have a hard time copying it effectively, I think if Warren went back to being 30 years of age with a modest amount of capital and not much else, he'd have a hell of a time doing it again, too.

WARREN BUFFETT: I'd like to try. (Laughter)

OK. Becky?

36. Rarely try to change companies in our stock portfolio

BECKY QUICK: This question comes from David Schermerhorn (PH) in Boulder, Colorado.

And he writes that "Berkshire Hathaway has several substantial investments in other publicly traded companies.

"As a shareholder, Berkshire is entitled to annually cast votes on matters such as election of directors, advisory vote on executive compensation, approval of stock option plans, and so forth.

"So could you tell us what goes into your thinking and decisions with respect to how you vote our shares in these companies?"

WARREN BUFFETT: Yeah. We virtually never have voted against management, but we've done it a couple of times. There have been a —

CHARLIE MUNGER: Yeah, in 50 years.

WARREN BUFFETT: Yeah. There have been a couple of times when we thought — on the question of stock option expensing when that was put on a ballot.

If we — there may have been a particularly egregious option grant or something, we might have voted against, but our general feeling is that when we're a large shareholder of a company that we certainly generally like the business, we generally like the management.

We realize that they're not going to subscribe to our views 100 percent, in many cases 90 percent or 80 percent. Doesn't mean we think they're bad people or anything. They just — they have a different — they're sort of judging by behavior elsewhere. And they're perfectly decent people, but they don't think about things exactly the same way we do.

But that doesn't rule out owning a big piece of the business. We are not in the business of trying to change people. We don't try and change people when we buy the entire business. We think it's like marrying somebody to change them. It just doesn't work very well.

CHARLIE MUNGER: Doesn't work very well with children, either. (Laughter)

WARREN BUFFETT: No. And we know we don't want anybody to marry us to change us.

So I mean, we're not going to do it — we accept people the way they come, pretty much. Doesn't mean we look — we decide we'll associate with anyone, but we don't expect everybody to be clones of us.

And if we were to see a particularly dumb merger, a particularly egregious stock option plan, we might vote against it. It would pass anyway. We wouldn't conduct a campaign against it.

But we have seen a few of our companies engage in some — what we thought were really dumb deals, and we've usually been right, but we couldn't stop them.

But we have — I think we've voted against maybe one or two of them.

Charlie?

CHARLIE MUNGER: Well, I think you've said it all.

37. Good commercial insurance companies are hard to find

WARREN BUFFETT: OK. Jay.

JAY GELB: This question is on Berkshire's commercial insurance operations. Berkshire has a smaller presence in primary commercial lines insurance compared to its much larger reinsurance and auto insurance businesses.

Under what circumstances would Berkshire be open to increasing the scale of its primary commercial insurance operations, including acquisitions?

WARREN BUFFETT: Yeah, if we thought we can either expand internally, which would be tough, or buy a great company in the commercial field, which would — that would be the more likely way — you know, we'd do it.

Now, we got a chance, I don't know, six or seven years ago to get in the medical malpractice field when GE wanted out and we bought that, and then we added to that with our Princeton Insurance acquisition last year.

So we did get a chance to go into a first-class company with a first-class manager in Tim Kenesey about six or seven years ago, and we jumped at it. And GE was just getting out of the insurance business.

So it's hard to think of very many commercial insurance companies that I would get excited about, a very few. There might be a couple, and we'd like the business. I mean, you know, there are very few personal lines companies we like, but love GEICO, obviously.

There are very few reinsurance companies we like, but we love the ones we've got. And if we could find a quality company in commercial lines and we — presumably it would have quality management — we'd buy it in an instant. We've got nothing against that business.

38. More flexible buyback threshold?

WARREN BUFFETT: Station 11.

AUDIENCE MEMBER: Mr. Munger and Mr. Buffett, this is Whitney Tilson. I'm a shareholder from New York. I have a question for Debbie.

I'm just kidding. I applaud the fact that you've —

WARREN BUFFETT: She's in the president's box. (Laughs)

AUDIENCE MEMBER: I applaud the fact that you've set a price above which you won't buy back your stock, but it seems, based on the trading of the stock since the announcement, the wall may have put a floor on the stock. It also may have put a ceiling on it slightly above 1.1 times book value.

If so, this is obviously contrary to your desire to have the stock trade close to intrinsic value, which you've said is far higher than 1.1 times book.

Have you considered being a little more flexible in the price at which you'd buy back your stock depending on how well your business is going and what other opportunities are available?

For example, I would much prefer it if you bought back 3.4 billion of your own stock at 1.15 times book value last quarter, rather than the stocks you bought of other companies.

WARREN BUFFETT: Yeah, so would I. But the — I'm afraid — I don't think it puts a ceiling on, but I do think it certainly has an effect on a floor. It doesn't make a floor. I mean, you and I have seen enough of markets to know that if things get chaotic or anything like that, floors disappear.

So, I think there could be circumstances under which we would buy a lot of stock, but I don't think they're, you know, highly likely at all.

I think if we were at 115 — and believe me 115 would not be a crazy price — I don't think we'd probably buy a lot more stock. It might have the effect of the stock selling at, you know, a little above that or even a lot above it, just like 110 can do the same thing.

I do think it signals to a lot of people that they don't have much to lose if they buy it just slightly above the price we've named and perhaps they've got a lot to gain. But I don't think it sets a ceiling, Whitney.

When people feel differently in markets, it can sell it at a much different price.

If I thought we would buy a whole lot more stock at a slightly higher price, I would probably adjust the price, but I don't think that's the case. I think it would just cause everybody to think, you know, I can buy it at this little higher price and have very little to lose, just like they may very well think now.

But you get into any kind of a chaotic market — and we'll have chaotic markets in the future — and we might buy a lot of stock.

Charlie?

CHARLIE MUNGER: Oh, I've got nothing to add to that, either.

39. No permanent damage to Walmart from Mexico bribery scandal

WARREN BUFFETT: OK. We'll just have one or two more and then we'll break. Andrew?

ANDREW ROSS SORKIN: OK. This question comes from a shareholder named David Cass (PH) of Maryland.

He says, "One of Berkshire's largest investments in recent years has been Walmart. Has your opinion of this company changed as a result of the Mexican bribery scandal?"

WARREN BUFFETT: No. I think — it looks — if you read the New York Times story, there's always another side to it. But it looks like they may well have made a mistake in how that was handled, but I do not think it — and it may well result in a significant fine, you know.

But I don't think it changes the fundamental dynamic. I mean, Walmart does operate on low gross margins, which means it offers low prices. And that works in retailing, and a lot of other things they do work in retailing.

So I do not see — I mean, it's a huge diversion of management time and it's costly and a whole bunch of things, but I don't think the earning power of Walmart five years from now will be materially affected by the outcome of this situation.

Charlie?

CHARLIE MUNGER: Well, these are interesting issues.

I'm unaware of any place where Berkshire is slipping on this, but we have so many employees that it's not inconceivable we could have some slippage somewhere.

And you get as big as Walmart, you're going to have an occasional glitch. I don't think there's something fundamentally dishonorable about Walmart.

WARREN BUFFETT: When you have something as big as Berkshire, you're going to have an occasional glitch. I mean, we have 270,000 people today interacting with customers and government officials and vendors and all kinds of people. I will guarantee you somebody is doing something wrong.

In fact, I would guarantee you at least, you know probably 20 people are doing something wrong. You can't have a city of 270,000 people and not have something going on.

And we can talk until we're blue in the face about what people should do and not do, but people don't get messages sometimes the same way that you give them, and you know, we're layers removed from people operating and others. And a lot of people just do crazy things.

So it is a — I mean, it is a real worry if you're running a business like this that — you don't worry about the fact somebody is doing something wrong, because there is going to be somebody doing something wrong. What you worry about is that it's material and nothing gets done about it, and that you act fast if you hear about something.

And, you know, we've got hotlines and we've got all communications and everything, but that does not stop the fact that right now, somebody is doing something wrong at Berkshire.

And if we get twice as large someday we'll have more people. And we try to convey to the managers that when they find out about something, you know, act on it, immediately let us know. We can handle bad news as long as we get it promptly.

But I'm very sympathetic to anybody running hundreds of thousands of people to the problems of the ones that — sometimes, you know, they don't even think they're doing something wrong. I mean, if you get 270,000 people together, maybe even a crowd this size, you'll have some very peculiar people in it. (Laughter)

40. Update on Buffett's wager against hedge funds

WARREN BUFFETT: OK, we're at noon, roughly.

I made this bet four years ago with a group at Protege Partners about the S&P versus — or an index fund — versus five funds of funds. And I told them at the time I'd put up the results every year.

And as you can see — I can't see it from here, but the first year they — it was a huge down year. And as you might expect, just like us, we beat the S&P a lot in a down year and the last three years, the S&P has beaten them, but we're still a tiny bit behind the hedge funds at the end of four years.

There's six years to go. You might find it interesting, we each bought a zero-coupon 10-year bond so that there would be $1 million to go to the charity of — selected by either them or by me, depending on who won the bet — and that zero-coupon bond has performed magnificently, much better than Berkshire. (Laughter)

We should have bought nothing but zero-coupon bonds. But the zero coupon bond, because interest rates are so low, you know, is practically selling at par, so we have petitioned the stakeholder in this case — and I don't think we've heard yet — but to let us sell the zero-coupon bond and put the money in Berkshire. And I'll guarantee them that it will be worth more than a million bucks at the end of 10 years.

But so far, the best thing you could have done was ignored both of us and just looked at where we were putting the money.

And I will keep you up to date on this bet as we go along and we're having a lot of fun.

We'll come back in an hour, and then we'll go till 3:30, and then we'll have the business of the meeting.

Afternoon Session - 2012 Meeting

1. Gen Re improving after "major fix-up operation"

WARREN BUFFETT: OK. Round two. Gary, you're up.

GARY RANSOM: Am I up yet?

WARREN BUFFETT: You're up.

GARY RANSOM: OK. A question on General Re. If I look back at the General Re property-casualty premiums, it's been cut in half, roughly, from 10 years ago, maybe a little more stable recently.

Can you give us some idea of how you've had to adjust the personnel over that time, and then also what opportunities are there for General Re to grow as we go forward?

WARREN BUFFETT: Yeah, Gen Re, I think, got off the track. It may — it was probably off the track when we bought it, and I didn't spot it.

CHARLIE MUNGER: Sure it was.

WARREN BUFFETT: Yeah. OK. (Laughter)

I was in charge of that part. And, they had — I think they'd gotten more concerned about growth and satisfying certain personnel, in terms of their activities, than they had about emphasizing profitability, and it took us awhile to figure that out.

And when Joe Brandon came in, he operated 100 percent, in terms of focusing on underwriting profit instead of premium volume, and Tad Montross has followed through on that, with terrific results.

But it did mean getting rid of a lot of business that didn't make any sense. They did an awful lot of what I would call "accommodation business." So, it's true that the PC volume dropped very significantly during that period, but it's not volume that we miss.

The life business kept growing consistently during that period. Their life business strikes me as very, very good. They've got a little long-term care mixed in there that we wish we didn't have.

But I think Gen Re is — it's right-size, in terms of people. It's got an underwriting discipline to it. And I wouldn't be surprised if it grows at a reasonable rate in the future.

But it, there was a major change that had to be made in the culture at Gen Re. And, you don't make that overnight, and you don't keep a lot of the business — or some of the business — that you got through a wrong culture when you do straighten it out.

It's a terrific asset to us now. And I think that, the life business will continue to grow, and I would bet the PC business grows, too. But it will only grow if we see the chance to do it on a profitable basis.

That's one we feel enormously better about than we did some years back.

Charlie?

CHARLIE MUNGER: Well, it was a major fix-up operation, but we finally got it done.

WARREN BUFFETT: We don't go looking for those, though.

CHARLIE MUNGER: No.

2. Threats to Berkshire's culture after Buffett

WARREN BUFFETT: OK. Station 1.

AUDIENCE MEMBER: Hi. Dan Lewis (PH) from Chicago.

I wanted to get your thoughts on two of my concerns about a post-Buffett Berkshire.

Do you worry that some of your key operating and investing managers might leave for more lucrative opportunities once they realize they're working for one of their peers instead of a legend?

And do you think it's possible that a large investor or hedge fund could ever gain enough control of Berkshire to force a change in the unique culture and structure?

WARREN BUFFETT: Yeah. I think that — I would say I virtually know — that the successor we have in mind will not be the kind that will turn off our managers because that — the manager in mind is a — successor in mind — has got the culture as deeply embedded in as I do.

They would not — our managers would not — I don't think it would be a question of leaving for more lucrative jobs.

I think it would be because they love the kind of environment in which they exist. And if that environment didn't exist, it wouldn't be a question whether the alternative was more lucrative.

Many of them, a majority, could retire, wouldn't need to work at all. They're only going to work if it's more fun for them to work than to do anything else, you know, in the world, because they've got the money to leave, in a great many cases.

The conditions — it's the same reason I work. I mean, I'm 81, and I am doing what I find the most enjoyable thing to do in the world, and there are a couple reasons for that. I get to paint my own painting and, you know, I have a lot of fun, working with the people I work.

And our managers work for the same reason. They do get to paint their own paintings. And my successor will understand that just as well as I do. And there would be a lot of people that might very well manage other companies that, I think if stuck in my position, would lose a fair number of managers. They just have a different style. And our managers don't need that style.

In terms of a takeover, I think that really gets unlikely. The size is a huge factor. And, even because of the A and B shares, the A shares get converted to B shares when I give them away.

And even 10 years from now, it would be likely that I would own, or my estate would own, something in the area, you know, perhaps, of 20 percent of the votes, thereabouts.

So the Buffett family will probably have 10 times the voting power, for a long time, of anybody else. So I really — I think it's extraordinarily unlikely for both those reasons, size and the concentration that will exist.

And the longer we go, the larger we'll get. So the — as the voting power aspect goes down, the size aspect goes up. So I don't think there will be a takeover of Berkshire.

And I really — you do not need to worry about my successor. You know, in many ways he'll be better than I am.

He will be totally imbued with the culture. The company is imbued with the culture. It would reject anything. The board of directors reflect that culture. It's everyplace you look around.

Berkshire stands for something different than most companies, and, that's not going to change.

Charlie?

CHARLIE MUNGER: Well, what I said last night was that the first 200 billion was hard, and the second 200 billion, with the momentum in place, is likely to be pretty easy compared to what's been accomplished in the past.

So, I don't think it's going to hell at all. I think the momentums are in place and the right kind of people are in place and the culture is, by and large, pretty well loved, I would say, by the people who've chosen to be in it. Nobody's going to want to change it.

WARREN BUFFETT: Yeah, the businesses are in place to take it to 400 billion.

CHARLIE MUNGER: Hmm?

WARREN BUFFETT: The business — we have the businesses to take it to 400 billion.

CHARLIE MUNGER: Well, but in addition to that, I think people of the type who have sold to us when we were the only acceptable buyer, I think will come to our successors because they will be the only acceptable buyer, at least for some significant part of what's done.

So I don't think it's going to be all that difficult.

WARREN BUFFETT: Don't make it sound too attractive, Charlie. (Laughter)

3. Buffett OK with 12 percent return for cash-consuming businesses

WARREN BUFFETT: Carol?

CAROL LOOMIS: You're interested in businesses that throw off lots of cash, for instance, See's Candies, as well as those where you expect significant capital reinvestment needs, for example, Burlington Northern.

What is it about a capital-consuming business that persuades you to forego the cash yield you seem to have historically preferred?

How do you balance the expected need for reinvestment in a capital-consuming business against the other possible uses of cash Berkshire may have in the future, such as new investments or stock repurchases?

WARREN BUFFETT: Well, cash-consuming businesses, by their nature, are unattractive unless the cash they consume gets to earn a reasonable return.

And, in the electric utility business, you know, we can expect, cash retained to perhaps earn an average of 12 percent or something like that, which we regard as quite satisfactory.

It's not as exciting as having some business that's going to grow 20 percent a year and not require any capital. I mean, there are a few wonderful businesses like that, but it's perfectly satisfactory.

Same way with the railroad business. You know, we are going to invest a lot of capital over the next 10 years in railroads. Every year we will spend way more than depreciation charges. I think the prospect of earning reasonable returns on that are pretty darn good.

But if I had to put a lot of money, you know, into some capital intensive business where all we were doing was staying alive with that money, you know, we would be in a terrible situation.

And we don't have — in any meaningful way — we do not have any capital-consuming businesses where I see that as the prospect.

It's true, if you go back to a world where we thought we could earn 20 percent on equity or something of the sort, then there's very few capital-consuming businesses where huge amounts of incremental capital can earn at a 20 percent rate.

So that would be disadvantageous, but we don't know how to make 20 percent on equity going forth in the future with the kind of sums we're working with.

And we will be very happy if we can earn 12 percent or something like that on equity, particularly when some of that capital is being consumed is generated by float, which doesn't cost us anything. We've got some small advantage there.

Charlie?

CHARLIE MUNGER: Well, I think it's going to work pretty well. (Laughter)

There's some Mungers here. I hope you won't listen to the siren songs of others and kind of stay with the family heirloom.

WARREN BUFFETT: My family is just hoping for an heirloom. (Laughter)

4. Berkshire's float growth rate likely to slow

WARREN BUFFETT: Cliff?

CLIFF GALLANT: Along those lines, in regard to float, in your annual letter this year, you say that you expect the rate of growth in your float to slow going forward.

How slow? What are the drivers? Is it possible that float could shrink going forward?

WARREN BUFFETT: The float could shrink because we have lots of retroactive contracts, that by their nature, the float runs off, although not at a really rapid rate.

And, the float at GEICO is going to grow. I mean, that — the float at our smaller insurance companies will probably net grow over time a little bit, but it's not a lot of money.

In Ajit's operation, where we have a lot of the retroactive stuff, it's very, very tough. You've always got a melting ice cube that you've got to, you know, add a little more water to.

And I have felt — I felt when the float was 40 billion it probably wasn't going to grow very much, and now we're at 70 billion. So, we are looking for ways to intelligently grow the float all the time. That's been true ever since I got in the insurance business in 1967.

So, the desire is always there. We've been reasonably imaginative in figuring out ways to do it and still have the float cost us less than nothing. We've got the smartest guys in the business out there working on it. But the numbers are huge now, and you do have a natural runoff from the retroactive contracts.

So I just thought that it was fair to tell the shareholders that they really should — while they look at that history of float growth, that they really can't extrapolate that.

If we get lucky, you know, we could add a fair amount more, but it's also — it's possible that it will actually dwindle down a little bit and — not at a fast rate — and it certainly is more than possible that it won't grow at very much of a rate from here on.

Ajit told me that when I put that in the annual report that it became a challenge to him. So I'm glad I stuck it in there. He wants to make me look like an idiot, which isn't too hard sometimes, and I may have to stick some other things in the annual report next year to get the attention.

I — if I had to bet on whether float will be higher or lower five years from now, I probably would bet just a slight bit higher, but I also wanted the shareholders to know there's a possibility that it will decline a bit.

We're working on things, though. Every day we're working on things to try to figure out how to increase it.

Charlie?

CHARLIE MUNGER: Yeah. The casualty insurance business, by its nature, is not a terribly good business. You have to be in the top 10 percent, really, to do at all well in it, and I think we're very lucky.

We probably have the best large-scale casualty insurance business in the world. Just because it came out of nothing doesn't mean it's nothing now. But I don't think it will be wildly — it won't grow wildly, will it, Warren?

WARREN BUFFETT: No.

CHARLIE MUNGER: No. But if you have something that is very good and it doesn't grow wildly, that's not the end of the world.

WARREN BUFFETT: It's certainly brought us to where we are today.

CHARLIE MUNGER: Yes.

WARREN BUFFETT: It's done wonders for us, and there's been multiple people that have done — I mean, with the jobs that Tony has done at GEICO, I mean, he's created billions and billions of dollars of value for Berkshire shareholders. That's true certainly with Ajit. You know, it's huge.

CHARLIE MUNGER: We get used to having Ajit work miracles, and he'll probably continue to do so for a long time. But if Matt Rose has to carry some of the future freight, well, that's all right.

5. Past mistakes buying declining businesses

WARREN BUFFETT: OK. Station two.

AUDIENCE MEMBER: Greetings to all of you from the Midwest of Europe. I'm Norman Rentrop from Bonn, Germany.

Warren, thank you very much for being so open about your health situation. You are in my thoughts and in my prayers, and I wish you a thorough healing.

WARREN BUFFETT: Thank you. (Applause)

AUDIENCE MEMBER: As I have traveled a long way and can no longer ask questions in Pasadena, I'm hoping for an elaborate answer from you, Charlie, as well. (Laughter)

My question is, how do you value declining businesses? You were talking about the encyclopedia businesses brought down by Encarta or retailing disrupted by Amazon and others by comparison shopping. How do you value declining businesses?

CHARLIE MUNGER: Want me to answer that one? They're not worth nearly as much as growing businesses. (Laughter)

WARREN BUFFETT: Well —

CHARLIE MUNGER: But they can still be quite valuable if a lot of cash is going to come out of them.

WARREN BUFFETT: Yeah. Generally speaking, it pays to stay away from declining businesses.

It's very hard. You'd be amazed at the offerings of businesses we get where they say, you know, it's — I don't want to upset Charlie, but they say, you know, it's only six times EBITDA, and then they project some future that doesn't have any meaning whatsoever.

If you really think a business is declining, most of the time you should avoid it. Now, we are in several declining businesses.

You know, the newspaper business is a declining business. We will pay a price in that business. We do think we understand it pretty well. We will pay a price to be in that, but that is not where we're going to make the real money at Berkshire.

The real money is going to be made by being in growing businesses, and that's where the focus should be.

I would never spend a lot of time trying to value a declining business and think, you know, I'm going to get one free — what I call the cigar butt approach, where you get one free puff out of the cigar butt that you find.

It just isn't — the same amount of energy and intelligence brought to other types of businesses is just going to work out better. And so we — our general reaction, unless there's some special case, is to avoid new ones.

We're playing out certain declining businesses, by their nature, but you know, we started with declining businesses. We started with textiles in New England and we tried U.S.-made shoes and we've —

CHARLIE MUNGER: Department store in Baltimore.

WARREN BUFFETT: Department store in Baltimore. Howard and Lexington Street.

CHARLIE MUNGER: Trading stamp company. We're specialists in — (Laughter)

WARREN BUFFETT: Yeah. We have one business that did 120 million or so of sales in 1967 or '8, and what did we do last year, about 20,000?

CHARLIE MUNGER: Yes.

WARREN BUFFETT: 20,000. Yeah.

CHARLIE MUNGER: I presided over it myself. (Laughter)

WARREN BUFFETT: Yeah. Well, I want to say I helped. I mean, he didn't do it all by himself.

CHARLIE MUNGER: No, no, but I sat there on the location and watched the —

WARREN BUFFETT: We thought of bringing the sales chart down here and turning it upside down to impress you, but Charlie is still in charge of this business. He's — (laughter)

I can't get him to sell it, but make me an offer. (Laughs)

CHARLIE MUNGER: If you think what came out of those three declining businesses, all of which failed, it's so many billions you — it's hard to imagine how much came out of it. We're not looking for an opportunity to do it again.

WARREN BUFFETT: No. But it was — in 1966 — maybe we should, because in 1966, Sandy Gottesman — one of our directors and Charlie and I — we put $6 million into a company.

We called it Diversified Retailing, although we only had one operation but, you know — (Laughter)

It was kind of like Angelo Mozilo calling his one location, you know, in New York, Countrywide Mortgage, at the time. (Laughter)

And we bought a department store at Howard and Lexington Street. Now, in our defense, I would have to say there were four department stores at Howard and Lexington Street in Baltimore, and all four of them are gone.

But that $6 million has turned into about $30 billion, starting with that —

CHARLIE MUNGER: — failed business.

WARREN BUFFETT: Failed business. Yeah, yeah.

And of course, Blue Chip Stamps was another example of that because that was another company that — and then, of course, Berkshire was the textile business.

So we were sort of masochistic in the early days. (Laughs)

Becky?

CHARLIE MUNGER: Ignorant, too. (Laughter)

WARREN BUFFETT: Yeah, OK. (Laughter)

That was the word that came to mind, but I didn't really like to use it. (Laughter)

6. Stay away from IPOs and big commissions

BECKY QUICK: This question is from Bill Nolan who's a shareholder from West Des Moines, Iowa.

He says, "Many of us are interested in what you," meaning Berkshire, "are buying and you won't tell us that.

"Using Charlie's principle of invert, invert, always invert, maybe you can help us by suggesting what to avoid and stay away from, specifically, what in the investment world today strikes you as folly, fad, unsustainable, crazy, or dumb?

CHARLIE MUNGER: A lot. (Laughter)

WARREN BUFFETT: Yeah, well. We — I think I would describe it as we try to stay away from the things, to start with, that we don't understand. And when I say don't understand, it isn't that I don't understand, you know, what a certain business does.

But when I say understand, it means that I think I have a reasonably — a reasonable fix on about what the earning power and competitive position will look like in five or 10 years. So I've got some notion of how the industry will develop and where the company will stand within the industry.

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

But we — well, I would say this: I can't recall any time in the last 30 years, at least, that we've bought a new issue, have we, Charlie?

CHARLIE MUNGER: I can't think of one.

WARREN BUFFETT: No. I mean, the idea, that somebody is bringing something to market today, a seller who has a choice of when to come to market, and that that security, where there's going to be a lot of hoopla connected with it, is going to be the single cheapest thing to buy out of thousands and thousands and thousands of businesses in the world is nonsense, you know.

CHARLIE MUNGER: And then when it carries a 7 percent commission, or higher. It's ridiculous.

WARREN BUFFETT: Yeah, it's ridiculous. So you know it can't be the most attractive thing. But people get excited about what's coming and all that sort of thing.

But I will guarantee you that if you have thousands of opportunities among stocks all over the world and most of them are not being promoted or being sold with special commissions in them or something else, and then some other security is coming to market that day, when the seller picks the time to bring it, as opposed to just this auction market operating otherwise, you know, it just doesn't make any sense to spend five seconds thinking about new issues, so we don't think about them.

And we also — you know, there's industries we know that may have a wonderful future, but we don't have the faintest idea who the winners will be, so we don't think about those, either.

So there's a whole lot of things we don't think about. And we have a — Charlie and I have a number of filters that things have to get through very quickly before we're willing to think about them.

And sometimes we're thought of as rude — probably Charlie is thought of that way a little more often than I am — (laughter) — sometimes we're thought of as rude because people will call us and they start explaining some idea to us, and it just doesn't make it through the first filter or two.

So we just — we think we're saving their time if we just politely say, you know, that we just have no interest, and we don't want to have you finish the sentence. (Laughter)

But we do that, don't we, Charlie?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: We don't have to do very many things that work. I mean, that's the beauty of this business.

You don't have to be able, you know, to spell 500 words or something to get to the end of the spelling bee and beat everybody else.

You just have to do one or two things every now and then that — where you don't make a big mistake and where every now and then one works out real well. And the solution — you know, you'll get a good result.

You can't have a big disaster. You just — that is what we try to avoid. We do not ever want to lose a significant percentage of Berkshire's net worth, and so far we haven't.

CHARLIE MUNGER: I think there are a couple little rules of thumb. If it's got a really large commission in it —

WARREN BUFFETT: Forget it.

CHARLIE MUNGER: — don't read it. Because the chance of somebody who is paying a very high commission to give you a big advantage is very low.

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

WARREN BUFFETT: Charlie knew me when, I used to look at — I grabbed the Graham-Newman reports as fast as they would come out. (Laughs)

CHARLIE MUNGER: Yeah, sure.

WARREN BUFFETT: You know, if Graham Newman was doing something, it was certainly worth my time to look at it.

CHARLIE MUNGER: Warren has made a lot of people rich he doesn't even know. Just copied him.

WARREN BUFFETT: Don't go into things with big commissions.

7. Berkshire is "not just an investment company"

WARREN BUFFETT: Jay?

JAY GELB: On the subject of regulation, a question I often get from investors is, what are the implications if Berkshire ends up being subject to the Investment Company Act of 1940 because of insurance becoming a smaller part of Berkshire's overall business?

WARREN BUFFETT: I don't — I may be —

CHARLIE MUNGER: That's too remote. That's not going to happen.

WARREN BUFFETT: Yeah. I used to — I read the Investment Company Act of 1940 probably 20 times because it was quite pertinent when I was setting up my partnership and all that.

I don't remember every detail now, but I see no way that — that Berkshire comes close to that.

We used to worry about both personal holding company status and investment company status, but we steered — we made very clear that we steered clear of both of those. But now — I think we're a million miles away from it now.

CHARLIE MUNGER: Yeah, we really need the financial heft we have to make our basic businesses work. We are not just an investment company.

WARREN BUFFETT: Yeah. We've got 270,000 employees. We own 8 companies that each would qualify for Fortune 500 stand-alone. So it's — people thought of us as investment company long after we were nothing remotely —

CHARLIE MUNGER: Like one.

WARREN BUFFETT: — like one, and where we had no intention of going in that direction.

But the background of both of us caused people to hang on to that notion longer than it was appropriate.

8. Great Chinese companies

WARREN BUFFETT: Station 3.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. Good afternoon. My name is Yung (PH). I'm from Toronto, Canada. I appreciate you giving me this opportunity to stand here and ask a question.

And my question is, how long do you think it will take China to appear a great company like Coca-Cola, and in which industry you think it will be? Thank you.

WARREN BUFFETT: How long will it take China to do what?

CHARLIE MUNGER: I didn't quite get that one.

WARREN BUFFETT: Connection to Coca-Cola, yeah.

CHARLIE MUNGER: How long will it take China to do what?

AUDIENCE MEMBER: Oh, just how long do you think it will take China to appear a great company like Coca-Cola, and in which industry you think?

CHARLIE MUNGER: China already has some great companies. It's hard to think of a great branded goods company, but China has some very great companies already.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: (Inaudible). I can't pronounce them, but they've got some very great companies. (Laughter)

WARREN BUFFETT: Yeah. So far it has not been Chinese fast food companies that have been exported to the United States as opposed to — you know, we've got over 500 Dairy Queens now in China.

We tend to export certain products well, some consumer products, entertainment products, that sort of thing.

But China's got some huge companies and they may eclipse in market value, you know, some of the ones such as Coca-Cola that we're talking about.

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

WARREN BUFFETT: Let's see, that was station 3. Andrew?

ANDREW ROSS SORKIN: OK. This question comes from Larry Pitkowsky from the GoodHaven Fund, also another shareholder, also asked a similar question that I've tried to combine.

Given that you're now in IBM, are there any other entrenched leaders in technology that are, to use one of your terms, inevitable, in the same way that Coke and Gillette were?

For example, is Google inevitable? Is it reminiscent of the advertising agencies you owned in the 1970s, i.e., a toll bridge on all digital spending that's highly likely to keep growing over time?

What are the one or two things about Google, for example, that you think are real risks? And what about Apple?

WARREN BUFFETT: Well, those are extraordinary companies, obviously, and both — they're both huge companies. They make lots of money. They earn fantastic returns on capital. They look very tough to dislodge, where they have their strengths.

You know, I would not be at all surprised to see them be worth a lot more money 10 years from now, but I wouldn't want to buy either one of them.

I do not get to the level of conviction that would cause me to buy them. But I sure as hell wouldn't short them, either.

Charlie?

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

WARREN BUFFETT: Now he's going to say isn't the same thing true in IBM?

CHARLIE MUNGER: Well, I don't think it is. I think IBM is easier to understand.

WARREN BUFFETT: Yeah. The chances of being way wrong in IBM are probably less, at least for us, than being way wrong with Google or Apple. But that doesn't mean that those — the latter two companies —aren't going to do, say, far better than IBM.

But we wouldn't have predicted what would happen with Apple 10 years ago. And it's very hard for me to predict, you know, what will happen in the next 10 years.

They're certainly — you know, they've come up with these brilliant products. There's other people trying to come up with brilliant products.

I just don't know how to evaluate the people that are out there working, either in big companies or in garages, that are trying to think of something that will change the world the way they have changed it in recent years.

CHARLIE MUNGER: And what do we know about computer science?

WARREN BUFFETT: There's no reply. (Laughter)

10. Strong freight railroad economics will overcome politics

WARREN BUFFETT: Gary?

GARY RANSOM: Politics sometimes affects your businesses. Recently we've seen some coal plant closings, turndown of XL pipeline, all of which seemed to have potential effect on BNSF revenues.

Can you talk about how you manage that risk or what the impact might be of some of those political issues?

WARREN BUFFETT: Yeah. Well, BNSF runs their own business very much. I went down to Fort Worth once after we bought it a few years ago, and I haven't been there since. And I probably talk to Matt on the phone, I don't know, once every three months or something of the sort.

But there's no question that railroads, utilities, insurance companies, are all very much affected by the political process.

Fortunately, I think, in the railroad industry, you know, we've got economics on our side. And economics usually win out.

I mean, we can move a ton of product 500 miles on one gallon of diesel, and that may be three times or so as efficient as trucking. And that may be why the railroads currently move, say, 42 percent of all intercity traffic.

I don't think our percentage is going to go down, the railroad industry as a whole, no matter what the politics may be. It's just too compelling to move heavy traffic long distances over steel rail. And in terms of congestion, in terms of emissions, all kinds of reasons.

So we've got a wonderful product, and there will always be struggles in the political arena between competitors and railroads, and customers and railroads. It's just — it's the nature of the game, and there will be some of that in utilities, too. But overall, I like our position in it.

They do have to be involved in politics. I mean, the railroads — all four of the big railroads — are going to be involved in the political process because people have got a — who would like to change some of the rules, either as customers or competitors, are going to be in politics, too, and things will get decided in state capitals ,and more important in Washington, of importance.

So they will — they'll have lobbyists and they'll play a political game and their opponents will.

I like our position. The — it would be very dumb for the country to do anything that discouraged the railroad industry from spending the kind of capital that will need to be spent to take care of the transportation needs of this country in the future.

If you think about the money that will have to be spent on highways, and on the costs involved in there, and the congestion problems, the emissions problems, everything, the country has a strong interest in the railroad industry having every incentive to invest.

And the railroad industry pays its own way, you know. We'll spend $3.9 billion this year, and a lot of it will go to improve our present system an awful lot, and some will go toward expansion of a type. And the country will be better off on that, and the Federal Government will not write a check for it.

Charlie?

CHARLIE MUNGER: Yeah. It's in the nature of things that there are waves of good breaks and bad breaks.

Burlington Northern was enormously helped when you could double the container carriage by making the tunnels a little higher and the bridges a little stronger. And they were enormously helped when they found all this oil in North Dakota and there weren't any pipelines.

And they will get some bad breaks, too, occasionally, where somebody will take away a little break. But averaged out, it's a terrific business with terrific management. I don't think our main problems are political at all.

WARREN BUFFETT: No. The railroad industry —

CHARLIE MUNGER: For one thing, we're headed by a prominent Democrat.

WARREN BUFFETT: The railroad industry was — (laughter) — that may not be a help, Charlie. (Laughter)

Right after World War II — now, there was a lot of passenger traffic then — but the railroad industry, I think, had as many as 1,700,000 employees in the United States.

And here we are today, there's less than 200,000. I mean, railroads have become so much more efficient, just by a huge factor, and it's a fundamentally very good way to move heavy stuff a long distance.

I mean, it's hard to conceive of anything — it's be nice maybe to have barge traffic, but you only got a few rivers that are going to lend themselves to real volume along that line.

And so, you know, you have air, pipeline, you know, vehicles, planes, trains. Trains are pretty darn good.

11. No question from station 4

WARREN BUFFETT: OK. Station 4.

AUDIENCE MEMBER: Section 4 does not have any questions at this time. Thank you.

WARREN BUFFETT: Well, that's a first. (Laughter)

12. Comparing Berkshire to the S&P

WARREN BUFFETT: Carol, have you run out?

CAROL LOOMIS: Unprepared as I am, this is a question about the table on the first page of the annual letter, which shows the relative performance of the S&P 500 index against Berkshire's book value.

"This is an unfair apples-to-oranges presentation. An investor in the S&P 500 index can easily earn the returns shown for the S&P, but an investor in Berkshire will not earn the returns implied by the company's book values figures shown.

"Instead, he or she will earn returns over any given period that depend on the market's assessment thereof, that is, the price-to-book value ratio, and we've seen that go down in the last few years.

"A fairer comparison would be against the annual percentage change in the book value per share of the S&P 500 with dividends included. Wouldn't your shareholders be better served by better information?"

WARREN BUFFETT: Well, actually you can make the calculation two different ways as alternatives to what we do. You could have the market value of the S&P, which is in there with dividends added back, versus the market value of Berkshire.

Berkshire would show up better on that table than it does in the table I present. In other words, our advantage over the S&P would be larger if calculated that way because we started at a discount from book value and we ended up at a premium.

So it would bounce around the years. But overall, our gain would be probably at least — well, it would be about 35 or so percent higher in aggregate over the time than is shown by the book value gain, which is a lot of dollars when you make the calculation.

You could also show the book value of the S&P versus the book value of Berkshire. That figure will be a wash, pretty much, because if you take the S&P's price to book value, if that maintains the ratio at the beginning to the same ratio at the end, it's a wash as to how that calculation comes out.

So I think we could show — we could make a calculation that was more favorable to Berkshire. I don't think what the person suggests there would result in a calculation that's less favorable to Berkshire.

CHARLIE MUNGER: Long-term, the stock value has tracked fairly well with book value.

WARREN BUFFETT: But it's over-performed book value —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: — for the whole time. Which is the point this question seems —

CHARLIE MUNGER: Well, you've been criticized for making yourself look worse.

WARREN BUFFETT: Yeah. (Laughter)

CHARLIE MUNGER: It's all right. You can bear it. (Laughter)

WARREN BUFFETT: I've done the other, too. (Laughs)

13. We don't even try to coordinate our subsidiaries

WARREN BUFFETT: Cliff.

CLIFF GALLANT: In studying the collapse of AIG, one of the things we learned is there were parts of the company that understood there were certain financial risks in the market and they were lowering their exposure.

While, at the same time, there were other parts of AIG which were actually increasing their exposure to the same risk.

In terms of enterprise risk management at Berkshire, how do you share information across units to make sure that the same mistakes aren't made?

WARREN BUFFETT: I didn't totally get that. Did you get that, Charlie?

CHARLIE MUNGER: Well, he was talking about how do we share information across units.

Well, if there's any sharing, they're doing it; we're not.

WARREN BUFFETT: Yeah. We don't —we don't have any — we're the most uncoordinated pair of individuals, operating both in sports or at the executive level.

There are certainly some people at Berkshire that have some contact with other people at Berkshire, but there's nothing in the way of an organized way of doing that.

I mean, [Gen Re CEO] Tad [Montross] and [GEICO CEO] Tony [Nicely] and [reinsurance chief] Ajit [Jain] are friends, and [National Indemnity President] Don Wurster, and they see each other sometimes so they're — and I'm sure they talk insurance.

But we don't make any attempt — if somebody goes in to get a quote from Gen Re and gets a quote from Ajit, there's no — we have no system that prevents — or that coordinates — our two units to give the same quote or anything of the sort.

We want our businesses to run very autonomously, and we want the managers of those businesses to feel like they're their own business. That's enormously important at Berkshire.

So we don't tell the people at Clayton Homes to buy their carpet from Shaw or to buy their paint from Benjamin Moore. We just don't do that.

And you could say that's kind of silly, but it's — any gains we would get from doing that, by selling incremental units, I think would be far offset by the change in the feeling of the manager as to whether they're really running their own business.

We hand people billions of dollars and they hand us stock certificates and they have been running those businesses for decades in many cases.

And we want them to feel the same way the next day, when they've got the money and we've got the stock certificates, as the day before when they had the stock certificates and we had the money.

And the moment we start telling them how to change the way they operate, or to coordinate with this guy, or get this person's approval, or anything like that, you know, that just erodes that advantage, which we think is very substantial, that they have this proprietary feeling about their business.

Have I answered that, Charlie?

CHARLIE MUNGER: Yeah. We're trying to fail at what you wanted us to succeed at. (Laughter)

WARREN BUFFETT: I'll have to think about that a little. (Laughter)

14. Acquisition of a forest products company unlikely

WARREN BUFFETT: Station 5?

AUDIENCE MEMBER: Hello, Charlie and — Warren.

WARREN BUFFETT: I'm Warren, yeah. (Laughs)

AUDIENCE MEMBER: Yes. Well, my name is Richard Cooper, and I'm from Honor, Michigan. And I'm a professional forester.

Trees are one of America's greatest resources, and it seems that a well-run forest products firm would fit well with Berkshire's holdings.

You've got the transportation system to move the product. You have the construction firms to use the product — furniture companies, home builders — and you've got insurance companies to cover the insurance end of the holdings.

Have you given any thought to getting a forest products firm?

WARREN BUFFETT: Well, your question touches on the answer we just gave. We would not really consider the other activities that Berkshire has in determining whether we would get into forest products.

We've looked at forest products companies, but we don't think about them in terms of how they may divert their products to some other subsidiaries of ours, or how other subsidiaries might benefit from selling them something.

To date, we've looked at several. To date, we've never really found any that met our test for returns against purchase price.

I mean, it's a business that's easy — or reasonably easy — to understand, I mean, in terms of the economics and its permanence and all that sort of thing. But the math has escaped us, in terms of being compelling.

Charlie?

CHARLIE MUNGER: A lot of forest products companies convert themselves into flow-through partnerships of some kind so they don't pay normal full corporate income taxes the way we do.

Berkshire is actually organized so that we'd be a disadvantage — we'd be at a disadvantage — in bidding for forests.

WARREN BUFFETT: Yeah. We're at a disadvantage in terms of any kind of activity that people manage to convert into pass-through organizations.

So particularly — take REITs, Real Estate Investment Trust, you know, they have eliminated one tax in their structure that we would bear.

And like Charlie says, you know, you have firms like Plum Creek Timber and those sort of operations where they have eliminated the federal income tax, and we don't have any structure like that. So just going in, we have a structural disadvantage that is really quite significant.

15. No magic formula for calculating risk

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Scott Bondurant who is from Chicago, Illinois, and he's a shareholder.

And he asks, "Can you please elaborate your views on risk? You clearly aren't a fan of relying on statistical probabilities, and you highlight the need for $20 billion in cash to feel comfortable. Why is that the magic number, and has it changed over time?"

WARREN BUFFETT: Yeah. Well, it isn't the magic number, and there is no magic number.

I would get very worried about somebody that walked in every morning and told us precisely how many dollars of cash we needed to be, you know, secured at three sigma or something like that.

Charlie and I have had a lot of — we saw a lot of problems develop in an organization that expressed their risks in sigma, and we even argued sometimes with the appropriateness of how they calculated their risk.

CHARLIE MUNGER: It was truly horrible.

WARREN BUFFETT: And they were a lot smarter than we were. (Laughs) That's what's depressing.

But we both have the same bend of mind whereby we think about worst cases all the time, and then we add on a big margin of safety, and we don't want to go back to go.

I mean, I enjoy tossing those papers in the other room, but I don't want to do it for a living again.

So we undoubtedly build in layers of safety that others might regard as foolish, but we've got 600,000 shareholders and we've got members of my family that have 80 or 90 percent of their net worth in the company.

And I'm just not interested in explaining to them that we went broke because there was a one-hundredth of 1 percent chance that we would go broke and there was a — the remaining probability was filled by the chance of doubling our money, and I decided that that was just a good gamble to take.

We're not going to do that. It doesn't mean that much. We are never going to risk what we have and need for what we don't have and don't need. We'll still find things to do where we can make money, but we don't have to stretch to do it.

And it's my job — and Charlie thinks the same way. We don't have to talk about it much.

But it's our job to figure out what can really go wrong with this place and, you know, we've seen September 11th, and we've seen September of 2008, and we'll see other things of a different nature but similar impact in the future.

And we not only want to sleep well all those nights, we want to be thinking about things to do with some excess money we might have around.

So it is — if you're calibrating it in some mathematical way, I would say it's really dangerous. I could give you a couple examples on that, but unfortunately I've learned about them on a confidential basis.

But some really great organizations have had dozens of people with advanced mathematical training and make — and thinking about it daily, making computations, and they don't really — they don't really get at the problem.

So it's at the top of the mind, always, around Berkshire, and your returns in 99 years out of 100 will probably be penalized by us being excessively conservative, and one year out of a hundred, we'll survive when some other people won't.

Charlie?

CHARLIE MUNGER: Yeah, how do these super-smart people with all these degrees in higher mathematics end up doing these dumb things?

I think it's explainable by the old proverb that, "To a man with a hammer, every problem looks pretty much like a nail." They've learned these techniques and they just twist the problem so they fit the solution, which is not the way to do it.

WARREN BUFFETT: And they have a lack of understanding of history, I would say.

One of the things — in 1962, when I set up our office in Kiewit Plaza, where we still are, it's a different floor, I put seven items on the wall. Our art budget was $7, and I went down to the library, and for a dollar each I made photo copies of the pages from financial history.

And one of those cases, for example, was in May of 1901 when the Northern Pacific Corner occurred, and it's kind of interesting in terms of being in Omaha because Harriman was trying to get control of the Northern Pacific, and James J. Hill was trying to control the Northern Pacific.

And unbeknownst to each other, they both bought more than 50 percent of the stock. Now, when two people buy more than 50 percent of the stock each, and they both really want it, they're not just going to resell it. You know, interesting things happen.

CHARLIE MUNGER: To the shorts.

WARREN BUFFETT: And in that paper of May 1901, the whole rest of the market was totally collapsing because Northern Pacific went from $170 a share to $1000 a share in one day, trading for cash, because the shorts needed it.

And there was a little item at the top of that paper, which we still have at the office, where a brewer in Troy, New York, committed suicide by diving into a vat of hot beer because he'd gotten a margin call.

And to me, the lesson — that fellow probably understood sigmas and everything and knew how impossible it was that in one day a stock could go from 170 to 1,000 to cause margin calls on everything else.

And he ended up in a vat of hot beer, and I've never wanted to end up in a vat of hot beer. (Laughter)

So those seven days that I put up on the wall — life in financial markets has got no relation to sigmas.

I mean, if everybody that operated in financial markets had never had any concept of standard errors and so on, they would be a lot better off.

Don't you think so, Charlie?

CHARLIE MUNGER: Well, sure. (Laughter)

WARREN BUFFETT: Here, have some fudge. (Laughs)

CHARLIE MUNGER: It's created a lot of false confidence and — now, it has gone away.

Again, as I said earlier, the business schools have improved. So has risk control on Wall Street. They now have taken the Gaussian curve and they've just changed its shape.

WARREN BUFFETT: Threw it away.

CHARLIE MUNGER: They threw it away. Well, they just made a different shape than Gauss did, and it's a better curve now, even though it's less precise.

WARREN BUFFETT: They talk about fat tails, but they still don't know how fat to make them. They have no idea.

CHARLIE MUNGER: Well, but they knew — they've learned through painful experience they weren't fat enough.

WARREN BUFFETT: Yeah. They learned the other was wrong, but they don't know what's right.

CHARLIE MUNGER: We always knew there were fat tails. Warren and I, in the Salomon meetings, would look over at one another and roll our eyes when the risk control people were talking.

16. Swiss Re contract expiration is "nonevent"

WARREN BUFFETT: OK. Jay?

JAY GELB: This question is on Swiss Re.

Berkshire's quota share treaty with Swiss Re, covering 20 percent of Swiss Re's property-casualty risk, ends in 2012. Does Berkshire plan to replace that premium volume through another transaction?

WARREN BUFFETT: Well, we would hope to — we always hope to get more good volume, but what we do has no relationship to the expiration of that contract.

I mean, that contract was a five-year contract. It's a big contract, billions of dollars a year. But the fact that that expires and our premium volume will go down by multiple billions does not cause us to do one thing differently than we would do otherwise.

We've got the capacity to write billions and billions of business, and we would love to do it if we were expanding the Swiss Re contract, and we don't want to write any dumb business when we lose that contract. It's just — it's a nonevent, in terms of future strategy.

It's not a nonevent, in terms of losing some business that we like, but it's a nonevent in terms of any future strategy.

We regard every decision, you know, as independent. We don't do — if money comes in, that doesn't cause us to want to think about doing something today that we weren't thinking about doing the day before. We just don't operate that way.

We'll have things that come along that are terrific, and that doesn't mean the next day we don't want to look for something in addition that's terrific. Every decision is sort of independent.

CHARLIE MUNGER: I don't think there's another large insurance operation in the world that is more cheerful about losing volume than we are. If it doesn't make sense —

WARREN BUFFETT: We don't want it.

CHARLIE MUNGER: — if the business has to shrink, we let it shrink.

WARREN BUFFETT: We don't measure ourselves in any way —

CHARLIE MUNGER: By size.

WARREN BUFFETT: — by size, except by the growth in value over time.

17. Housing problems after Fannie and Freddie "left the tracks"

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Wendy Wasserman (PH) from Boston. Warren, best wishes on a speedy and complete recovery.

My question is regarding Fannie Mae and Freddie Mac. You wrote that you expected the housing market to be improved by now but that it hasn't improved.

You spoke about demographics and the housing-dependent parts of the business. You did not, however, speak about Fannie and Freddie. Fannie Mae, the Federal Reserve, and Freddie Mac are the three largest financial institutions.

Then comes J.P. Morgan and Bank of America. Fannie and Freddie have been in conservatorship for 3 1/2 years, the longest. Initially they had combined assets of 1.6 trillion, each a Lehman Brothers.

Now they have 5.5 trillion, adding 4 trillion of off-balance sheet items and government mortgage modification programs.

They are public companies with operating losses, a negative net worth, owned by the government, acting at times with the power of the government, financed with a blank check from Treasury, and taxpayers, who are usually also homeowners.

Most near-bankrupt companies shed assets. These two added assets and liabilities. AIG and General Motors have emerged; these two have not.

Contrary to popular belief, the securities law did not need the biggest rewriting since the Great Depression. The 1933 and 1934 Securities Acts worked. Sarbanes-Oxley works.

Fannie and Freddie, and the 1938 and 1968 governing laws, do not, no matter how much they have contributed to U.S. housing standards.

What is the solution? How many years can they stay in conservatorship? Can the resolution trust authority be used? Are they truly too big to fail? What role will banks like Wells Fargo and U.S. Bancorp, who are leading mortgage players — (applause) — play now that they are well capitalized?

What happens to the MBS market and the (inaudible) system? How can housing improve even with better demographics without an answer to Fannie and Freddie?

WARREN BUFFETT: Well, I got through college answering fewer questions than that. (Laughter and applause)

I would say that the overall tone of your remark, which indicates that you think Fannie and Freddie are a mess, is probably justified.

And of course, the reason they're a mess is we haven't figured out yet, or we can't get agreement, on what the best structure is to have in this country going forward to generally finance mortgages.

There's no question that a government guarantee program brings down the overall cost of financing mortgages over time.

And then we had one, of course — we've had several — but we had one in Fannie and Freddie that went wild when we introduced the profit motive into the mix of two institutions that really were half trying to serve a housing mission and half trying to serve a profit mission, and gradually the profit mission sort of overcame the housing mission.

Congress hadn't sorted that out yet. It's a huge item, obviously. There are roughly 50 million residential mortgages in the United States, you know, and they total 10 trillion or so.

It's important that you have a market that does minimize costs for borrowers who have adequate down payments and adequate income and all of that.

And I think for a while, we were going in that direction with Fannie and Freddie, and then they left the tracks.

But that's going to get — how long they can stay in conservatorship? They can stay there a long time.

They will stay there, in my view, until politically we get some kind of a resolution that — as to a future policy — that both parties can go along with, and it looks to me that's a ways off.

Charlie?

CHARLIE MUNGER: Well, of course, the interesting thing is that Canada, right to the north, kept a more responsible real estate lending system, and they had almost no trouble.

We departed completely from sanity and decency and morality in mortgage lending in the United States, and the government of the United States participated in the folly, and they did it in a big way.

And it was wrong not to step on the boom that was obviously so full of fraud and folly. And I sometimes say that [former Federal Reserve Chairman] Alan Greenspan overdosed on [author] Ayn Rand when he was young. (Laughter)

He thought if an ax murder happened in a free market, it was probably all for the best.

And so we had — there's a lot of disgraceful behavior we have to regret, in terms of what happened, and it caused enormous damage. And a modest little country like Spain, and another one called Ireland, you had something somewhat similar.

People just allowed craziness to go unchecked, and that was a big mistake. And Greenspan was really wrong. It's the duty of the government to step on crazy market booms — (applause) — and prevent them by keeping sound policies, as Canada did.

And so you put your finger on a very disgraceful episode in United States history.

But once we were into it, I think we had no option but to do exactly as the government did, which was to nationalize Fannie Mae and Freddie and try to make them behave better in the future, and that's what's happened.

WARREN BUFFETT: It's going to be a long runoff.

And Congress, it wasn't just the Fed— Congress did their share in that, too. But it was —

CHARLIE MUNGER: Everybody did.

WARREN BUFFETT: Everybody did. I mean, it —

CHARLIE MUNGER: By the way, we didn't. (Laughter)

WARREN BUFFETT: Charlie, we resigned from the Savings and Loan League a good many years ago just because we thought such nutty stuff was going on and —

CHARLIE MUNGER: It was disgraceful.

WARREN BUFFETT: Yeah. And Charlie got lectured for it, too. (Laughs)

CHARLIE MUNGER: Yes, I did.

WARREN BUFFETT: They made him go to school, learn how to loan money, and I think one of the regulators said, "Well, what kind of people do you lend money to?"

And I think Charlie said, "Well, the one thing we do is we don't lend money to people like you." (Laughter)

And for some reason we had regulatory problems after that. (Laughter)

CHARLIE MUNGER: I was not popular because he said you're using the government's credit in our savings and loan, and therefore, you have to make a lot of dumb loans because we're telling you to.

And I said, "We're not using the government's credit. As a condition of one of our mergers, Berkshire Hathaway agreed you'd never have trouble with our savings and loan. We're paying you insurance premiums, and you're using our credit." This did not make me popular.

WARREN BUFFETT: No. (Laughter)

CHARLIE MUNGER: And he was a florid-faced alcoholic. (Laughter)

I remember it very well.

WARREN BUFFETT: I do, too, but —

CHARLIE MUNGER: We left the savings and loan business.

WARREN BUFFETT: We have more problems when Charlie wins an argument. (Laughter)

But it's a lot of fun. (Laughter)

CHARLIE MUNGER: Well.

18. How Todd Combs and Ted Weschler are compensated — and taxed

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: OK, here's the question:

“Please tell us more about your experience this past year with Todd Combs and Ted Weschler. What did they do well, and did they make any mistakes? And please discuss how you compensate them a bit more.

In an interview, you said that Todd Combs was well compensated for the performance of his stock picks last year.

Should we be worried about a short-term horizon for compensation? How do you ensure that Todd and Ted don’t chase high-flying stocks for the sake of compensation?

WARREN BUFFETT: Well, we’ve always been more concerned about how our record is achieved than the precise record itself. And with both Todd and Ted, Charlie and I were struck by, not only a good record, but intellectual integrity and qualities of character, a real commitment to Berkshire, a lifelong-type commitment.

And we’ve seen hundreds and hundreds of good records in our lifetimes; we haven’t seen very many people we want to have join Berkshire.

But these two are perfect, and we pay them each a salary of a million dollars a year, and we give them 10 percent of the amount by which their portfolios beat the S&P.

So that if they beat the S&P by 10 points, they get one point, for example, and we get nine points. But we do it on a three-year rolling basis so you don’t get the seesaw effect.

And each one gets paid 80 percent based on their own efforts and 20 percent based on the other person’s, so that they have every incentive to operate in a collaborative way rather than sit there jealously guarding their own ideas and hoping the other guy doesn’t do very well.

So it’s a — I don’t think we could have a better — it’s the same structure on pay, basically, that we had with Lou Simpson for 20-some years, except he did not have a partner.

To the extent that they employ people underneath them, that comes out of their performance record, and it’s worked far better than either Charlie and I had hoped, and we had pretty high hopes.

We had 1 3/4 billion with each of them at year end, but we’ve added another billion each on March 31, so they’re running 2 3/4 billion apiece.

I don’t look at what they do. I see it eventually when I look at a GEICO portfolio at the end of the month or something of the sort.

But they operate through their own brokers. They don’t — I’ve told them that the only thing I want to know is, if they’re getting into a new name, I just want to know the name so I’m certain that it isn’t something that I am familiar with some inside information on, or something, so that there’s no inadvertent appearance that we would be — or that their purchase would have been influenced by something that I knew about.

That’s never come up. They can’t — they can’t — if there’s something we would have to file a 13D on, they would have to check with me. But basically none of that’s going to happen. Never happened with Lou, either.

They operate in different stocks. They’ve got a much bigger universe than I have because they’re working with 2 3/4 billion instead of 150 billion, so they can look at a lot more things.

And they’ve cheerfully pitched in for other duties that they don’t really get compensated directly on, but that are helpful to Berkshire. And they will — they’ll do a great job for Berkshire when they’re running a whole lot more money than they are now.

Ted only joined us this year. Todd did substantially better than the S&P last year, so he racked up a big performance gain, a third of which was paid to him in the first year, but the two years is deferred and he could lose that back if he were to underperform.

So I think we’ve got a good system and terrific people.

Charlie?

CHARLIE MUNGER: What’s interesting about it is that at least 90 percent of the investment management business of the United States would starve to death on our formula. I think — and I think these people will do pretty well with it. So —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And not only that, they’ll be terrific for the long pull for Berkshire. They’re the kind of people we like having around headquarters.

WARREN BUFFETT: Yeah. I hope they get into that — those 400 taxpayers I mentioned, but if they do, even under the present haul, they’ll be paying taxes in the mid-30s.

They are doing what they did before which — they ran hedge funds — but they’re going to work every day thinking about the same things, and they get taxed at 35 percent-plus.

And if they were running hedge funds, they’d get taxed at 15 percent. And for all of those in the audience who can reconcile that, there’ll be a free Dilly Bar. (Laughter)

CHARLIE MUNGER: I think each of them could earn more money in a different format but with a less desirable lifestyle.

WARREN BUFFETT: Yeah. We have a little free Coke machine at our office. (Laughter)

CHARLIE MUNGER: Well, they get to hang around with a fellow eccentric of the same type as Warren.

19. GEICO's profit hurt by Florida decision on auto insurance liabilities

WARREN BUFFETT: OK, Gary, before we go too far with this. (Laughs)

GARY RANSOM: My next question is on GEICO, a little bit more detailed question.

In the fourth quarter of last year, the GEICO combined ratio went up over 100 percent for the first time since, I think, in some quarter in 2001.

Now I realize a quarter doesn't make a trend, but something unusual happened in the quarter. Can you tell us more about that?

WARREN BUFFETT: The biggest thing that happened was a decision, or maybe a couple of decisions — Tony Nicely could elaborate more on them — but they involved Florida and some interpretation down there, I think, of the PIP coverage that caused us to set up some extra reserves that — they weren't extra — I mean, they were called for by what was happening in Florida at that time.

But it was a one-time sort of arrangement. And in the first quarter of this year, on a comparable basis, as you've probably seen in our Q, we wrote at about 91.

So, the basic business is good, but the Florida decision cost us significant money because it changed our potential liability for a bunch of claims already outstanding.

And my guess is you're more familiar with the exact terms of that than I am, but that is the bottom line answer on it.

And GEICO — every metric for GEICO that I've seen this year, in terms of retention, combined ratio on seasoned business versus new, all of that sort of thing, is quite consistent with our general record.

GEICO is a terrific asset for Berkshire. I mean, it will be worth — it's worth a lot of money now. It will be worth a lot more money in the future.

20. Environmental benefits of freight railroads

WARREN BUFFETT: Station 7.

AUDIENCE MEMBER: Hello, Charlie and Warren. My name is Stuart Kaye from Matarin Capital Management in Stamford, Connecticut.

You mentioned earlier today that one of Burlington Northern Santa Fe's competitive advantages is its environmentally-friendly business relative to transportation alternatives.

When evaluating other investment opportunities, what financial statement or other publicly available data do you use to gauge whether a company is both environmentally responsible and a good investment?

WARREN BUFFETT: Well, in terms of what's a good investment, you know, we try to look at every aspect, everything we can that will tell us how the world is going to develop for both that industry and the company in the future.

And sometimes we feel a lot of confidence about that. If we're looking at Coca-Cola, we think we know a lot about how the world will look with the Coca-Cola Company over the next five or 10 or 20 years.

If we're looking at some retail business or something, we would not have the same degree of conviction at all.

I mentioned the environmentally-friendly aspect of it. It is just — you know, it is just — requires less, in the way, of the world's resources to move goods, you know, on a steel rail in large containers, you know, with only a couple people involved with 120 cars, a train a mile long, than it does if you're working, you know, with trucks that have many, many more people and much more in the way of fuel to deliver the same kind of tonnage.

So there's no — we don't — there's no magazine we go to or books we go to or anything like that. We just look at the dynamics of the specific industry and company.

Charlie?

CHARLIE MUNGER: Warren, even though he's an unseasoned young man, was able to figure out that if you used a lot less fuel per ton of freight, you were causing fewer undesired particles to go into the air.

WARREN BUFFETT: That's about the limit of my capabilities, folks. (Laughter)

21. Berkshire lets managers paint their own pictures

WARREN BUFFETT: OK. Station 8.

We've gotten into the — we've covered 36 questions from the two panels, so we're now going to keep going around the audience as long as the questions last, we're going to give you more than your share at this point.

AUDIENCE MEMBER: Good afternoon, Warren and Charlie. Up here.

WARREN BUFFETT: Yeah, I see ya.

AUDIENCE MEMBER: All right. Very good.

John Norwood from West Des Moines, Iowa. We spent a lot of time today talking about two out of the three things you fellows said you spend a lot of time thinking about. One is allocating capital; one is managing risk.

We've had just one question related to motivating your people and tied into executive compensation. So that's what I'm interested in learning more about: executive compensation, how you motivate Berkshire managers, financial versus nonfinancial incentives. Can you speak more about that?

WARREN BUFFETT: Yeah. Well, obviously, Charlie and I have thought a few times about why do we do what we do when we don't need the money at all. And we jump out of bed excited about what we're going to do every day, and why is that the case?

Well, we get the opportunity to paint our own painting every day, and we love painting that painting, and it's a painting that will never be finished.

And you know, if we had somebody over us that was saying why don't you use more red paint than blue paint, and we had all the money in the world, we might tell them what they could do with the paint brush. (Laughter)

But we get to paint our own painting, and ours overlap. We have more fun doing it together than we would have doing it singly, because it is more fun to do with people around you that are pleasant and interesting to be around, and we also like applause.

So if that works with us, we say to ourselves — (applause) — that was not a brazen — (Laughs)

If that works for us, why shouldn't it work for a bunch of other people who have long been doing what they like to do and now, in many cases, have all the money they possibly need? But still, they may have to sell us their business for one reason or another connected with family or taxes, who knows what else?

But they really like what they've been doing. That's the reason — probably — the reason they've been so good at it — part of the reason they've been so good at it.

So we give them the paint brush, let them keep the paint brush, and we don't go around and tell them to use more red paint than blue paint or something of the sort. And we applaud and we try to compensate them fairly, because though they aren't primarily doing it for the money in many cases, nobody likes to be taken advantage of.

But that has not been a big problem at Berkshire. We have not had compensation problems over time. If you think about it, over 40-odd years, the times when compensation has been of importance are practically nil.

And it — we don't — we'll just take that we've talked about the investment — the compensation of two investment people. Those people are making below hedge fund standards, below private equity standards, and having a less favorable tax treatment.

They'll still make a lot of money, I mean, huge amounts of money. And I hope that they are having a good time doing what they're doing. I think that's why they're here.

And I think they'll enjoy it a lot more over the years than going around to a bunch of people explaining why they're worth two and twenty even in the years that aren't so good and trying to attract new money when other people are making bigger promises someplace else. It's just a different way to live your life.

So we want to have our managers enjoying their lives and enjoying their business lives. And we get rid of some of the things they don't like, a lot of them.

I was with a fellow the other day that had come from England. And he's got plenty of business problems to work on, and he's spending a significant part of his time talking to investors, which does him no good.

I mean, he ought to be talking to customers or, you know, employees or something, but he — I think a number of managers may have to spend time talking to lawyers or talking to bankers or talking to investors and what they really like to do is run their businesses, and we give them the best opportunity to do that.

So I can't put passion into somebody about their jobs, but I can certainly create a structure that will take that passion away from them.

And Berkshire is a negative art in that way. We focus on not messing up something that's already good, and that's my job. And I think the person that follows me will have a very similar job.

But we have a unique — we have a bunch of managers nobody else can hire and, you know, how many companies of size can you say that about around the country these days?

And I think we will retain that advantage for many, many decades to come. It works, and people know that it works within the company.

So it's self-reinforcing, and there's nothing like getting proof that what you've designed works, to cause you desire to perpetuate it and to build upon it.

Charlie?

CHARLIE MUNGER: Well, and we don't have any standard formulas like they have in some big companies where X percent is on diversity and Y percent is on something else and Z percent is on something else and everybody is putting all this stuff through a big human resources department.

And every incentive arrangement with a key executive is different from every other, so we can't help you with a standard formula. We don't have one.

WARREN BUFFETT: Our businesses are all so different. It would be crazy to try and have some master arrangement, you know, that involved return on capital — there are some businesses that don't use any capital in our companies — or operating margins. They're just — you know, we could hire consultants in compensation to come in and they —

CHARLIE MUNGER: We never have.

WARREN BUFFETT: No, we never will.

But, you know, they would want to please the people they were working for and get referred elsewhere.

I mean, I will guarantee that you can go to many corporations, if you've got a comp committee, it meets periodically, and the human relations VP comes in and probably suggests a compensation consultant to take. And, you know, who does a human relations VP want to — whose approval do they want? The CEO's.

Whose approval does the compensation consultant want? Well, they want to get recommended elsewhere by the CEO and the human relations VP. So what kind of a system do you get? You get what I call ratchet, ratchet, and bingo, you know.

We're not going to have any of that at Berkshire, and like I say it's worked very well.

Now, we've had people make lots of money at Berkshire. I mean, we've got numbers in eight figures, you know, a page-and-a-half or so, I saw it the other day, that would be at a million dollars and over, and we'll have more.

But it does relate to logical measures of performance in practically all cases. And the amount of time we spend on it is just — I am the compensation committee for 60 or 70 people, and I'm not overworked. (Laughs)

Anything further on that, Charlie?

CHARLIE MUNGER: Well, in past years, I've made the remark about compensation consultants that prostitution would be a step up for them. (Laughter)

WARREN BUFFETT: Charlie is also in charge of diplomacy at Berkshire. (Laughter)

We told you we'd get to everybody in terms of offending them before the day was over. (Laughter)

It didn't even take until 3:30.

22. Modest GDP growth creates "staggering" increases over time

WARREN BUFFETT: Station 9.

AUDIENCE MEMBER: Good afternoon gentleman. (Inaudible), Arlington, Virginia. I have a question for you.

What will it take to get America growing by 4 percent again?

WARREN BUFFETT: Well, Charlie, that's too easy for me. You take it. (Laughter)

CHARLIE MUNGER: A lot. A lot. It's not going to be easy.

WARREN BUFFETT: No. But if population grows 1 percent a year and GDP, in real terms, grows 2 1/2 percent a year, by the standards of 2,000 or 5,000 years, that would be remarkable.

I mean, it would result in, you know, a quadrupling of real GDP per capita every century.

We don't — it's nice to have 4 percent in real terms, but 2 1/2 percent, it may be slow in getting us out from the slump that we entered into a few years ago, but it's a really — it's a remarkable rate of growth for a country that already enjoys a very high standard of living.

It's a remarkable rate of growth for a country that has 1 percent a year gain in population. It is huge over one person's lifetime. I've used this a lot of times, but in my lifetime, the real GDP per capita has increased six-for-one.

CHARLIE MUNGER: But it's nowhere near 4 percent per annum.

WARREN BUFFETT: No. It's staggering. It's staggering. And we have $48,000 or thereabouts of GDP per capita in the United States. We are unbelievably rich.

But an awful lot of people are not feeling that way, and in many cases for good reason. But we've got a tremendous country to work for — to work with.

It's got all kinds of strengths. And it has this huge abundance that — if my parents back in 1930, if you'd told my mother and father that when I was 81, that I would be living in a country that had six times the per capita output of their day, they would have thought, you know, that this would be a utopia. And it hasn't been bad, I might add.

But our country is not a mess. Our politics may be a mess, but the output is — (applause) — you know, it's terrific.

Charlie, if you had to guess the real growth rate per capita over the next 20 years in the United States, what do you think it would be?

CHARLIE MUNGER: That's after inflation?

WARREN BUFFETT: No. This is just real.

CHARLIE MUNGER: Real, that's what I mean. After taking inflation out of it?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Well, if God were making the guarantee, I would settle for a very low figure. I think we're a very mature economy, with a lot of social safety net, and a lot of competition from new nations rising, I think 1 percent per capita in real growth would be a sensational result.

WARREN BUFFETT: Yeah, which in 20 years means people would be living close to 25 percent better on average. That's not bad. That's the next generation — in one generation.

CHARLIE MUNGER: You get your expectations too high. When you think that 4 percent is what the world ought to provide, you're asking for trouble.

WARREN BUFFETT: It won't do it.

CHARLIE MUNGER: That's what happened in the housing boom. People got these foolish dreams, and they just started doing foolish things to try and reach unattainable objectives.

WARREN BUFFETT: But if you had the 1 percent, you would be talking about each generation living something over 20 percent better than their parents did.

CHARLIE MUNGER: For this base, it would be a sensational result.

WARREN BUFFETT: And we'll probably get it, in my view.

It won't come in even increments, but the system still works.

And incidentally, you've actually seen — even after the incredible crash, in effect, that we had in the fall of 2008, you've seen an enormous amount of resilience here and, of course, you compare it with Europe and it looks particularly strong, but —

CHARLIE MUNGER: Yes, but the resilience has been better for the businesses than it has been for the employment situation —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — which is too bad.

WARREN BUFFETT: Yeah. Business has done extraordinarily well.

Business profits as a percent of GDP were right at the height, you know, last year — and of course our own worth.

I mean, that produces a lot of strains on the political system.

Well, we've mused enough on that.

23. Buffett won't contribute to super PACs

WARREN BUFFETT: So let's go to station 10.

AUDIENCE MEMBER: Hi, Warren. Arthur Lewis (PH) from Denver, Colorado, new home of Peyton Manning. But my question is —

WARREN BUFFETT: It's also the home of Johns Manville. (Laughter)

AUDIENCE MEMBER: My question is with the election coming up, have you thought about making a donation to a super PAC to try to protect a competitive advantage?

WARREN BUFFETT: No, I won't. You know, I wish it never — (applause) — [U.S. Supreme Court case] Citizens United never happened.

It's very tempting, and I will hear this argument put forth to me. People will say, well, you know, we don't believe in it either, but they're doing it on the other side, and, you know, you've got hundreds of millions pouring in on the other side and you're going to tie your hands behind your back, you know, just over principle.

But, you know, I think the whole idea of super PACs is wrong, and I think the idea of huge money by relatively few people influencing politics, I think we've got enough of a push toward a plutocracy from a lot of other factors that we don't need to throw it into the voting process.

And I might say that — I'll say this for [Las Vegas Sands CEO and GOP contributor] Sheldon Adelson who was — you know, he and his wife I think have probably put 12 million in or something. He says this, and I believe him entirely. He says the same thing. He thinks the system is wrong, but he says that's the way the system is. So he has to — you know, he has to play or other people will play and he won't be.

I can understand that, but I don't want to do it. I just think that, you know, you've got to take a stand someplace.

And the idea that I should toss $10 million into some super PAC which is going to spend its whole time kind of misleading people about the opponent's behavior or record, I don't want to see democracy go in that direction.

Charlie? (Applause)

CHARLIE MUNGER: Well, I'm ordinarily so negative and I am extremely negative about our — the nature of our politics with both parties doing the gerrymandering and requiring this unified thought so that the crazies on each side get all this power.

And I remember when we did the Marshall Plan with bipartisan support. That's more my kind of a world. So I don't like it.

That said — (applause) - I think we're lucky to have two candidates as good as we have. Considering the system, I think we've done pretty well this year.

WARREN BUFFETT: How would you feel about contributing to a super PAC if the other side had way more going to their super PACs?

CHARLIE MUNGER: Well, there are certain subjects where I would give money to a super PAC if I thought it would work. If I thought I could really reduce legalized gambling in the United States by a major amount, I would be willing to spend some money to get it done. (Applause)

I think it does us no good. And to the extent we have allowed our securities markets to be more like gambling casinos, I think that's a dumb outcome, too. (Applause)

WARREN BUFFETT: Yeah. If you've got a super PAC out there, call on Charlie, not me.

24. Don't worry about Berkshire's short-term stock moves

WARREN BUFFETT: 11.

AUDIENCE MEMBER: Glenn Tongue, T2 Partners, shareholder from New York.

In an interview with Becky yesterday, Mr. Munger commented that in the old days, the vast majority of Berkshire's value was embedded in the investment portfolio, which is presumably worth around book value.

Today the majority is in the controlled businesses, which we believe are worth a substantial premium to book. In light of this, Berkshire Hathaway's intrinsic value, as a multiple of book value, should be increasing over time, yet Berkshire's price-to-book value has been declining. I'm trying to understand this.

Since the beginning of the year, Berkshire's investment portfolio — I'm sorry — since the beginning of last year, Berkshire's investment portfolio has increased in value by $20 billion and you've acquired Lubrizol. The controlled businesses are going gangbusters, yet the stock price hasn't budged. Is "Mr. Market" simply in one of his manic moods?

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Well, I'd say no, but I'd say it's in the nature of things that the market is not going to do exactly what you want when you want it.

I think over time, "Mr. Market" will treat the Berkshire shareholders fine, and I wouldn't worry too much about what happens over this six months or this 12 months.

I don't think you're really all that welcome in this room if the short-term orientation is what turns you on. (Applause)

WARREN BUFFETT: I think you'd agree, though, probably, that Berkshire is somewhat cheaper relative to its price than it was a year ago.

CHARLIE MUNGER: Yes, absolutely, if that's your test. Should you feel better about the margin of safety in Berkshire? Yes, it's fine.

25. Why Berkshire hasn't paid a dividend

WARREN BUFFETT: OK. Station 1.

AUDIENCE MEMBER: Good afternoon. Based on your earlier — oh, this is Roberta Cole (PH) from the Twin Cities of Minnesota.

Based on your earlier comments you made this morning, we understand you will buy back shares to help increase share value.

Our confusion, and appreciate clarification, arises as to why you are unwilling to distribute a dividend on a sporadic basis when the stock is too expensive to buy back, and you have the excess cash so that you could do that, particularly in a low interest rate environment. We look forward to clarification. Thank you.

WARREN BUFFETT: Yeah. By and large, we feel, perhaps unjustifiably, but so far justified, that we can create more than a dollar of present value by investing.

Sometimes, if the stock is cheap, we can create more than a dollar of present value by simply repurchasing shares. But even if that option isn't available, we feel that by every dollar we retain, we can — overall — we can turn that into a greater than a dollar of present value.

And for 47 years, that's worked. I mean, we have — every dollar retained is turned into more than a dollar of value.

So, if somebody wanted to create their own income stream out of it, they were much better off selling a little bit of stock every year than they were by getting a dividend out of it.

They would have more money working per share in Berkshire if they sold off 2 percent of their holdings than if we actually paid them out in 2 percent dividends.

So the math has been compelling to this point. Now, the question is whether we can keep doing that in the future.

But so far, at any point in our history, if we had paid out dividends — and I paid out 10 cents a share back in the 1960s which was a big mistake, but — we won't repeat that.

If we paid out dividends, our shareholders, net, would be worth less money than they are by having left it in, and I think that will continue to be the case, but who knows?

Charlie?

CHARLIE MUNGER: Well, I think the dividends will come in due course because eventually we'll find it difficult to multiply the rabbits, but we hope that that evil day is delayed.

WARREN BUFFETT: And even events of the last few years are encouraging in that respect.

CHARLIE MUNGER: Yeah, absolutely, particularly encouraging.

WARREN BUFFETT: Yeah. I would feel better about — well, the last few years have been better than we anticipated, in terms of being able to put money to work in ways that we think are creating more than a dollar of present value at the time we did it.

CHARLIE MUNGER: You know, MidAmerica may have very unusual opportunities in the next ten or fifteen years to employ an enormous amount of capital at a very reasonable return.

WARREN BUFFETT: Perhaps 100 billion.

CHARLIE MUNGER: What?

WARREN BUFFETT: Perhaps 100 billion.

CHARLIE MUNGER: Perhaps $100 billion. And you can see why that doesn't make us too excited about dividends.

WARREN BUFFETT: We'll think about it when we're older. (Laughter)

CHARLIE MUNGER: A lot older. (Laughs)

26. "Learning and learning and learning"

WARREN BUFFETT: Number 2.

AUDIENCE MEMBER: Hi, Warren and Charlie. This is Thomas Schulz (PH) from Germany.

You once said that if you had just $1 million to invest now, you could achieve returns of 50 percent per year.

Given what you know now, how would you be able to improve on the already spectacular performance of when you started out with your partnership?

CHARLIE MUNGER: We can't do with our present resources what we did once. There are a lot of things I can't do that I used to do better. (Laughter)

WARREN BUFFETT: Well, you can confess to those, Charlie. (Laughter)

CHARLIE MUNGER: And so —

WARREN BUFFETT: Well, but I think he may be driving it to the point that have we learned things in managing since we were at that level where we can do even better with $1 million now than we could have done with $1 million then, and I would say the answer to that is yes. Wouldn't you?

CHARLIE MUNGER: Yeah, I think that's true.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: There's enough craziness out there. If you have endless time and only a very small amount of money, I think you could find ways to do pretty well.

WARREN BUFFETT: And in the course of 50 or so years, we have probably learned more, or been exposed to more, that if we were back at the million-dollar level we would know more places to look, I think.

CHARLIE MUNGER: Well, I say what's interesting about Berkshire, and many of you have been around for so long you've actually seen it happen, Berkshire's record would have been terrible compared to the way it turned out if Warren hadn't kept learning and learning and learning all the way.

I mean, each decade, to make the record decent, he had to learn to do some things he didn't know how to do at the start of the decade. And I think that's pretty much the human condition, and of course, he's getting old. I worry about him a lot. (Laughter)

WARREN BUFFETT: I'll resist commenting. (Laughter)

27. Learning from the follies of others

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Hi. My name is Jeff Chen (PH). I'm from San Francisco. I'm 26, and I run a software start-up out there.

My question is about mistake minimization. I found that I've made a lot of mistakes in my business, looking back, and I want to know besides thinking harder and learning from your own mistakes, what are the most effective techniques you've used to minimize the mistakes?

WARREN BUFFETT: Yeah. Well, I — we made mistakes; we'll make more mistakes.

We do — we think not so much — we think in terms of not exposing ourselves to any mistakes that could really hurt our ability to play tomorrow.

And so we are always thinking about, you know, worst-case situations and there are — on the other hand, we have a natural instinct to do things big, both of us.

So we have to think about whether we're doing anything really big that could have really terrible consequences.

And, I would say this, that A) I don't worry much about mistakes, I mean, the idea of learning from mistakes. The next mistake is something different. So I do not sit around and think about my mistakes and things I'm going to do differently in the future or anything of the sort.

I would say that the — you may get some advantage — I think I've learned something over the years. I haven't learned more about a basic investment philosophy. I got that when I was 19 and I still —

I think I've learned more about people over the years. And I'll make mistakes with people. You know, that's inevitable. But, I think I'll make more good judgments about people. I'll recognize the extraordinary ones better than I would have 40 or 50 years ago.

So I think that improves, but I don't think it improves by certainly any conscious sitting around and focusing on what mistake did I make with that person or this person. I just don't operate that way.

Charlie?

CHARLIE MUNGER: Warren, I would argue that what you've done, and what I've done to a lesser extent, is to learn a lot from other people's mistakes. That is really a much more pleasant way to learn hard lessons. (Laughter)

And we have really worked at that over the years, partly because we find it so interesting, the great variety of human mistakes and their causes. And I think this constant study of other people's disasters and other people's errors has helped us enormously, don't you, Warren?

WARREN BUFFETT: Oh yeah, well that's true. In terms of reading of financial history and all that sort of thing, I've always been absolutely absorbed with reading about disasters. (Laughs)

And there's no question. I mean, when you look at the folly of humans — you know, I've focused on the folly in the financial area — there's all kinds of folly elsewhere — but just the financial area will give you plenty of material if you like to be a follower of folly.

And I do think that understanding — and that's what gave us some advantage over these people that have IQs of 180, you know, and can do things with math that we couldn't do.

They just — they really just didn't have an understanding of how human beings behave and what happens. 2008 was a good example of that, too.

So we've — we have been a student of other people's folly, and its served us well.

28. We don't build strong barriers to entries, we buy them

WARREN BUFFETT: Station 4, have we got a question yet?

AUDIENCE MEMBER: John Boxters (PH), Dartmouth, Massachusetts, which as you know is next door to New Bedford, a former home of Berkshire.

My question is how do you build barriers to entry, especially in industries which have few?

WARREN BUFFETT: Industries which have?

CHARLIE MUNGER: Few barriers to entry.

WARREN BUFFETT: Oh.

CHARLIE MUNGER: How do we build barriers?

WARREN BUFFETT: Pretty tough. (Laughs)

CHARLIE MUNGER: Yeah. We sort of buy barriers; we don’t build them. (Laughter)

WARREN BUFFETT: Yeah. Well, think about that because it’s true. It’s very — there are some industries that are just never going to have barriers to entry.

And in those industries, you better be running very fast because there are a lot of other people that are going to be running and looking at what you’re doing and trying to figure out, you know, what your weakness is or what they can do a little bit better.

You really — you know, a great barrier to entry, you know, is something like this. If you gave me 10, 20, $30 billion and told me to go in and try and knock off the Coca-Cola Company with some new cola drink, I wouldn’t have the faintest idea how to do it.

I mean, there are billions of people around the world that have something in their mind about Coca-Cola, and you’re not going to change that with 10 or $20 billion.

CHARLIE MUNGER: Yeah, but our great brands we bought, we didn’t create.

WARREN BUFFETT: We didn’t create them, no.

We eat them but we don’t create them. (Laughter)

But you know, not so many years ago, you remember Richard Branson, he came to this country and he came up with something called Virgin Cola. And, you know, they say a brand is a promise. Well, I’m not sure what promise he was trying to convey by that particular branding — (laughter) — but you know, you haven’t heard anything about that since.

I don’t know how many cola drinks there have been in the history. Don Keough would probably know but there’s been hundreds, I’m sure.

And those are real barriers, but it’s hard to do.

I mean, the people — as Pfizer finds out with Lipitor, you know, the time runs out and what was an absolute gold mine still is a pretty good mine, it’s not what it was by a long shot.

But we've got a number of businesses that have — well, nobody's going to build another railroad, you know. We have a competitor and we will have competitors in alternative methods of transportation and all of that.

But if you're buying something at a huge discount from replacement cost and it's an essential sort of activity, you've certainly got a barrier to new competition.

But the UP is out there fighting for every bit of business every day, of course.

Charlie?

CHARLIE MUNGER: Yeah. We have found in a long life that one competitor is frequently enough to ruin a business.

WARREN BUFFETT: Well, I did find that out. I started with a gas station out at 30th and Redick here in Omaha, and we had a Phillips station next to it. I had a Sinclair station. And you know, whatever he charged for gas was my price. (Laughs)

I didn't have much choice. You don't like to be in a business like that.

29. Munger on China's BYD and electric cars

WARREN BUFFETT Number 5.

AUDIENCE MEMBER: Hi. I'm Kyle Miller (PH) from Kansas City, Missouri, and I was wondering about the BYD electric car company and if — with the new cars going on sale in the U.S., if that will hopefully increase the value of the company.

WARREN BUFFETT: Charlie is our expert on BYD, and he will now carry forth. (Laughter)

CHARLIE MUNGER: Well, the car market in China is a huge market, and they happen to be located in China. So that's the main focus of BYD.

I think the first cars they will try and bring here will be for fleets in California where we have environmental troubles and so on, and there may be a market for electric cars with that.

And of course, there are various subsidies that come to people who use electric cars.

I have some relatives who commute into Washington, D.C., and they can only use the fast lane on the freeway if they buy a Prius, and that's been very helpful to Toyota. And we'll see a lot more of that sort of thing.

Generally speaking, I think BYD is an interesting company, if you stop to think about it.

Here's one of eight children of a peasant that becomes a famous engineering school professor, and before he's reached 50, he's won the equivalent of China's Nobel Prize.

And he has created a company which has 180-some thousand employees, a land holding about the size of Macau, and 100-and-some million square feet of buildings.

It's a very interesting start-up company.

WARREN BUFFETT: What percent of the cars do you think in 2030 will be electrics?

CHARLIE MUNGER: Not many. (Laughter)

WARREN BUFFETT: I shouldn't have asked.

CHARLIE MUNGER: I think society — it's like the wind power that's being subsidized in Iowa.

We should subsidize electric cars in various ways, as they do in Washington, D.C. by letting them use the fast lane on the freeway, in order to get the technology going so that we can wean ourselves from oil more quickly.

So I think there will be more subsidies, and there will be more electric cars, but I'm not expecting a sudden revolution.

I drove the latest version of BYD's electric car. I was driven around the block Tuesday, and I was flabbergasted at how much improved that car was.

It's simply amazing how fast people in China are learning to do what took us a long time to learn. The world is getting very much more competitive.

30. Berkshire's insurance float and low interest rates

WARREN BUFFETT: OK. Area 6.

AUDIENCE MEMBER: Good afternoon, Warren and Charlie. Jay (inaudible) from Mumbai, India, residing in Austin, Texas.

I want to thank you for a great show again, and over the few years that I've been here, I've truly enjoyed hearing both of you speak and especially ability to synthesize and clarify so many issues on important things like, you know, valuation, the philosophy of life, or sometimes even the trivial things, Warren, like you clarifying two years ago about, you know, your joke on Charlie Rose about Sophia Loren.

They've all been extremely beneficial.

My question is regarding some clarification around the insurance business, and especially how you value it. Now, typically we've had, you know, a lot of float information and the underwriting profit or loss info.

So, in one way we've been geared to think about it is the value of the investments that you get — the present value of the investments that you get — from the future expected float.

However, I think last year, you also talked about the economic goodwill, especially in GEICO, and I think you were using some ratio, 90 percent of that year's insurance premiums.

So I was wondering if you could just talk to us a little bit about the different ways you could look at valuing the different insurance businesses. That would be of huge help. Thank you.

WARREN BUFFETT: Well, the economic value comes from the ability to utilize float if obtained at a bargain rate.

Now, if interest rates were 7 or 8 percent and float even cost you 2 percent to obtain, it still would be very valuable.

But the economic — at GEICO, for example, I think it's quite reasonable to expect a fairly substantial underwriting profit, on average, for as far as the eye can see, and growth for as far as the eye can see.

And then coupled with that is a growing float, because float grows with the premium volume. Well, that's the most — you know, that is a very attractive combination of factors that comes about because GEICO is a low-cost producer.

And it has some real advantages, in terms of scale, in terms of the whole method of operation, that makes it very hard for other companies to duplicate their cost structure. It's always good, though, to own a low-cost producer in any business, but it's very, very nice in the insurance business.

Now, Ajit's business did not come the same way at all. I mean, at GEICO we have, you know, almost — we have well over 10 million policies, and that's a statistical-type business.

And so we have, you know, hundreds of thousands of drivers in New York, and we have them by age and profession and all kinds of things. So it's a very statistical-type business, and that coupled with a low cost, is very, very likely to produce a good result over time.

In Ajit's business, he has to be smart on each deal, because something comes along and somebody wants to buy coverage for events causing the loss of more than $10 billion in Japan in the next year.

That is not — you can't look it up in any book, and you can't do enough transactions just like that one to even know whether your calculation was right on that specific deal.

Now, if you make 100 calculations on 100 of these type of deals, you'll soon find out whether you have the right person making those calculations or not.

But the economic goodwill with Ajit's operation is based much more on the skill to price individual transactions and the ability to find the people even that want those transactions. Whereas at GEICO, it's based basically on a machine.

But it's enormously important how that machine is run, and Tony Nicely has absolutely knocked the ball out of the park, in terms of managing it.

In the years prior to when he took over, it was — you know, it had gone along at 2 percent of the market and really hardly gone anyplace.

And Tony is — quintupled, virtually, our share of the market, while at the same time producing great underwriting results.

So he took a machine that had a current — had a lot of potential — and then he exceeded even the potential that I thought it had. So you get the value in different ways.

It does relate in the end to a combination of growing a large float, and extremely low-cost float, and in our case, the cost of float has been negative, so people are actually paying us to hold $70 billion of their money, and that's a lot of fun. (Laughter)

And I think that the chances of that continuing are really quite high, although I don't think the chances of the 70 billion growing at a fast clip are high at all. I think we'll be lucky to hold onto the 70 billion.

But I think the chances of the fact of us being able to get that at a less-than-zero cost is good, and I think that will even be true if interest rates go up to 4 or 5 or 6 or 7 percent. I think we may very well be able to do it, and that's a huge asset under circumstances like that.

Charlie?

CHARLIE MUNGER: Yeah. And we're currently in a low-return environment from conventional investment float, but that won't last forever.

And there were times in the past when Ajit would generate a lot of one-of-a-kind float, and Warren would make 20 or 30 percent with it before we had to give it back. That was a lot of fun, and we did it over and over and over again.

Whether that will ever come again on that scale, I don't know, but it doesn't have to.

WARREN BUFFETT: You know, when we have 30 — presently our cash position — well, really if you counted all the companies, it's probably 36 or 7 billion — you know, we're essentially getting nothing on that.

So if you — our earning power today is being affected by current Fed policies.

And I — you know, that is not going to be a normal rate for many, many — for over the longer term. So we — in that sense, our normal earning power is being depressed by Mr. Bernanke but probably for very good reason.

31. Munger: Energy independence is a "stupid idea"

WARREN BUFFETT: Seven?

AUDIENCE MEMBER: Ola Larson (PH), Salt Lake City.

Five, six years ago, you wrote in your annual shareholders report that the current account deficit, the trade deficit, couldn't go on indefinitely. Of course, a very large part of that is crude oil import.

Now some people in the energy markets are sort of talking about United States becoming independent in the energy market.

Could you shed some light on how this might affect the trade deficit? Thank you.

WARREN BUFFETT: Yeah. It will be a huge plus, obviously, if our total energy production increases substantially and what we have to import costs us less. I mean, it is a big factor in the current account deficit.

We're doing a lot in oil. I don't see us getting self-sufficient in oil, but gas is huge. We — our picture has changed a lot in the last three years, in terms of energy.

Charlie and I might argue that, over time, we'd still be better off using somebody else's up and keeping our own for a long time.

CHARLIE MUNGER: That's my view.

WARREN BUFFETT: Yeah. For a long time — we were an oil exporter in my lifetime, a substantial oil exporter. And it might have been better if we would have been using Saudi —

CHARLIE MUNGER: It would have been better.

WARREN BUFFETT: Yeah. (Laughs)

You can't get by with much with Charlie here.

It would have been better. OK. It would have been better if we had been using Saudi Arabia's oil then and just, in effect, treated all of those huge reserves we had in places like East Texas and such as a strategic petroleum reserve which we just kept around for another century, but —

CHARLIE MUNGER: It would have been much better.

WARREN BUFFETT: Yeah, it would have.

But our picture has changed for the better, and that means our current account deficit picture has changed for the better.

We still got a ways to go, but it does look better than three or four years ago. Don't you think so, Charlie?

CHARLIE MUNGER: Well, I think the — those — that's a very complex interaction.

My view is that the single-most precious resource in the United States are its hydrocarbon reserves, the ones that are right here and, of course, I want to use up —

I'm a puritan. I always want to suffer now to make the future better, because I think that's the way grown-ups should behave. So I'm all for — (applause) — using up the other fellow's oil and conserving our own.

You know, I think the idea of energy independence is one of the stupidest ideas I've ever heard grown people talk about.

Think of what terrible shape we'd been in if we'd achieved total energy independence way earlier.

We wouldn't have any oil and gas left at all. Wouldn't that be a wonderful condition? We don't want energy independence. We want to conserve this stuff.

And thank God other people have some of this precious stuff they're willing to sell.

I have the exact opposite idea on this subject than most people and, of course, I think I'm right. (Laughter)

WARREN BUFFETT: This is Charlie's version of saving up sex for your old age. (Laughter)

CHARLIE MUNGER: No, we're going to use the oil. (Laughter)

32. Wealth inequality and economic growth

WARREN BUFFETT: OK. Number 7. Was that 7?

AUDIENCE MEMBER: Jim Powers (PH), Newton, Massachusetts.

A few minutes ago you were talking about per capita GDP, and if it went up 1 percent a year, each generation would be 20, 25 percent better off than the previous one.

In Boston right now, we have a big controversy where the executive officer of Liberty Mutual Insurance Company has been making over 50 million a year in compensation plus other perks.

And that amount of money, in an hour or two, is more than 95 percent of the employees of that company make in the course of a year.

The newspapers have been commenting on the concentration of the profits of that mutual insurance company not going to the insurance policyholders who own the company because it's a mutual insurance company, and the lack of compensation going to the average employee.

What good does it do the average American for the economy to improve 1 percent of GDP per year if they don't — if they don't enjoy some of that themselves?

WARREN BUFFETT: We certainly agree — (applause) — without commenting on any specific individuals, but obviously, if we start out with $48,000 per capita GDP and we do increase by 20 percent or so each generation, you would certainly hope that that would not keep bubbling to the people at the top as it has during the past generation.

I mean, the past 20 years we have not seen the progress that the country overall has made distributed in any kind of way except very, very much at the top.

And the tax code has encouraged that. The tax code is — you know, the tax code, which was taking those people making the $45 million incomes in 1992, was taking 27 or 28 percent from them. When they got up to 270 million now, it's taking a figure that's more like 18 percent.

So, we've got a tax code that has become more and more pro the ultra-rich, and coupled with what you see, and you've seen in compensation, and what the CEO makes in relation to the average worker and all that, you know, we've gone a long direction — a long way — in making sure that what we were promised in the way of trickle-down benefits has not been achieved.

CHARLIE MUNGER: It's also true that most of the great mutual insurance companies — and there are a lot of them in the United States — do not have that kind of compensation abuse in them.

WARREN BUFFETT: That's true, for example —

CHARLIE MUNGER: That's quite fair.

WARREN BUFFETT: — State Farm, or something like that, does not have that.

CHARLIE MUNGER: No, no. Most of them don't. That's a very egregious example, but Boston has always led in egregious examples. (Laughter)

WARREN BUFFETT: No — it's — the corporate world —

CHARLIE MUNGER: It got there early, you know. It mastered the art. (Laughter)

WARREN BUFFETT: The corporate world has been — there's been a lot more egregious behavior in the corporate world than the mutual world.

CHARLIE MUNGER: Well, that's why it's so anomalous, really.

WARREN BUFFETT: Yeah, yeah.

CHARLIE MUNGER: No wonder it's drawing some attention.

WARREN BUFFETT: The rich like it that way. You have to understand that. (Laughs)

But the tax code is basically — you know, that is an important place where people decide, you know, who actually bears the cost of this government, and we have moved away from the rich on that as they have gotten further and further away from the middle class, in terms of earnings.

And, you know, there's a — there may be a natural tendency in a democracy to work toward a plutocracy. If you think about the effect of money in politics, if you think of the nature of how market systems work, you know, there may be some underlying trends that push a democracy toward plutocracy, and you need countervailing factors to prevent it.

CHARLIE MUNGER: I don't think you ought to be too discouraged about Boston, either, because when I first went to Boston, the mayor was running the city from the federal penitentiary. (Laughter)

WARREN BUFFETT: Was that Curley or —

CHARLIE MUNGER: Yes, Mayor Curley.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And nobody in Boston saw anything peculiar about it. (Laughter)

WARREN BUFFETT: If you live long enough, you'll see everything. (Laughter)

CHARLIE MUNGER: Yeah, right.

33. Sovereign debt and "fiscal virtue"

WARREN BUFFETT: Area 8.

VOICES FROM AUDIENCE: Nine, nine.

CHARLIE MUNGER: Nine, he says.

WARREN BUFFETT: Oh, 9? OK. Nine.

AUDIENCE MEMBER: My name is Brian Chilton (PH), also from the Boston, Massachusetts, area.

WARREN BUFFETT: I'm surprised you admit it. (Laughter)

AUDIENCE MEMBER: I was tempted.

Warren, a lot of today's questions referenced risk. It seems to me one of the biggest risks facing us is the (inaudible) sovereign debt levels both here in the U.S. and in many countries in Europe.

The liquidity injections by the Fed, and more recently the ECB, have given us some breathing room, but how do these large debts get balanced and do they concern you? (Applause)

WARREN BUFFETT: Well, the nice thing about sovereign debt is they can not pay you in the end and you can't grab anything from them, unlike other kinds of debts.

And, you know, the truth is that the world has seen many, many failures of sovereign debt. I remember when Walt Wriston, back in the early 1980s, said sovereigns don't default.

Well, the truth is they've defaulted many, many times over history. And what happens then is you get a big reallocation of wealth.

Now, the wealth doesn't go away. I mean, you don't lose the farms, you don't — you lose the (inaudible), you don't lose the people with their skills and all of that sort of thing. I mean, there may be some marginal losses.

But I don't know how it plays out in Europe. We have seen the ECB here recently give the trillion dollars to banks which are loaded with sovereign debt, which really is questionable in many cases.

And I wouldn't be surprised, in some cases, if they haven't used some of those — some of the borrowing to even buy more of it.

So it's like giving a guy with a margin account with some perhaps bad assets in it even more money to play with to further leverage themselves up and make an even bigger bet.

But when they did that at MF, or whatever it was, Global, you know, then it had a bad ending, and it might have a bad ending over there.

I would much prefer, you know, a world that was getting its fiscal house in order, including in the United States.

The counterargument, of course, is that when you're in a recession, or close to it, as some or all of Europe might be, that that will feed on itself and be destructive in the same way that it was in the early '30s in the United States.

But we have been having in the United States — it's very interesting. We talk about the fact that there was a stimulus bill a few years ago, even though they didn't call it that, and whether it was adequate and inadequate and all that.

When the government is operating at a deficit that's 8 to 9 percent of GDP, that is stimulus on a huge, huge level. They don't call it — they may not call it, but that is, by definition, huge fiscal stimulus.

So we have been having consistent, huge fiscal stimulus in this country, and we will have to wean ourselves off of that fairly soon.

And the interesting, I think, almost — leaders of both parties realize that you probably have to get revenues up to something around 19 percent of GDP and you have to get expenses down to 21 percent of GDP.

And that that will work fine over time, but you have a situation where both sides feel they will show weakness by going first.

And you also have a situation where the leader, probably, of at least one party can't speak for their party, so that you can't have negotiations in private, which are probably the way to get something like this solved.

I would avoid — I would — certainly at these rates, I would totally avoid buying medium-term or long-term government bonds. I think that's the obvious answer. I wish I had answers that would solve the problem further beyond than that.

But in terms of your own situation, I would stay away from medium- or long-term government bonds, our own, or those of other countries.

Charlie?

CHARLIE MUNGER: Well, of course, he's asking the really intelligent question of the day, and of course we're having difficulty answering it. (Laughter)

It is very hard to know how much of this Keynesian stuff will work after you've lost all your fiscal virtue.

You know you come to a time, if you're a government which has pretty much lost all its fiscal virtue, that the Keynesian stuff won't work, and the money printing won't work, and it's all counterproductive, and you're heading for calamity.

We don't know the precise point at which it stops working. And somebody like Paul Krugman — who I think is a genius — but I also think he's more optimistic about doing well with various economic tricks after you've lost a lot of fiscal virtue than I think is justified by the facts.

I think it's very dangerous to go low on fiscal virtue and, of course, here in the United States, we've used up some of our store.

And it's very important that we not go too far in that direction because we want to be able to do what we did in the Great Recession, where we avoided a huge calamity because we had enough fiscal virtue left so the economic tricks would work.

So it's a terrible problem, and I ask you the question, Warren. Is it inconceivable that we could get a very mediocre result in the United States as a result of all this trouble?

WARREN BUFFETT: I think we'll get a good result over time.

CHARLIE MUNGER: I know you do, but — (Buffett laughs) — is it inconceivable? I'm trying —

WARREN BUFFETT: Well, we can have problems, but —

CHARLIE MUNGER: I'm a little less optimistic than he is. I'm roughly in his position. I think there's some slight chance that we can get a pretty mediocre result.

WARREN BUFFETT: Let's say I came to you right now with a budget that made sense in general — in what it achieved — it had a 19 percent revenue built into it and 21 percent of expenditures. Would you want to adopt that now?

CHARLIE MUNGER: I think the reason intelligent people disagree on this subject is because it's so difficult.

Everybody wants fiscal virtue but not quite yet. They're like that guy who felt that way about sex. He was willing to give it up but not quite yet. (Laughter)

WARREN BUFFETT: Saint Augustine.

CHARLIE MUNGER: Saint Augustine, yes.

WARREN BUFFETT: He's a hero to many of us. (Laughter)

CHARLIE MUNGER: I think these are very, very hard questions. And I have one thing I'm sure of: that it is safer, if you're going to these deficit financing things, to use the money intelligently to build something you're sure to need than it is to just throw it off the end of trains or give it to crooked lawyers. (Applause)

And so I think we all have an interest in making sure that whatever tricks we play are intelligently used because it will protect our reputation and reality in having this fiscal virtue.

WARREN BUFFETT: I'll let you design the 21 percent that gets expended.

CHARLIE MUNGER: Oh, if I were doing it, I would expend it sensibly on infrastructure that I knew we were going to need, and I would have a massive program — (applause) — and I would have the whole damn country pay more cheerfully, like we were so many Romans in the Punic Wars.

The Punic Wars, the Romans paid off two-thirds of the war debt before the war was over. That's my kind of —

WARREN BUFFETT: That's our campaign slogan, folks. Punic Wars again. (Laughs)

CHARLIE MUNGER: But the answer is, I think we do need more sacrifice. I think we need more patriotism, we need more sensible ways of spending money, and we need more civilized politics. (Applause)

But it's still a hard question. I think we should go on to an easier one. (Laughter)

Warren is not strained, but I'm at my limit. (Laughter)

34. Economy held back by health costs, not tax rates

WARREN BUFFETT: OK. We'll do one more question, from area 10.

AUDIENCE MEMBER: This will be an easier question.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: Thank you so much both for being here today, and I hope when you're both in your 90s and your 100s, you'll still be here doing these meetings. (Applause)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: And I’m Candy Lewis (PH) from Denver, Colorado.

And my question has to do with taxes and what do you feel is the ideal corporate tax rate to get this economy started and excited?

WARREN BUFFETT: Yeah. Last year the actual taxes paid were about 13 percent of profits, as I remember.

So the corporate rate is 35 percent, and last year you were allowed to write off 100 percent of most kinds of fixed-asset purchases.

I don’t think the — corporate profits are not the problem, or corporate balance sheets, or corporate liquidity, is not the problem in the economy moving.

I mean, there is money available, huge amounts of money available in the corporate world, including at Berkshire, to push forward on opportunities.

You know, we will — we’re spending money where we see opportunity. And we spent lots of money in the railroad business, we spent lots of money in the energy business, and we built plants elsewhere and did other things.

But — so it is not a lack of capital at all that’s holding back, nor is it tax rates, in my view, that are holding back, at all, investment.

You know, this country prospered in the ’50s and the ’60s when the corporate rate was 52 percent and people actually paid it.

When it was cut to 48 percent, we all rejoiced. And our GDP per capita grew. So it is not a factor holding back.

I will tell you, I mean, corporate tax rates last year were 1.2 percent of GDP. Medical costs were 17-and-a-fraction percent of GDP. And there we have at least a 7 percentage point disadvantage against the rest of the world, which is a big multiple of all the corporate taxes paid.

So if you ask me about the tapeworm of American industry, you know, it’s basically our medical costs. We’ve got a huge cost disadvantage against the rest of the world. (Applause)

Now, that’s unbelievably tough to address, but that is where — as Willie Sutton would say — that’s where the money is.

And you can fiddle around with corporate tax rates. I don't think that will have any big effect on the economy.

You may achieve greater fairness within the corporate tax code, I wouldn't argue about that at all.

And incidentally, the Treasury — I mean, I think both parties agree that they would like to see a lower overall corporate tax rate but one that applies more equally across corporations so that the —

But getting from here to there is going to be very, very difficult, because it's fine when you talk about it in the terms I just used. But once you put specific proposals out, everyone whose tax rate is going to go up — and some have to go up if others are going to go down — everyone whose tax rate is going to go up will fight with an intensity against that bill that far outstrips the intensity with which those on the other side fight.

It's a real complex problem that way. But corporate tax rates are not our country's problem, in my view.

Charlie?

CHARLIE MUNGER: Well, I used to say when I was younger that I expected to live to see a value-added tax, and now I'm not so sure. But I think it's going to come eventually and probably should.

It equalizes the import-export effect of the taxes, and I think it's quite logical to tax consumption.

I think we get in a lot of trouble when we give people the money and then come around later and try and take it back.

Human nature really resists that. And I think it's much better, if you're going to rely on taxes, to have taxes that are sort of taken out right off the top, and they don't vary so much from year to year.

I come from a state where the state income tax is based on capital gains — go way up and then they collapse. And of course, the politicians spend like crazy when they go up, and there's agony when — it's a crazy way to have a tax system.

We have a lot of problems.

And I don't think a 52 percent tax rate — we may have gotten by with it when we sort of led the world, but I'm not so sure it would be such a good right now to have our tax at 52 percent and the rest of the world taxing corporate profits at 15 percent or something.

That might have a lot of perverse consequences. And since so little money is involved, it's not where the game should be played.

And if Warren could save a lot of money on medical expense for everybody, why, he probably would have done it already. It's really hard.

WARREN BUFFETT: It's hard. So we'll end with a hard one. And I thank you all for coming. We're going to reconvene in about ten minutes to conduct the business of the meeting, and thank you. (Applause)

35. Formal business meeting begins

WARREN BUFFETT: We'll now go to the business meeting. We follow a script here, at least to quite a degree. And the meeting will now come to order.

I'm Warren Buffett, Chairman of the Board of Directors of the company. I welcome you to this 2012 annual meeting of shareholders.

This morning, I introduced the Berkshire Hathaway directors that are present.

Also with us today are partners in the firm of Deloitte & Touche, our auditors. They are available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Forrest Krutter is secretary of Berkshire. He will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting and she will certify to the count of votes cast in the election for directors and the motions to be voted upon at this meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

FORREST KRUTTER: As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 7, 2012, being the record date for this meeting, there were 934,158 shares of Class A common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 1,075,302,988 shares of Class B common stock outstanding, with each share entitled to 1/10,000th of one vote on motions considered at the meeting.

Of that number, 640,153 Class A shares, and 664,293,280 Class B shares are represented at this meeting by proxies returned through Thursday evening, May 3rd.

WARREN BUFFETT: Thank you. That number represents a quorum and we will therefore directly proceed with the meeting.

The first order of business will be a reading of the minutes of the last meeting of shareholders, and I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

The motion has been moved and seconded. Are there any comments or questions?

We will vote on this motion by voice vote. All those in favor, say aye. Opposed? The motion's carried.

36. Election of directors

WARREN BUFFETT: The next item of business is to elect directors.

If a shareholder is present who wishes to withdraw a proxy previously sent in and vote in person on the election of directors, you may do so.

Also, if any shareholder that is present has not turned in a proxy and desires a ballot in order to vote in person, you may do so.

If you wish to do this, please identify yourself to one of the meeting officials in the aisles, who will furnish a ballot to you.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Thomas Murphy, Ron Olson, and Walter Scott be elected as directors.

WARREN BUFFETT: Is there a second?

It has been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott be elected as directors.

Are there any other nominations? Is there any discussion?

The motions are ready to be acted upon. If there are any shareholders voting in person they should now mark their ballots on the election of directors and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxyholders in response to proxies that were received through last Thursday evening, cast not less than 697,021 votes for each nominee. That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Donald Keough, Thomas Murphy, Ronald Olson, and Walter Scott have been elected as directors.

37. Shareholder proposal for written CEO succession planning policy

WARREN BUFFETT: The next item of business is a motion put forth by the AFL-CIO Reserve Fund. The motion is set forth in the proxy statement.

The motion requests Berkshire Hathaway to amend its corporate governance guidelines to establish a written succession planning policy, including certain specified features.

The directors have recommended that shareholders vote against this proposal.

I will now recognize Ken Mass to present the motion. To allow all interested shareholders to present their views, I ask Mr. Mass to limit his remarks to five minutes.

KEN MASS: Mr. Buffett — Mr. Buffett, members of the board of directors. My name is Ken Mass. I represent the AFL-CIO, a federation of 56 unions, representing more than 12 million members.

I'm here today to introduce the AFL-CIO shareholders proposal for succession planning.

Our proposal urges the board of directors to adopt and disclose a policy on CEO succession planning.

Planning for the succession of CEO is one of the most important responsibilities of the board of directors. Having a succession plan in place is particularly important at a company like Berkshire Hathaway where the CEO has created tremendous value.

Shareholders are thankful for Warren Buffett's leadership as CEO.

Last year, shareholders became concerned when David Sokol resigned from the company after allegations of improper trading.

Mr. Sokol has been rumored to be a possible successor to Mr. Buffett.

We filed our proposal last fall because we feel that an internal CEO candidate is needed to carry out Mr. Buffett's legacy.

Internal candidate may be maintain — can help maintain — Berkshire Hathaway's strong culture.

In Mr. Buffett's letter to shareholders earlier this year, he disclosed that the board of directors had identified his successor, as well as two superb backup candidates.

We were relieved to hear this news.

We are not asking the company to disclose the name of Mr. Buffett's successor. All we're asking for is the board of directors update shareholders annually on the status of its succession planning.

We are pleased that Berkshire Hathaway has adopted all of these practices we recommended in our shareholders proposal, except for an annual reporting.

We hope the company will continue to keep shareholders informed about the status of its succession plan.

Thank you again — AFL-CIO — for considering this proposal. Thank you.

WARREN BUFFETT: Thank you Mr. Mass.

Is there anyone else that wishes to speak?

OK, if there's no one — no one else, I would say, Mr. Mass, you know, we are on the same page.

We regard it — and I speak for all the directors — we regard it as the number one obligation of the board to have a successor, and one that we're very happy with, as to both ability and integrity, and that we know well, to step in tomorrow morning if I should die tonight.

And we spend more time on that subject than any other subject that might come before the board.

So we do not disagree with you on the importance of it. We have taken it very seriously, and I note that you do not ask us to name the candidates, and I think there are obvious disadvantages to doing that. So again, we're on the same page on that.

And so as I understand it, you basically want to be sure that we report annually to you that the subject continues to be at the top of the list, and I can assure you that it will. And in terms of affirming that fact, I would say that certainly more often than once a year, I get — in some public forum — I get asked questions where I get to answer precisely the question that you want me to address, and I think that will continue in the future.

We have not built it into any formal item in the proxy statement, which your organization has suggested we do, but we have covered it in the annual report. We cover it at these meetings. We cover it when I'm interviewed, frequently.

And I don't think that anything would be gained by putting it in some other form, but I do want to say that we — I'm glad you take it seriously. We take it seriously. And I think we're going to get a result that you'll be very happy with, although I hope it doesn't happen too soon. (Laughter)

So, with that I would say that the motion is now ready to be acted upon. If there are any shareholders voting in person they should now mark their ballots on the motion and allow the ballots to be delivered to the inspector of elections.

Miss Amick, when you're ready, may you give your report.

BECKI AMICK: My report is ready.

The ballot of the proxyholders in response to proxies that were received through last Thursday evening, cast 32,179 votes for the motion and 672,285 votes against the motion.

As the number of votes against the motion exceed a majority of the number of votes of all Class A and Class B shares outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: The vote was about 95 percent — 5 percent, and thank you, Miss Amick. The proposal fails.

38. Formal meeting adjourns

WARREN BUFFETT: Does anyone else have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second?

A motion to adjourn has been made and seconded. We will vote by voice.

Is there any discussion? If not, all in favor say yes. Aye. Yes.

All opposed say no.

Morning Session - 2013 Meeting

1. Welcome

WARREN BUFFETT: Good morning.

I'm a little worn out. (Laughter)

We're going to — well, first of all, I really want to thank Brad Underwood. He puts the movie together every year, does a terrific job. (Applause)

Andy Heyward and Amy are responsible for the cartoon. They also produce "The Secret Millionaire's Club," which has been a huge hit this year, and I really want to thank them for their part in this, too. (Applause)

And finally, Carrie Sova who — who puts this whole affair together, she's four months pregnant. She got her MBA, I think, yesterday or — and, in addition, she is the ringmaster for all of this. Let's give Carrie a terrific hand. (Applause)

We'll go through a few figures, few slides. I'll introduce the directors and make one or two more announcements, and then we'll get on to the questions.

2. Q1 earnings

WARREN BUFFETT: Now, if we could put up the first slide, which is the earnings that were released yesterday. And as you can see, it was a good quarter.

It wasn't quite as a good a quarter as it looks, which I'll explain in a second. But really all of our businesses did very well.

You should focus on operating earnings. Charlie's getting a head start here on the peanut brittle and fudge, so I'll catch up later.

It was a very good — it was a benign quarter in insurance, but our other businesses, particularly our big businesses, did quite well, and I don't remember whether we've ever had operating earnings of more than 3 point — almost 8 billion. But, in any event, it was quite satisfactory.

Now, we'll put up slide two. The insurance earnings were helped a bit. They were still terrific without these factors, but they were helped a bit by the fact that the dollar was strong, and that reduces the liabilities we have on outstanding in foreign currencies.

So if we have losses we're going to pay in the future and they're payable in pounds or euros and the dollar appreciates against those currencies, we get a small benefit from that.

We also have it — it hurts us in other ways. We have so many different kinds of businesses, and then we own other earnings through Coca-Cola that operate around the world, that I really never know whether when the dollar goes up or down, whether it helps us or not.

So I've never been able to figure it out. So we just sort of take it as it comes. And we do want to explain that to you, the insurance earnings.

And then we had another item, which is kind of interesting. We've had a disagreement with Swiss Re about a life reinsurance contract, and that's — the disagreement's probably lasted for well over a year, and that was settled in the first quarter.

And as you can see, we showed a gain of 255 million pretax from settling this disagreement, but, interestingly, Swiss Re showed a gain of 100 million also from settling the disagreement. (Laughter)

So, we are working on an arrangement with Swiss Re whether we'll get in an argument every quarter (laughter), and both report higher earnings when we settle it.

It's magnificent what accounting can do. (Laughter)

One real high point of the first quarter was the pickup which I noticed — which I noted — in the annual report, about the gain in both the closure rate and the persistency rate at GEICO. These are hugely important factors.

And if we'll put up the chart showing the gain of GEICO's auto policies, the strengths I mentioned in 2012, and not only continued in 2013, but the trend has become even stronger.

And there's a lot of seasonal to policy gains. But as you can see, month by month, our gains have — and policies have very significantly improved over 2012.

And, again, it's because our closure ratio, in other words, the number of people that get a quote from us and then go on to buy a policy, that rate has improved very significantly this year, and with it we also had a gain in persistency, the people that renew the policies with us, and that's pure gold.

A policy has a mathematical value to us of at least $1,500, so if we had a million policies in a year — and I'm hopeful we might do that this year — that's a billion-and-a-half of value that gets built into our intrinsic value, which does not show up on the income statement or balance sheet at all, but it does increase the value of GEICO versus what we carry it for.

And I can't resist a little sales pitch on that because this closure rate, which, like I say, is at incredible levels, means that when people go to our website or call us and get a quote, they find that they can save a lot of money.

I mean, people love our little gecko, but they buy the policies because we save them money.

And it just so happens that in the auditorium right near here, the exposition hall, we have a lot of very friendly people that will help you save money, too.

So I urge you — you can walk out anytime Charlie is talking (laughter) and go and get a quote, and a very high percentage of you could save money by doing that.

And, you know, that is in the Berkshire spirit, to save money at every opportunity. So I'm hoping you will check that out, and we will set a record for policies sold.

And, finally, our railroad, this year, is doing very well. You saw the earnings in the first quarter report, if you've had a chance to look at that.

And we've got some figures up that show our gain in car loadings in the first 17 weeks. It's been 3.8 percent, whereas the other four major Class I railroads in the United States have had a gain of four-tenths of a percent.

That's significant money that — and we don't have the Canadian railroads here that operate in the United States. They both come down, the Canadian National, Canadian Pacific. But — but this is representative of what's been happening.

We've been helped by the fact that, fortunately, a lot of oil has been found very, very close to our railroad tracks, and what better place to find oil? (Laughter)

And so we've been moving a lot of that, and it's worth — and we'll be moving a lot more the way things are going.

And the result of all this — we now will put up the next slide — we're now the fifth most valuable company in the world. (Applause)

And that will change over time, but I hope it changes for the better.

3. Directors introduced

WARREN BUFFETT: I'd like — the business part of this meeting starts at around 3:30, and at that time we'll have the election of directors.

But I would like, nevertheless, for those of you who won't stick around to the bitter end, I would like to introduce our directors, and — Charlie and I are directors.

And if our directors would stand and remain standing when I call your name. And no matter how strong the urge, withhold your applause until they're all finished standing, and then you can withhold your applause then if you wish, too, but I plan to applaud. OK.

Howard Buffett. Steve Burke. Susan Decker.

So just stand and remain standing — there we are. OK.

Bill Gates. Sandy Gottesman. Charlotte Guyman. Don Keough. Tom Murphy. Ron Olson. Walter Scott, Jr.

And our soon to be new member, Meryl Witmer.

OK. No more withholding. (Applause)

4. Table tennis champ Ariel Hsing

WARREN BUFFETT: Now, we'll start the questioning in just one minute, but there were one or two announcements to make.

We did not put it in the — we did not put it in the annual report because we hadn't firmed it up yet, but tomorrow at Borsheims, our friend Ariel Hsing will be available to play table tennis with any of you foolish enough to challenge her.

I met Ariel when she was nine, and she became the youngest women's table tennis champion of the United States, and then last summer she went on to the Olympics.

And at the Olympics, she won her first two matches, and she won more games off the woman that became the eventual Olympic champion than any other participant in that event.

So Ariel will be out there tomorrow at 1 o'clock. And if you're courageous, you'll show up with your paddle and end up looking like an idiot. (Laughter))

5. Buffalo News publisher Stan Lipsey retires

WARREN BUFFETT: One more introduction, I don't know whether we can get a spotlight on him or not, but Stan Lipsey retired this year as publisher of The Buffalo News.

And, as Charlie can attest, as well as I, back in 1978, '79, '80, we had an enormous business problem in the Buffalo News. We were locked in a competitive struggle. And we were not doing well, in part, because of we were operating under a tough judicial order for a while until it got reversed on appeal.

And Stan gave up a wonderful life here in Omaha and asked no questions and for no pay came up to Buffalo, and The Buffalo News would not have turned out to be the paper that it's turned out to be or produced the profits that have been produced for Berkshire, without Stan Lipsey.

So, if Stan could stand, let's give him a hand. Stan the Man. (Applause)

6. Berkshire buys remaining ISCAR stake

WARREN BUFFETT: One other announcement, then we'll go to the questions.

It was announced a couple of days ago that we bought out the final 20 percent of ISCAR held by the family for about $2 billion. It's a transaction they're happy with, we're happy with.

As a matter of fact, if you saw Eitan Wertheimer dancing at "Dancing with the Stars" there, you could have seen how happy he was.

So we will now own 100 percent of ISCAR, but our relationship with the Wertheimer family will continue.

It's been a sheer joy. The business has done terrifically. The people have behaved magnificently, and ISCAR will be part of Berkshire forever. So I want to thank Eitan and his family.

And, Eitan, are you here? Can you stand up, and your family? Thank you. (Applause)

Let's have a light here in the front row. OK. (Applause)

7. Q&A begins

OK. We'll now move on to our questions. We'll continue these until about noon. We'll take an hour break for lunch. We'll come back, and then we'll continue until about 3:30, at which time we will convene the business meeting.

And we will start off — we have three journalists who have been here before on the right, and we have a distinguished panel on the left, including a short seller, perhaps the first at any annual meeting, and we will start off with Carol Loomis.

8. Berkshire lagging the S&P 500

CAROL LOOMIS: Good morning. Speaking for the three of us, I hope here, we have received into the thousands of questions. We don't even know how many. And if we didn't pick your question, it was because we just didn't get to it.

I do want to tell you that Warren and Charlie have no idea of what our questions are going to be, no hints at all, and so we look forward to sending them curve balls.

I'll start off here. Warren, you measure Berkshire — this is from William Bernard (PH) of Colleyville, Texas.

You measure Berkshire's corporate performance based on growth and book value per share. The table on page 103 of the annual report shows book value per share has grown at less than an average 12 percent a year for 9 of the last 11 5-year periods, yet in your last annual letter, you state, quote, "The S&P 500 earns considerably more than 12 percent on net worth," and then you say, "That seems reasonable for Berkshire also."

Why do you say that, given the past record showing that Berkshire has not been earning that much, or is it that you expect to earn that much, recognizing that it is not assured in the future?

WARREN BUFFETT: It certainly is not assured in the future. And the last ten or so years have not been the best for business, generally.

But if the stock market continues to behave in 2013 as it has so far, this will be the first five-year period where the gain in book value per share has fallen short of the market performance, including dividends, of the Standard & Poor's.

And that won't be a happy day, but it won't be — it won't totally discourage us because it will be a period where the market has gone up in every one of the five years. And as we've regularly pointed out, we're likely to be better in down years as we did in 2008, for example, which is the year that gets dropped this year. We're likely to do better in down years, relatively, than we do in up years.

Charlie, how do you feel about the prospects of — I should point out, incidentally, that we use book value because it's a calculable figure, and it does serve as a reasonable proxy of the year-to-year change in the intrinsic value of Berkshire.

If we could really give you a figure for intrinsic value, and back it up, that would be the important figure.

As I pointed out, if we gain a million policyholders at GEICO, that actually adds a billion-and-a-half to intrinsic value, and it doesn't add a dime to book value.

So, there's a significant gap, which is why we're willing to buy in stock at 120 percent of book value — a significant gap between the two. But book value is a useful tracking device.

I should point out also — I did this in the annual report in respect to Marmon — when we buy the ISCAR stock, which we pay about 2 billion for, the day we buy it, we mark it down in terms of our book value by roughly a billion dollars.

So a billion dollars comes off our book value for making a purchase which we regard as quite satisfactory. And so there are these distortions that occur.

But in the end, we have to do better for you than you would do in an index fund. And if we don't, we aren't earning our pay.

And I think we'll do that in the future, but I don't think we'll do it every year, and we've proven that in the last few years.

Charlie?

CHARLIE MUNGER: Well, I confidently expect that Berkshire's going to do quite well over the long term.

I don't pay much attention to whether it's five years or three years or — I think we have momentums in place that are going to do OK.

Of course, we won't do as well in the future, in terms of annual gain averaged out, because our past returns were almost unbelievable.

So, we're slowing down, but I think it'll still be very pleasant.

WARREN BUFFETT: At 89, Charlie is not really concerned about this stuff year-to-year. I mean, he's taking a longer-range view. (Laughter)

CHARLIE MUNGER: I'm trying to take care of my old age, which might come on at any time. (Laughter)

WARREN BUFFETT: I haven't noticed it.

9. Jonathan Brandt introduced

WARREN BUFFETT: OK. Jonathan Brandt, who is a newcomer to the panel, his area is the other-than-insurance aspects of Berkshire Hathaway.

And I can assure you that no one has paid more — I played Jonny in chess when he was about four years old, and, I don't know, I must have been 40 or something at the time, and he kept insisting during dinner that we play chess afterwards.

And we started playing, and, of course, he got me into some impossible position in a few moves, and I told his parents to put him to bed. (Laughter)

So, Jonny, I still have kind of comebacks in me, so be careful what you ask. Jon Brandt. (Laughs)

10. ISCAR vs Sandvik

JONATHAN BRANDT: Good to see you, Warren.

A question about ISCAR: what do you feel are the specific competitive advantages that ISCAR has over its primary competitor, Sandvik, and, in turn, what advantages does Sandvik have over ISCAR as the larger player?

WARREN BUFFETT: Yeah. Sandvik is a very good company, and ISCAR is a much better company.

The advantage it has is brains and incredible passion for the business.

It's interesting to reflect on ISCAR because if you go back to — what would it be? — 1951 or thereabouts, when Stef Wertheimer, who had come from Germany, was in Israel, started ISCAR, just think of the prospect that was facing him.

Here was a company like Sandvik, or in this company — country — Kennametal, or different countries, well-entrenched companies, well-entrenched, well-financed.

And here's this fellow in Israel, 25 years old, and the raw material for these cutting tools comes from China. It isn't that the raw material is in Israel.

So everybody buys their tungsten from China, and they sell to customers that are using large machine tools throughout the world, but they're selling it to heavy industry to a significant extent.

So they're selling to people like Boeing or General Motors or big industrial companies in Germany, and there's no great locational advantage, in terms of being in Israel doing this.

But here's this 25-year-old fellow getting the tungsten from thousands of miles away, selling it to customers thousands of miles away, competing against people like Sandvik, and this remarkable business, ISCAR, comes from that.

And there's no other answer you can give to your question when you see that result than to say that you have had some incredibly talented people who never stopped working, never stopped trying to improve the product, never stopped trying to make customers happy, and that continues to this day.

Sandvik is a very good company. I can tell you that based not only on the figures, but on every other aspect of business observation that I possess, that ISCAR is one of the great companies of the world, and we feel very fortunate to own it and to be associated with their management.

Charlie?

CHARLIE MUNGER: Well, it's a good comparison. Sandvik is a fabulous company, and it's a particular achievement to really do a little better in the competitive market, as ISCAR has done.

WARREN BUFFETT: Quite a bit better.

CHARLIE MUNGER: They've gained.

WARREN BUFFETT: Have you really ever seen much — a better operation than ISCAR in the manufacturing business?

CHARLIE MUNGER: It's the only place I was ever in where I saw nothing but robots and engineers working computers.

WARREN BUFFETT: It's a —

CHARLIE MUNGER: You cannot believe how modern ISCAR is.

WARREN BUFFETT: Yeah. And the game's not over yet, either.

11. Preserving Berkshire's culture after Buffett

WARREN BUFFETT: OK. Now we go to a shareholder in station number 1.

AUDIENCE MEMBER: Hi. Dan Lewis (PH) from Chicago. First of all, I wanted to thank you for letting us in the building early today. But let's not — (Applause)

Let's not do that again next year, though. I don't want to wake up any earlier to get in line.

WARREN BUFFETT: If we had a company that sold coats, we would have left you out there. (Laughter)

AUDIENCE MEMBER: Always a comeback.

When you think about Berkshire in the decade after you're gone, my question is what worries you the most? What — I know nothing keeps you up at night — but what are your big worries and, you know, what can go wrong?

WARREN BUFFETT: Well, it's a good question. It's one we think about all the time.

And that's why the culture is all important, the businesses we own are all important, because those trains will keep running and people will keep calling GEICO the day after I die. There's no question about that.

And the key is preserving the culture and having a successor as CEO that will have more brains, more energy, and more passion for it, even than I have.

And it's the number one subject that our board considers at every meeting, and we're solidly in agreement as to whom that individual should be.

And I think the culture has just become intensified year after year after year. And I think Charlie would agree with that.

I mean, we always knew what we were about when we first got involved with Berkshire, but making sure that everybody that joined us, that the owners, the shareholders, directors, managers, everybody that bought into this what I think very special culture. That took time, and — but it is — I think it's really one of a kind now, and I think that it will remain one of a kind.

I think that anything that came in — any foreign-type behavior would be cast out because people have self-selected into this group, into the company, and it would be rejected like a foreign tissue if we got the wrong sort of person in there.

We have a board that is especially devoted to Berkshire. We don't hold them by paying them huge amounts, it may be noted.

And we have people who have brought their companies to Berkshire because they want to be part of it, as did ISCAR.

So, I think that whoever succeeds me — and it will be a lot of newspaper stories and people — after six months, there will be a story that says, you know, it isn't the same thing.

It will be the same thing. You can count on that.

Charlie, what are your thoughts?

CHARLIE MUNGER: Well, I — my thoughts are very simple. I want to say to the many Mungers in the audience, don't be so stupid as to sell these shares. (Laughter)

WARREN BUFFETT: That goes for the Buffetts, too. (Laughter)

12. Partnering with 3G Capital for $23B Heinz deal

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This is a question that comes from Ben Knoll, who happens to be the chief operating officer at the Greater Twin Cities United Way.

And he writes in that after the Heinz deal, there was a column that was written indicating that you had gotten the better end of the Heinz deal from your Brazilian partners [3G Capital].

That column said that your return was likely to come from the preferred stock dividends, with the common equity portion being dead money.

It also said that the way the deal was structured indicated your low expectations for the market overall.

Is this an accurate portrayal of the deal and of your expectations for the market overall?

WARREN BUFFETT: No. It's totally inaccurate.

The — it's interesting. [3G Capital co-founder] Jorge Paulo Lemann and I were in Boulder, Colorado, in early December. And I can't remember if it was — yeah, on the way to the airport or when we got in the plane. But he said that he was thinking about going to the people at Heinz and proposing a deal and would I be interested.

And I, because I knew both Heinz and I knew Jorge Paulo, and I thought highly, very highly, of both, I said, "I'm in."

And maybe a week later — I don't remember exactly how long — I received from Jorge Paulo, who I had known for many years starting at Gillette when we were both directors — I received a term sheet on the deal and another sheet on the governance procedures that he suggested.

And he said, "If you got any thoughts about changing this, just let me know." They were just his thoughts.

It was an absolutely fair deal, and it was — I didn't have to change a word in either the term sheet or the governance arrangement.

Now, we actually, Charlie and I, probably paid a little more than we would have paid if we had been doing the deal ourselves, because we think that Jorge Paulo and his associates are extraordinary managers.

They're both classy, and they're unusually good, and so we stretched a little because of that fact.

We like the business, and the design of the deal is such that if we do quite well over time at Heinz, that their 4.1 billion will achieve higher rates of return than our overall 12 billion.

We have a less-leveraged position in the capital structure than they have. We created — they wanted more leverage, and we provided that leverage on what I regard as fair terms and what they regard as fair terms.

If anybody thinks that the common is dead money, you know, we think they're making a mistake.

But we'll know the answer to that in five years.

But the design of the deal, essentially — we have more money than operating ability at the parent company level, and they have lots of operating ability and wanted to maximize their return on 4 billion.

So my guess is that five years from now or ten years from now, you will find that they've earned a higher rate of return on their investment. But because we put more dollars in, we will have received that same rate of return on our 4 billion, plus of cap common equity, but we also will have received a very fair return on the 8 billion that we put in that created more leverage for them.

Charlie?

CHARLIE MUNGER: Well, as you said, the report was totally wrong. (Laughter)

WARREN BUFFETT: That'll teach them. (Laughter)

13. Moving into commercial insurance

WARREN BUFFETT: OK. We have Cliff Gallant from Nomura who will ask insurance-related questions for this meeting.

CLIFF GALLANT: Thank you.

At Berkshire Hathaway Reinsurance group, Mr. Ajit Jain appears to be employing a new strategy recently with some high profile actions.

Berkshire signed a portfolio underwriting arrangement with Aon to do business with Lloyd's. And then last week, there was the hiring of several AIG executives.

It appears that Berkshire may be taking a broader share of the market.

What is the goal of these moves, and won't these actions eventually produce more average results?

WARREN BUFFETT: Well, you — the goal is to take a greater share of the market.

There have been two important moves made by Ajit's operation in the last month or so.

One is the — the first one that was announced — was this participation of 7 1/2 percent in all of the business.

Originally, it was announced as applying to the Lloyd's market. I believe it's been extended to the entire London market.

And, now, bear in mind that the people that are insured still have the right to pick who their insurers shall be, so it isn't totally automatic that we receive 7 1/2 percent of every slip.

But we had had an arrangement for a couple of years with Marsh on a marine book and perhaps some other areas, but not across the board.

And we think that — we think that the profit possibilities are reasonable for that business, or we wouldn't have entered into it.

It will give us more of a cross-section of business than we've been used to having, but it doesn't mean that we give up our present business at all, either.

The second item you mentioned is just in the last week or thereabouts. It was announced that four pretty well-known insurance people that had been with AIG had joined us to write, primarily, commercial insurance, initially domestically, perhaps, but around the world.

And these are people that reached out to Berkshire. In the case of at least one of them, even reached out a number of times in the past.

But we were ready to enter this field with these people who were very able people. We've had a number of people reach out since the announcement was made only a week or so ago.

So I think you will see Berkshire, in addition to all of the other insurance businesses that has had over the years, I think you'll see us become a very significant factor, worldwide, in the commercial insurance business.

I mean, it could be business that reaches into the billions. In fact, I would hope that it would — it could be — you know, a fair number of billions over time.

And we've got the right people. We've got capital like nobody else has. We have the ability to sign on to coverages that other people have to spread out among others.

So, I think we're ideally situated to go into this business, and I'm looking forward to it.

Charlie?

CHARLIE MUNGER: Well, generally speaking, I don't think the reinsurance business is a very good business for most people.

And I think it's a very desirable part of Berkshire's business, the way it's run, but it's different from something like the other businesses, which would work pretty well if somebody else owned them.

I think our reinsurance business under Ajit is very peculiar, and other people who think it's easy are going to find out that it isn't.

WARREN BUFFETT: Yeah. And I should point out, this commercial insurance business also, I mean, it will be primary insurance. The Aon arrangement is a reinsurance arrangement, but we will be in the primary business.

So, it will be large commercial risks, but there's a lot of premium buy-in there, and there's a lot of chances to make mistakes.

But I'd rather have the group we have overseeing that business than any other group I can think of.

14. GEICO vs Progressive's Snapshot

WARREN BUFFETT: OK. Station 2?

AUDIENCE MEMBER: Hi. Mike Sorenski (PH) from New York.

In regards to GEICO, Warren, last year you said the firm had no plans to adopt usage-based driving technology, similar to what competitor Progressive —

WARREN BUFFETT: Right.

AUDIENCE MEMBER: — called Snapshot.

Is that still the case, and if so, why wouldn't that technology give GEICO better data to potentially give discounts to customers?

WARREN BUFFETT: Yeah. That still is the case, and Snapshot has attracted a fair amount of attention and there are other companies doing that.

It's an arrangement, essentially, to tie — well, the term "Snapshot," perhaps, says it — to get a picture of how people really do drive.

Insurance underwriting, you know, is an attempt to figure out the likely propensity, based on a number of variables, of a person having an accident.

Now, you know, in life insurance, it's very obvious that somebody 100 is — if you don't know anything else about them — is more likely to die in the next year than somebody that's 20.

When you get into auto insurance, figuring out who's likely to have an accident involves assessing a number of variables, and different companies go at it different ways.

Clearly, on statistics, if you're a 16-year-old male, you're more likely to have an accident than I am.

Now, that isn't because I'm a better driver. It's because the 16-year-old is probably driving about ten times as much, and he's trying to impress the girl sitting next to him.

And that doesn't work with me anymore, so I've given it up. (Laughter)

But the — we ask a number of questions, and our attempt, as much as possible, is to figure out the propensity of any given applicant, or the possibility, that they will have accidents.

And there are a number of variables that are quite useful in predicting. And Progressive is focusing on this Snapshot arrangement, and we'll see how they do.

I would say that our ability to sell insurance at a price that's considerably lower than most of our competitors, evidenced by the fact that when people call us, they shift to us, and, at the same time, earn a significant underwriting profit, indicates that our selection process is working quite well.

I mean, if your selection process is wrong, if you treat a 16-year-old male and give him the same rate that you'd give a 40-year-old that's driving their car 3 or 4,000 miles a year, you know, you're going to get terrible underwriting results.

So our systems, our underwriting criteria, have been developed, you know, over many decades. We have a huge number of policyholders, so that it becomes very credible, these different underwriting cells.

And everybody in the business is trying to figure out ways to predict with greater accuracy the possibilities that a given individual will have an accident.

And Progressive is focusing on this Snapshot approach, and we watch it with interest, but we're quite happy with the present situation.

OK. Andrew Ross Sorkin?

Oh, Charlie, I've got to give you a chance to comment.

CHARLIE MUNGER: I have nothing to add. (Laughter)

15. Business Wire and new rule allowing internet disclosures

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: OK. Warren, we got a couple questions related to this.

Warren, now that you're on Twitter and the SEC is allowing companies to make material announcements over social media, what are the implications for Business Wire, a unit of Berkshire?

Do you agree with the SEC's new position on the distribution of material information, and would you consider selling Business Wire given the new rules?

If not, how do you think Business Wire will have to transform itself? And, by the way, what are you doing on Twitter? (Laughter)

WARREN BUFFETT: I haven't figured that last one out yet.

The — no, I think it is a mistake. Some companies have announced — made important announcements — on webpages, and some, in certain cases, they've messed it up and caused a fair amount of trouble.

But the key to disclosure is accuracy and simultaneity. I mean, if we own stocks, or are thinking about owning stocks, we want to be very sure that we get accurate information and we get it exactly at the same time as all other people.

And Business Wire does a magnificent job of that.

And I do not want, if I'm buying Wells Fargo, or selling it, or whatever it may be, I do not want to have to keep hitting up to their webpage, or something, and hoping that I'm not 10 seconds behind someone else if there's some important announcement.

So, Business Wire has got a traffic record of accuracy and of getting the information to every part of the globe in a simultaneous manner, and that is the key to disclosure.

And I think — I don't think that — I don't think anything has come close to doing that as well as Business Wire.

So I think we will do very well. We've got a sensational manager in Cathy Baron Tamraz.

I couldn't be happier with the business, so we will not be selling it. And if I could clone Cathy, I would do it.

I will not — Berkshire, when it puts out its information — and we like to put it out, actually, after the market closes because we think there's so much to digest that it's a terrible mistake to have people try and figure it all out in reading a one- or two-page announcement.

But anything important from Berkshire, or any of our companies, is going to come out on Business Wire so that people get accurate information at exactly at the same time.

Charlie?

CHARLIE MUNGER: Well, it’s very hard for me to know anything about Twitter when I’m avoiding it like the plague.

WARREN BUFFETT: He sent me out to venture in it, and he’s going to see if anything bad happens to me. (Laughter)

16. As Berkshire grows, it’s paying more for bigger acquisitions

WARREN BUFFETT: OK. We now have a short seller in a first, I believe, at any meeting, Doug Kass.

DOUG KASS: Thank you, Warren and Charlie. Thanks for this unusual invitation. I’m honored, and I look forward to playing the role of Daniel in the lion’s den in front of 45,000 of your closest friends and greatest admirers.

WARREN BUFFETT: You can bring your own crowd next year. (Laughter)

DOUG KASS: I would note, you have me asking the last question in the group, though.

My first question is a follow-up to Carol Loomis’s first question. Warren, it’s said that size matters.

WARREN BUFFETT: It does. (Laughter)

DOUG KASS: In the past, Berkshire has purchased cheap or wholesale. For example, GEICO, MidAmerican, your initial purchase of Coca-Cola.

And, arguably, your company has shifted to becoming a buyer of pricier and more mature businesses, for example, IBM, Burlington Northern, Heinz, and Lubrizol. These were all done at prices, sales, earnings, book value multiples, well above your prior acquisitions and after the stock prices rose.

Many of the recent buys might be great additions to Berkshire’s portfolio of companies; however, the relatively high prices paid for these investments could potentially result in a lower return on invested capital.

You used to hunt gazelles. Now you’re hunting elephants. As Berkshire gets bigger, it’s harder to move the needle.

To me, the recent buys look like preparation for your legacy, creating a more mature, slower-growing enterprise.

Is Berkshire morphing into a stock that has become to resemble an index fund and that, perhaps, is more appropriate for widows and orphans, rather than past investors who sought out differentiated and superior compounded growth?

WARREN BUFFETT: Yeah. There's no question that we cannot do as well as we did in the past, and size is a factor.

Actually, the — it depends on the nature of markets, too. We might — there will be times when we'll run into bad markets, and sometimes there our size can even be an advantage. It may well have been in 2008.

But there — I would take exception to the fact that we paid fancier prices in some cases than, say — in GEICO, I think we paid 20 times earnings and a fairly-sized — good-sized — multiple of book value.

So we have paid up — partly at Charlie's urging — we've paid up for good businesses more than we would have 30 or 40 years ago.

But it's tougher as we get bigger, I we've always known that would be the case.

But even with some diminution from returns of the past, they still can be satisfactory and we are willing — there's companies we should of bought 30 or 40 years ago that looked higher priced then, but we now realize that paying up for an extraordinary business is not a mistake.

Charlie, what would you say?

CHARLIE MUNGER: Well, we've said over and over again to this group that we can't do as well in percentage terms per annum in the future as we did in our early days.

But I think I can make the short seller's argument even better than he did, and I'll try and do that.

If you look at the oil companies that got really big in the past history of the world, the record is not all that good.

If you stop to think about it, Rockefeller's Standard Oil is practically the only one, after it got monstrous, continued to do monstrously well.

So, when we think we're going to do pretty well in spite of getting very big, we're telling you we think we'll do a little better than the giants of the past. We think we've got a better system.

We don't have a better system than riding up oil, you know, but we have a better system than most other people.

WARREN BUFFETT: Yeah. In terms of the acquisitions we've made in the last five years, I think we feel pretty good about those and — overall — and, obviously, including the Heinz.

We are buying some very good businesses.

We actually, as we pointed out, we own eight different businesses that would each be on the Fortune 500 list if it was a separate company, and then in a few months, we'll own half of another one, so we'll have eight-and-a-half, in effect.

Well, you haven't convinced me yet to sell the stock, Doug, but keep working. (Laughter)

17. Will U.S. dollar lose reserve currency status?

WARREN BUFFETT: Section 3.

AUDIENCE MEMBER: Thank you. Jonathan Schiff, visiting from Macau, China.

You briefly touched upon this. But on our side of the world, there's a lot of discussion about the U.S. dollar's status at the world's reserve currency.

I'm sorry, there's some feedback. It's kind of weird.

What would be the effect upon the U.S. and the world economy if the dollar loses that status as a world reserve currency?

WARREN BUFFETT: Well, I don't know the answer to that, but fortunately, I don't think it's going to be relevant.

I think the dollar bill will be the world's reserve currency for some decades to come. I think China and the United States will be the two supereconomic powers, but I don't see any — I think it's extremely unlikely — that any currency supplants the U.S. dollar as the world reserve currency for many decades, if ever.

Charlie?

CHARLIE MUNGER: Well, there are advantages to a country that has the reserve currency, and if you lose that, you lose some advantage.

England had a better hand when it had the reserve currency of the world than it had later when the United States had the reserve currency of the world.

If that eventually happened to the United States, it would not be, I think, all that significant.

It's in the nature of things that sooner or later every great leader is no longer the leader.

Over the long run, as Keynes said, we're all dead, and over the long run —

WARREN BUFFETT: This is the cheery part of the section. (Laughter)

CHARLIE MUNGER: Well, if you stop and think about it, every great leading civilization of the past passed the baton.

WARREN BUFFETT: What do you think the probabilities are that the U.S. dollar will not be the reserve currency 20 years from now?

CHARLIE MUNGER: Oh, I think it'll still be the reserve currency of the world 20 years from now. That doesn't mean that it's forever.

18. "Extraordinary" corporate profits despite tax complaints

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: This question comes from John Custabal (PH) of the Philadelphia area.

Mr. Buffett, you have said in the past, specifically in a 1999 speech that was printed in Fortune, quote, "You —"

WARREN BUFFETT: You would bring that up, wouldn't you?

CAROL LOOMIS: I would bring that up, right. I'm so glad he sent this question.

"You have to be" — you have said, "You have to be wildly optimistic to believe that corporate profits, as a percent of GDP can, for any sustained period, hold much above 6 percent."

Corporate profits are now greater than 10 percent of GDP. How should we think about that?

WARREN BUFFETT: What we should think is pretty unusual, and particularly considering the economic backdrop.

Corporate profits are extraordinary, as a percentage of GDP, at least looking back on the history of the United States.

And what's interesting about it, of course, is that American business, to a great extent, is complaining enormously — or frequently, anyway — about the level of the corporate income tax.

Now, the corporate income tax is about half what it was 40 years ago, as a percentage of GDP. But yet, as you point out, corporate profits are at an all-time record, as a percentage of GDP.

So I would have you take with a grain of salt the complaint that American business is noncompetitive because of our corporate income tax rate, which gets so widely complained about.

American business has done extraordinarily well at a time when inequality, actually, is — has widened considerably — both measured by net worth and measured by income, if you take the top versus the people down below.

And — (loud noise) —

Well, we heard from one of the people here. (Laughter)

And, it will be interesting to see whether these levels can be maintained.

Corporate — business has come back very, very strong, in terms of profits, from the precipice that we were on in the fall of 2008, the panic.

Employment has not come back, the same way. And that's going to be, I would say, a subject of a lot of public discourse. And you're seeing — you're reading more about that, currently.

If I had to bet on whether corporate profits would be 10 percent of GDP — and, of course, we're talking about profits that are earned outside the United States, I believe, in that — in the figures you quote — I would say they're likely to trend downward.

But I think that, of course, GDP will be growing, so that does not mean any terrible things will be happening to profits.

Charlie, what do you think about the —?

CHARLIE MUNGER: Well, I wouldn't be too surprised if that 6 percent figure turned out to be on the low side, in the estimate.

Just because Warren thought something 20 years ago, doesn't mean it's a law of nature. (Laughter)

WARREN BUFFETT: We'll talk this over at lunchtime. (Laughter)

How do you feel about 10 percent?

CHARLIE MUNGER: Well, I'm a natural conservative on such items.

But you've got to recognize that the stocks themselves are owned by a lot of endowments and pension funds and so on. So it — that figure doesn't mean that the world's becoming grossly more unequal.

There's no automatic correlation between those two figures.

WARREN BUFFETT: Do you feel the corporate tax rate is too high?

CHARLIE MUNGER: Well, I think when the rest of the world is — keeps bringing the rates down, —there's some disadvantage to us if we're much higher. So I — (Applause)

I rather like Warren's idea that people like us should pay more, but the corporate tax rate, I'm glad to have lower.

WARREN BUFFETT: OK. He's the Republican; I'm the Democrat.

19. Too many subsidiaries for Buffett's successor to manage?

WARREN BUFFETT: Jonathan? (Laughter)

JONATHAN BRANDT: Thanks, Warren.

You probably have a couple of dozen direct reports from the multitude of noninsurance businesses that Berkshire owns, and this arrangement seems to work wonderfully for you.

But I wonder if this could potentially pose a challenge to your successors.

Adding smaller units like Oriental Trading and the newspaper group, even if they are economically sound transactions individually, could arguably add to the unwieldiness of the organization.

How do you weigh the benefits of adding earnings with the risk of leaving a less-focused and harder-to-manage company for even highly capable successors?

WARREN BUFFETT: Yeah. I think my successor will probably organize things a little differently on that, Jonathan, but not dramatically so.

And we'll certainly never leave the principle of our CEOs running their businesses in virtually all important ways except, perhaps — except for capital allocation.

But, I actually have delegated a few units to an assistant of mine, and my guess is that my successor will modestly organize things in a somewhat different way.

I've grown up with these companies and with the people and everything, and so it's a lot easier for me to communicate with dozens of managers, sometimes very infrequently, because they don't need it. It just — sometimes it's their own preference to some degree.

And somebody coming in fresh would want, obviously, to be — to understand very well — and that person will understand, in fact, understands now — very well, the major units.

But you're right, when you get down to units that we have, you know, some businesses that make, you know, only 5 or $10 million a year or something like that.

And my guess is that it gets rearranged a little bit, but that won't really make any difference.

I mean, the real money is made by the big businesses. It will continue to be made by the big businesses, and the insurance business, and a little change in reporting arrangements, maybe one more person at headquarters if they go crazy, will really take care of things.

Charlie?

CHARLIE MUNGER: Well, I think, of course, it would be unwieldy to have so many businesses, a lot of them small, if we were trying to run them through an imperial headquarters that dominated all the details.

But our system is totally different. If your system is decentralization, almost to the point of abdication, what difference does it make how many subsidiaries you have?

WARREN BUFFETT: Yeah. It's working pretty well now.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: It'll work pretty well afterwards, too.

But my successor is not going to do things identically. It'd be a mistake.

But the culture will remain unchanged. And the preeminence of the managers of the operating units will remain unchanged, and then every now and then something comes along and a change needs to be made. Sometimes it's through death or disability, or sometimes a mistake is made.

But, in the end, we're now trying to acquire companies that are at least at the $75 million pretax level.

Incidentally, the best acquisitions — to some extent, the best acquisitions — certainly from my standpoint makes it easier — is the one — is these bolt-ons that I talked about in the annual report, in which we did, I think, 2-and-a-half billion worth of last year, because they fall under the purview of managers that we've got terrific confidence in and they add really nothing to what happens at headquarters.

And, of course, the best bolt-ons out of all are when we do buy a — buy out — a minority interest.

When we buy $2 billion worth more of ISCAR, or a billion-and-a-half more of Marmon, with another billion-and-a-half to come in the next year, you know, that's adding earning power without it, you know, posing any more work.

Those are the ultimate in bolt-on acquisitions, getting more of a good thing.

Charlie, any more on that, or—?

CHARLIE MUNGER: Well, if you stop to think about it, if it were all that difficult, what we're doing now would be impossible, and it isn't.

WARREN BUFFETT: I'll have to think about that a little. (Laughter)

CHARLIE MUNGER: Well, think if 50 years — 20 years ago — they said to you, can you make something this size with a staff of ten or something in a little office in Omaha? People would've thought that's ridiculous. But it's happened, and it works.

WARREN BUFFETT: Well, we'll let it go at that.

20. Dangers when Fed reverses economic stimulus

WARREN BUFFETT: Station 4? (Laughter)

AUDIENCE MEMBER: Thank you. Scott Moore (PH), Overland Park, Kansas.

With the Fed buying 85 billion per month of mortgage securities and Treasurys, what do you think are the long-run risks to this process, and how does the Fed stop this without negative implications? Thank you.

WARREN BUFFETT: Charlie, you answered that yesterday in an interview, so I'll let you lead off.

CHARLIE MUNGER: My basic answer is I don't know.

WARREN BUFFETT: Yeah. (Laughter)

I might say I have nothing to add. (Laughter and applause)

But Scott, you came from Overland, so we'll do our best.

CHARLIE MUNGER: I think you're— the questioner — is right to suspect that it's going to be difficult.

WARREN BUFFETT: It's going to be — yeah, it is really uncharted territory.

And as many people have found out, whether it was the Hunt Brothers buying silver or whatever it might be, it's a lot easier to buy things, sometimes, than it is to sell them.

And the Fed's balance sheet is up around 3.4 trillion now, and that's a lot — those are a lot of securities.

And the bank reserve positions are incredible. I mean, Wells Fargo is sitting with $175 billion at the Fed earning a quarter of a percent, and really earning nothing, after attendant expenses.

So, there's all this liquidity that's been created. It hasn't really hit the market because the banks have let it sit there.

You know, in classical economics, you know, that's how you juice the economy, and you pushed it out by having the Fed buy securities and create reserves for the banks and all of those things.

But, believe me, the banks want loans. I mean, they are not happy — Wells is not happy — having 175 billion at the Fed, and they're looking every place they can to get it out, with the proviso that they hope to get it back from whoever they get it out to, which can slow down a bank at times.

But it— we really are in uncharted territory. I've got a lot of faith in Bernanke. I mean, he — if he's running a risk, he's running a risk he knows and understands.

I don't know whether he's affected by the fact that his term expires pretty soon, so he just hands the baton off to the next guy and said, "Here. Here's this wonderful balance sheet. And all you have to do is bring it down a few trillion dollars," you know. (Laughs)

And I gave a few lectures at George Washington University last year, if you care to read them, and maybe it'll help you.

The — this is something we haven't seen. It certainly has the potential for being very inflationary. It hasn't been so far. In fact, my guess is that the Fed wishes it had been a little more inflationary.

If you're running up a lot of debt, it gets measured in relation to nominal GDP, and the best way to run up — easiest way to run up, not the best way — the easiest way to run up nominal GDP is to inflate, and my guess is that they never would admit it but that the — that at least some Fed members — are probably disappointed that they haven't seen more inflation.

It won't be when they start selling. It'll be — when the market gets a — any kind of a signal — that maybe just the buying ends, maybe that selling will take place, you know, it's likely to be the shot heard around the world.

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

So, while I've been talking, Charlie, have you got any new insights?

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

Who would have guessed that interest rates could go so low and stay so low for so long? Or that Japan, a mighty, powerful nation, could have 20 years of stasis after using all the tricks in the economist's bag?

So I think given this history, the economists ought to be a little more cautious in believing they know exactly how to stay out of trouble when they print money in massive amounts.

WARREN BUFFETT: It is a huge experiment.

CHARLIE MUNGER: Yeah. (Applause)

WARREN BUFFETT: What do you think the probabilities are that within ten years you see inflation at a rate of 5 percent or higher a year?

CHARLIE MUNGER: Well, I worry about even more than inflation.

If we could get through the next century with the same results we had in the last century, which involved a lot of inflation over that long period, I think we'd all be quite satisfied.

I suspect it's going to be harder, not easier, in this next century. And it wouldn't surprise me — I'm not going to be here to see it — but I would predict that we may have more trouble than we think — than we now think.

WARREN BUFFETT: Charlie says he won't be here to see it, but I reject such defeatism. (Laughter)

21. Effects of low interest rates

WARREN BUFFETT: Becky?

BECKY QUICK: This is actually a follow-up to the shareholder from Overland Park, the question that was just asked.

This comes from Anthony Starace (PH) who is in Lincoln, Nebraska, and he says, "How has the Fed's zero-interest policy affected Berkshire Hathaway's various business segments? For example, has it helped or hurt their operations and profitability?"

WARREN BUFFETT: Well, it's helped. You know it— interest rates are to asset prices, you know, sort of like gravity is to the apple.

And when there are very low interest rates, there's a very small gravitational pull on asset prices.

And we have seen that getting played out. I mean, people make different decisions when they can borrow money for practically nothing than they made back in 1981 and '2 when Volcker was trying to stem inflation and use — and the government bond rates got up to 15 percent.

So, interest rates power everything in the economic universe, and they have some effect on the decisions we make.

We borrowed the money on the Heinz purchase a lot cheaper than we could've borrowed it 10 or 15 years ago, so that does affect what people are willing to pay.

So it's a — it's a huge factor and, of course, it will — presumably — it will change at some point, although, as Charlie was pointing out in Japan, it hasn't changed for decades.

So, if you wanted to inflate asset prices, you know, bringing down interest rates and keeping them down — at first, nobody believed they'd stay down there very long, so it reflects the permanence that people feel will be attached to the lower rates.

But when you get the 30-year bond down to 2.8 percent, you know, you are — you're able to have transactions take place.

It makes houses more attractive.

I mean, it's been a very smart policy, but the unwind of it, you know, has got to be more difficult, by far, than buying.

I mean, it is very easy if you're the Fed to buy 85 billion a month and — I don't know what would happen if they started trying to sell 85 billion.

Now, when you've got the banks with loads of reserves there, it might — it'd certainly — be a lot easier than if those reserves had already been deployed out into the real economy. Then you would really be tightening things up.

But I have — you know, this is like watching a good movie, as far as I'm concerned, because I do not know the end, and that's what makes for a good movie.

So, we will be back here next year and I will — or maybe in two or three years — and I will tell you I told you so and hope you have a bad memory.

Charlie? (Laughter)

CHARLIE MUNGER: Well, I strongly suspect that interest rates aren't going to stay this low for hugely extended periods. But as I pointed out, practically everybody has been very surprised by what's happened, because what's happened would've seemed impossible to practically all intelligent people not very long ago.

At Berkshire, of course, we've got this enormous float in the insurance business, and our incremental float, when we're carrying huge amounts of cash, is worth less than it was in the old days.

And that, I suppose, should give some cheer to you people because if that changes, we may get an advantage.

WARREN BUFFETT: Yeah, we have 40 — at the end of the first quarter, we had, whatever it was, 48 or maybe 9 billion or something like that — in short-term securities.

We're earning basically nothing on that. We do not — we never stretch for yield in terms of commercial paper that brings ten basis points more than Treasury.

Our money— we don't count on anybody else, so we keep it in Treasurys, basically, and so we're earning nothing on that.

So if we get back to an environment where short-term rates are 5 percent, and we would still have the same amount, then that would be a couple billion dollars of annual earnings, pretax, that we don't have now.

But of course, it would have lots of other effects in our business.

We have benefited significantly, and the country has benefited significantly, by what the Fed has done in the last few years.

And if they can successfully pull off a reversal of this without getting a lot of surprises, you know, we will all have been a lot better off.

22. Building, not buying, commercial insurance growth

WARREN BUFFETT: Cliff?

CLIFF GALLANT: Thank you.

WARREN BUFFETT: Cliff, incidentally, you ran a 2:40 last year, didn't you, in the marathon at Lincoln?

CLIFF GALLANT: I ran the Lincoln marathon after the shareholder meeting.

WARREN BUFFETT: OK. We've got incredible talent on this thing. (Laughter)

CLIFF GALLANT: I wanted to ask you more about the commercial insurance business and Berkshire's interest.

WARREN BUFFETT: Right.

CLIFF GALLANT: If the business is attractive, why not make an acquisition? Do you think that public company valuations are too high today?

WARREN BUFFETT: Yeah. There aren't too many commercial operations that we would want to acquire, big ones.

It wouldn't do much — I mean, we're acquired — when we acquired GUARD Insurance, it's workers' compensation, but it's just — it's a small acquisition. It's a good acquisition, but that is a commercial, in effect, underwriter that we acquired late last year.

But, if you look at the big ones, some of them we wouldn't want. There's a couple that we would. But the prices would be probably far higher than what we think we might be able to develop a comparable operation for.

I mean, we — in effect — I think we're going to build a very large commercial operation, and essentially we've built it at book value. And we pick up no bad habits of other companies, at least we hope we don't.

And so, it's really better to build than buy, if you can find the right people with the right mind-set, and everything, in the business.

And you know, we've got a terrific manager, obviously, in Ajit, and these other people have sought him out, so I think — if there were certain commercial operations, and we could've bought them at the right price, we'd have done it.

But we have not been able to do that so we will build our own. And I predict that we will have a good and significant commercial insurance operation in a relatively short time.

23. Munger: bitcoin won't be "big universal currency"

WARREN BUFFETT: OK. Station 5?

AUDIENCE MEMBER: Good morning. My name is Benjamin. I'm from Appleton, Wisconsin, and I had a question for you regarding unregulated digital currency, such as bitcoin.

I was wondering what you think the significance of something like that showing up in the last few years is, and what you think that might mean for the future? Thank you.

WARREN BUFFETT: Charlie, I hope you know something about this subject because I don't know a thing. (Laughs)

CHARLIE MUNGER: I know what he's talking about.

WARREN BUFFETT: I know what he's talking about, but I just don't —

CHARLIE MUNGER: I have no confidence whatsoever in bitcoin being any kind of a big universal currency.

WARREN BUFFETT: That would certainly be my gut reaction, but I don't — I haven't really looked into it.

But I— I'll put it this way: of our 49 billion, we haven't moved any to bitcoin. (Laughter)

My— well, the truth is I don't know anything about it. That doesn't always stop me from talking about things, but it will in this case.

24. Pampered Chef isn't a pyramid scheme

WARREN BUFFETT: OK. Andrew? (Laughter)

ANDREW ROSS SORKIN: OK.

Bill Ackman, the activist investor, who's also a Berkshire investor as well, has raised questions in recent months about the legality of the multilevel marketing company Herbalife. He called it a pyramid scheme.

Berkshire owns a multilevel marketing company, too: the Pampered Chef.

Will Ackman's attack on Herbalife have any impact on the Pampered Chef or Berkshire, and do you believe Ackman's concerns are legitimate?

How do you think about the debate over multilevel marketing companies and decipher which ones are legitimate and which ones are not?

WARREN BUFFETT: Yeah. I don't know anything— I've never actually even looked at a 10-K of Herbalife, so I do not know about their operation.

But, I think the key, obviously, is whether a direct marketing operation is really based on selling product to would-be distributors of one sort, and loading them up, instead of sell— in effect — selling it to end users.

And Pampered Chef is a million miles away from anything where the money is made, in any way, by selling to level A, and then those people selling to level B, and all that sort of thing.

It is true that certain people — lots of people — get paid on the results — the selling results — of other people that they recruit.

But this business of loading up people with a couple-hundred dollar package of something that they never sell, and that being sort of the main business — and I don't know anything about Herbalife on this, I do know about Pampered Chef — and that is not Pampered Chef's business.

Pampered Chef's business is based on selling to the end user.

And we have thousands and thousands and thousands of parties every week where people who are actually going to use the product buy it from somebody, and we are not making it — we're not making the money — by loading up people and then having them leave the sales force and our profit coming from that.

Charlie?

I think that should be the distinguishing characteristic. If I were regulating the industry, I would look very hard at operations where thousands of people got their hopes as to earning a living by selling the product, invested their savings, and buying a whole bunch of product that they didn't need themselves, and then sort of being — abandoning the hope and being left with the product.

And the parent company just— or the main company — just going out and selling millions and millions of people on a dream that was not fulfilled.

Charlie?

CHARLIE MUNGER: Well, there's likely to be more flimflam in selling magic potions than pots and pans. (Laughter)

WARREN BUFFETT: At our age, we're in the market, though, for any magic potions, if any of you have them. (Laughter)

That's the extent of your comment, I assume, Charlie?

CHARLIE MUNGER: Yes.

25. “Lender of last resort” after Buffett?

WARREN BUFFETT: OK.

Doug?

DOUG KASS: Warren —

WARREN BUFFETT: Doug. (Laughs)

DOUG KASS: Warren. (Laughter)

Much of Berkshire’s returns over the last decade have been based on your reputation and your ability to extract remarkable deals from companies in duress, as compared to the past, when you conducted yourself more as a value investor digging and conducting extensive analysis.

What gives you confidence that your successor’s imprimatur will be as valuable to Berkshire as yours has been?

WARREN BUFFETT: Well, the successor will probably have even more capital to work with, and they will have capital, presumably, from time to time, when markets are in distress.

And at those times, very few people — few people have the capital, and a lot fewer people have the willingness, to commit.

But I have no question that my successor will have unusual capital at times when — at turbulent times when — the ability to say “yes” very quickly with very large sums sets you apart from virtually anybody in the investing universe.

And I would not worry about that successor being willing to deploy capital under those circumstances, and being called upon.

I mean, Berkshire is the 800 number when there’s really, sort of, panic in markets, and for one reason or another, people need significant capital.

Now, that’s not our main business. You know, it happened a couple times in 2008. It happened once in 2011. But that’s not been our main business, but it’s fine. And it will happen again.

And I would think if you come to a day when the Dow has fallen 1,000 points a day for a few days, and the tide had gone out and we’re finding out who’s been swimming naked, that those naked swimmers may call Berkshire — they will call Berkshire — if they need lots of money.

I mean— and Berkshire’s reputation will become even more solidified, in terms of being willing to provide capital for sound deals at times when most people are frozen.

And when that happens when I'm not around, it becomes even more the Berkshire brand and not anything attached to a single individual.

Charlie?

CHARLIE MUNGER: Well, I would argue that in the early days, Warren had huge success as a value investor in little-owned companies because his competition was so small.

If he stayed in that field, he would have to be in bigger companies, and his competition would be way more intense.

He's gotten into a field, being a good home for a big companies that don't want to be controlled in meticulous detail by headquarters, where there isn't much competition.

So I would argue that he's done exactly the right thing, and it's ridiculous to think that the past is the thing he should have stayed in.

WARREN BUFFETT: Well, we will send— I think he's probably referring to something like the Bank of America transaction or Goldman Sachs and GE — and there will come a time, in markets, where large sums — I've gotten calls on other things, too, but —

CHARLIE MUNGER: Yeah, but other people are not getting the calls.

WARREN BUFFETT: Well, they don't have the money and they don't have the willingness to act immediately.

And Berkshire will — those qualities will remain with Berkshire after I'm gone.

In fact, in a sense, the area we occupy becomes more and more our own as we get even bigger, I would say, Charlie.

CHARLIE MUNGER: That's what I like about it. (Laughter)

26. We only buy from willing sellers

WARREN BUFFETT: OK. Station 6?

AUDIENCE MEMBER: Hi. My name is Andre from Beverly Hills, California.

During very key events, like the Sanborn incident, when you were buying See's, or when you were buying Berkshire stocks, you persuaded people to sell you their shares when they really didn't want to.

What were your three keys to influencing people in those specific situations?

WARREN BUFFETT: Yeah. I don't think — you brought up Sanborn and you brought up See's and— I don't think —the See's family, there had been a death in the See's family— it was Larry See, wasn't it, that died?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: And he had been the instrumental, I guess, grandson of Mary See, and the operator, and there was a— the rest of the family really didn't want to run the business.

So it was put up for sale, and I didn't even hear about it until they'd had one other party— I don't know even know who it was— but that they negotiated a deal with and that it didn't go through.

Charlie probably remembers this better than I do. We certainly — the See family— and Charlie persuaded me to buy it. We didn't persuade them to sell it. Charlie?

CHARLIE MUNGER: Yeah. We didn't buy anything from any unwilling sellers.

WARREN BUFFETT: No. And Berkshire, we started buying that in 1962 in the open market. It had quite a few shareholders. It was a — it traded fairly actively, and we bought a lot of stock, and we did buy a couple of key pieces.

We bought one from Otis Stanton, who was Seabury Stanton's brother, but Otis wanted to sell.

It wasn't the most attractive business in the world. I mean, here was a textile company that lost money in most of the previous years, and over a ten-year period, that had significant losses. And it was a northern textile company.

So, we bought stock in the market, a lot of stock in the market. We had two big blocks from Otis Stanton and from some relatives of Malcolm Chace, but they were happy to sell.

I never met — at the time I bought the stock from Otis Stanton — I had never met him, and so I delivered no personal sales talk to him.

And the same thing is true of the Chase family, not Malcolm himself, but some relatives, they sold us a block of 100,000 shares. But we were not out convincing anybody to sell their stock.

So there's been very little that I can remember where — we talked to Betty Peters about avoiding a transaction we thought was dumb, when Wesco was considering merging with Financial Corp of Santa Barbara.

I flew out to see her in San Francisco. But she stayed with us. She did not sell her stock and remains a shareholder to this day, 30-plus years, almost 40 years later.

Charlie?

CHARLIE MUNGER: Well, I've got nothing to add to that at all.

27. Berkshire's edge for acquisitions

WARREN BUFFETT: OK. Then we'll go to Carol.

CAROL LOOMIS: This question comes from Mark Trautman of Crested Butte, Colorado.

And you've touched on this, Warren and Charlie, on little fringes today, but this is a direct question.

"Warren, both you and Charlie have described over the years how you have built Berkshire Hathaway to be sustainable for the long term.

"I am having difficulty explaining to my 13-year-old daughter, and frankly, to many adults, also, in easy to understand terms, Berkshire's business model and long-term sustainable, competitive advantage.

"Can you give all of us, and particularly my daughter, Katie, who is here today, the Peter Lynch two-minute monologue explaining the business of Berkshire Hathaway and its merits as a long-time investment for future decades?"

WARREN BUFFETT: OK, Charlie, you talk to Katie. (Laughter)

I'm going to have some fudge. (Laughter)

CHARLIE MUNGER: All right. I'll try that.

We've always tried to stay sane, and other people, a lot of them, like to go crazy. That's a competitive advantage. (Laughter and applause)

Number two: as we've gotten bigger, we've used this sort of golden rule that we want to treat the subsidiaries the way we would want to be treated if we were in the subsidiaries.

And that, again, is a very rare attitude in corporate America, and it causes people to come to us who don't want to come to anybody else. That is a long-term competitive advantage.

We've tried to be a good partner to people who come to us and need a partner with more money. That is a competitive advantage.

And so, we are leaving behind a field that's very competitive and getting into a place where we're more unusual.

This was a very good idea. I wish we had done it on purpose. (Laughter)

WARREN BUFFETT: A few years ago, a person who's in this audience, I believe, came to me and he was in his 60s, and he said that for about a year, he'd been thinking about selling his business.

And the reason he had been thinking about it was not because he wanted to retire. We're not — we very seldom buy businesses from people who want to retire. He didn't want to retire at all. He loved what he was doing.

But he'd had an experience in buying a business a few years earlier from a family where he had known the fellow that built it, the fellow had died, and then just everything bad started happening in the family and the business and the employees, everything else.

So he really wanted to put to bed the question of what happened with his business.

It wasn't that he really cared a lot about monetizing it or having the money. He just wanted — he wanted to put his mind at ease, that what he had spent lovingly building up over 30 or 40 years was not going to get destroyed — or that his family would get destroyed — if he — if he made a — if he died.

So he said he thought about it a year. And he thought about it and he thought, "Well, if I sell it to one of my competitors" — and they would be a logical buyer, they usually are. That's why we have antitrust laws.

If he sold it to a competitor, they would come in and basically they would put their people in charge.

They would have all these ideas about synergy, and synergy would mean that the people that had helped him build the business over 30 years would all get sacked and that the acquiring company would come in like Attila the Hun and be the conquering people, and he just didn't want to do that to the people that helped him over the years.

And then he thought he could — he might — sell it to some private equity firm. And he figured that if he sold it to them, they'd load it up with debt, which he didn't like, and then they'd resell it later on. And so he would, again, have lost control and they might do the same thing that he didn't want to have happen in the first place, in terms of selling it to a competitor, or whatever it might be.

So when he came to me, he said — he described this — and he said, "It really isn't because you're so attractive."

But he said, "You're the only guy left standing. You know, I mean, you're not a competitor, you're not a private equity firm, and I know I will get a permanent home with Berkshire and that the people that have stayed with me over the years will continue to get opportunities and they will continue to work for me. I'll keep to get doing what I love doing, and I won't have to worry about what will happen if something happens to me tonight."

Well, that company has turned out to be a wonderful acquisition for Berkshire, and our competitive advantage is we had no competitors. And I think — well, we will see more of that. We've seen a lot of that over the years. We'll see more of it.

Charlie, anything?

And I don't think you mentioned the fact that developing a shareholder base, too, that's different than —we do look at shareholders as partners, and, you know, it's not something a public relations firm wrote for us, or anything of the sort. We want you to get the same result we get, and we try to demonstrate that in every way we can.

28. BNSF outlook for carrying coal and oil

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: I have a — (Applause)

I have a couple questions about Burlington Northern's two energy franchises, coal and crude.

WARREN BUFFETT: Uh-huh.

JONATHAN BRANDT: Given that coal-fired generation is in gradual structural decline, can you discuss whether the tracks, locomotives, and other assets used to deliver coal can be redeployed, equally profitable, serving other customers? Are those assets fungible?

Can you also discuss whether crude by rail can continue to grow even as pipelines are built to serve the Bakken, and as the currently large geographic spreads in crude prices potentially narrow?

You've talked about the flexibility of crude by rail on TV. Can you elaborate on that, please?

WARREN BUFFETT: Yeah. If there was no coal moving, we would not find a lot of use for some of the tracks we have, there's no question about that.

So, the — I think what you're talking about would be very gradual over time. But, I mean, the outlook for coal is not the same as the outlook for oil.

A lot of the coal, in terms of the year-by-year fluctuations, may depend on the price of natural gas because some of the generating capacity can go in either direction.

In terms of oil, I think the view a few years ago was that there might just be a little blip in terms of rail transportation. But I've talked to some oil producers, the largest up there in the Bakken, and I think there will be a lot of rail usage for a long time, in fact, increased rail usage.

Oil moves a whole lot faster, incidentally, by rail than it does by pipeline. Most people have sort of a visual conception that the oil is flowing at terrific speeds through pipelines and that the railcars are sitting on the sidelines someplace.

But it's just the opposite. You can move oil a lot faster.

And with change — with different market prices and different refinery situations and all that — there's a lot of flexibility in the oil transportation by rail.

Matt Rose is right up front here, and if somebody would give him a microphone, I think he can probably tell you a lot more about moving coal and oil than I can. Matt?

We got a spotlight someplace that can focus right on here?

MATT ROSE: Yes. So, Warren, the two franchises are really different. That's just the way the geographic is laid out.

We expect the coal franchise to basically stay about where it is today, depending on natural gas prices as well as what happens with the EPA.

Our crude by rail, right now we have about 10 loading stations in the Bakken with about 30 destination stations. We're currently in negotiation, looking at about another 30 destination stations.

So it's really an exciting time right now. We're handling about 650,000 barrels of crude a day. We think we'll be at 750 by the end of this year, and we see a pathway to a million-two to a million-four.

WARREN BUFFETT: When you think of the whole country producing 5 million barrels a day not long ago, that is a lot of oil.

And of course, it isn't just the Bakken. You know, the shale developments, they can open up a lot of things over time.

29. Sorry to see Harley-Davidson notes expire

WARREN BUFFETT: OK. Station 7?

AUDIENCE MEMBER: Good morning, Warren and Charlie. My name is Bill Hennessy (PH) and I'm from Milwaukee, Wisconsin.

I have a similar question. Back in 2009, you made a substantial investment in Harley-Davidson with the five-year term at 15 percent. I noticed that note comes due in 2014.

What are your plans or thoughts once that investment comes due?

WARREN BUFFETT: Well, what we'd like to do is not answer the mail, and just let him keep paying his 15 percent, but that won't happen.

The — no, those were — we had a few private transactions during a period when the corporate bond market was basically frozen and received unusual terms, although the best terms those companies obviously could obtain at that time. And those deals are coming due, and I wish the five-year deals had been ten-year deals.

But, now those — that was a special time. And in effect, that's a depleting asset that we have that's left over from five years ago.

We won't see anything like that for a while, but we'll see similar things at some point in the future.

I mean, the world is given to excesses, and they have consequences, and we are always willing to act.

I mean, we did not think Harley-Davidson was going to go broke. I mean, it was that simple.

You know, any kind of company that gets its customers to tattoo ads on their chest can't be all bad, you know, I mean— (Laughter)

But it will be a sad day when the Harley-Davidson notes mature.

30. Todd Combs and Ted Weschler's stock-picking independence

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from Andishi Tuzush (PH) who asks, "If Todd Combs and Ted Weschler, if they purchase stock in a company that you have reviewed before and did not believe to be a good investment, would you share your thoughts with them?"

WARREN BUFFETT: I would probably not know they were even buying it until, maybe, a month after they started.

I do not — they do not check with me before they buy something.

I gave them each another billion dollars on March 31st, and I do not know whether they've spent the billion or whether — which stocks they bought or—

Now, I will see it on portfolio sheets. I get them monthly, but they're in charge of their investments.

They've got one or two things that they're restricted on, in terms of— things that — for example, if we own a chunk of American Express, and under the Bank Holding Company law we would not be able to buy another share.

So there's a couple things like that — restrictions they have. But otherwise, they have no restrictions on what they buy.

They've bought things I wouldn't buy. You know, I buy things they wouldn't buy. That part of the investment process.

I do not tell them how much to diversify. They can put it all in one stock if they want to. They can put it in 50 stocks, although that's not my style.

They are managing money. And when I managed money, you know, I wanted to be a free agent.

If he wanted to give me — they could make the decision on whether they wanted to give me the money, but once they gave me the money, and I had the responsibility for managing it, I wanted free reign to do what I wanted. And I did not want to be held responsible for things with my hands tied.

And that's exactly the position we have with Todd and Ted now.

It takes a lot of — it's an unusual person that we will give that kind of responsibility to. That's not something that Charlie and I would do lightly at all.

But we thought they deserved the trust when we hired them, and we believe that more than ever after watching them in action for a time.

Charlie?

CHARLIE MUNGER: What can I say in addition to that?

31. Why GEICO isn't copying Progressive's Snapshot

WARREN BUFFETT: OK. Cliff?

CLIFF GALLANT: Thank you. I wanted to ask a follow-up question about Snapshot at Progressive.

Now, I realize that GEICO's first quarter numbers are very good, things are going very well at the company.

But Progressive is claiming that the data is profound, that they're getting from Snapshot. That they can give their best drivers 30 percent rate cuts, and those customers are still their most profitable customers.

We have a lot of GEICO policyholders here today. I'm sure they're very good drivers.

Why shouldn't they go try Snapshot and try to save 30 percent or more? Why isn't GEICO investing in what I think appears to be a credible underwriting tool and potential threat?

WARREN BUFFETT: Yeah. They — I don't think — but obviously Progressive disagrees with us — but I don't think their selection method is better than ours. And I would say that I might even feel that ours is a little bit better than theirs.

But every company has a different approach to it.

Peter Lewis, who runs Progressive, when he started the company— he told me this story himself. I mean, it was a tiny, tiny little company. It came out of a mutual company, as you know.

And he went in the motorcycle business. And the first guy that he insured— or the first loss, I think, that was reported— came from some guy that was redheaded, and he just decided not to insure any redheads for a while. (Laughter)

That — you know—when you don't have very much money, you can't afford to experiment too long.

Well, Peter learned that that was not a criteria, and he knew that, but he had fun telling the story.

But all we're trying to do— if I'm looking at all these people here and I'm going to issue them insurance policies for the next year, I'm going to charge different rates to different people.

And, if I'm going to sell them life insurance, I'm going to charge different rates to them. If I'm going to sell them health insurance, I'm going to charge different rates.

There's a different — there's a different probability attached to each individual, based on a whole lot of variables.

And Progressive — before Snapshot, they had a different selection approach than GEICO.

And like I say, ours has worked very well and we think it will continue to work well.

And we are obtaining, under our selection system, we are obtaining a hugely disproportionate number of new policyholders compared to the growth in the market, so our rates are attractive and our underwriting results are attractive.

And we continue, always, to look for further ways, obviously, to refine the selection technique.

But we don't do any of it lightly because what we're doing now is working very well.

And I just invite you to compare the Progressive results with the GEICO results in the next two or three years, and I will — if we're wrong — I will be here to freely admit that we were wrong, but I don't think we will be.

OK, station 8?

Oh, Charlie, you want to add something?

CHARLIE MUNGER: Well now, obviously, we're not going to immediately copy the oddball thing that every single competitor does in the world, particularly when we've got an operation that's working so well.

WARREN BUFFETT: If I were starting in the direct auto insurance business, I think I would attempt to copy GEICO.

It wouldn't work, but it would offer you the best chance, I think. It's a remarkable system.

And Tony Nicely, you can't give him enough credit. I mean — you know, we will — I hope we will — gain a million policies this year.

The entire industry, I don't think, will gain more than a million-and-a-half. So we will probably get two-thirds — in my view — we'll get two-thirds of all the growth and we'll do it profitably, and we'll save people a lot of money. So I think that's quite a company.

32. We rely on sugar and caffeine, not to-do lists

WARREN BUFFETT: OK. Station 8?

AUDIENCE MEMBER: Hi. My name is Alex, and I'm from Los Angeles.

Mr. Buffett, I've heard that one of your ways of focusing your energy is that you write down the 25 things you want to achieve, choose the top 5, and then avoid the bottom 20.

I'm really curious how you came up with this, and what other methods you have to prioritizing your desires?

WARREN BUFFETT: Well, I'm actually more curious about how you came up with it, because — (laughter) — it really isn't the case.

It sounds like a very good method of operating, but it's much more disciplined than I actually am. (Laughter)

If they stick fudge down in front of me, I eat it, you know, I'm not thinking about 25 other choices. (Applause)

So I don't mean to —you know, Charlie and I live very simple lives. We know what we do enjoy, and we now have the option of doing it, pretty much.

Charlie likes to design buildings. I mean, he's not—he's no longer a frustrated architect — he's a full-fledged architect now. And, you know — and we both like to read a lot.

But we — I've never made lists. I can't recall making a list in my life, but maybe I'll start.

You've given me an idea. Thank you.

Charlie?

CHARLIE MUNGER: Well, what's really interesting on the subject of Warren's operating methods, you can see happening here.

We didn't know, when we started out, this modern psychological evidence to the effect that you shouldn't make a lot of important decisions when you're tired and that making a lot of difficult decisions is tiring.

And we didn't also know, as well as we now do, how helpful it is to be consuming caffeine and sugar when you're making important decisions. (Laughter)

And what happens, of course, is that both Warren and I live entirely on autopilot, in terms of the ordinary decisions in life, which is totally habitual, so we don't work — waste — any decision making industry — I mean energy — on that stuff, and we're ingesting caffeine and sugar.

And, it turns out, under the modern evidence, this is an ideal way to sit where Warren sits. And he didn't know that, he just stumbled into it. (Laughter)

WARREN BUFFETT: When we write our book on nutrition, it promises to be a huge seller. (Laughter)

CHARLIE MUNGER: I cannot remember an important decision that Warren has made when he was tired.

He’s never tired. (Laughter)

He sleeps soundly, and he doesn’t waste time thinking about what he’s going to eat. As you say, he just eats what he’s always eaten.

You know, his style turns out to be absolutely ideal for human cognition. (Laughter)

It looks peculiar, but he stumbled into something very good.

WARREN BUFFETT: You can write the forward to my next book. OK. (Laughter)

33. Buffett defends buying newspaper companies

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This following question comes from a shareholder who asked to remain anonymous.

They write, “I’m from Omaha, and I’m thrilled you bought our newspaper as a local citizen, but not so much as an investor in Berkshire.

“I read your reasons for acquiring newspapers, but it still doesn’t make sense to me, economically, given the downward trends in the industry.

“Don’t you think there are other businesses with higher rates of return that you could buy?

“Why would you buy such a small business, since you always say you want to buy elephants?

“Please quantify exactly what rate of return you expect from the newspapers.” (Scattered applause)

WARREN BUFFETT: Yeah. I would say that we will get a decent rate of return.

Whether it’s — most of them, incidentally, have been bought, and they were either S corporations or partnerships of some sort.

So they — compared to buying a Heinz, for example, or a BNSF or something of the sort — they actually have a certain structural advantage in terms of the eventual return after tax, because we get to write off the intangibles we’re purchasing.

That affects the after-tax return, compared to the pretax return that would come from this.

But I would say that our after-tax return, with declining earnings, which I expect, would be at least 10 percent after tax, but I think — and it could well be somewhat higher.

I think it's very unlikely that it would be significantly lower.

And everything we have seen to date, and it hasn't been that long, but we have a number of papers now, would indicate that we will meet or beat the 10 percent.

It doesn't have — it's not going to move the needle at Berkshire.

You know, the papers we have bought now, we're probably getting close to maybe having 100 million of pretax earnings, a good bit of which is — fair amount of which — we get a favorable tax treatment on, because they were bought from S corporations.

You know, and 100 million is real money, but it doesn't move the needle at Berkshire.

But it will end up being a very — I think it will be a perfectly decent return in relation to capital employed.

Now, we wouldn't have done it in any other business. I mean, there's no question — the questioner is right about that.

But, it doesn't — you know — doesn't require an extra ounce of effort by me or Charlie or people at headquarters. We will get a decent return and we like newspapers and —

Although, the one thing I'll promise to do with you is I will be glad to give you figures, annually, as to how we are doing relative to investment.

We are buying the papers at very, very low prices compared to current earnings, and we must do that because the earnings will go down.

Now, the interesting thing is, of course, is that we see books from investment bankers on all kinds of businesses, and always the projected earnings go up in the book.

A lot of times they don't — you know, in reality — they don't go up. The difference is that we expect them to go down in the newspapers, and whatever the investment salesmen expect, they certainly don't project that any business they sell will have declining earnings.

Charlie?

CHARLIE MUNGER: Well, I think what you're saying is that it's an exception and you like doing it. (Laughter)

WARREN BUFFETT: I wish I hadn't asked. (Laughter) OK.

34. Follow Teledyne CEO Henry Singleton's lead

WARREN BUFFETT: Doug? Sort of a lead-in to you, Doug. (Laughter)

DOUG KASS: Warren, in a previous answer to a question, you suggested, I think for the first time, that when you're gone — and everyone here hopes that's not for a very long time —

WARREN BUFFETT: No one more than I. (Laughter)

DOUG KASS: I thought you would say that —

You're going to move — Berkshire will likely move — to a more centralized style, or approach, to management.

My question is, in the past you've demonstrated a great deal of respect for Dr. Henry Singleton, the founder and longtime CEO of the diversified conglomerate Teledyne.

You have written about Singleton, quote, "Henry is a manager that all investors, CEOs, would-be CEOs, and MBA students should study.

"In the end, he was 100 percent rational, and there are very few CEOs about whom I can make that statement," close quotes.

Prior to his death, he broke up Teledyne into three companies. Dr. Singleton told our mutual friend, Lee Cooperman, that he did it for several reasons.

There was one reason in particular that Lee mentioned to me that I want to ask you about. According to Singleton, Teledyne was getting very hard to manage for one CEO.

What would you say about the Berkshire situation, given your company's greater complexity, size, and the management issues that you faced in the last three years?

And what is the advisability of restructuring Berkshire into separately-traded companies along business lines?

WARREN BUFFETT: Berkshire, to me, seems about the easiest company to manage imaginable.

And if you took an earlier answer — and I understand why you did, that implied greater centralization after my death, there will be a tiny bit more, just in terms of the small companies. But I do not anticipate any change of any real significance.

Now, Charlie knew Henry Singleton, and I think it might be interesting for Charlie to give you his views on what Singleton did right and, eventually, wrong.

And, I'll answer the last part of your question, though.

Breaking it up into several companies, I'm convinced, would produce a poorer result. Certainly now, and I believe in the future.

Charlie?

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

And, I knew him. He lived in my community.

But he started as a conglomerate where he was very interested in reporting higher earnings all the time so he could keep the daisy chain going. And when he managed it on the way down, he bought in the stock relentlessly and very logically, like a great chess player should.

And — but he managed those companies on a way more centralized basis than Berkshire has ever operated.

And in the end, the great bulk of the enterprises, he wanted to sell to us. And by that time, he was ill and he really wanted to sell to us. And of course, he wanted Berkshire stock.

And we basically said to him, "Henry, we love you and we'd love to buy your businesses, but we don't want to issue Berkshire stock."

So, I don't think you should get the idea that just because he was a genius he did it better than we did.

He did, in some ways, because he understood these very high-tech businesses, but —

WARREN BUFFETT: He played the public markets way better. I mean, it—

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: We're not interested in doing that, actually.

CHARLIE MUNGER: No, we're not.

WARREN BUFFETT: And he was incredible in that, and he made a fortune for shareholders that stayed with him.

But he was — to some extent, he looked at the shareholder group as somebody to be taken advantage of, and he issued stock like crazy. I'll bet he did at least 50 acquisitions where—

CHARLIE MUNGER: Yes.

WARREN BUFFETT: He wanted to use a very fancy price stock. He was playing the game of the ’60s, and we actually have never wanted to get in that game.

I mean, he promoted the stock. And, you know, he had the Litton Industries background on it, and it was a game that worked wonderfully if you didn’t care about how it ended up.

And so we have not played that game. He was — in terms of wanting to get Berkshire stock — you know, he essentially was going into the third stage—(laughs) — of first issuing shares at overprice, then buying it back very underpriced, and then he was going to —

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

WARREN BUFFETT: Yeah, exactly.

CHARLIE MUNGER: It was the wrong stock. But he was an enormously talented man and that cool rationality was to be admired.

I like our system better. We’re more avuncular than Teledyne was.

WARREN BUFFETT: Not the toughest test. (Laughs)

35. High health costs are hurting competitiveness

WARREN BUFFETT: OK. Station 9?

AUDIENCE MEMBER: Hi. My name is Kelly Morrell (PH) from New York, and I have a question.

You’ve been both very outspoken on corporate and personal tax rates, as well as the trade deficit.

And I’m wondering if you can elaborate on what the top two or three things you think both business leaders and policy makers should be focused on to preserve U.S. competitiveness?

WARREN BUFFETT: Well, I would say health care costs would be a big item.

We’re spending — we’re a country that’s spending, we’ll say — you get different figures — but call it 17 1/2 percent or so of GDP. And most of our rivals in the world are paying anywhere from, probably, 9 1/2 to, maybe, 11 1/2, or thereabouts.

So, you know, there are only 100 cents in the dollar, and if you give up 6 or 7 or 8 points of that dollar, I mean, it’s just like having a raw material that costs you more, or something of the sort.

So, that will be a major problem in American competitiveness. It is right now, and it will — all signs point to the fact that it will become more so.

And it doesn't relate to the Medicare problem, which is a huge problem, obviously, but the real problem is health care costs, whether it's in the private system or whatever payer system you have.

We have a big, big disadvantage in cost versus the rest of the world.

People used to talk about how General Motors had $1500 a car in health care costs that Toyota didn't have. Well, if they had $1500 a car disadvantage in steel costs, I mean, you know, the management would be focused on that.

If they had $150 — if they had $15 — difference in steel costs, but health care costs, which are sort of beyond the control of any one company, promise to be a huge competitive disadvantage.

Overall, though, incidentally, I mean, the United States — since the crisis of 2008 — we have done very well, compared to most countries, and our system works.

But if you asked me the number one problem for American business, I would say it's that health care cost disadvantage.

Charlie?

CHARLIE MUNGER: Well, I would add that I don't think it does our competitiveness any good to have this grossly swollen securities and derivative market — markets. (Scattered applause)

And the young men from Caltech and MIT going into high finance and derivative trading, and so on, I think this is a perfectly crazy outcome in terms of its effect on the country.

WARREN BUFFETT: Anything further? (Scattered applause)

CHARLIE MUNGER: Well, I agree with you about the health care, but I find the other more revolting.

WARREN BUFFETT: Charlie's very Old Testament. And he's right.

36. Obamacare's effect on Berkshire?

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question picks up, indeed, from where you were on the previous answer. It's from John Sealme (PH).

"I have never heard or read whether all of Berkshire's nearly 300,000 employees are currently receiving health benefits.

"If all employees today are not receiving benefits, has Berkshire quantified the cost of complying with the Affordable Care Act? And if so, what will be the costs be?

"In other words, how is the Affordable Care Act going to affect Berkshire?"

WARREN BUFFETT: Yeah. I don't know the answer to that.

The— I'm virtually certain that — you know, we've got 70-plus subsidiaries, some of which — one of which — has over 100 itself.

So, very hard to speak totally categorically. But to my knowledge, I don't know of any units that don't have health care benefits.

But like I say, I mean, we just bought 27 or 28 daily newspapers, some of them are very small, so I can't really speak to every single unit.

But health care costs are a huge cost for us. We're actually going to do — we do very few things with, as you know, on a centralized basis — but that is something where all of our companies will try to learn what's in store for them and try to figure out some answers.

But we have not yet — we have not assessed in any way — put together — the kind of figures that that question calls for.

We spent a lot of money, obviously, I mean, to get up to the kind of numbers that are coming through on health care costs.

I see them at some of our — a few of our — individual units, as I look at their monthly reports. I will see costs rising 10 or 12 percent.

And what happens in 2014, I don't know.

But the same thing will be happening to our competitors, and we will try to figure out what makes the most sense at that time.

And our individual managers are already working, particularly the larger units, are spending a lot of time on that.

But it's not something we try to control out of headquarters.

Charlie?

CHARLIE MUNGER: Yeah, it's a — we really don't want to try and control it out of headquarters. We like that kind of decision being made near the firing line.

37. Future of rooftop solar power

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: Here's a question for Charlie on a subject which I consider him an expert on, and I hope I don't prove my ignorance by asking the question.

The question is about capital spending plans at your regulated utilities and a potential long-term risk to realizing returns on current and future capacity.

With the ongoing reduction in the cost of solar panels causing more utility customers to, at least, consider generating electricity from their own rooftops, some worry about a vicious circle of customers reducing their dependence on the grid, forcing utilities to raise rates, to maintain returns on the remaining customers who, in turn, are then incentivized to reduce their dependence on the grid, or even exit it.

I understand the risks are greatest to regulated utilities in sunny places like Arizona and California, but given how much solar power is generated in cloudy places like Germany, are regulated utilities in Iowa, the Pacific Northwest, the Rocky Mountains, and the UK really immune?

CHARLIE MUNGER: Well, my answer would be I don't think anybody really knows exactly how this is going to play out.

I confidently predict there will be more solar generation in deserts than there is going to be on rooftops in cloudy places — (laughter) — and there's a good reason for that.

And Berkshire's big operations, as you — in solar — are in what amounts to desert.

And we get very favorable terms and incentives, and I think Berkshire's going to do fine in solar.

I am skeptical, myself, about trying to run the utilities of the world from a bunch of little, tiny rooftops. I suspect there's some twaddle in that — and some fancy salesmanship in that arena.

And of course, the people that did it early were foolish because the price came down rapidly thereafter. So put me down as not totally charmed by rooftops in cloudy areas.

WARREN BUFFETT: We have Greg Abel here from MidAmerican Energy. If we can direct a spotlight down there, Greg can probably speak to this with a lot more intelligence than Charlie and I. I noticed that —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: I noticed that—I noticed that Jonathan left me out of the thing entirely when he wanted to get an intelligent answer, but I'm not taking any offense at that. Greg?

GREG ABEL: Sure. Happy to touch on it.

Jonathan, I would touch on the fact you're absolutely right. We're seeing, when it comes to rooftop solar, a decline in the total cost of installing them.

At the same time, when you compare it to a regional tariff, or a specific tariff in most of those states, the utility is extremely still competitive.

And I would highlight that as you see more rooftops coming on, you'll see a restructuring of the tariffs, but at the same time, there's a lot of protection for the utilities.

So in the regions we're supplying power, we will see some introduction of solar, but we're absolutely comfortable our systems for the long-term are valuable both to our customers and to our shareholders — Berkshire shareholders — for the long term. Thanks.

38. Luck, timing, and success

WARREN BUFFETT: OK. Station 10.

AUDIENCE MEMBER: Thank you. Marc Marzotto, Toronto, Canada.

Bill Gross made recent comments that his generation of investors, yourselves included, owed a deal of their success to timing.

Do you agree with Bill's comment, and do you think a similar opportunity will provide itself to today's investors? Thank you.

WARREN BUFFETT: Yeah, there's no question that being born in the United States was a huge, huge, huge advantage to me, and as I've pointed out in a recent article, being born male was a big advantage.

I would not have had the same opportunities in the investment, or in the business world, remotely, that I've had if I'd been a female born in 1930.

And the timing could have been a little better. Actually, my dad was a security salesman and, you know, I was conceived in November, 1929. And if you remember, the stocks had gone down dramatically at that time.

There really wasn't anybody to call on, for my dad, and there wasn't any television at home or anything. So here I am, you know. (Laughter)

So I feel myself very lucky that the crash of 1929 came along.

And that also provided a decade, more than a decade, of people who were very turned off. Well, it was a decade of terrible business for quite a while, and then a decade of — more of people that were turned off on stocks, just as we sort of had a decade like that in the past decade going up to 2010 or so, people that — a lot of people — that had gotten turned off by stocks.

So that was a favorable environment. But the United States itself was an incredibly favorable environment. If I'd been born five years earlier, I probably would have made more money. But if I'd been born 10 or 15 years later, I would've made, probably, less money.

But, it— I envy the baby that's being born today in the United States. I mean, I think, on a probability basis, that's the luckiest individual that's ever been born.

And I think that they will do very well in life in all kinds of ways, on a probability basis, better than existed when I was born.

And I think they'll have opportunities to do very well in the investment field.

It may not be as good a field as it was for me starting in 19-, say, '50, '51 or thereabouts, but it will be a very good field to operate in.

The person that has a passion for investing, born today, coming of age 20 years from now, is likely, in my view, to do very well, and to live far better than we live today, just as we live far better than John D. Rockefeller lived many years ago.

Charlie?

CHARLIE MUNGER: Well, the competition was very weak in your early days, and I don't think the competition is as weak now.

So I think, sure, we got advantages from timing. And I don't think that means there's nothing to be done ahead.

WARREN BUFFETT: But Charlie, in 2008 and '9, there were all kinds of high IQ —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — highly experienced, investment professionals, I mean, thousands and thousands and thousands of them.

And you invested at the Daily Journal Company in some equities at X that are worth, what, three X or four X now, or something like that?

CHARLIE MUNGER: That’s right.

WARREN BUFFETT: Yeah. Well, I call that opportunity, but it may be routine to him. (Laughs)

CHARLIE MUNGER: But I sat for a lot of years before I did it.

WARREN BUFFETT: But it still became available.

CHARLIE MUNGER: Oh, yes. But you were drowning in opportunities when I first knew you. (Laughter)

You were waiting for —

WARREN BUFFETT: I wasn’t drowning in money, unfortunately. (Laughs)

CHARLIE MUNGER: No, what you lacked was money.

WARREN BUFFETT: Yeah. Well, now we’ve got money and no ideas.

39. You have to like what you’re doing

WARREN BUFFETT: OK. Station—(Laughter)

Station 10? Station 10? Do we have a Station 10? Let’s take a look. It should be right over there.

AUDIENCE MEMBER: Hi.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: My name is Dexter Ang (PH). I’m from Stafford, Virginia.

I’m 30 years old, and I’m wondering what my life will be like in a few years, let alone 50 years from now.

My question for both Mr. Buffett and Mr. Munger is: how do you think you’ve changed over the last 50 years?

And if you could communicate to yourself 50 years ago, what would you tell them, one piece of advice, business or personal, and how would you do it in a way where your former self would actually heed it? (Laughter)

WARREN BUFFETT: Charlie, I’ll let you answer that. (Laughter)

Incidentally, I’ll trade you places, so don’t worry about your future.

CHARLIE MUNGER: Yeah, we're basically so old-fashioned that we're boringly trite.

We think you ought to keep plugging along and stay rational and stay energetic and just all the old virtues still work, and—

WARREN BUFFETT: But find what turns you on.

CHARLIE MUNGER: You've got to work where you're turned on.

I don't know about Warren, but I have never succeeded to any great extent in something I didn't like doing.

WARREN BUFFETT: Charlie and I both started in the same grocery store, and neither one of us are in the grocery business. (Laughs)

CHARLIE MUNGER: We were not going to be promoted, either, and even though you had the family name.

WARREN BUFFETT: Yeah. (Laughter)

My grandfather was right, too. (Laughs)

It's really — I mean, if you're lucky, and Charlie and I were lucky in this respect. We — well, we were lucky to be in this country to start with — but we found things we like to do very early in life, and then we, you know, we pushed very hard in doing those things, but we were enjoying it while we did it.

We have had so much fun running Berkshire, I mean, it's almost sinful.

But, we were lucky to — you know, my dad happened to be in a business that he didn't find very interesting but I found very interesting.

And so when I would go down on Saturday, there were a lot of books to read, and, you know, it just flowed from a very early age. And Charlie found — he found —

CHARLIE MUNGER: We found a way to atone by your — for your — sins in having so much fun. You're giving all the money back.

WARREN BUFFETT: Yeah, but you give it all back whether you want to or not, in the end.

CHARLIE MUNGER: That's true, too. (Laughter)

40. Rational insurance pricing

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from Laurence Endersen in Dublin, Ireland.

And he asks, “What factors have enabled Berkshire’s insurance pricing policy to stay so rational while also being a very sizable market participant?”

WARREN BUFFETT: In insurance, was that the —

BECKY QUICK: In insurance, yeah.

WARREN BUFFETT: Yeah. Well, I would say this: I really do think that Berkshire is an unusually rational place.

I mean, we know what we want to accomplish. We’ve had the benefit of a very, very long run, and we’ve had the benefit of a — you can argue whether it was a benefit or not — but of controlling shareholders, so we did not have outside influences that pushed us in directions that we didn’t want to go.

So, you know, insurance should be conducted as a rational activity. And one of the problems that some insurers have had is that they would have a pressure for increasing premium volume every year, brought upon by Wall Street, you know— very few—

We actually contracted the business written by National Indemnity, formerly our main business, its traditional business, I think we contracted it, probably, by 80 percent or something of the sort when the business became less attractive.

I’m not sure any manager of a public company that was answering to quarterly earnings calls and that sort of thing, I’m not sure whether they could’ve really stood up to the kind of pressure that they would receive if they followed a similar policy.

We have no — if we do something stupid, it’s because we did something stupid. It’s not — no external factors are pressing on us. And that’s a great way to operate, and it’ll continue to be the way we operate.

Most people, if you own a half of 1 percent of the company or less, you know, and other people are doing things that Wall Street is applauding and you’re not doing them, it could be very hard to resist.

And you know, you respond to media criticism and all kinds of things that—

We don’t have — we don’t have to do it. And there’s no reason for us to do anything stupid in insurance.

You get offered a lot of opportunities to do things that are stupid. We were major writers of catastrophe — natural catastrophe — insurance in the United States some years ago when the prices were right.

We don't think the prices are right now, so we don't write it. We haven't left the market, the market left us, and — but we are not about to do something where we get paid 90 cents for running the — running a probabilistic loss of a dollar.

It just doesn't make any sense and we won't do it. And we don't put any pressure on anybody to do it, and their incomes are not dependent on doing it. So it's not hard to be rational at Berkshire.

Charlie?

CHARLIE MUNGER: Yeah. There are pressures on other people that we don't want and therefore don't have.

It is very hard to shrink an insurance operation by 80 percent when the people who come in every day don't have enough to do, and it's just — it's a counter-intuitive thing to do.

But it's absolutely required that you do it in a place where people go as crazy as they do in insurance.

WARREN BUFFETT: Well, it's like buying Internet stocks, you know, in the late 1990s. I mean, the — all around you, you have these people that have high IQs and they're doing it and they're being successful in it.

So, you know, everybody from your, you know, your spouse to your employer to the press says, you know, "How come all these other — how come you think you're so smart, you know, avoiding this when everybody else is doing it and they're making a lot of money?"

And, of course, it creates this social proof where it works for a while.

That's the great danger period in all of these bubbles, is that what starts out with skepticism ends up with your neighbor getting richer than you are because he went along and you didn't.

And that sort of thing — the bandwagon effect and everything — those things are very hard to resist.

But we don't have any pressures to do that sort of thing. I mean, we just don't give a damn, you know, and if —

We don't necessarily think we're smarter than the other person on that. We just think we don't understand what it's all about.

And if they can make a lot of money, you know, day trading or whatever it may be, you know, good luck to them. But we're not envious of them, but we certainly are not going to do it just because they're doing it.

Charlie, any more on that?

CHARLIE MUNGER: Oh, I always say there's a reason why all that stuff is in the Bible. You can't covet your neighbor's ass or — (Laughter)

I mean, they were having trouble with envy a long time ago. And it's a perfectly terrible thing to do, and how much fun can you have being envious?

We always say it's the one sin there's no fun in.

WARREN BUFFETT: Yeah. (Laughter)

Gluttony is a lot of fun. (Laughs)

Lust has its place, too, but we won't get into that.

41. "Dumb" competition from hedge funds in reinsurance

WARREN BUFFETT: Cliff? (Laughter)

CLIFF GALLANT: We can follow that up. (Laughter)

Reinsurance pricing is expected to be down at midyear renewals this year, despite the fact that we've had a lot catastrophes in recent years.

The finger is being pointed towards alternative capital entering the market, new capacity entering the market.

How concerned are you about this new capacity, and, you know, what is the likelihood that cheap reinsurance pricing soon leads to cheaper primary commercial pricing?

WARREN BUFFETT: Yeah. We hate dumb competition, and hedge fund — managed money, but particularly hedge funds — have entered the insurance, and more particularly, probably, the reinsurance business, quite aggressively in the last few years.

For one thing, it gives them a chance to have a beard, in effect, to operate in Bermuda or someplace where the tax rates are low and where they defer their own income from U.S. income taxes for a long time, and it's a perfectly respectable beard.

And it can be sold to investors. And people talk about it, you know, being an uncorrelated type of operation and all of that. Anything Wall Street can sell, it will sell. I mean, you can count on that. And —

CHARLIE MUNGER: They like big words, too.

WARREN BUFFETT: Yeah. And it's very salable now, and the money will flow in and the money will — may — bring down prices, it may do stupid things in reinsurance, but that's happened before.

And in the end, you know, we know what we're willing to do, we know what we think the prices should be, and we will do insurance business where we think that the odds favor us earning an underwriting profit. And if we can't do it, we'll watch for a while.

You can't afford, you know, to go along with the crowd in investment, insurance, or a whole lot of other things.

And it can be irritating to have a dumb competitor. I mean, if you've got a service station on the corner and you've got a guy across the street that is willing to sell gas below cost, you know, you've got a terrible problem. That's why I got out of the gas station business a long time ago.

But insurance, it's — nice thing about it is— the standby costs are not huge, so it's not like idling steel plants or something.

So we were perfectly willing in the 1980s to have our expense ratio go up significantly because our volume went down so dramatically.

And, you know, it was a standby cost that was real, but it wasn't back breaking, and we just waited for better days, and they came along.

Charlie?

CHARLIE MUNGER: With our cranky, wait-it-out methods, we probably have ended up with the best large-scale causality insurance operation in the world.

WARREN BUFFETT: Yeah, I think that's true, but —

CHARLIE MUNGER: So why would we change?

WARREN BUFFETT: We never really anticipated it would happen, though, when we started in.

CHARLIE MUNGER: That's true.

WARREN BUFFETT: Yeah. It just sort of evolved.

But the principles were useful, and then we were very lucky in getting some sensational people.

You know, we've got Tad Montross at Gen Re, we've got Ajit Jain, we've got Don Wurster, we've got Tony Nicely at GEICO.

I mean, we have just hit the jackpot, in terms of the people. And they like the environment of Berkshire in which to operate, because they do not get pressures to do dumb things, which they would get at many other places.

42. Buffett calls for more women in corporate leadership roles

WARREN BUFFETT: OK. Station 11.

AUDIENCE MEMBER: Hi. My name is Susan Tilson, and I'm from New York City. I am a long-term shareholder, but this is my first time to Omaha. This is quite the little gathering you've got going on here.

You, just a few minutes ago, Mr. Buffett, mentioned that you enjoyed a lot of advantages as a male.

I have three daughters, and I would like them to be able to go as far as their aspirations and hard work take them.

I've noticed and applaud the fact that you've added women to Berkshire's board, but both the board and senior management at Berkshire still reflect the reality that in 2013, there are very few women holding the top jobs in corporate America.

Do you see this as a problem? And if so, what should be done about it?

WARREN BUFFETT: Well, I do see it as a problem, and I — (Scattered applause)

I've written an article in Fortune Magazine, which if you go to Fortune.com, I guess it's in front of the paywall. You can click on it. It's only 1150 words or so. And you'll see my views on that.

But there's no question that women throughout my lifetime and, you know, for a millennia before that, have not had the same shot at many things in the world that males have.

I mean, I have two sisters, as I pointed out in this article — both here today, I believe — and, you know, a couple years on each side of me, and absolutely as smart as I am. They're more personable than I am. They got along with people much better than I did when we were young. Got — their grades were the same, but they did not have the same opportunities at all.

I mean, nobody really wanted to limit them. Certainly the— you know, my parents love them the same way as they felt about me, and they never would've dreamt of saying to them that, you know, Warren gets all these opportunities and you don't. But it just existed.

And, you know, all my teachers in grade school, every one of them was a female. And the reason they were females is because they only had a few occupations open to them.

So, as a result, I had way better teachers than I sort of deserved for the pay level that existed in it because all this talent was being compressed into a few areas.

Well, a lot of improvement has been made, but there's still a ways to go.

And there is a pipeline effect, so I mean, you couldn't change it all in one day if you wanted to. But on the other hand, that should not be an excuse for not changing at all.

And then I also wrote about the fact that there's — that when people are placed in that position, they start believing it about themselves, so they do not set their own objectives as high as their potential would indicate.

And that's — I use the example of Katharine Graham, who I knew quite well, and she was, you know, she was very, very intelligent. She was very high-grade. She had all kinds of good qualities.

But she had been told by a mother, and she had been told by a husband, and she had been told by society that women couldn't run businesses as well as men.

And she knew it wasn't true, but she couldn't get rid of it. And she saw herself in this funhouse mirror, and it — no matter how hard you tried, you couldn't really get rid of the funhouse mirror. It had just been there too long.

And I kept saying, you know, "Look at yourself in a regular mirror, and you'll see somebody who's very smart and very high-grade and just as good as any male you'll find."

Her stock went up 40-for-1 when she was CEO. She wrote a Pulitzer Prize-winning autobiography. And to her dying day, you know, she — at one level she knew she was the equal of the males around her, and at another level, she couldn't get rid of that little voice inside of her that came from her mother and came from all of society that said, you know, "You should take care of the garden and let the males do all the important work."

So, both the exterior obstacles— they're crumbling to a very significant degree and they should. I mean, it only took thousands of years.

I mean, as I point out in the article, we said in the Declaration of Independence, "We hold these truths to be self-evident, that all men are created equal," but they weren't so self-evident when they got around to writing the Constitution and they used a bunch of male pronouns in describing the presidency in Article II, or when they didn't get around to putting a Supreme Court—a female Supreme Court — justice on until 1981.

So, the country has come a long way on it. It continues to move. It's moving in the right direction.

But you know, I hope it keeps moving and moving faster, and I hope that the females that are laboring under these beliefs that were told to them about themselves that aren't true, get rid of the funhouse mirrors and get regular mirrors. And I say all this in this article if you want to read it in Fortune.com. Thank you. (Applause)

43. Berkshire is not "too big to fail"

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: You'll know why I'm asking this question in a second, and why I picked it.

This question is the following: "Is Berkshire too big to fail? On the same topic — "

WARREN BUFFETT: I think I heard of a book by that name. Who wrote it? (Laughs)

ANDREW ROSS SORKIN: "On the same topic, how do you feel about Dodd-Frank? And now that it's being implemented, how is it impacting Berkshire's insurance businesses and our investments in banks like Wells Fargo and Goldman Sachs?"

WARREN BUFFETT: Yeah. I don't think it's affecting Berkshire's insurance businesses, to my knowledge. I mean — we're — we've had — to my knowledge, you know, we've never had anything that impinges on our activity arising from a too-big-to-fail doctrine.

The capital ratios for large banks are being established at somewhat higher levels than smaller banks, and that obviously affects return on equity.

The ratios, as I understand it, for Wells are not as high as they would be for Citi or J.P. Morgan, but they're higher than they would be for a local bank in Omaha.

And the higher the capital ratio, the lower the return on equity will be.

I consider the banking system in the United States to be stronger than, certainly, any time in the last 25 years.

Capital is dramatically higher. A lot of the — well, a very significant part — of the loans that were troublesome are gone. The loans that have been put on the last four or five years are far better.

It's a — I think we've got — the Canadian banking system is very strong, but compared to Europe, I think our banks — or compared to our banks of 20 years ago — I think they're dramatically stronger than they were then.

I do not worry about the banking system being the cause of the next bubble. I mean, it will be something else.

I mean, we will have bubbles in capitalism. Capitalism goes to excess, and it's because of the humans that operate it.

And we will have that again, but usually you don't get it the same way as you got it before. I don't think it will be a housing boom next time.

But, I am — you know, I feel very good about our investment in Wells Fargo. I feel very good about our investment in U.S. Bank. I feel very good about our investment in M&T.

All of those are very strong banks pursuing, in my view, sound practices, and they should result — they should be decent investments, over time.

They won't earn as high a return on tangible equity, nearly as high a return as they would have seven or eight years ago, because the rules have been changed. And they have been changed to provide thicker equities, and that pulls down return on equity.

Charlie has been known to express himself on this subject, and I'll give him the floor.

CHARLIE MUNGER: Well, I'm a little less optimistic about the banking system, long-term, than you are.

I would like to see something more extreme, in terms of limiting bank activities. I do not see why massive derivative books should be mixed up with insured — deposits that are insured — by the country.

WARREN BUFFETT: I'm with Charlie on that. (Applause)

CHARLIE MUNGER: The more bankers want to be like investment bankers instead of bankers, the worse I like it. (Applause)

I don't want to say more.

WARREN BUFFETT: Yeah. (Laughter)

CHARLIE MUNGER: I get in enough trouble on the subject already.

WARREN BUFFETT: (Laughs) I can—I can see the journalists just licking their chops over there waiting for Charlie to throw a thunderbolt, but he's unusually restrained.

44. Buffett updates his bet against hedge funds

WARREN BUFFETT: We're now very close to noon.

I promised — five years ago — I wrote about five or six years ago about the inordinate costs that investors bear in — many investors bear in—getting sold various types of products.

And I talked about hedge funds and private equity and all kinds — and a whole variety of things.

The investment world has been very good at extracting a very significant percentage of the returns that investors get for themselves.

So I offered to bet anyone that wanted to step up to the plate that a group of hedge funds would not beat an unmanaged no-load index over a ten-year period.

And I promised — and then I got a taker, a very nice group of people. I like them. Ted Seides is in the group.

So they took me up on this. So we each put about $350,000 or so into something where in ten years — well, we put it in zero-coupon Treasurys, which would mature and be worth a million dollars in ten years.

And I promised to report on the bet every year.

And what we did this year, interest rates fell so far that our original 700,000 or so investment got to be worth like 950,000 just because the five-year Treasury got so low. So there was very little appreciation left into it between now and five years from now when it matures.

So, we sold the zero-coupon Treasurys and we bought Berkshire with the proceeds, and I guaranteed that it would be worth a million dollars. Currently it's worth about a million-two, so that the charities are benefiting to some extent.

Now, Ted has one charity, which is a very worthwhile charity. I have Girls Inc. of Omaha, which is a charity I selected.

And we'll put the — we can put the figures up on the — there as to where we stand at the moment.

The hedge funds got off to a fast start, and were 13 points ahead of the index fund at the end of the first year.

But the last four years — and these are funds of funds, so they really represent probably 2 or 300, maybe, hedge funds underneath.

But there's two levels of fees involved. There's the standard fees of the hedge funds, which probably many times are "2 and 20," but can be other things, and then there's the fee of the fund of funds on top of it.

So, we now are at the halfway point, and I'll keep reporting to you every year how we do. And if Berkshire does well, we'll have well over a million dollars to distribute to one of two charities.

You might enjoy going to a website called longbets.org. That's where — they're the people that hold the money.

And you will see that there are a number of propositions that people have wagered on, and the proponents and the opponent of every proposition give a short little description. Ted gave a description of why he thought he'd win. I gave a description of why I thought I'd win.

But some of these are — I just can't resist a couple of — pointing out a couple of them. You can see these on the web.

But one of it is that a large collider will destroy the Earth in 10 years. Now there's a $1,000 bet on that, but I'm not sure who will collect. (Laughter)

I thought that was an interesting one. And there was one other, and then we'll go to lunch. But there are a number of these that are quite interesting.

At least one human alive in the year 2000 will still be alive in 2150. Now, that's 148 years from when the bet was entered, there's a $2,000 bet on that.

And I hope Charlie is in contention for the — being the winner of that one.

Afternoon Session - 2013 Meeting

1. Buffett's hot dog lunch

WARREN BUFFETT: I had a hot dog with a lot of ketchup for lunch. I hope you did the same.

2. Buffett: I haven't lost any intensity

WARREN BUFFETT: And we'll go to Doug.

DOUG KASS: Thank you, Warren.

Mae West once said, "The score never interested me, only the game."

Are you at the point now where the game interests you more than the score? But before you answer the question, let me explain to you why I asked it.

In the past, your research has been all-encompassing, whether measured in time devoted to selecting investments and acquisitions, or the intensity of analysis, your interest in the old days of knowing the slightest minutia about a company.

You once said, in characterizing Ben Rosner, quote, "Intensity is the price of excellence," closed quotes.

Your research style has seemed to morph over time from a sleuth-like analysis — American Express comes into mind when you hired Jonathan's dad, Henry Brandt. You and he conducted weeks of analysis and sight visits and channel checks.

Not so much in the later investments. As an example, you famously thought of making the Bank of America investment in your bathtub.

There is an investment message of this transformation from being intense to less intense.

Would you please explain the degree it has to do with the market, Berkshire's size, or some other factors?

WARREN BUFFETT: Yeah. I think, actually, you have to love something to do well at it. There may be exceptions on that, but it is an enormous, enormous advantage if you absolutely love what you're doing, every minute of it.

And the nature of it is that that intensity adds to your productivity.

And I have every bit of the intensity — not manifested exactly the same way — but it's there every minute. I mean, I love thinking about Berkshire. I love thinking about its investments. I love thinking about its businesses. I love thinking about its managers. It's part of me.

And it is true, you can't separate the game from the scorecard. I mean, you — so your score card is part of playing the game and loving the game.

The proceeds are — you know, to me — are unimportant, but the proceeds are part of the score card, so they come with a score card.

But it's much more important — I mean, I would — no question about it, I wouldn't be — feel — the same way about Berkshire at this point if I didn't own a share of it, if I didn't get paid. I mean, it's what I like doing in life, and that's why I do it.

So, I don't think you'll — I don't think it's actually a correct observation — and Charlie can comment on this — to say that because we're doing things in a somewhat different way, that any of the intensity or the passion has been lost.

There's nothing more fun for me than finding something new to add to Berkshire, and that was true 40 years ago. It's true now. And it'll be true 10 years from now, I hope.

Charlie, how would you answer that?

CHARLIE MUNGER: Well, I think when you bought American Express for the first time, you didn't know that much about it, so, naturally, you were digging in rather deeply.

The second time you bought it, I remember you got on the golf course with Olson —

WARREN BUFFETT: Frank Olson, yep.

CHARLIE MUNGER: — and you just saw how he couldn't get rid of American Express if he wanted to, and then you bought it the second time.

The research is still — the first one was hard, and the second was easy.

WARREN BUFFETT: It's all cumulative.

CHARLIE MUNGER: Yeah, it's cumulative, eventually.

WARREN BUFFETT: Yeah. And, you know, what I learned sitting with Lorimer Davidson on a Saturday at GEICO in January of 1951 is still — is useful to me, and I don't have to learn it a second time. I can build on it.

But that's one of the great things about investing. I mean, the universe, there's enough in it so that you can finds lots of opportunities, but there — it's not like it's changing dramatically all the time.

There's some things that may change, and we just don't play in that part of the game if we don't understand them.

But what Charlie says is true. I didn't know a thing about American Express when the Salad Oil Scandal hit in November of 1963. But I thought I saw an opportunity, so I learned a lot about it.

I went around to restaurants and talked to people about travel and entertainment cards, as they were called then. I learned about traveler's checks. I talked to banks. And I was absorbing some knowledge.

And then, as Charlie said, when we were up at Prouts Neck playing golf with Frank Olson, and he was running the Hertz Corp., and he was telling me that there was no way in the world that he could get rid of American Express, or even get them to cut their fees. That was my kind of business.

And I knew enough to proceed to buy a fair amount of stock, and now we own whatever it is, probably 13 percent of the company or thereabouts. And they keep buying in their stock. We can't buy anymore stock ourselves.

I got asked that question in March of 2009 by Joe Kernen, "Why aren't you buying the stock of American Express?" Well, it was a bank holding company, and we couldn't add a share.

But they are doing it for us, and I love it.

At Coca-Cola, at Wells Fargo, to a lesser degree, at IBM, at most of our companies, our interest in the company goes up every year because the companies are repurchasing shares and they probably earn more money so we got a double play going for us.

But the passion is not gone, I promise you.

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

WARREN BUFFETT: Station 1.

AUDIENCE MEMBER: Hi, Warren and Charlie. My name is Vincent Wong (PH) from Seattle.

When people analyze a stock, a lot of them look at quantitative metrics, such as P/E ratio, return on equity, debts-to-asset ratio, et cetera.

So, Mr. Buffett, when you analyze a stock for purchase, what's your top five quantitative metrics that you looked at, and what's your preferred number for each metric? Thank you.

WARREN BUFFETT: Well, we're looking at quantitative and quality — we aren't looking at the aspects of the stock, we're looking at the aspects of a business.

It’s very important to have that mindset, that we are buying businesses, whether we’re buying 100 shares of something or whether we’re buying the entire company. We always think of them as businesses.

So when Charlie and I leaf through Value Line or look at annual reports that come across our desk or read the paper, whatever it may be, that, for one thing, we have a — we do have this cumulative knowledge of a good many industries and a good many companies, not all by a long shot.

And different numbers are of different importance — or various numbers are of different importance — depending on the kind of business.

I mean, if you were a basketball coach, you know, you would — if you were walking down the street and some guy comes up that’s 5’4” and says, you know, “You ought to sign me up because you ought to see me handle the ball,” you would probably have a certain prejudice against it. But there might be some — one player out there it made sense on.

But on balance, we would say, “Well, good luck, son, but, you know, we’re looking for 7-footers.” And then if we find 7-footers, we have to worry about whether we can get them halfway coordinated and keep them in school, a few things like that.

But we see certain things that shout out to us, look further or think further.

And over the years, we’ve accumulated this background of knowledge on various kinds of businesses, and we also have come up with the conclusion that we can’t make an intelligent analysis out of — about all kinds of businesses.

And then, usually, some little fact slips into view that causes us to rethink something. It was mentioned how I got the idea about buying the Bank of America — or making an offer to Bank of America on a preferred stock — when I was in the bathtub, which is true.

But the bathtub really was not the key factor. (Laughter)

The truth is, I read a book more than 50 years ago called “Biography of a Bank.” It was a great book, about A.P. Giannini and the history of the bank.

And I have followed the Bank of America, and I’ve followed other banks, you know, for 50 years.

Charlie and I have bought banks. We used to trudge around Chicago trying to buy more banks in the late ’60s.

And so, we have certain things we think about, in terms of a bank, that are different than we think about when we’re buying ISCAR. And so there is not one-size-fits-all.

We have certain things we think about when we're buying an insurance company, certain things we think about when we're buying a company dependent upon — that depended upon — brands. Some brands travel very well, Coca-Cola being a terrific example, and some brands don't travel.

And, you know, we just keep learning about things like that, and then every now and then we find some opportunity.

The Bank of America — whenever it was — in 2011 — was subject to a lot of rumors, terrible — I mean, lots — big short interest, morale was terrible, and everything else. It just struck me that an investment by Berkshire might be helpful to the bank and might make sense for us.

And I'd never met Brian Moynihan at that point — maybe I'd met him at some function, some party of something, but I had no memory of it — and I didn't have his phone number but I gave him a call. And things like that happen.

And it's not because I calculate some price — precise — P/E ratio or price-book value ratio or whatever it might be.

It is because I have some idea of what the company might look like in five or ten years, and I have a reasonable amount of confidence in that judgment, and there's a disparity in price and value, and it's big.

Charlie, would you like to elaborate?

CHARLIE MUNGER: We don't know how to buy stocks just by looking at financial figures and making judgments based on the ratios.

We may be influenced a little by some of that data, but we need to know more about how the company actually functions. And anything a computer could be functioned to do, in terms of screening — I know I never do it. Do you use a computer to screen anything?

WARREN BUFFETT: No. I don't know how to. (Laughter)

CHARLIE MUNGER: No. Bill's still trying to explain it to me.

WARREN BUFFETT: I — we — you can — it's a little hard to be precise on, because we don't really use screens — (inaudible) were screening everything. But it's not like we sit there and say, you know, we want to look at things that are below the price of book value, or low P/Es, or something of the sort.

We are looking at businesses exactly like we'd look at them if somebody came in and offered us the entire business, and then we try to think, what is this place going to look like in five or ten years, and how sure are we of it.

And most — a lot of companies, you know, we just don't know the answer to it. We do not know which auto company is going to, you know, be knocking the ball out of the park ten years from now or which one is going to be hanging on by its fingernails.

You know, we watched the auto business for 50 years, a very interesting business, but we don't know how to — we don't know how to foresee the future well enough on something like that.

CHARLIE MUNGER: We think that the Burlington Northern will have a computer — a competitive —advantage 15 years from now, with a high degree of confidence. We would never have that degree of confidence about Apple, no matter what their financial statement showed.

WARREN BUFFETT: No.

CHARLIE MUNGER: It's just — it's too hard.

WARREN BUFFETT: Yeah. We don't know about an oil company ten years from now, you know, in terms of what the product will be selling for or anything.

I would say we're — you know, we're virtually 100 percent confident about a Burlington Northern, or a GEICO, or some other companies that I won't name.

CHARLIE MUNGER: People with very high IQs who are good at math naturally look for a system where they can just look at the math and know what security to buy. It's not that easy.

You really have to understand the company and its competitive position, and the reasons why its competitive position is what it is, and that is often not disclosed by the math.

WARREN BUFFETT: Yeah. It's not what I learned from Ben Graham, although the fundamentals of looking at stocks as businesses, and the attitude toward the market and all that, is absolutely still part of the catechism.

But I wouldn't — I don't know exactly how I would manage money if I was just trying to do it by the numbers that —

CHARLIE MUNGER: You'd do it poorly. (Laughter)

WARREN BUFFETT: Yeah. That takes care of that. (Laughs)

4. Disagreement on whether the "new normal" will bring lower returns

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: This question is from Benjamin Knoll of Greater Twin Cities United Way.

“Every time Bill Gross writes a new essay on the, quote, ‘new normal,’ unquote, I get more depressed about the prospects for my retirement.

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

WARREN BUFFETT: Yeah, Charlie and I don’t pay any attention to macro forecasts.

We have worked together now for 54 years, and I can’t think of a time when we made a decision on a stock, or on a company, where a macro discussion — where we’ve talked about macro.

We don’t know what things are going to look like, in any precise way. And, incidentally, naturally, we think if we don’t know it, nobody else knows. That’s the conceit that we have. (Laughs)

And — so we — you know, why talk — why spend time talking about something you really don’t know anything about? I mean it — people do it all the time, but it not very productive. So we talk about the businesses.

I like Bill Gross. Sounds like Lloyd Bentsen, you know, back in the — he’s a friend of mine.

But I don’t — it doesn’t make any difference to me what he thinks about the future, doesn’t make any difference to me, you know, what any economist thinks about it.

I have a general feeling that America will continue to work well. And I don’t — you know — there’s — throughout my adult lifetime, and before that, there’s always been all kinds of opinions that, you know, about what’s going to happen this year or the next year or anything like that. And nobody knows.

What you do know, with a very high degree of certainty, in my view, is that BNSF will be carrying more carloads 10 years from now, 20 years from now; that there will be no substitute for the service that they provide; that there will be two important railroads in the west and two important railroads in the east; and that they will have an asset that has incredible replacement value, nobody could turn out something like it, and that they’ll get paid fairly for what they do. It’s not very complicated.

And to ignore what you know because of predictions about what you don’t know, or what nobody else knows, in our view, it’s just plain silly.

So we don’t have anything against somebody talking about a new normal or an old normal or an in-between normal, but it doesn’t mean anything to us.

My own guess is that people will do very well owning good businesses, if they don't pay too much for them, you know, whether they hold them for 10 years or 20 years or 30 years.

And if they try and time their purchases in some way by listening to forecasts about what's going to happen in business and try and buy and sell them, they're going to do very well for their broker and not so well for themselves.

Charlie?

CHARLIE MUNGER: Yeah. But, of course, Warren, we have a lot of money. We have to do something with it. So we're going to do our thing no matter what the external climate is.

If you're a busy surgeon and trying to decide whether to work two more years before you retire, then you may be more interested, and rationally so, in the new normal.

And I would personally advise the guy to work an extra couple of years. (Laughter)

In other words, I kind of agree with Bill Gross.

WARREN BUFFETT: What do you think the normal is?

CHARLIE MUNGER: Well, less than we've enjoyed in our lifetimes, the new normal.

WARREN BUFFETT: What have we enjoyed in the last 10 years? I mean, you know —

CHARLIE MUNGER: It hasn't been so bad.

WARREN BUFFETT: No. And it hasn't been —

CHARLIE MUNGER: It's not nearly as good as it was in the first 30.

WARREN BUFFETT: Yeah. And do you think it would be worse than the average of the last 10 years?

CHARLIE MUNGER: I think that's quite a conceivable outcome.

WARREN BUFFETT: So take your pick. OK. (Laughter)

5. Fruit of the Loom's vs. Gildan Activewear

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: Warren, I'm sorry. My last question about solar was directed at Charlie, but my next question is about underwear, so I think you can probably field this one.

WARREN BUFFETT: Boxers or briefs? (Laughs)

JONATHAN BRANDT: I'm not talking.

Over time, Fruit of the Loom and others have lost nearly all of the T-shirt-focused wholesale screen print market to Gildan, a relatively new player with very low cost structure.

Gildan is now going after the underwear-focused retail market and is having some success with certain large customers. Branding is obviously more important in the retail market, but is there any reason to think Fruit of the Loom won't lose significant amounts of share here over time, just as they did in the wholesale screen print market?

What can they do to protect what remains of their franchise?

WARREN BUFFETT: Yeah. You keep — you keep your costs down and you constantly work at brand building, and you try very hard to make sure that your main customers, in turn, have their customers happy with the product, and are happy with the price points that you can deliver it at.

And you're correct that Gildan, in terms of certain aspects, the non-branded aspects, basically, of some parts of the business, has hurt Fruit in the last — well, last 10 years, certainly.

But we turn out first-quality, low-priced underwear with a strong brand recognition. And I think it will be very tough to either build a brand against it or to beat our costs significantly.

Now Gildan pays very little in the way of income taxes, you know, because they route stuff through the Cayman Islands, and that's a modest factor.

But I think you'll find five years from now, or 10 years from now, that our market share in men's and boys', particularly underwear, will hold up.

But you're right. They're a competitive threat. Hanes is a competitive threat. And it's not a business that you can coast on. It's not Coca-Cola, but it's not an unbranded product, either.

And I think Fruit will do reasonably well, but it will not get anything like, you know, the kind of profit margins that you can get in certain branded products.

Charlie?

CHARLIE MUNGER: Yeah. And then, too, as many products as we have, we may average out pretty well, in terms of market shares, but we're not going to win every skirmish or every battle.

6. Influential books and early investments

WARREN BUFFETT: OK. Station 2.

AUDIENCE MEMBER: Yeah. Hi, Warren. Hi, Charlie. I'm Fritz Hauser (PH) from Offenburg, Germany.

I'd like to know what 10 books influenced you the most and that weren't written by Graham and Fisher, and I'd also like to tell you that I think it would be great if you would publish the portfolio statements of the Buffett Partnership years.

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

WARREN BUFFETT: Yeah. Well, Charlie ran something called Wheeler,Munger and his portfolio was even more interesting, so we'll start with you, Charlie. (Laughs)

He ran a more concentrated portfolio than I did in those days.

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

You'd recognize American Express. Rattle off some of the names.

WARREN BUFFETT: Yeah. Well, we can start with Mosaic Tile and —

CHARLIE MUNGER: The map company.

WARREN BUFFETT: — Meadow River Coal & Land. There's hundreds of them. Flagg-Utica, Philadelphia Reading Coal & Iron, you name it.

I've literally owned — I bet I've owned 4- or 500 names at one time or another, but most of the money's been made in about 10 of them.

CHARLIE MUNGER: And I couldn't name 10 books either that have — that I regard as that much better than the next 10. My mind is a blend of so many books I can't even sort it out anymore. (Laughter)

WARREN BUFFETT: Yeah. "The Intelligent Investor" changed my life, in terms of — I literally had read every book in the Omaha Public Library by the time I was 11 on the subject of investing, and there were a lot of books.

And there were a lot — there were technical books, Edwards & Magee, I mean, that was a classic in those days, and a whole bunch of them, Garfield Drew. But — and I love — I enjoyed reading them a lot. Some of them I read more than once.

But I never developed a philosophy about it. I enjoyed it. I charted stocks. I did all that sort of thing.

Graham's book gave me a philosophy, a bedrock philosophy, on investing that made sense. I mean, he taught me how to think about a stock, he taught me how to think about the stock market, and he taught me that the market was there not to instruct me but to serve me.

And he used that famous "Mr. Market" example. He taught me to think about stocks as pieces of businesses, rather than ticker symbols or things that, you know, you could chart, or something of the sort.

And so it was that philosophy — and in some way, further influenced by Phil Fisher's book — and Phil Fisher was just telling me the same thing that Charlie was telling me, which was that it's very important to get into a business with fundamentally good economics, and one that you could ride with for decades, rather than one where you had to go from flower to flower every day.

And those — that philosophy has carried me along. Now, I've learned different ways of applying it over the years, but it's the way I think about businesses now.

I have not found any aspect of that bedrock philosophy that has flaws in it. You have to learn how to apply it in different ways.

So those are the books that influenced me.

And, of course, in other arenas, Charlie's probably read more biography than anybody that I know of. And I like to read a lot of it.

We're just about through reading the Joe Kennedy biography. You've read that, haven't you, now, Charlie?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: You know, I'm not sure you want to emulate everything he did, but it's still interesting reading. (Laughs)

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

And on top of it, we have gotten very substantial benefits from it. My life would have been different if Ben Graham hadn't gone to the trouble of writing a book, which he had no financial need to do at all. You know, I would have a very different life.

7. Buffett remains bearish on airlines

WARREN BUFFETT: OK. Becky.

BECKY QUICK: This question comes from Bill Miller of Legg Mason.

He writes, "The U.S. airline industry has been plagued with terrible economics for over 100 years. With the pending merger of USAir and American, the industry will have consolidated to the point where the top four carriers will control almost 90 percent of the traffic.

"As a result, the industry has been consistently profitable this past several years, with many of the airlines now earning double-digit returns on invested capital and generating substantial free cash flow.

Do you think the industry's much improved economics are likely to persist? And would there be any economic benefits if Berkshire were to own a domestic airline and pair it with NetJets?"

WARREN BUFFETT: Yeah. Well, the answer to the second is no.

But the question about the industry is really interesting, because it is true that it has consolidated very significantly.

And in some businesses, you can have only two competitors and they're still terrible businesses, they beat each other's brains out. And sometimes they end up competing to do very stupid things. You can argue that that's what happened with Freddie Mac and Fannie Mae. I mean, enormous companies that had a huge advantage over everybody else, but they still, in their battle to both report higher earnings every quarter and to beat the other guy out, you know, drove prices for insuring loans down to the improper levels, and did a lot of other stupid things, too.

So you see — you do see certain industries where once they get down to very — a very few companies, do extremely well. And you see other industries where, even when they get to be two of them, they don't do that that well.

I mean, you can take Coke and Pepsi in the United States.

I mean, they're the only two colas that people can name, and 50 percent or so of the soft drinks are colas. But if you go into a supermarket on the weekend, you will see them pricing their product at ridiculously low prices and competing very vigorously.

So it's very industry specific. The airline industry, you know, has this situation where they have very, very, very low incremental costs per seat, you know, with enormous fixed costs, and the temptation to sell that last seat at a very low price is very high and it's very — and sometimes it can be very difficult to distinguish between the last seat and other seats.

So it's a labor-intensive, capital-intensive, largely commodity-type business, and it's been — as Bill Miller points out in that question, it's been, you know, a death trap for investors ever since Orville [Wright] took off.

I mean, as I've said, if there had been a capitalist at Kitty Hawk he should have shot down Orville and done us all a favor. (Laughter)

But the — but having neglected to do that, investors have poured money into airline companies, and aircraft manufacturing companies, now for 100 years-plus, with terrible results.

And if it ever gets down to where there's one airline and there's no regulation, it will be a wonderful business. And then the question is whether, having gotten down, now, through a lot of bankruptcies, to a relatively few that are doing a high percentage of the seat miles, whether it's a good business yet. I don't know the answer, but I'm skeptical.

Charlie?

CHARLIE MUNGER: Well, the last time we were presented with a similar opportunity was when the railroads did exactly what Bill Miller suggests. The railroads got down and consolidated and got better control of their labor costs and it turned into a wonderful business. And what did we do? We missed it. We stumbled in very late to the party, right?

WARREN BUFFETT: Right.

CHARLIE MUNGER: So we've proven ourselves to be slow learners in this field, and it's conceivable, isn't it, that Bill Miller is right in what he suggests?

WARREN BUFFETT: Which way do you bet?

CHARLIE MUNGER: It goes into my too hard pile. (Scattered laughter)

WARREN BUFFETT: Mine, too.

CHARLIE MUNGER: But he could be right.

WARREN BUFFETT: Yeah, sure he could. And it will be fun to watch.

But we like things we have stronger feelings about.

We do not think that things will change dramatically in — well, with See's Candy, you know, it's — we've got — even there, you know, the real profitability is limited to the West Coast, but we do not see some competitor coming along and taking away business.

CHARLIE MUNGER: You really couldn't create another railroad and —

WARREN BUFFETT: I hope not.

CHARLIE MUNGER: — and you — and you can create another airline.

WARREN BUFFETT: Very easily, and you have people that like to do it.

CHARLIE MUNGER: That's what we don't like about it.

WARREN BUFFETT: And people love doing it. It's exciting to people.

And you can sell the idea. I've had, probably, a dozen proposals over the last 25 or 30 years from people that want to get into the airline business one way or the — and a number of them have. It's sexy, for some reason.

I mean, it — you know, if you go to the office of some Mr. Big CEO and say, "I want to talk to you about this new airplane," you get in the door. You know, I mean, if you want to talk to him about hauling coal or something, it's a little different.

So it is a business that attracts people. And you can go out and raise money for a new airline, and the record is — it's really been something. I don't know how many bankruptcies there have been in the airline field, but it's an enormous number.

And, of course, some have done it more than once. We bought USAir. I bought that. I was at Gorat's with [CEO] Ed Colodny, and he explained to me how wonderful the airline was — he's a good guy, incidentally — and I wrote a check.

And by the time the check was cashed, they were having troubles. I mean, it did not take long.

CHARLIE MUNGER: No.

WARREN BUFFETT: And then they went bankrupt twice. We were very lucky on — we actually made quite a bit of money on it, as it turned out, because there was a little blip at one point. But I think it went bankrupt twice after we bought it.

And Charlie and I were on the board, and we would look at these projections, you know, and they were just ridiculous. I mean, they never came true, did they, Charlie?

CHARLIE MUNGER: No, no, no. It was —

WARREN BUFFETT: We were very popular because we actually pointed that out a few times. (Laughter)

8. Mixed feelings on Berkshire stock buybacks

WARREN BUFFETT: OK. Cliff.

CLIFF GALLANT: I want to ask you about share repurchases. How hard a floor should shareholders think about the 1.2 times book value buyback multiple?

Are there circumstances under which you would not be buying back at 1.2?

WARREN BUFFETT: Yeah. Well, generally speaking, book value has got nothing to do with the price at which you should purchase your shares; intrinsic business value does. And the correlation between intrinsic business value and book value throughout the investment universe is — you know, there's virtually no correlation.

So book value is unimportant to most companies. It actually has — it has a reasonable tracking utility at Berkshire.

Our intrinsic business value is very considerably above book value, and we have signaled that — we'll say it right here, we've said it before — but in addition, we've signaled that by saying that we would repurchase our shares as long as we had a substantial cash balance, met all the needs of our operating companies, at 120 percent of book value, and if we got the opportunity to buy it there, we would probably buy a whole lot of it.

The calculus is very much what I put in the report. You know, you take care of your business with money first, and if you can buy additional businesses at something where you add to the per-share value of the business, you do that.

If you can repurchase your shares at a significant discount from intrinsic value, it like buying dollar bills at 90 cents or 80 cents or whatever it may be, and it's a very sure way of improving per-share value.

It's been very difficult for us to do it because every time we announce it, people say, "Well, if it's — if he thinks it's worth more than 120 percent of book," you know —

CHARLIE MUNGER: Yeah. Those cheapskates are willing to pay that.

WARREN BUFFETT: Yeah, right. Well, if at least one cheapskate is willing to pay that, the —

And, you know, they're right. And we don't really — we've got mixed emotions on it.

We don't really like the idea of running a company where it makes most of its money by buying its partners out at a discount, but if partners want to sell out at a discount, we also like the idea of buying and making, you know, sure money that way.

We haven't done much of it. Most of the time our stock has sold in a reasonable range in relation to intrinsic business value. We would think that probably a fairly significant percentage of the time in recent years it sold at at least some discount. There were a few years when we thought it sold for more than intrinsic business value.

But if it, in our opinion, the directors' opinion, the stock is selling at a significant discount and we've got the money around and we've got the stock offered to us in a reasonable quantity, we will buy it, and then — and there could be circumstances — it's unlikely — but there could be circumstances where we'd buy a whole lot at a price that would be attractive for the stockholders who stayed in.

Charlie?

CHARLIE MUNGER: Nothing to add.

9. Munger won't be moving to Omaha

WARREN BUFFETT: Station 3.

AUDIENCE MEMBER: Hi there. Sean Cawley. I'm a real estate agent in Los Angeles, California.

Question for Charlie. It's kind of a real estate question, and it's also a company culture question. Have you ever considered moving to Omaha to be closer to corporate headquarters?

CHARLIE MUNGER: (Laughs) Oh, I think the answer to that is no. (Laughter)

WARREN BUFFETT: I'm sure the answer to that is no.

Our partnership works extremely well. And even though we're somewhat technophobic, we have gotten to the point where we can handle using the phone — (laughter) — don't push us beyond that.

CHARLIE MUNGER: No, we've never learned anything beyond the phone.

WARREN BUFFETT: But we — I mean, as a practical matter, we each know exactly how the other guy thinks, so that we don't really even need the phone, exactly. (Laughter)

We used to do a lot of phoning back when it cost a lot of money to phone. Now it doesn't cost anything to phone, and we don't talk to each other, hardly. (Laughter)

Charlie — but Charlie has a lot of fond thoughts about Omaha, incidentally, as do I.

CHARLIE MUNGER: Yes. Although, I — as I said earlier on this weekend, they're rebuilding it so rapidly now that I felt like Rip Van Winkle. They've torn down so many of the buildings I remember. It's amazing how much Omaha has changed the last five years.

WARREN BUFFETT: Well, you have to remember that a third of the lifetime of the country has passed during our lifetime, so you have to expect a little change occasionally, Charlie. (Laughter)

10. Climate change isn't a factor for short-term insurance rates

WARREN BUFFETT: OK. Andrew.

ANDREW ROSS SORKIN: OK, Warren. We got a couple of questions related, this year, to climate change and its impact on the company.

So let me ask this question from Clem Dinsmore, who asks: "If asked, what would the underwriting experts at your casualty insurance and reinsurance companies advise you and your fellow board members are the emerging risks to Berkshire's many enterprises from the changes in extreme weather associated with climate change?"

And I would add that Jed McDonald asked a separate question, but related, saying, "What are your thoughts on the price on carbon debate?"

WARREN BUFFETT: Yeah. Well, as you've noticed if you've been here the last few years, the climate really is getting a lot warmer. (Laughter)

Obviously — well, Charlie knows far more about science than I do, which is not saying a whole lot, but the — my general feeling is that there is a — certainly a reasonable chance — that people that are worried about warming and the effect of CO2, et cetera, are right.

But I don't know enough so that I can say that, you know, that I can speak as any kind of an expert on it.

I don't know the answer on it, but I certainly am willing to assume that — there are a lot of very smart people who think that, and I think that it's a reasonable assumption.

I don't think that it makes any real difference in assessing insurance rates from year to year.

We have a general tendency to be pessimistic in our assumptions about the likelihood of natural catastrophes, but we would have that general bias, which I think is useful, regardless, if there were no carbon emissions of any kind going on.

We would still assume that whatever the past history had been of natural disasters, we would assume that they were going to be somewhat worse.

And the global warming, in terms of resetting prices of insurance from year to year, is not a real factor.

Our general pessimistic bias is something of a factor.

The second part about pricing of carbon emissions, do you want to repeat that again?

ANDREW ROSS SORKIN: The full question — and I abbreviated it — was, "What are your thoughts on the carbon — the price of carbon — debate?

"Do you think it's a feasible way, for example, to incentivize efficiency improvements and capture the externalities of carbon's damaging effects, or is it a lofty, idealized concept too tricky to figure out in practice?"

WARREN BUFFETT: I would say that the question calls for having Charlie give the answer. (Laughter)

CHARLIE MUNGER: Well, you've got to realize that I'm a Caltech-trained meteorologist, but that was before they'd invented most of modern meteorology. (Laughter)

I think that I think that carbon trading is pretty impractical, a whole bunch of nations with different ideas, and so on.

And I think if you're going to change habits, the correct answer is carbon taxes.

I think Europe, because they're socialists and wanted to tax the thing the people needed the most, they put these big high taxes on motor fuel. So they did it by accident, and not because it was a good idea, vis-a-vis global warming and a lot of other issues, but because they really needed the money.

But I think they stumbled into the right policy. I think the United States should have way higher taxes on motor fuel, and that's efficient. (Applause)

Some group of shareholders, though. They like clapping for high taxes. (Laughter)

WARREN BUFFETT: They weren't all clapping. (Laughter and applause)

11. Doug Kass's short-selling challenge

WARREN BUFFETT: OK. Doug.

DOUG KASS: Warren, my next question is both a question and an unusual challenge.

I'm asking this next question because in the past, you've been open to inviting your audience to apply for jobs.

In 2002, you suggested that shareholders who thought they were eligible to send in their qualifications if they were interested in seeking a seat on your board of directors.

And, again, in your 2006 letter, when you advertised for a successor to Lou Simpson at GEICO, you said at the time "Send me your resume."

In the past, you have discussed your views on short selling. You have cited that stocks tend to rise over time, and you've talked about the asymmetry between reward and risk.

By contrast, the last 15 years has demonstrated that short selling can be a value additive tool to total return when done by professionals. In fact, I believe Todd Combs had success as a short seller when you hired him.

CHARLIE MUNGER: He had so much success he stopped doing it. (Laughter and applause)

DOUG KASS: Yes, Charlie, but he got the job from that success. My question is —

WARREN BUFFETT: No, no, he didn't. (Laughs)

Can't slide that one in there, Doug. (Laughter)

DOUG KASS: My question is: would you ever consider committing capital to a short-selling strategy? Would you or Berkshire consider being my Homer Dodge, who invested in your partnership after the original seven investors?

Would you or Berkshire Hathaway be willing to give my firm at least $100 million in a managed account?

If Seabreeze failed to outperform the increase, during the two-year period, of the book value increase in Berkshire, all the earned fees earned would be contributed half to the Sherwood Foundation, and half to two charities of my choice, including the Jewish Federation of Palm Beach County?

And even if Seabreeze outperformed Berkshire's change in book value, 25 percent of the earned fees would be contributed to the charities.

And I want to add something else. You talked about being technophobic.

Technology may be very hard for Berkshire to invest in, but it is also disruptive to many industries whose business models are scathed by it, and this produces very fertile ground for short-selling opportunities.

WARREN BUFFETT: Well, we got to —

CHARLIE MUNGER: Let me add to that.

WARREN BUFFETT: OK — 1:55 without an ad, but — (laughs)

CHARLIE MUNGER: The answer to your question is no. (Laughter and applause)

WARREN BUFFETT: Charlie and I are no strangers to short selling. I mean, we both —

CHARLIE MUNGER: Failed at it.

WARREN BUFFETT: Yeah. (Laughter)

So we'll — just think about how lucky you are. You don't have the competition from all kinds of people that listen to us or — ourselves.

No, we — I may even propose a little wager at some point, but we'll let that ride for the time being.

I've known — well, if you go back far enough, you know, we did a reasonable amount of short selling, and I've certainly identified lots of companies that I thought were far overpriced, and I've identified a fair number of companies that I not only thought, but was virtually certain, were frauds. And so, Charlie — we've been seeing them ever since we got in the business.

But making a lot of money short selling, still, is not a game that appeals to us over a long period of time. It's one of those things that —

CHARLIE MUNGER: We don't like trading agony for money. (Applause)

WARREN BUFFETT: But we wish you well. (Laughter)

12. Reluctantly paying more for a great business

WARREN BUFFETT: Station 4.

AUDIENCE MEMBER: Ben Sauer (PH) from Shreveport, Louisiana.

Could you be more specific about what factors you considered when determining what a fair price was for an acquisition such as Heinz?

And also, what sources do you use to make judgments about major changes that will affect an industry?

WARREN BUFFETT: Well, we usually — we usually feel we're paying too much. Isn't that right, Charlie? (Laughs)

But we find the business so compelling, the management, our associates, so compelling, that we gag and we get there on the price.

But we — there is no mathematical — perfect mathematical — formula.

Looking back, when we've bought wonderful businesses that turned out to continue to be wonderful, we could've paid significantly more money, and they still would have been great business decisions. But you never know 100 percent for sure.

And so it isn't as precise as you might think. Generally speaking, if you get a chance to buy a wonderful business — and by that, I would mean one that has economic characteristics that lead you to believe, with a high degree of certainty, that they will be earning unusual returns on capital over time — unusually high — and, better yet, if they get the chance to employ more capital at — again, at high rates of return — that's the best of all businesses. And you probably should stretch a little.

Charlie and I have had several conversations where we were looking at a building — a business — which we liked, and were sort of gagging at the price, and Charlie or I will say, you know, "Let's do it," even though it kind of kills us to pay that last 5 percent.

We did that with See's Candy. Charlie was the one that said, "For God's sakes, Warren, write the check." I was the one that was suffering.

But it's happened quite a few times, hasn't it, Charlie?

CHARLIE MUNGER: It almost always happens. (Laughter)

Modern prices are not cheap.

WARREN BUFFETT: No, no. And great businesses, you know, you're not going to find lots of them, and you're not going to get the opportunity to buy them and — although you do in the market.

The stock market will offer you opportunities for profit, percentage-wise, that you'll never see, in terms of negotiated purchase of business.

In negotiated purchase of a business, you're almost always dealing with someone that has the option of either selling or not selling, and can sort of pick the time when they decide to sell, and all of that sort of thing.

In stock markets, it's an auction market. Crazy things can happen.

You can have, you know, some technological blip that will cause a flash crash or something. And the world really hasn't changed at all, but all kinds of selling mechanisms are tripped off, and that sort of thing.

So you will see opportunities in the stock market that you'll never really get in the business market.

But what we really like, we really like buying businesses to hold and keep. We like buying cheap marketable securities, too. But particularly when you've got lots of cash coming in and you're going to continue to have lots of cash coming in, you really want to deploy it in great businesses that you can own forever.

Charlie, anything?

CHARLIE MUNGER: No. It — we're sort of in a different mode now, and that has a great lesson, in that if we'd kept our earlier modes, if we'd never learned, we wouldn't have done very well.

The game of life is a game of everlasting learning. At least it is if you want to win.

WARREN BUFFETT: We want to win.

CHARLIE MUNGER: Yeah.

13. George W. Bush's 10 words of economic wisdom

WARREN BUFFETT: Carol.

CAROL LOOMIS: This question is from Logan Reed (PH) of Pawling, New York, and has both a question and a postscript, and I'm going to do the postscript first. It's friendly.

"I'm an 86-year-old World War II vet, which puts me about halfway between you and Mr. Munger. I would respectfully and urgently request that you quit eating so many hamburgers. (Laughter)

"Those things plug up your arteries, and I want to keep you around for a while, in spite of the fact" — the unfriendliness comes in here — "that you voted for President Obama." (Laughter)

Now, here is the question.

WARREN BUFFETT: This guy is trying to kill me, and he's doing it — (Laughter)

CAROL LOOMIS: "Over the years, you've frequently alluded to your legendary reputation for thriftiness, and you've extolled the virtues of the managers of Berkshire companies who have invariably been extremely cost conscious.

"If these are hallmarks of the philosophy which has enabled you to achieve your astounding success, how can you possibly support an administration which has plunged our country into $16 trillion worth of debt, and has not indicated the slightest concern — (applause) — over the efficiency — inefficiency — over the inefficiency of big government?"

WARREN BUFFETT: Yeah. Well, the 16 trillion, we'll have to give Bush a certain amount of credit for that, too. (Applause)

They certainly didn't — certainly wasn't — the Obama administration that, at least, allowed policy that created the greatest financial crisis and required an appropriate stimulus on the part of the government. (Applause)

But, in the end, I find it totally unproductive — and that fellow at 86 probably is — should have found it out by now — to discuss politics with people. I mean, you're to have roughly half agree with you and half disagree.

So if you — if you look at this — the trouble is, Charlie and I, even though he's a Republican, I'm a Democrat, we really don't disagree as much as you might think based on that.

Otherwise, I could say you could just take your pick here and vote for one of us and ignore the other one, and we would offer a little something for everyone.

The amount of deficit spending in the last four years, the amount of stimulus provided — fiscal stimulus provided — I think, has been quite appropriate in relation to the threat to the economy that was posed by the greatest panic in my lifetime.

I mean, you literally had a situation where Berkshire Hathaway was getting a phone call because General Electric needed money, and we were the last stop.

That is quite a situation. It's quite a situation when Freddie and Fannie go into conservatorship and WaMu and Wachovia fail, and where money market funds have 5 percent drained out of them in three days, and with a panic underway.

So I — we needed fiscal stimulus in this country.

Now, the real question is: how do you get off of that? And that is a problem, but it's a lesser problem than we would've had if we'd decided to follow some austerity program, in my view, at least, starting in 2008.

How do you feel about that, Charlie?

CHARLIE MUNGER: I agree with you completely. (Applause)

And, by the way, so did George W. Bush.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: That was bipartisan. We were in so much trouble, that on both sides of the aisle, we finally got together and supported these extreme interventions.

WARREN BUFFETT: George Bush issued, probably, the ten greatest words of economic thought in history. Most people don't give him credit for that.

They think of Adam Smith and comparative advantage and Keynes and animal spirits and all those guys.

But George Bush went out there in September of 2008 and said, "If money doesn't loosen up, this sucker could go down." (Laughter)

I mean, that is a man that knew how to get to the point. (Laughter)

And I give him great credit for it, enormous credit.

And plenty of members of his party did not agree with what he was doing, but we owe him a lot, in that respect.

And, you know, we — our leaders, generally speaking, in both parties, once they were in the terrible trouble, I think they behaved, or came up with policies that, in general, were very useful in avoiding something far worse than what we experienced.

And they weren't easy to do. I mean, it took some guts.

So, I am disturbed by a national debt that grows in respect to GDP. In fact, I wrote an article in The New York Times, an op-ed piece, in — I think maybe 2009 or 2010 — talking about this very problem.

But, you know, we came out of World War II with a debt higher — a gross or net debt — higher in relation to GDP than we have now, and people were predicting terrible things at that time because of that situation, and the country has done sensationally.

The real danger is that it just continues to grow, and it gets easier to print money than exercise some discipline.

But we've encountered far worse problems than we face now. I mean, this is not our country's toughest hour, by a huge margin.

And I think we will do fine, but with a lot of bickering, and kind of nonsense that will bother you when you read about it day to day. But when you look at it from a viewpoint of history 10 or 20 years from now, you will not be that disturbed.

Charlie?

CHARLIE MUNGER: Well, I agree with you about George W. Bush, and I like these nonpartisan episodes when we get together and do things right.

And I also think that our current problems are quite confusing. In fact, if you aren't confused, I don't think you understand it very well. (Laughter)

WARREN BUFFETT: That sort of immunizes you from everything. (Laughs)

How bothered are you by the level of debt in relation to GDP?

CHARLIE MUNGER: Well, I don't think there's any one fixed ratio that is written in the stars.

As a matter of fact, most of the debt, as I conceive it, is not even counted in what you call "debt." The off-the-books debt of the United States is bigger than the on-the-books debt, all the present value of future promises that are unfunded.

WARREN BUFFETT: That can be changed, however.

CHARLIE MUNGER: Yes. But, if they can be changed, but are we really going to take Social Security away from somebody who's worked a lifetime?

WARREN BUFFETT: Well, we shouldn't.

CHARLIE MUNGER: I don't think it's very likely.

WARREN BUFFETT: No, no. But Social Security is not a killer, actually, in terms — if you have a GDP that rises a couple percent in real terms —

CHARLIE MUNGER: Of course — that's the great problem. All of our problems are trivial, if GDP will just rise at 2 percent per annum, per capita.

All these problems that the Republicans are screaming about fade into insignificance if we can do that.

But you've got to have policies that enable you to do it, and I'm not sure we always do that very well. (Applause)

WARREN BUFFETT: OK. Stay tuned.

14. Benjamin Moore won't go downmarket

WARREN BUFFETT: Jonathan.

JONATHAN BRANDT: I have a question about the competitive landscape in the paint business.

I personally always use Benjamin Moore, but some say that Benjamin Moore is disadvantaged because it doesn't control its own distribution, as does Sherwin-Williams, and they note that it has lost market share to Behr, which is sold in the home centers at lower prices.

You recently replaced management there. What changes in strategy and/or pricing, if any, are being undertaken at that unit, and what is the outlook for that franchise?

WARREN BUFFETT: Yeah. Benjamin Moore, it's a relatively small percentage of the total paint industry, but it — at the high end, it is the best regarded paint, and we have not lost position in that respect.

But the — when we purchased Benjamin Moore, I made a promise. I even made a video. It had a dealer system, and people that invested their savings and passed on from generation to generation dealerships from Benjamin Moore, and counted on the company adhering to a dealer system, even though you could always get a huge jump in volume, particularly in the first year, if you went with the big boxes.

So we were always approached by the big boxes, and they said, you know, "Let us take Benjamin Moore into our stores," whether it be Home Depot or whomever. And we would've gotten a big jump in volume when that happened and they would've loved us — to have us — as a brand with that kind of identity in their stores, but it would've represented a total change in the distribution arrangement.

I don't think it would've worked out as well over time, and I know it would have been essentially — particularly after my pledge, which the other — which the management pledged too, they would've been double-crossing a network of dealers that trusted us, and trusted us when we bought it to continue with the policy.

A dealer policy will work with a first-class brand like Benjamin Moore. It will never get the kind of market share as will take a Behr, which is distributed through Home Depot.

We were actually offered Behr at one time. Charlie, do you remember that one?

CHARLIE MUNGER: Yes, I do.

WARREN BUFFETT: Yeah, yeah. But the company was actually investigating, and went on its way to implementing, some moves that would've, in effect, gutted, or we felt would drastically hurt the dealers and violate the pledge that I'd made to them back when we bought it.

So we did have a change there. And we will — we will not follow the Sherwin-Williams path, which is a very — I mean, it's a very effective business strategy. I'm not knocking that at all, but that is not our strategy. Our strategy will be a dealer strategy, focused on the high end of the market.

CHARLIE MUNGER: Besides, it's worked very well.

WARREN BUFFETT: Oh, yeah, it's worked well, and it'll continue to work well.

It doesn't mean that Sherwin-Williams won't do extremely well. I think they will. It doesn't mean that Behr won't do well. I think they will.

But we are in a different segment and it's up to us to protect and really foster the dealer distribution network, and I think we can have something, and do have something, very special with those dealers and with the position that Benjamin Moore has.

But it will not lead to far higher market shares or anything. I think it will lead — and it has — to very decent profitability. Benjamin Moore is a good business, and I think it will continue to be a good business.

Charlie?

CHARLIE MUNGER: Well, I agree totally. I always wish we could buy five more like it tomorrow.

WARREN BUFFETT: Yeah, exactly.

15. Stock strategy

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: Derek Foster, Ottawa, Canada.

First of all, thank you, Warren, for sharing all your information. You've changed my life. I took finance in university, couldn't understand Greek formulas, but now I can invest reasonably well.

My question to you is, in the past you've said for an investor, you should simply — for 99 percent of investors — you should simply stick money in an index fund and let it go and don't worry about it. Those 1 percent of investors, choose your best five stocks and put a substantial amount of money in it.

I'm just wondering, how about a strategy of, perhaps, buying 20 of the best stocks in America, you know, Procter & Gamble, Coca-Cola, Johnson & Johnson, whatever, the companies that have been around for centuries — or a century or decades or whatever — and just leaving it at that.

Do you think that that would outperform an index fund over the long term? And I want Charlie's opinion as well.

WARREN BUFFETT: Well, I don't know whether you're saying the 20 largest companies or the 20 best. You might get different thoughts from different people on what they are.

But I think you would — probably the 20 you would pick would virtually match the results of an index fund. Who knows exactly which ones would be the best?

But the real distinction — and Graham made this in his book, basically — is between the person who is going to spend an appreciable amount of time becoming something of an expert on businesses, because that's what stocks are, or the person who is going to be busy with another profession, wants to own equities, and actually will actually do very well in equities. But the real problem they have is that they may tend to get excited about stocks at the wrong time.

You know, they, really, the idea of buying an index fund over time is not to buy stocks at the right time or the right stocks. It's to avoid buying them at the wrong time, the wrong stocks.

So equities will do well over time, and you just have to avoid getting — you know, getting excited when other people are excited, or getting excited about certain industries when other people are, trying to behave like a professional when you aren't spending the time and bringing what's needed to the game to be a professional.

And if you're an amateur investor, there's nothing wrong with being an amateur investor, and you just simply — you've got a very logical, profitable course of action available to you, and that is simply to buy into American business in a broadly diversified way and put your money in over time.

So I would say your group of 20 will probably match an index fund, and you'll probably do well in that, and you will do well in an index fund.

Charlie?

CHARLIE MUNGER: Well, I have nothing to add. I do think it's — that knowing the edge of your own competency is very important. If you think you know a lot more than you do, well, you're really asking for a lot of trouble.

WARREN BUFFETT: Yeah. And that's true outside of investments, too.

CHARLIE MUNGER: Yes. Works particularly well in matrimony. (Laughter)

WARREN BUFFETT: Do you want to give any other advice on that subject?

CHARLIE MUNGER: No.

WARREN BUFFETT: He gave it in the movie. I saw people taking notes.

16. Are Buffett's stock donations hurting Berkshire's price?

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from James Brodbelt Harris of Columbus, Ohio.

He says that your enormously generous multibillion charitable gifts of Berkshire Hathaway stock over the past decade have, and will continue to be, sources of salable assets for the charities linked to the Buffett, Gates, and Munger families.

Could annual sales of billions of dollars' worth of donated stock by these charitable foundations be a reason why shares have traded under 120 percent of book value, and will announced share repurchase plans fully address this selling by the charitable funds in the coming decade?

WARREN BUFFETT: Yeah. I give away 4 3/4 percent of my stock, we'll say, every year, and let's say that's $2 billion worth of stock, roughly. That's 1 percent — a little less than 1 percent — of the market value of Berkshire.

Many companies in the New York Stock Exchange trade over 100 percent a year. A 1 percent sale annually of the outstanding capitalization is absolutely peanuts, and you can even argue, in some cases, that it can aid, in terms of market price, because the availability of stocks sometimes determines whether people get interested in buying.

But a supply of 1 percent annually is not going to change the level at which a stock trades. I mean, it just it's insignificant compared to the volume.

Berkshire — I think Berkshire's volume, A and B combined, is — probably averages, what, 4 or $500 million a day, so 2 billion spent over a year is not going to affect things.

And you can argue that, you know, everybody else has a right to sell their stock or give it to a charity. I don't think I should be totally tied up, in terms of being able to give the stock away.

Charlie?

CHARLIE MUNGER: Well, there's nothing so insignificant as an extra $2 billion to an old man. (Laughter)

WARREN BUFFETT: I've never given away a penny that in any way changed my life. Have you, Charlie?

CHARLIE MUNGER: No, of course not.

WARREN BUFFETT: We never even thought of it. (Laughs)

CHARLIE MUNGER: It would be unthinkable.

WARREN BUFFETT: It's — it has a lot more utility in the hands of other people than it does in my safe deposit box.

17. Most of our opportunities will be in the U.S.

WARREN BUFFETT: OK. Cliff? (Applause)

CLIFF GALLANT: Looking over your first quarter results in the 10-Q, I was wondering — and this might apply more to the noninsurance businesses — what are you seeing in terms of reading the tea leaves for the U.S. economy right now?

Are you starting to see lift? And I'm curious if you have any — if you feel any — need to start to expand Berkshire internationally outside of the U.S.?

WARREN BUFFETT: Well, we're willing to go, you know, anyplace where we think we understand what things are — in a reasonable way— what things are going to look like in five or 10 years, and where we get our money's worth, and good management, and all of the things that we emphasize.

But — so we don't — we've never foreclosed anything, but we're going to find most of our opportunities in the United States. It's just the nature of things that this is a huge, huge market for businesses, and we're better known here.

But, you know, most of our deals will take place here, but we find things outside the United States, particularly in terms of bolt-on acquisitions.

In terms of current business, ever since the fall of 2009, coming on four years, we've seen a gradual improvement. And sometimes people have gotten encouraged to think it was speeding up quite a bit, and then they get feeling that — they start talking about a double-dip, which I've never believed in and hasn't happened.

What we see overall is just a slow progress in the American economy. You saw those figures on carloadings for the first 17 weeks. And, you know, we were up 3-and-a-fraction percent, but the other railroads were up 4/10 of a percent, so the industry as a whole might be up 1 percent or thereabouts, a little over 1 percent.

This economy is not — for the last four years — it's not come roaring back in any way, shape, or form.

It's never faltered, and I wouldn't be surprised if it keeps going this way.

Now, finally, the overhang in housing ended — it ended about a year ago — but — so we're starting to get — we're seeing some recovery in home prices, which has a big psychological effect, and we're seeing some improvement in construction.

But we don't want to start overbuilding again. We really want to have housing starts that more or less equal household formation. And I think we're seeing that.

So if you ask me where we're going to be when we meet here next year, you know, I think we will have moved forward.

But I don't think it will be in any surge of any sort, but I don't think we'll stall, either.

Charlie?

CHARLIE MUNGER: Well, it's not a field where —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — I've been good.

WARREN BUFFETT: We do know what's going on now, though. I mean —

CHARLIE MUNGER: Yeah, we know what's going on now.

WARREN BUFFETT: And I guess that ends it? (Laughs)

CHARLIE MUNGER: Can't make a lot of money knowing what's going on now. (Laughter)

WARREN BUFFETT: And you can't make a lot of money thinking you know what's going to go on tomorrow if you don't, either.

We will — we'll just keep — we keep playing the game. I mean —

CHARLIE MUNGER: Yeah, we keep playing the game.

WARREN BUFFETT: And if we hear about something tomorrow that we can spend 15 or $20 billion on and we feel we like the business, United States or otherwise, we'll move in an instant, and if we don't, we won't do anything.

And we just never know when opportunity is going to come along, but it does come along from time to time. And sometimes in financial markets, it comes in a huge way. I mean, that will happen from time to time.

We may not see very many more, but most of the people in this room will see four or five times in their — during their lifetimes — they will see incredible opportunities offered in — probably in equity markets — but maybe in bond markets as well.

People — things will happen, and then, you know, you have to be able to act, and then you have — and that means both in terms of having the ability and also having the mental fortitude to jump in when most people are jumping out. OK. Station 6. Charlie, you want to —

CHARLIE MUNGER: No.

18. How should a young money manager attract investors?

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Hi. Brandon from Los Angeles.

I'm in my 20s and I'm starting a partnership. What advice do you have about getting people to put in money before I have a track record as a solo investor? (Laughter)

WARREN BUFFETT: Well, you haven't sold me. (Laughter)

No, I think people should be quite cautious about investing money with other people, even when they have a track record, incidentally. There are a lot of track records that don't mean much.

But overall, I would advise any young person that wants to manage money, and wants to attract money later on, to start developing an audited track record as early as they can.

I mean, it was far from the sole reason, far from the sole reason, that we hired Todd and Ted, but we certainly looked at their record, and we looked at a record that we both believed and could understand, because we see a lot of records that we don't really think mean much.

I mean, if you get — you know, if you have a coin flipping contest, as I wrote, you know, some years ago, and you get 310 million orangutans out there and they all flip coins and they flip them 10 times, you know, you will — instead of having 300 million left, you'll have 300,000, roughly, left that'll flip ten times in a row successfully.

And those orangutans will probably go around trying to attract a lot of money to back them in future coin flipping contests.

So it's our job when we hire somebody to manage money to figure out whether they've been lucky coin flippers or whether they really know what they're —

CHARLIE MUNGER: When you had his problem, didn't you scrape together about $100,000 from a loving family?

WARREN BUFFETT: Yeah. Well, I hope they kept loving me after they gave me the money. That was —

Well, it was very slow, and it should have been very slow. As Charlie has pointed out, some people thought I was running a Ponzi scheme, probably, there.

And other people may not have thought it, but it was to their advantage to sort of scare people because they were selling investments in Omaha.

But you — to attract money, you should deserve money, and you should develop a record over time that — and then you should be able to explain to people why that record is a product of sound thinking rather than simply being in tune with a trend or simply just being lucky.

Charlie? You're starting today and you're 25 years old. How do you attract money?

CHARLIE MUNGER: I think most people start with friends and family, or people whose trust they've already earned in some other way. So it's hard to do when you're young, and that's why people start so small.

WARREN BUFFETT: And a relatively few will be successful.

CHARLIE MUNGER: That's right, too.

WARREN BUFFETT: Some of them — a great many will be successful and make — I mean, you know, we have the hedge fund record here. And during that time, the hedge fund managers have probably made a very considerable amount of money.

As I pointed out, Todd and Ted, working under a 2 and 20 arrangement, if they put the money in a hole in the ground, would make $120 million each this year.

So it's not exactly an arrangement that you don't want to think about a little bit before you engage in it.

CHARLIE MUNGER: The arithmetic attracts many of the wrong sort of people.

WARREN BUFFETT: Naturally, we thought we were exceptions.

CHARLIE MUNGER: Yes.

19. Is Ajit Jain going to run Berkshire after Buffett?

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: OK. At Berkshire, there is a unique dynamic that exists between your recognition of Ajit's special skills and Ajit's special skills.

You comment often about how unique Ajit's skills are. So just tell us, is Ajit your successor? (Buffett laughs)

And if not, what happens to Ajit's businesses without Ajit?

WARREN BUFFETT: Well, they won't be without Ajit for a long time. And he — what — he's remarkable in many ways, but one of the ways he's particularly remarkable is that when people start copying something he's doing and turning what was maybe quite profitable into something that becomes something every Tom, Dick, and Harry is doing, he figures out new ways to do business.

And I notice you started with the 'A's when you started on a possible successor with Ajit, and you won't have any more luck when you get to the 'B's. (Laughs)

Charlie?

CHARLIE MUNGER: Well, I think the basic answer is that if Ajit ever is not with us —

WARREN BUFFETT: We won't look as good.

CHARLIE MUNGER: Yeah, we won't look as good, right.

WARREN BUFFETT: And that's true of a number of other managers, too. We have an extraordinary group of people, in most cases, who do not need the money that they earn working for us. They may make substantial money. And they are doing a job for you shareholders and for me and Charlie that you can almost say we don't deserve.

But they are having — I think they're having — a good time running their businesses. The one thing we do is try and create an atmosphere where they can enjoy running the businesses rather than spend all their time running back and forth to headquarters and doing show-and-tell operations and that sort of thing.

And it's taken a long time, though, too. I mean, we operated Berkshire for 20 years without Ajit. If he'd come in the office in 1965 instead of 1985, we'd probably own the world. (Laughter)

Kind of fun to think about, isn't it?

Charlie?

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

WARREN BUFFETT: Doug?

DOUG KASS: Howard, like you, I have two sons that I love. Like you, I have a son in the audience today. This question is not meant to be disrespectful —

WARREN BUFFETT: Sounds like it's going to be, but go ahead. (Laughter)

DOUG KASS: — but it's a question I have to ask.

WARREN BUFFETT: OK.

DOUG KASS: Someday your son, Howard, will become Berkshire's nonexecutive chairman. Berkshire is a very complex business, growing more complex as the years pass. Howard has never run a diversified business, nor is he an expert on enterprise risk management.

Best as we know, he hasn't made material stock investments, nor has he ever been engaged in taking over a large company.

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

WARREN BUFFETT: Well, he's not taking on the role that you described. He is taking on the role of being nonexecutive chairman in case a mistake is made in terms of who is picked as a CEO.

I don't — I think the probabilities of a mistake being made are less than 1 in 100, but they're not 0 in 100. And I've seen that mistake made in other businesses.

So it is not his job to run the business, to allocate capital, do anything else. If a mistake is made in picking a CEO, having a nonexecutive chairman who cares enormously about preserving the culture and taking care of the shareholders of Berkshire, not running the business at all, it will be far easier to then make another change.

And that — he is there as a protector of the culture, and he has got an enormous sense of responsibility about that, and he has no illusions about — at all — about running the business.

He would have no interest in running the business. He won't get paid for running the business. He won't have to think about running the business.

He'll only have to think about whether the board and himself — but as a member of the board — but whether the board may need to change the CEO.

And I have seen many times, really many times, over 60-plus years or — well, probably 55 years as a director — times when a mediocre CEO, likable, you know, not dishonest, but not the person who should run it, needs to be changed.

And it's very, very hard to do when that person is in the chairman's position. It's not as — it's a bit easier now that you have this procedure where the board meets at least once a year without the chairman present.

That's a very big improvement, in my view, in corporate America. Because it — a board is a social institution, and it is not easy for people to come in, we'll say, to Chicago or New York or Los Angeles once every three months, have a few committee meetings, and maybe have some doubts about whether they've really got the right person running it.

They may have a very nice person running it, but they could do better. But who's going to make a change?

And that's the position that the nonexecutive chairman, in this case, Howard, will be in. And I know of nobody that will feel that responsibility more in terms of doing that job as it should be done than my son, Howard, you know.

CHARLIE MUNGER: Yeah. I think the Mungers are much safer — (applause) with Howard there.

You've got to remember, the board owns a lot of stock, you know. We're thinking about the shareholders. We're not trying to gum it up for the shareholders.

WARREN BUFFETT: Yeah. After my death, whatever it may be in terms of value then, but it would be $50 billion worth of stock, will, over a period of time, go to help people around the world and it makes an enormous difference, you know, whether the company behind that stock is doing well or not.

And both Charlie and I have seen — we've seen some — more than one example — of where a CEO who might be a six on a scale of 10, and is perfectly likable and has, perhaps, helped select some of the directors that sit there, and continues to run the business year after year when somebody else could do it a whole lot better.

And it can be hard to make that — very hard — to make that change if that person controls the agenda and, you know, keeps everybody busy when they come into town for a little while.

CHARLIE MUNGER: You can have a CEO that's nine out of 10 on everything but with deep flaws, too.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: It helps to have some objective person with a real incentive sitting in the position Howard will be in.

WARREN BUFFETT: The example I've used in the past, I mean, that — you know, that blessed are the meek for they shall inherit the earth, but after they inherit the earth, will they stay meek?

Well, that could be the problem, you know, if somebody got named CEO of Berkshire. It could be a position where people might want to throw their weight around in various ways.

You may have noticed that in the annual report, in terms of our newspapers, I said, you know, I am not going to be telling them who to endorse for president. Ten of them endorsed Romney and two endorsed Obama. I voted for Obama, but I'm not going to change that.

But when I write that sort of thing, I'm trying to box in my successor, to some degree, too, and we do not want somebody using Berkshire Hathaway as a power base in the future. We want them to be thinking about the shareholders. It's that simple.

CHARLIE MUNGER: Sometimes somebody becomes CEO who has the characteristic of a once-famous California CEO, and they used to say about him he's the only man who could strut sitting down. (Laughter)

21. Near-zero rates "brutal" for bonds

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Hi. I'm Brad Johnston from Minneapolis, Minnesota.

And my question is within the context of a very low interest rate environment that may be sustained for some time and the challenge that insurance companies are facing in that environment with respect to managing their capital, as well as managing their risk and uncertainty when they have future liabilities and potentially the need for liquidity.

And maybe you could transcend that down to the individual, as well, who is dealing with a low interest rate environment, trying to manage uncertainty and yet still get some cash return from investments.

I appreciate your concept of selling, you know, some of your shares periodically and being better off to do that rather than take dividends, but many people are dealing with the challenges of cash flow.

WARREN BUFFETT: Yeah.

AUDIENCE MEMBER: And then — and just one final tag-on. If you could at the end, could you explain what Federal Reserve Chairman Ben Bernanke believes he has as a tool in his toolbox called the "term credit facility"?

WARREN BUFFETT: No. The answer is I can't. Can you, Charlie?

CHARLIE MUNGER: No.

WARREN BUFFETT: The problem faced by people who have stayed in cash, or cash equivalents, or short-term Treasurys, or whatever, I mean, it is brutal.

The loss — if they live off their income, you know — the loss of purchasing power, it's just staggering when you get into these low interest rates. They are huge victims of a low-interest policy and a dramatically low-interest policy, you know.

Basically, you know, I've written — I wrote back in 2008 to own equities. I mean, it was — equities were cheap.

And you were almost certain to get killed, you know, in terms of — for at least a while — we had a promise that the Fed was going to hold rates very low, so it was a great time to own equities.

And I feel sorry for people that have clung to fixed-dollar investments, particularly short-term ones, during a period like this, and I don't know what I would do if I were in that position.

Imagine having, you know, some sum that seemed like a very large amount of money in the past but, you know, a quarter of a percent on a million dollars is $2,500 a year, and that is not what people anticipated when they were saving over the years.

So I — well, anybody I've advised, I've always felt that owning businesses certainly made sense — more sense — than fixed dollars, under most circumstances.

Not every time in my life, but probably 90 percent of the time in my life, it's made more sense than owning fixed-dollar investments. And it's certainly made dramatic sense a few years ago when equities were marked down to where they were, you know, terrific buys, and where you could see the prospect that fixed-dollar investments were going to pay very little for a considerable period of time.

And I didn't anticipate that we would see the kind of rates for the extended period that we have already, and I don't know how long it will go on.

But it's a real dilemma for people. I get letters — I get a lot of letters — from people that say, you know, "I've got $300,000," and they say, "What should I do?"

So it's — the fallout from low interest rates has hit millions of people in a very harsh way. And you don't read much about it and they don't have much of a voice, but it's been a good argument for owning productive assets rather than dollars during a period like this.

Charlie?

CHARLIE MUNGER: Well, they had to hurt somebody, and the savers were convenient.

WARREN BUFFETT: What would you do about it?

CHARLIE MUNGER: I would've done about what they did.

WARREN BUFFETT: Yeah, so would I.

CHARLIE MUNGER: I would've felt bad about it, but I would have — that's what I would have done.

22. IBM's competitive moat

WARREN BUFFETT: OK. Station 8. We're now going to the shareholder base. We've gone through the panels, and we've got about 45 minutes left and so we're going to give the shareholders a chance to ask — answer — to ask all the questions — maybe answer them — ask all the questions from this point.

Station 8.

AUDIENCE MEMBER: Hi. Chris Hu (PH) from Tokyo, Japan.

Can you talk a little bit more about the IBM investment? Where do you see the moat for that business? And just in the spirit of full disclosure, I work for Microsoft.

WARREN BUFFETT: Yeah. Was your — what was your — the moat about which business?

AUDIENCE MEMBER: IBM.

WARREN BUFFETT: Oh, IBM. Well, I would say that I do not understand the moat around an IBM as well as I understand the mode around a Coca-Cola. I think I have some understanding of it, but I feel I would have more conviction about the moat around a Coca-Cola, or a Wrigley or a Heinz, for that matter, than an IBM.

But I feel good enough about IBM that we've put a considerable amount of money in it. And there's nothing that precludes both Microsoft, which you mentioned, and IBM being successful. In fact, I hope they both are.

We — I've got enough conviction about IBM's position that we took a very large position.

I like their financial policies. I think the odds are good that their position is maintained in a strong way over time, but I don't feel the same degree of conviction about that as I do about the BNSF railroad. I mean, you know, it's very hard for me to think of anything that could go wrong with BNSF. I could think of some things that could go wrong with IBM.

They, incidentally, have a very large pension obligation. Now, they have a large pension fund, too, but you're talking 75 or $80 billion of assets and liabilities that, you know, is a big — it is a big annuity company on the side.

And you can have — balls can take funny bounces in the annuity field. I would rather they didn't have that, but that is a fact that I take into consideration when I buy. They show the assets and liabilities of being roughly equal, but the liabilities are a lot more certain than the assets over time.

Charlie?

CHARLIE MUNGER: Yeah. Well, at least the IBM pension plan has the resources of IBM. Suppose you're a big life insurance company now. All over the world, the life insurance companies have started to suffer the tortures of hell.

In Japan, they agreed to pay 3 percent interest, and, of course, there was no way to earn 3 percent interest once the Japanese policies had been in place a long time.

A whole lot of once revered, secure places look unsecure now.

And around Berkshire, you'll notice the life operations are — where we have our own policies as distinguished from reinsurance — are pretty small, right?

WARREN BUFFETT: Yeah. We do not like giving options in this world, and people tend to — well, particularly they've got a sales force pushing them on, as you have in the life insurance industry. They have tended to give people options that have, in certain cases, cost them huge amounts of money.

It's — you know, you always want to accept an option; you never want to give an option. But the life business is in just the reverse side of that.

Actually, the mortgage business — I mean, you know, Charlie and I were in the savings and loan business. The idea of giving somebody a 30-year mortgage where they can — if it's a good deal for you — they can call it off tomorrow, and if it's a good deal for them, they keep it for 30 years.

Those are terrible instruments. They're good for you if you're buying a house, and I recommend that you — I recommend everybody in this room get a 30-year mortgage immediately on a house for all they can.

If it's a bad deal and rates go to 1 percent, you can refund it. If rates go to 6 or 7 percent, maybe you can buy it back for 70 cents on the dollar or something of the sort.

So the life companies have engaged in that big time — big, big time — in the last few decades, and a lot of them are paying the price, and some of them haven't even realized exactly quite what the problems are.

They're kind of like the fellow in the switchblade fight, you know, where the other guy takes a big swipe at him with a switchblade and the fellow says, "You didn't touch me," and the other guy says, "Well, just wait until you try and shake your head." Well, that's a little bit like where some of the life companies are right now.

Charlie? Anything further, Charlie?

CHARLIE MUNGER: No, that's gloomy enough.

23. Investing with much smaller amounts of money

WARREN BUFFETT: OK. Station 9. (Laughter)

AUDIENCE MEMBER: Hi. My name is Masato Muso. I'm from Los Angeles, California, and an MBA student at Boston University.

You have mentioned that you are 85 percent Benjamin Graham and 15 percent Phil Fisher, and you have also said that if you only had $1 million today, you could generate 50 percent returns.

Since I'm a young investor, this is my question for the both of you: how was your investment strategy different when you were still accumulating money as opposed to managing billions?

Did you focus on specific industries, small cap, large cap, et cetera? Thank you.

WARREN BUFFETT: Well, managing a million dollars is an entirely different game than running Berkshire Hathaway, or running some 20 or $50 billion fund of money.

And if Charlie and I were running a million dollars now or 100,000 or — we would be looking in some — we'd be looking at some — probably some very small things. We would be looking for small discrepancies in certain situations.

And the opportunities are out there, and periodically, they're extraordinary.

But that's something we really don't think about anymore because our problem is handling 12 or 14 billion, or whatever it might be, coming in every year, and that means we have to be looking for very big deals and forget about what we used to do when we were very young.

Charlie?

CHARLIE MUNGER: Yeah. I'm glad I'm through with that particular problem. (Laughter)

WARREN BUFFETT: He worked pretty hard at it when —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: We both did.

CHARLIE MUNGER: Did we ever.

WARREN BUFFETT: Yeah, yeah. We looked under a lot of rocks, and —

CHARLIE MUNGER: I used to make big returns on my float on my own income taxes. Between the time I got the money and I paid it to the government, I frequently made enough money to pay the tax. It was working for small amounts of money and doing it on most things.

WARREN BUFFETT: He didn't tell me how to do it, though. (Laughs)

24. Don't invest in countries or categories

WARREN BUFFETT: OK. Station 10.

AUDIENCE MEMBER: Hi, Warren and Charlie. This is Andy Ling (PH) from Shanghai, China.

Thank you very much for what you have said and what you have done. People around the globe have benefited a lot from your philosophies, so you have fans — even a lot of fans — even in China.

My question is: how did you see investments in emerging markets where Berkshire is spend its investments in places like China? If yes, what kind of industries and companies you are interested in? Thank you.

WARREN BUFFETT: Yeah. We don't really start out looking to either emerging markets or specific countries or anything of the sort.

We may find things, you know, as we go around, but it isn't like Charlie and I talk in the morning and we say, you know, it's a particularly good idea to invest in Brazil or India or China or whatever it may be. We've never had a conversation like that, have we, Charlie?

CHARLIE MUNGER: No.

WARREN BUFFETT: It just won't happen.

We don't think that's where our strength is. We know that our strength is not there. And we think, probably, most people's strength isn't there either. I mean, it sounds good, but I don't really think it's the best way to look at investments.

If you told me that we can only invest —

We're perfectly willing to do it. We owned a lot of PetroChina at one time. We own some BYD now. We've owned securities outside the United States and will continue to.

But if you told us that we could only invest in the United States the rest of our lives, we would not regard that as a huge hardship, would we, Charlie?

CHARLIE MUNGER: Yeah. It's a great way to sell investment advice, to have a whole lot of different categories, lots of commissions, lots of advice, lots of action.

And a lot of things we just — we don't feel we've got enough of an edge so that we want to play.

WARREN BUFFETT: Yeah. When we hear somebody talking concepts, of any sort, including country-by-country concepts or whatever it might be, we tend to think that they're probably going to do better at selling than at investing.

It's just such an easy way — I mean, it's what people expect to hear when — you know, when somebody comes calling that, you know, today we think you ought to be looking at this or that around the world.

The thing to do is just find a good business at an attractive price and buy it.

CHARLIE MUNGER: Our experts really like Bolivia. And you say, "Well, last year you liked Sri Lanka." It's just — we're not comfortable with that.

WARREN BUFFETT: Yeah. And we usually think it's a lot of baloney, but —

CHARLIE MUNGER: That's why we're not comfortable.

WARREN BUFFETT: Yeah. (Laughter)

25. Washington not solely to blame for housing bubble

WARREN BUFFETT: OK. Station 11.

AUDIENCE MEMBER: Hello, Mr. Buffett, and Mr. Munger. My name is Brandt Hooker from Los Angeles.

I want to thank you both, first of all, for all the years of advice and your financial philanthropy, as well as your education and/or knowledge philanthropy you've given to so many investors around the world.

And my question is: the U.S. government was seemingly complicit in enticing the American public to buy a home, and, therefore, a mortgage, at any cost. Do you think our legislators are doing the same thing now, and are we creating a bubble?

WARREN BUFFETT: No. I don't think we're remotely near a bubble, in terms of housing, now.

And I certainly think that your statement is accurate but not complete, in terms of what went on before.

I mean, the whole country, almost, every — really kind of went crazy in terms of housing. And the government was a very big part of it because they're a very big part of the financing of it. And it's certainly true that plenty of legislators were encouraging Freddie and Fannie to be doing things that they shouldn't have been doing, not just in retrospect. I mean, if you looked at it at the time, you could come to that conclusion.

But there were an awful lot of people doing the same thing. I mean, it was coming from all sources. And it had that aspect to it, which bubbles do, where year after year for three or four or five years, whatever it might be, that the skeptics looked like idiots and that the people who jumped on the bandwagon were the ones that were refinancing their houses at ever higher prices and people who were speculating on other houses.

So it just looked all so wonderful. And people are really susceptible to that sort of bandwagon effect where they see their neighbors making easy money, everybody's making easy money but them, and they finally succumb.

It's just — it's the nature of things. And it doesn't mean the people at Freddie or Fannie were necessarily evil — a few of them were — or that legislators, necessarily, were evil, although, again, a few of them probably were. But overwhelmingly, I think most people just get caught up in a grand illusion.

And, you know, it's happened many times in history, it'll happen again, and you can use that very much to your profit.

We're not in that kind of a period now on housing. You've got very, very low interest rates, which support, in many cases, the purchase of houses, because it brings down the payments, obviously.

But I personally, about a year ago, I mean, I recommended to people that they buy houses, and I certainly recommend to people that they finance them now.

And most places I would recommend if you find a — if you're going to live in the community for some time and you find a house that fits your needs, I think it's probably a very good time to buy it, in part because the financing is so unbelievably attractive.

Charlie?

CHARLIE MUNGER: Well, the main problem was that as things got crazier and crazier, the government could've intervened by pulling away the punch bowl before everybody was totally drunk, and instead, the government increased the proof.

And this was not a good idea. But you — it's hard to get governments in a democracy to be pulling away the punch bowl from voters who want to get drunk.

WARREN BUFFETT: Well, it's almost impossible.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. I mean, it isn't —

CHARLIE MUNGER: So you're complaining a little bit about what's sort of inevitable in life. Not too good an idea.

WARREN BUFFETT: Yeah. You'll see it again, not necessarily in housing, but you will see it.

And humans will continue to make the same mistakes that they have made in the past.

I mean, they get fearful when other people are fearful. I mean, that's — you saw it in those money market funds when 175 billion, you know, flowed out in three days. I mean, everybody gets — when people get scared, you know, they — it's very, very pervasive.

I've often thought that, you know, if I owned a bank in a two-bank town, you know, I'd — if I were inclined to — I might hire a whole bunch of Hollywood extras to form a line in front of the other guy's bank. (Laughter)

The hell of it is that they — you know, as soon as they got through forming a line there, they'd start forming a line at my bank because they — people really get — they get fearful en masse.

Confidence comes back sort of one at a time, but when they get greedy, they get greedy en masse, too.

I mean, it just — it's just the way the humans are constructed. That's where Charlie and I have an edge. We don't have an edge, particularly, in many other ways.

But we are able, I think, perhaps better than most, to not really get caught up with what other people are doing. And, you know, I don't know whether we learned that over time or what.

But when we see falling prices, you know, we think it's an opportunity to buy, and it doesn't bother us.

Now, we don't own things on margin or, you know, we don't get ourselves in a position where somebody else can pull the rug out from under us. That's enormously important in life. You never want to, you know, get out on a limb.

And, of course, leverage gets very tempting when things are going up. And leverage was what was introduced into housing in a huge, huge way. I mean, people just felt that you were an idiot if you didn't keep borrowing more on your house, and using that to buy more houses, or using it to live on, or whatever, and then finally the roof fell in.

Charlie?

26. Ready to invest in Europe despite its debt problems

WARREN BUFFETT: OK. Station 1.

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. My name is George Islets (PH) from Cologne.

Do you see investment opportunities in the eurozone? For example, extending your stake in Munich Re?

Do you trust in the policy of the ECB to bring the things together? Thank you.

WARREN BUFFETT: Yeah. Well, we're perfectly willing to look at business opportunity in the eurozone, and we bought a couple of bolt-on acquisitions, one for a couple hundred million in the farm equipment area. And we'll be happy if we find a business in any one of the 17 countries tied to the euro.

There might be a few of them we may be a little less inclined than others. (Laughs)

But — you know, it may create opportunities for us to buy businesses. We'd be happy to. Europe is not going to go away. But the European monetary union was — you know, had a major flaw, and they're grappling with a way to correct that flaw.

And with 17 political bodies and a lot of diverse cultures, it's really tough for them to do so.

They'll do it in time, in my view. But essentially they synchronized a currency without synchronizing much else.

And nature finds the fatal flaw always, and so does economics, and they found it fairly quickly, in terms of the euro. And the structure that was put in place will not work, and they'll have to find something that does work.

And they will, eventually, but they may go through a fair amount of pain in the process.

Charlie?

CHARLIE MUNGER: Yeah. Structured as Europe was structured, letting in Greece into the European Union was a lot like using rat poison as whipping cream. (Laughter)

It just — it was an exceptionally stupid idea. (Laughter)

It's not a responsible capitalistic country, a place where people don't pay taxes and so on and so — it just — and —

WARREN BUFFETT: I've tried for years to get him to use 'Country A' and 'Country B,' but he — (Laughter)

CHARLIE MUNGER: — and committed fairly extreme fraud in the course of getting into the union. They lied about their debt.

And so Europe made terrible mistakes. They have politicians, too. (Laughter and applause)

WARREN BUFFETT: You think it'll be behind them in ten years?

CHARLIE MUNGER: I think Europe will muddle through.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: Think what Europe has already muddled through.

WARREN BUFFETT: But we would be delighted, even with that dire forecast, not overly — we would be delighted, tomorrow, to buy a big business in Europe that we liked, and we'd pay cash for it.

CHARLIE MUNGER: I hope you'll call me if it's in Greece. (Laughter)

WARREN BUFFETT: I make these small suggestions, but you can see it doesn't help much. (Laughs)

27. Social media will help some Berkshire businesses

WARREN BUFFETT: OK. Station 2.

AUDIENCE MEMBER: Hi. I'm David Yarus (PH) from Miami Beach, Florida.

On behalf of the internet, welcome to Twitter.

And my question is: how has social media impacted your business and any Berkshire companies, and what impact do you see it having on the world in the short and long term?

WARREN BUFFETT: Probably half the people or more in this audience could answer that question better than I can.

It has — certainly in a place like GEICO, you know, we are — it makes a difference, and over time will make a huge difference in marketing, just as the internet made a change.

I mean, GEICO was founded in 1936 and it had a great business idea of going direct, but it did it entirely by mail, initially, and it worked very well.

And then it progressed to — as the world changed, it, you know, went to TV advertising and phone numbers and that sort of thing, and then it went to the internet, and now it goes on to social media.

So, you know, we have to listen to our customers in all our businesses. Some of them it's much more dramatic than others.

And I've been amazed, you know, at how fast the world has changed. I thought the internet, for example, in terms of GEICO, would affect younger people very quickly, in terms of their buying habits.

But the truth that it spread across the entire age range very, very quickly, a huge change. And you have to respond to that. And I am not the best person, by miles, to do that, but we have people that are very good at it at our businesses, and they're thinking about it plenty, and they'll continue to think about it.

But it would be a terrible mistake to put me in charge of social media at Berkshire Hathaway. (Laughter)

And Charlie would not be a particularly good choice, either. (Laughter)

Charlie, do you want to defend yourself, or —

CHARLIE MUNGER: Well, I don't understand it very well. For very good reason, I avoid it like the plague.

And I hate the idea of the teenagers in my own family immortalizing for all time the three dumbest things they said when they were 13. (Laughter)

WARREN BUFFETT: We would have been in big trouble, Charlie. (Laughs)

CHARLIE MUNGER: We would have been in big trouble, both of us, if that were the system.

And so I think there's a time when your ignorance and folly ought to be hidden. (Laughter and applause)

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I also think that when you multitask like crazy, like the young people do, none of the tasks is likely to be done well. (Applause)

WARREN BUFFETT: Is there anyone we've forgotten to offend? (Laughter)

28. Frauds, crooks, and accounting

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Hello. My name is Stuart Kaye (PH) and I work in Stamford, Connecticut.

Earlier in the meeting, you said when reading over financial statements, you identified companies you were virtually certain were frauds.

What was it in those financial statements that you saw that made you be so certain they were frauds?

WARREN BUFFETT: Well, it varies just enormously over the years, but there are — we can't identify 100 percent of the frauds, or 90 percent, or 80 percent, but there are certain ones that jump out to you, just — people give themselves away a lot, too.

I mean, in poker they talk about tells. And Charlie and I have bought a lot of businesses, and it's very important when we buy those businesses that we assess the individuals that we're buying from with some degree of accuracy.

Because, you know, they hand us the stock certificate and we hand them a lot of money, and then we count on them to run the business with as much enthusiasm after they have the money as they did before.

And so we are assessing people. And we don't think we can assess everyone accurately. We just have to be right about the ones where we make an affirmative decision.

And those decisions have not always been perfect, but they've been pretty good. And I would say they've probably gotten a little bit better, even, as the years have passed.

Similarly, in looking at financial statements — for example, in the insurance field, we've seen some frauds, and they're — you can see things being done with loss reserves occasionally. We saw it back in — I won't name any names. Unlike Charlie, I don't — we'll call them Company As and Bs instead of naming names.

But you would see companies that, when they were offering stock to the public, you know, the year or two before that, the reserves would be down very suspiciously, and — you know, then — or even when they were selling them to other insurance companies, if they were buying in stock they might be building the reserves.

But there's a million different ways. And I don't claim I know all the ways, obviously, but I have seen enough situations over the years, and I've seen how promoters act. And you can spot certain people who you know are, one way or another, playing games with the numbers. They give themselves away.

But I can't give you a checklist of 40 items or something of the sort that you look for in the balance sheet or the income account or the footnotes.

Charlie, can you help?

CHARLIE MUNGER: Sometimes it's pretty obvious. I once was introduced by Warren, of all people, by accident, to a man who wanted to sell us a fire insurance company. One of the first things he said, with a thick accent, from Eastern Europe, I think —

WARREN BUFFETT: Don't name countries. (Laughter)

CHARLIE MUNGER: And I don't remember the country.

WARREN BUFFETT: Good. (Laughter)

CHARLIE MUNGER: But what he told me was — he says, "It's like taking candy from babies," he said.

"We only write fire insurance on concrete structures that are underwater." And I figured out instantly that it was probably fraudulent.

WARREN BUFFETT: The guy's a crook.

CHARLIE MUNGER: I'm a very acute man.

WARREN BUFFETT: Yeah, the guy's a crook.

Well, you actually — you had some experience — you know, he was a lawyer in the movie industry. (Laughs)

CHARLIE MUNGER: Oh, my God.

WARREN BUFFETT: Yeah. The — when you get into accounting for — well, movies are a good thing, in terms of how fast you write off properties, and anything where you've got construction in progress or progress payment-type things — there's so many ways you can cheat in accounting.

And financial institutions are particularly, probably, prone to it. And there's been plenty of it in insurance.

CHARLIE MUNGER: A lot of it, they're not being deliberately fraudulent, because they're deluded. In other words, they believe what they're saying.

WARREN BUFFETT: Yeah. People like to hire them as salesmen. (Laughter)

If you've got doubts, forget it. There's probably some reason you —

It's interesting. The accounting — they worked harder and harder and harder at coming up with disclosures in accounting. And I'm not sure I find present financial statements more useful or, in some cases, as useful as I found them 30 or 40 years ago. (Scattered applause)

Charlie?

CHARLIE MUNGER: Well, I think the financial statements of big banks are way harder to understand now than they used to be. They just do so many different things, and they've got so many footnotes, and there's so much gobbledygook, that it doesn't — they're not my grandfather's banks.

WARREN BUFFETT: Well, we couldn't understand them when we owned them.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: I mean, we bought a company that — Gen Re — where they had 23,000 derivative contracts. And Charlie and I could've spent 24 hours a day, and had the help of 10 or 20 math Ph.Ds. and we still wouldn't have known what was going on.

It cost us about $400 million to find out, but — and that was in a benign market. But nobody can.

CHARLIE MUNGER: And the accountants had certified the balance sheet.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: It's a new kind of asset I invented a name for. I said, "Good until reached for." (Laughter)

WARREN BUFFETT: Yeah. Well, and you would — you would actually — the same auditing firm would be auditing two different companies that are on the opposite side of a derivative transaction and attesting to different values to the same contract.

And Charlie found one mistake at Salomon on a derivative contract. What was it, 20 million?

CHARLIE MUNGER: No. It was a big contract, and both sides reported a large profit, blessed by their accountants, on the same contract —

WARREN BUFFETT: Kind of like us and Swiss Re.

CHARLIE MUNGER: — just for breaking it.

Once people get in a competitive frenzy, things just go out of control.

WARREN BUFFETT: I became the interim chairman of — interim CEO — of Salomon in 1991, and, fortunately, I testified to both the House and Senate committee before I found this out.

And, generally speaking, incidentally, Salomon wanted to have conservative accounting. I think that would be a fair statement. And in many cases did.

But they did come in to me one day and they said, "Warren, you probably should know that we have this item" — and I think it was around 180 million or something like that — with a capital base of 4 billion, maybe — but 180 million.

And they said, this is a plug number, and we've been plugging it ever since Phibro merged with Salomon in 19 — I guess, '81.

For ten years, this number moved around every day. And as I remember, Phibro or some — one of them was on a trade date system, and that was on a settlement date system.

And in ten years, with Arthur Andersen as their accountant, paying a lot of money in auditing fees, they just never figured out how the hell to get the thing to balance, so they just stuck a number in every day.

And they literally plugged it for ten years, and I couldn't figure out how to unplug it myself. I mean, it was — you almost had to start over. Didn't they do that one time out there?

CHARLIE MUNGER: We did that, Warren.

WARREN BUFFETT: Right. (Laughs)

CHARLIE MUNGER: We had a discrepancy when we changed accounting systems in our savings and loan, and none of the accountants could fix it. So we just let it run out.

WARREN BUFFETT: Yeah, we let the account —

CHARLIE MUNGER: We just let the account run out, and then —

WARREN BUFFETT: Figured we'd start over again.

CHARLIE MUNGER: We started over, right.

WARREN BUFFETT: Accounting is not quite the science that people might want you to —

CHARLIE MUNGER: In accounting, you can do things like they do in Italy when they have trouble with the mail. You know, it piles up and irritates the postal employees. They just throw away a few carloads — (laughter) — everything flows smoothly thereafter.

WARREN BUFFETT: You're naming names again, folks. (Laughs)

That happened in some unnamed international country. (Laughter)

CHARLIE MUNGER: Yeah, Italy. (Laughter)

29. Would Berkshire invest in sub-Saharan Africa?

WARREN BUFFETT: OK. Section 4.

AUDIENCE MEMBER: Good afternoon. My name is Jerry Lucas (PH) from Newark, Delaware.

You answered the question earlier about emerging markets. I just have a similar question.

If you found the business that attracted you in sub-Saharan Africa, outside of South Africa, are the conditions right today to make that investment?

WARREN BUFFETT: Well, I might not know enough to do it myself, but I think — and I wouldn't rule — if it was attractive enough and I thought I understood the nature of the business, I would probably get some advice from some other people. And I might not end up doing it, but I wouldn't totally preclude it.

CHARLIE MUNGER: I saw that done. The University of Michigan hired an investment manager in London who specialized in sub-Saharan Africa. And I thought, "My God, how are they doing this?"

What they did is the little banks would trade in the pink sheets in Africa, and the first thing people would want was not to have the money under their pillow, and they just bought all the little banks in Africa, and they made a lot of money.

So it is possible, if you know what you're doing, to go into very unlikely places. I would say we're not very good at it.

WARREN BUFFETT: No, that isn't our specialty, but it can be done. And if we were poor enough, we might even be thinking about doing it, right, Charlie?

CHARLIE MUNGER: I don't think so.

WARREN BUFFETT: OK. (Laughter)

Next year we'll prepare for this. (Laughter)

30. Read over your will with your adult children

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: Hello. I'm Marvin Blum from Fort Worth, Texas, the home to four of your companies.

WARREN BUFFETT: Absolutely. We love Fort Worth.

AUDIENCE MEMBER: Thank you. We love you, too, and your presence in our community.

I'm an estate planning lawyer, and it's interesting as we wrap up today to ponder that the Baby Boomer generation is about to pass along the greatest transfer of wealth in history.

I can design plans that eliminate estate tax and pass down great amounts of wealth to the next generation, but many of my clients come to me and say they want a plan like Warren Buffett's, leaving their kids enough so they can do anything, but not so much that they can do nothing.

Now they ask me, and I'm asking you, how much is that, and how do you keep from ruining your kids?

WARREN BUFFETT: Yeah. Well.

(Applause)

I think more kids are ruined by the behavior of their parents than by the amount of the inheritance. (Applause)

Your children are learning about the world through you, and more through your actions than through your words, you know, from the moment they're born. You're their natural teacher, and, you know, it's a very important and serious job.

And I don't think — I don't actually think — that the amount of money that a rich person leaves to their children is the determining factor, at all, in terms of how those children turn out. But I think that the atmosphere, and what they see about them, and how their parents behave, is enormously important.

I would say this: I've loosened up a little bit as I go along.

Every time I rewrite my will, my kids are happy because they know I'm not reducing the amount, anyway. (Laughter)

And I do something else that — I find that — which I think is an obvious thing, but it's amazing to me how many don't do it.

I think that your children are going to read the will someday — that's assuming you're a wealthy person — your children are going the read the will someday.

It's crazy to have them read it after you're dead, for the first time. I mean, you're not in a position to answer questions then unless the Ouija board really works or something of the sort.

So if they're going to have questions about how to carry out your wishes, or why you did this or that, you know, why leave them endlessly wondering after you die?

So in my own case, I always have my children — I rewrite a will every five or six years or something like that — and I have them read it.

They're the executors under it. They should understand how to carry out their obligations that are embodied in the will, and they should — also, if they feel there's anything unfair about it, they should express themselves before I sign that will, and we should talk it over, and we should figure out whether they're right or I'm right, or someplace in between.

So I do think it's very important in wealthy families, once the kids are of a certain age. I mean, I don't advise doing this with your 14-year-old or something, but when they get — you know, certainly by the time they're in the mid-30s or thereabouts — I think they should be participants in the will.

And I do think that if you get to be very wealthy that the idea of trying to pass on, create a dynasty of sorts, it just sort of runs against the grain, as far as I'm concerned.

And the money has far more utility — you know, the last hundreds of millions or billions have far more utility to society than they would have to make — create a situation — where your kids don't have to do anything in life except call a trust officer once a year and tell them how much money they want.

Charlie?

CHARLIE MUNGER: I don't think I want to go into this one.

WARREN BUFFETT: OK.

CHARLIE MUNGER: And I'm absolutely sure you don't want to discuss your will with your children if you're going to treat them unequally.

WARREN BUFFETT: No.

CHARLIE MUNGER: That is poison.

WARREN BUFFETT: But there — one of the problems you have — I mean, and what you want to discuss just for that very situation is there may be circumstances where one child will have much more of an interest in one type of asset than others, or something of the sort.

And you want to make sure that your definition of equality, in terms of handling different kinds of assets, meshes, or at least is understood, by the children so that they don't think the fact that you may gave one a farm and another a house or something of the sort resulted in inequality when you thought it was equality.

Charlie, you got anything?

CHARLIE MUNGER: No. I'm —

WARREN BUFFETT: He's staying away from this one.

31. No question from station 6 — Buffett's happy

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: No question.

WARREN BUFFETT: No questions. I like station six. (Laughter)

32. Don't hold your breath until …

WARREN BUFFETT: Station 7.

AUDIENCE MEMBER: Mr. Buffett, Mr. Munger, thanks for everything that you do for us, including advice that you give us, and also for — as an individual investor — for the things that you've done for me.

I have a question. You've long been against stock splits, but as you think about the Berkshire A share and one day can — if you don't split it — it can get to a million dollars, is the board thinking about how to deal with that, in terms of getting new stock owners, the ownership structure, and so on?

WARREN BUFFETT: Well, I — we actually — I think we've got a pretty good arrangement now.

It evolved, originally, through some people that were going to try and make a lot of money off of our shareholders by creating their own split shares, so we created the B shares.

And then when the BNSF acquisition came along, we wanted to be sure that people that wanted to have a stock-free exchange, or that wanted to get shares, would not prohibit it simply because they had a small amount of BNSF, and, therefore, our B shares were too expensive.

So I think now with one stock, you know, in the $100 range, people can split the — people that own the A stock can split their stock anytime they wish.

And we've always pledged that there won't ever be this situation, but if there was some corporate transaction or anything like that, we will — the A and B will get treated identically.

And so I really see no reason to change the present situation.

Charlie?

CHARLIE MUNGER: I would not hold your breath until we change. (Laughter)

WARREN BUFFETT: That may apply to almost anything in our lives.

Morning Session - 2014 Meeting

1. Buffett's "second career" with singer Paul Anka

WARREN BUFFETT: Thank you. (Applause)

Good morning. Before we start, there are two very special guests that I'd like to introduce, have stand up.

The first, even though he was on tour, he took a quick detour to Omaha to be here today. And will my friend [singer-songwriter] Paul Anka please stand up. Paul? (Applause)

With all the talk that had been around about my succession, I thought it was probably a good idea to try and hook up with someone famous that might give me a shot at a second career here. (Laughter)

So we're available for weddings and funerals and bar mitzvahs. (Laughter)

We actually had one offer the other day. I thought it was kind of insulting. They offered $1,000. And, I mean, for me and Paul, that really seemed a little ridiculous.

I told the people that and they said, "OK. We'll make it $10,000 if just Paul comes." (Laughter)

2. Berkshire's Carrie Sova introduced

WARREN BUFFETT: Now we have one other very special guest.

This affair does not just happen by itself.

And there's a young woman who had a baby, a young boy named Brady, in September. And she has marshaled together 400-plus of the people from our various companies and put on the show you're witnessing today.

And I just want to say a special thanks to the woman we all love, and especially me, Carrie Sova. Carrie? (Applause)

Please stand up. There she is. (Applause)

3. Berkshire directors introduced

WARREN BUFFETT: OK. Now we get down to the minor players and we'll introduce the board of directors. (Laughs)

We’re going to have the — we’ll have the board meeting — the shareholders meeting, I should say — after the Q&A, which will end at 3:30. And then we’ll recess for 15 minutes. And at 3:45, reinstitute the — or begin — the shareholders meeting.

But for those of you who won’t be around at 3:45, I’d like you to have a chance to meet the directors now.

So, I will introduce them one at a time and ask them to stand. Hard as it may be, withhold your applause until they’re all finished standing, and then you can go crazy.

So, doing it alphabetically, and if you’ll stand as I give your name.

Howard Buffett, Steve Burke, Sue Decker, Bill Gates, Sandy Gottesman, Charlotte Guyman, Don Keough, my partner Charlie Munger, Tom Murphy, Ron Olson, Walter Scott, and Meryl Witmer.

And that is the board of directors at Berkshire. (Applause)

4. Berkshire’s Q1 earnings summary

WARREN BUFFETT: We have just a couple of slides and then we’ll move right into the questioning, which will go on until roughly at noon.

We’ll take a break at noon and come back about 1:00, and then we’ll continue till 3:30, at which point we’ll adjourn and then have the annual meeting at 3:45.

But, there are just a couple slides. We released our earnings yesterday.

And I’ve always emphasized — we try to release our earnings always after the market’s closed, and, preferably, after the market’s closed on a Friday, so that people will have a full weekend to digest the information, because there’s a lot of information about Berkshire every quarter. And it’s contained, primarily, in a 10-Q that we make available for you to read over the full weekend.

So we always urge you not to just look at the summary figures, but take a look at the 10-Q. It’s great reading. And absorb all that by Monday morning.

But here we have the summary for the first quarter.

And as you can see, our operating earnings were down a bit. And that was more than accounted for in insurance underwriting. And you should understand that insurance underwriting from quarter to quarter really doesn’t mean that much.

For one thing, it can be quite affected by changes in foreign exchange, which really don’t have anything to do with our insurance business. But — or at least in the reality of interim results.

Our insurance business now has a float of $77 billion. And that $77 billion is ours to invest. And whether it costs us anything or not is determined by whether we have an underwriting profit.

So even though our underwriting profit in the first quarter was quite satisfactory, but nevertheless down from the first quarter of last year, the insurance business is marvelous for us.

And if we even break even, that $77 billion, which is subtracted from net worth, I mean, it's a liability on the balance sheet, but if it's cost free, it really does us about as much good as net worth itself does. So it's a very remarkable business.

And frankly, if we average an underwriting profit over the years, I'll be very happy and you should be very happy with what our insurance business does for us.

But it was down in the first quarter. And, like I said, that more than accounted for the decline in earnings.

We always advise you to pay little — pay no attention, really — to quarterly or even annual realized gains or losses in securities because we make no attempt to time the sales of securities to produce earnings in any given quarter.

We just try to manage the money as well as we can. And we let the chips fall where they may, in terms of whether those actions produce gains or losses in the short term.

We hope that they produce a lot of gains over the longer term, and they have.

But they should be ignored in attempting to interpret our shorter-term earnings.

5. Buffett praises shareholders for rejecting dividend proposal

WARREN BUFFETT: With that, I would like to give you a little preview of a vote that has taken place and which we will talk more about when we get the shareholders meeting.

But it's so remarkable, that I wanted to put it up for all of you to look at now.

As you know, we had a shareholder resolution. Yeah, it's up there.

We had a shareholder resolution, rather elegantly stated, that suggested that we pay a dividend. And with the sort of subliminal suggestion that we weren't paying it because I was so rich that I could live in this grand style to which I've become accustomed, without a dividend, but that the shareholders were out there essentially bereft of the necessities of life because we were holding all the money here in Omaha. (Laughter)

So this gentleman put this on the ballot. And if we'll go to the next slide, you'll see some remarkable figures.

Bear in mind that, you know, you people get these proxies at your home or at your office. And you can mark anything you want.

We hire no proxy solicitation firms. So we are making no calls. We make no attempt to influence how anybody votes. We just count them as they come in.

And as you'll see at the top, among the Class A shares, the vote was roughly 90-plus-to-one, against the dividend. But you might suspect that I stuffed the ballot box, which I did. (Laughter)

And so I took my vote out. And you'll see down below, the vote was a little less than 40-to-one among the untainted shareholders of A against receiving a dividend.

And then you may say to yourself, "Well, you know, those are Warren and his rich friends, all the plutocrats. And easy for them to say."

So let's go onto the next slide. And you will see there that among the B shareholders — and we believe we may have as many as a million B shareholders. We don't know the exact number. We don't even know an approximate number very well. But it's not a bad guess that we have a million or so shareholders.

And remarkably, by a vote of 45-to-one — these are people — we're not making any phone calls to get their vote or anything — by 45-to-one, our shareholders said, "Don't pay us a dividend."

I'm not sure that there's any company in the world that would get quite that vote.

And now you go to one more slide and that'll be the end.

But this is the rather disturbing part of that vote. If you go to the next page, you'll see again, among the B shareholders, that — I've got that same vote up there — and if you look down below, you will notice that almost the same number of people voted against, or withheld their vote for me, as voted for having a dividend.

So from that you can only deduce that if the shareholders are ever forced with the choice — or I should say, if the directors are ever forced with the choice — of paying a dividend or getting rid of me, it's a close vote. (Laughter)

So you can see why I'm rather reluctant to bring up the dividend question with the directors.

The vote, actually, up until two days earlier, before these final figures, the vote was actually just virtually a dead heat.

The number of people that wanted to have a dividend and the number of people that wanted me to get out of the place were running neck in neck. So it — again, it's a rather unusual voting arrangement.

6. Q&A begins

WARREN BUFFETT: Well, with that we're going to do the questioning, as we always do.

We have journalists on this side. We have financial analysts on this side. And we've got a wonderful group of shareholders in the audience.

So we're going to alternate among these groups. And we will keep doing that until noon. And then we'll pick up where we left off at 1 o'clock, then continue doing it.

And we will start off with Carol Loomis of Fortune Magazine.

CAROL LOOMIS: Good morning. I'll make my two or three sentence introductory remarks.

First, Becky and Andrew and I get hundreds, if not thousands, of questions, and we can only ask a few. So, if we didn't get to your question, please excuse us.

Secondly, Warren and Charlie got no hint of what we were going to ask.

Though they read the news like we do, and that may explain that they would sometimes get a thought about what they were going to get asked. And that will explain my first question.

7. Buffett defends abstaining on "excessive" Coca-Cola compensation

CAROL LOOMIS: The question is from Will Elridge (PH) of New York City.

And he says, "Mr. Buffett, this is a question about Berkshire's holdings in Coca-Cola.

"This spring, Coke asked shareholders to approve a magnanimous stock option program for its executives.

"Asked about it by the press after the vote, you said the program was excessive. Yet, you did not tell the world prior to the Coke shareholders meeting that you believed the program to be excessive, a disclosure that, had it been made earlier, might've made shareholders vote against it.

"And in fact, you did not vote Berkshire's shares against the plan. You only abstained in the voting.

“I guess you had your reasons. I must say, I don’t expect to agree with them. And I cannot see how they can stand up under examination.

“But I still would like to know why you engaged in this very strange, un-Buffett-like behavior.

“So why did you abstain rather than voting no against a corporate action that deserved to be shouted down?”

WARREN BUFFETT: Yeah. Well, some people, incidentally, think that strange and un-Buffett-like are really not quite right. Strange is frequently Buffett-like. (Laughter)

The proposal was made by a shareholder who’d owned shares for a long time and was opposed to the option program.

His calculations — and I probably should explain this in a minute — but his calculations of the dilution were wildly off. And we did not care to get into a discussion of that or anything else.

But we did talk — or I did talk — to Muhtar Kent. And I informed him that we were going to abstain.

I told him that we admired, enormously, the Coca-Cola Company. We admire the management.

And we thought the compensation plan, although it was very similar to a great many plans, was excessive.

And Muhtar and I had a very good discussion right here in Omaha, as a matter of fact, as well as a couple of telephone discussions. And then immediately after the vote, I announced that we had abstained, and gave the reasons that we thought the plan was excessive.

And I think that in terms of having an effect on the Coca-Cola compensation practices, as well as maybe having an effect on some other compensation practices, that that is the most effective — was the most effective — way of behaving for Berkshire.

We made a very clear statement about the excessiveness of the plan. And at the same time, we, in no way, went to war with Coca-Cola. We have no desire to go to war with Coca-Cola.

And we did not endorse some calculations that were wildly inaccurate, and joined forces with someone that I had really no contact with him. I received several letters in the mail after they’d first been given to the press.

So, I think you have to be — I don’t think going to war is a very good idea in most situations. And I think if you’re going to join forces in going to war with somebody, you’d better be very sure about what that alliance might mean.

So, I think the best result for the Coca-Cola Company was achieved by our abstention. And we will see what happens in terms of compensation between now and the next meeting with Coke.

Charlie?

CHARLIE MUNGER: I think you handled the whole situation very well. (Laughter)

WARREN BUFFETT: And Charlie remains vice chairman. (Laughter)

Charlie, incidentally, was the — Charlie was the only one with whom I talked over the vote before — or the abstention — before I did it.

I called Charlie. And told him about the plan. And we agreed on the course of action.

I should point out one thing. And in fairness to David Winters who may — who led the war — he took figures from the Coca-Cola proxy statement. So it's hard to fault him for that.

But for those of you who would really — would like to know how to think about calculating dilution, Coca-Cola has regularly repurchased the shares that are issued through options.

And the share count has, thereby, come down just a small bit at Coca-Cola. Not anywhere near as much as if they hadn't issued as many shares, though, in repurchased shares.

But Coca-Cola has a plan that involves 500 million shares. And they say in the annual report that they expect to issue these over approximately four years. And then they have a further calculation between performance shares and option shares, but I'll leave that out. Make this a little simpler.

And that's a lot of shares.

Let's assume for the moment that Coca-Cola's selling around $40 a share now, which it is. And that when — and that all the options are issued at $40. And that the — when they're exercised, we'll say the stock is $60.

Now, at that point, there has been a $10 billion transfer of value. Twenty dollars a share times 500 million shares, a $10 billion transfer of value.

Now, the company, when that is done, gets a tax deduction — and at the — for 10 billion — and at the present tax rates, that would result in 3 1/2 billion less tax.

So if you take 20 billion of proceeds from exercise of the options, and you add 3 1/2 billion of tax savings, the Coca-Cola Company receives 23 1/2 billion.

And if they should buy in the stock at $60 a share, which it would be selling for then, they would be able to buy 391,666,666 shares.

So, in effect, the Coca-Cola Company, net, would be out a little over eight — 108 million shares. And that's on a base of four-billion-four.

So the dilution — assuming all the proceeds from the option exercise and the tax refund were used to buy shares — the dilution would be 108 million shares on 4.4 billion, or about 2 1/2 percent.

And I don't like dilution and I don't like 2 1/2 percent dilution. But it's a far cry from the numbers that were getting tossed around.

It's a long explanation, but I've never seen the math written about. I mean, I've seen people throwing out claims and all of that.

And you can change my supposition from 55 — 60 to 55 — or 65. It doesn't change things very much.

8. Berkshire likely to team with 3G again despite different styles

WARREN BUFFETT: Jon Brandt

JONATHAN BRANDT: Hi, Warren. Thanks again for having me back.

My first question is as follows: Berkshire has a track record of buying successful companies and leaving them alone.

3G has a more hands-on strategy with its acquisition. Its zero-base budgeting would seem to offer the potential to improve margins at any non-insurance business.

Is there a way for Berkshire to use 3G's methods to boost profits without violating promises made to selling shareholders or breaking faith with Berkshire's decentralized culture?

Would it be consistent with Berkshire's culture to hire a 3G alumnus to run a Berkshire subsidiary after an existing manager retired? Or alternatively, how hard would it be for a non-3G alumnus to learn and implement their management process? Thank you.

WARREN BUFFETT: Yeah. I don't think the two blend very well.

But I do think that we — I think 3G does a magnificent job of running businesses. And I've watched them in the past from afar and I've watched them more recently up close.

And there's no question that it's a different style than Berkshire. And I don't think it would pay to try and blend the two.

But I certainly think that we will see more opportunities to partner with 3G. And we're very likely to jump at those opportunities, because I think they're as able as anybody I've seen in the management of businesses.

And to get a chance to join with them — and in addition to that, they're marvelous partners. They're more than fair in everything they do with us.

So we will, as I've put in the past, I think we're very likely to partner with them, perhaps in things that are very large.

But I do not think a blending of the two would work very well. We've got a system, works very well for us.

And managers, when they join Berkshire, are joining into a large business that's unlike virtually any large business that's around. They really can't find a home exactly like Berkshire.

And that's a huge corporate asset. It's one that's grown over time. It'll continue to grow. And we want to maintain that with a very clear message that it goes well beyond my lifetime.

But we welcome the chance to join with 3G.

Charlie?

CHARLIE MUNGER: I don't think we've ever had a policy that loved overstaffing. (Laughter)

WARREN BUFFETT: Well, I would only slightly disagree with that.

We certainly never had a policy that allows for overstaffing at the home office.

We only feel happy when people are sitting in other people's laps. I mean, you have to understand this.

But the — but we have not enforced, or attempted to enforce, nor would wish to enforce, a strong discipline on every subsidiary as to whether they have a few too many people or not.

A great many don't. In fact, I mean, most of them are — overwhelmingly — they're managed on a lean basis.

But that's not true of everyone we've been involved in over the years. And it probably won't be true of everyone in the future.

We encourage — I mean, we encourage, just by example. But we do not encourage it by edicts, particularly.

Charlie?

CHARLIE MUNGER: I think a lot of great businesses spill a little just because they don't want to be fanatic.

And that's all right. I don't think you have to have the last nickel out of the staffing cost.

9. Corporate taxes aren't holding back businesses

WARREN BUFFETT: OK. We'll go to the shareholder in station 1, up on my far right.

AUDIENCE MEMBER: Yes, hello. My name is Doug Merrill (PH). I'm from Denver, Colorado, the home of Peyton Manning.

WARREN BUFFETT: Omaha, Omaha. (Laughter)

AUDIENCE MEMBER: Awesome.

The president's approval rating is at 40 percent. Steve Wynn said, "Obama is the biggest wet blanket to the economy." Other countries are lowering taxes and reducing debt.

You have Obama's ear. The train's going in the wrong direction. Can you conduct Obama to change the train's direction? (Applause)

WARREN BUFFETT: Doug, I think I'll let you communicate with him directly. (Laughter)

I don't agree with a number of things you've said there. American business is doing extraordinarily well. (Applause)

The — many of the American people are not. And, you know, and I think Obamacare is more about doing something for them than many other people would.

But we're going to have a difference of opinion on politics. And I'm not going to convince you, and you're not going to convince me.

But I will say that anybody that thinks American business is doing — is not doing well — should just look at corporate profits.

Anybody that thinks our corporate taxes are too high should look at a chart of corporate taxes as a percentage of GDP since World War II, and it's come down from 4 percent of GDP to 2 percent of GDP, while many other forms of taxes have, obviously, increased.

And American business earnings on net tangible assets, which is the way to measure profitability overall, you know, it's basically the envy of the world. I mean, we have extraordinary returns on tangible assets — net tangible assets — in this country.

And our tax rates now for corporations are far lower than when Charlie and I were operating. And American business actually was doing pretty good then.

But for much of our life, taxes were at — corporate taxes — were at either 52 percent or 48 percent.

But I don't want to try and convince you because I don't want you to try and convince me. So we'll call a truce on that and I'll let Charlie comment. (Laughter)

CHARLIE MUNGER: I'm going to avoid this one. (Laughter)

WARREN BUFFETT: And people complain about me abstaining. (Laughter)

10. Berkshire underperforms when stock market is strong

WARREN BUFFETT: OK, Becky Quick.

BECKY QUICK: This question is from Manolo Salseda (PH).

And I'll preface it by saying he says that he is "a true admirer of Buffett and what he stands for, so please don't confuse my bluntness and straightforwardness with a lack of admiration or empathy with this amazing person and his master creation." With that disclaimer —

WARREN BUFFETT: "But." (Laughter)

BECKY QUICK: But. His question is, "You've stated several times in the past that if management, you, wasn't capable of delivering a better return than the index, than management wasn't doing the job.

"Then you said that the yardstick should be any five-year period. You've just missed your five-year period comparison.

"How come you didn't tackle the issue in your annual shareholder letter? Are you changing the yardstick, and what's next?"

WARREN BUFFETT: No, we're not changing the yardstick.

But I would point out that we said, actually, in the 2012 report — and it's in the upper half of the first page — we pointed out how we do worse in very strong years and better in poor years.

And I said then, "If the market continues to advance in 2013, our streak of five-year wins will end."

I didn't say it might end, or could end, or anything. It was obvious that if you have five strong years in a row, we will not beat the S&P. And that will be true in the future, for sure.

And of course, last year was — I think there were two years in the last 40 or so that the market was up more than it was last year. So, despite the things mentioned about President Obama, the stock market seems to have done quite well.

We will underperform in very strong up years. We'll probably, more or less, match in moderate up years. We'll do better than average in even years or down years.

And I have said, and I'll continue to say, and it's been true that over any cycle, we will — I think we will overperform. But there's no guarantee on that.

But it was clearly said — like I say, on the first page of the 2012 report — that if the market went up, we would have a five-year streak of underperformance. And that's exactly what happened.

Charlie?

CHARLIE MUNGER: Well, we should remember that Warren's standard talks about net worth of Berkshire increasing, after full corporate taxes, at roughly 35 percent. And the indexes aren't paying any taxes.

And so, Warren has set a ridiculously tough standard and has so far met it over a long period of time.

In the last couple of years, the net worth of Berkshire, after full corporation income taxes, went up, what, 60?

WARREN BUFFETT: Something like that, yeah —

CHARLIE MUNGER: $60 billion —

WARREN BUFFETT: Yeah. Pre-tax, probably 90 billion in —

CHARLIE MUNGER: Yeah. And so, if this is failure, I want more of it. (Laughter and applause)

11. "Eager" to buy back shares at 120% of book value

WARREN BUFFETT: OK. Jay Gelb.

JAY GELB: Warren, this question is on Berkshire's intrinsic value.

In the annual letter, you appear to strongly signal that Berkshire's shares are undervalued, especially relative to intrinsic value.

Aside from share buybacks, what actions can Berkshire take to narrow the discount between the current share price and intrinsic value? For example, would you ever consider an IPO of Berkshire's individual operating units?

WARREN BUFFETT: The answer to the last part is no.

But the — I think we try to explain —my guess is I've never seen an annual report that uses the term, "intrinsic value," or even talks about the intrinsic value of its units or business, as much as Berkshire does.

So, Charlie and I really devote considerable effort to explaining which of our businesses — where there's really a significant discrepancy between what carrying value is, or book value — call it carrying value — and the true value, or the intrinsic value, of the business.

And I got very specific in the case of GEICO in the past year, for example.

And I said that GEICO, which is carried at about 1 billion over tangible assets, may be worth as much as 20 billion over tangible assets. And I wouldn't be surprised if five years or ten years from now that that figure itself will be a lot larger.

So we've talked about it. We said we are willing to buy — not only willing, but eager to buy — stock at 120 percent of book value.

Well, with book value being close to 230 billion now, that obviously means we think that at $45 billion, roughly, over that figure, we are getting a bargain, in relation to intrinsic value.

But we're never going to try and put out an exact number because we don't know an exact number.

And it's — A, it changes from day to day. And — although not a lot day to day, but certainly changes, you know, over the quarters and over the years.

And the second reason is, if you ask Charlie and me to write down a figure as we sit here as to the intrinsic value of Berkshire, we'd probably be within 5 percent of each other.

But we might very — we probably would not be within 1 percent of each other.

And so we will continue to try to give shareholders information about the important units.

It isn't — the small ones are not unimportant to us, but they are — they do not have a big impact on the overall intrinsic value.

We've got a few businesses. I mean, we have some businesses that may be carried at a few hundred million that might be worth a billion or maybe 2 billion, even.

But that isn't where the big, undisclosed by the balance sheet, values are.

You know, they're in the railroad, they're in the insurance business, they're in our utility business.

And we — they add up to some pretty big numbers. We try to tell you exactly the numbers and, really, and use the words that we use when we're thinking about those businesses ourselves, in terms of estimating their value. But we don't want to go further than that.

The 120 percent, obviously, is a loud shoutout as to a figure that we think is very significantly below intrinsic value, or we wouldn't use it to repurchase shares.

We only believe in repurchasing shares when we can do so at a significant discount from intrinsic value.

Some companies talk about — Coca-Cola does — they talk about buying in shares to cover options. That actually isn't the best reason to buy in shares.

I mean, the stock could be overpriced, and even though you issued on options, you shouldn't be buying it in.

But that's become sort of a mantra throughout corporate America, that if you buy shares to cover the option exercises that you've negated the dilution to shareholders.

But again, if you buy shares — if you buy a dollar bill for 90 cents, you're doing your shareholders a favor. And if you buy it for $1.10, you are doing them no favor at all.

Charlie?

CHARLIE MUNGER: Well, I don't believe we've ever wanted to get the stock way over intrinsic value so that we can issue it to other people and get an advantage for ourselves and a disadvantage for them.

And, I think the people that want the stock up very close to intrinsic value, or higher, really want egg in their beer. It's okay if it's a little below.

And we're not in the game of ballooning our stock up as high as we can get it so we can issue it more at a profit to ourselves.

I think over the long term, our system will work pretty well. And I think the stock will eventually go above intrinsic value, whether we like it or not.

WARREN BUFFETT: Yeah. But we have — we really watched a lot over the years of certain managers attempting to get their stock to sell for way more than it was worth, so they could use it to trade for other companies. I mean, that was all the rage in the late ’60s.

One of the reasons that I wound up my partnership was that that activity was going on so much and it affected all other values.

And it was really a game. And it was a game that some people played sort of halfway honestly, and other people really cheated like crazy, because if you’re trying to get your stock to be overpriced, you’re very likely to cheat on your earnings and cheat on projections. Cheat on everything.

And it works, incidentally. It doesn’t work indefinitely, but it works.

Some companies, whose names you know, were, to some extent, built on that principle.

That’s a game that we not only don’t want to play, we really found it very distasteful, because we saw a lot of these people in action.

And it comes in waves. And we just — we don’t want to come close to playing it.

Unless I’m careful, Charlie will name names, so we’d better move on to shareholders. (Laughter)

12. Why sellers trust Berkshire with the companies they’ve built

WARREN BUFFETT: Well, let’s go to station number 2.

AUDIENCE MEMBER: Hi, Mr. Buffett—

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: — and Mr. Munger.

My name is Masato Luso (PH) and I’m from Los Angeles, California.

Berkshire is known to buy into whole companies for many, many years. But earlier in your careers, that was not known.

And typically, acquisitions of other companies is very disruptive. Employees fear losing their jobs as a redundancy. And managers really have to think twice and be diligent about it.

So my question is, what do you do to gain the trust of founders or owners of the companies you have bought out in the past?

WARREN BUFFETT: Well, we've kept our word to them.

And now we have to be very careful about what we promise, because we can't promise, for example, never to have a layoff in a business we buy, because who knows what the world holds.

But we can promise that we won't sell their business, for example, if it turns out to be disappointing, as long as it doesn't run into the prospect of continuing losses or having significant labor problems.

But we keep — we are keeping — certain businesses that you would not get a passing grade at business school on if you wrote down our reasons for keeping them.

But the reason is, we made a promise.

And we put that — we not only make the promise, we put it in the back of the annual report now — we've done it for 30 years or so — where we list the economic principles.

And we put it there because we believe it. But we put it there, also, so that the managers who sell us their— the owners who sell us their business — know they can count on it.

And if we behave differently, you know, the word would get around. And it should get around.

So, we can make promises. We can't make promises we'll never change employment. We can't even make a promise that we'll keep a business forever.

But we can promise what we do promise, which is that if it turns out to be somewhat disappointing on earnings, but does not promise, sort of, unending losses, or if we have labor problems, we can keep that promise.

And we have kept that promise. We've only had to get rid of a few businesses, including our original textile business.

We promise the managers, you know, that they are going to continue to run their businesses.

And believe me, if we didn't do it, the word would get around on that very quickly. But we've been doing it now for 49 years.

And we've put ourselves in a class that is hard for other people to compete with, if that's important to the seller of a business.

A private equity firm is going to be totally unimpressed by what's in the back of our annual report. They don't care. And that's — there's nothing wrong with that. That's their business.

But for somebody that's built up their company over 20 or 30 or 40 years — and maybe their father or grandfather built it up even before that — some of those people care about where their businesses go.

They're very rich, they've accomplished all kinds of things in life. And they don't want to build up something which somebody else tears apart very quickly believe they handing it over to a few MBAs who want to show their stuff.

So, we do have a unique — close to a unique — asset at Berkshire. And as long as we behave properly, we will maintain that asset. And really, no one else will have much luck in competing with us.

But it doesn't solve all problems, but — and it — and frankly, it's the way we want to operate anyway.

So it's — we're comfortable with it. The sellers that do come to us that care about their businesses are comfortable with it. And I think it'll continue to work well.

Charlie?

CHARLIE MUNGER: Well, obviously, we behave the way we do because we like doing it. And number two, it's worked pretty well and we're unlikely to stop.

WARREN BUFFETT: OK. (Applause)

You can tell that he doesn't get paid by the word. (Laughter)

13. "Social dynamics" weaken oversight by corporate boards

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Warren. This is a tough corporate governance question. I probably received about a dozen of them this week, some polite and some less polite. This —

WARREN BUFFETT: Use one of the polite ones.

ANDREW ROSS SORKIN: This is probably one of the more polite ones.

"Your son Howard serves on the board of Coke and voted to support its CEO pay package proposal, which you have said was excessive and you were against.

"You have said Howard will become non-executive chairman of Berkshire after you step down, as its, quote, 'protector of culture,' to uphold the morals that you and we all hold so dear.

Given his role in the Coke vote, how can we count on Howard to defend the culture of Berkshire and ensure that the future management of Berkshire does not benefit at the expense of its shareholders?"

WARREN BUFFETT: Yeah. Well, I think, as I mentioned in at least one interview, I voted for not — I'm not referring to Coke here necessarily — but as a director of various companies, I not only voted for comp plans that were far from what I would've come up myself, but I voted for acquisitions that I didn't think make much sense.

I voted against a few. And they attracted a lot of attention. But they were big ones, where I really think — where I thought — it really made a difference.

But the nature — and this is something worth exploring, generally, because the nature of boards is such that they're part business organizations and part social organizations. And people behave in some ways with their business brain and they behave to some extent with their social brain.

And I would say — and I said this — that in 55 years of being on corporate boards, and 19 companies aside from Berkshire, I don't think I've ever seen a comp committee report come in and get a dissenting vote.

And the social reason for that is that the board organizes itself in a way whereby certain activities are delegated to a smaller portion of the board, one being a compensation committee.

And that committee presumably meets for a few hours the day before the meeting, or maybe the morning of the meeting. And then they go into a board meeting. And the comp committee reports on its activities. And you've delegated that activity, as a board member, to that group.

It's almost unheard of to question that. I'm not saying that maybe it shouldn't be questioned, but I'm just saying that that is the way it works.

Now bear in mind that the so-called independent directors on such a board are probably receiving maybe $200,000 a year, maybe $300,000 a year. Believe me, they are not independent.

They're independent as measured by some standards, perhaps, at the SEC, but they — you know, how would you feel about having a job that required you to go to work four or six times a year, pleasant company, you know, certain amount of prestige attached with it, and on top of it, you get paid maybe $300,000 a year and you kind of hope to get another job like that? That is not independence.

So, you get a group coming in like that from the comp committee. And in those 19 boards, I was put on the comp committee exactly once. Charlie might be able to tell you exactly what the result was that time. They do not look for Dobermans. (Laughter)

They look for cocker spaniels. And then they make sure that the tails are wagging. (Laughter)

But that is — don't condemn it too much because you and I are doing similar things in other parts of our lives.

You know, the social dynamics are important in board actions. My son Howard — in fact, my other two children as well, if they were involved — you know, they would have a dedication, and do have a dedication, to the culture of Berkshire, which is clearly defined. It's one of the reasons I want it clearly defined. And it's reinforced by the behavior and it's reinforced by results.

And, incidentally, their job would not be to set the compensation. I mean, the non-executive board chairman is not there to select the compensation of the CEO or others. He's not there to select the CEO.

He is there to facilitate a change if the board of directors decides a change is needed. And that can be important. Very, very, very unlikely to be important in the case of Berkshire.

But it's a nice, little, extra safety valve. And Howie's the perfect guy to carry that out.

And like I say, I voted for comp plans at various places, including way back, you know, at Coke that were far from what I would've designed myself. And the ones I designed myself would have worked.

But that is the way boards work.

I was made chairman of one comp committee, and Charlie can tell you a little about that.

CHARLIE MUNGER: Yeah. (Laughter)

Warren was totally voted down at Salomon Inc. In fact, people acted like, what in the hell is he doing? How could he be disapproving compensation on Wall Street?

And I think the general idea that a person should just shout disapproval all day long of everything he disapproves of is very suspect. In the world in which we inhabit, people accomplish more if they pick their spots for public disapproval.

And knowing both Howie and Warren Buffett, I don't think you have to worry that they're going to go crazy or be soft and foolish just because they don't shout all the time about everything they disapprove of. If we all did that, we wouldn't be able to hear each other.

WARREN BUFFETT: Yeah. (Applause)

If you — if you're in any social organization and you keep belching at the dinner table, you'll be eating in the kitchen before very long. (Laughter)

And people won't pay any attention to you.

I mean, you really have to — you not only have to pick your spots, you have to pick how you do it.

I mean, you — that could even be — I mean, sure, Charlie gives the marital advice around here, as you noticed, in the movie, but it's not even a bad thought to keep in mind in marriage, I mean, in terms of — of attempting to change the behavior of others, which is — you'll have a very limited ability to do, in any event. It's not helped by shouting a lot.

CHARLIE MUNGER: I offend more people than you do. And I'm quite satisfied with your level of disapproval. (Laughter)

14. Everyone else is wrong on cost of capital

WARREN BUFFETT: OK. Gregg Warren of Morningstar. Gregg, welcome.

GREGG WARREN: Thank you. Warren and Charlie, on behalf of Morningstar, I want to thank you for having us on the panel this year.

I may not be an accredited bear, but hopefully, I ask probing questions that add value for shareholders.

My first question relates to the measurement of management performance.

For Morningstar, the ultimate measure of success is not just whether or not a firm can earn more than its cost of capital, but whether or not it can do so for an extended period of time.

Berkshire has historically done a good job of generating outsized returns. But as you've noted in the past, the sheer size of the firm's operations, which continue to grow, will ultimately limit the returns that Berkshire could generate.

With that in mind, what do you believe Berkshire's cost of capital is? How much do you think that this hurdle rate is increased as you've acquired more capital intensive, debt-heavy firms?

And how much confidence do you have that future capital allocators at Berkshire will be able to generate returns in excess of the firm's cost of capital, acknowledging, of course, the fact that Berkshire's days of outsized returns are most likely behind it?

WARREN BUFFETT: Yeah. Well, there's no question that size is an anchor to performance. And we intend to prove that up to the point where it starts really biting.

But it — we cannot earn the returns on capital with well over 200 — well, with a market cap of 300-plus billion. It just isn't doable.

Archimedes, he said he could move the world if he had a long enough lever, didn't he, or something like that, Charlie?

CHARLIE MUNGER: Yes, he did.

WARREN BUFFETT: Well, I wish I had his lever because we don't have that lever at Berkshire.

So we — well, we'll answer two questions there.

In terms of cost of capital, Charlie and I always figure that our cost of capital is the — is what could be produced by our second best idea. And then our best idea has to exceed that.

We think — I have listened to so many nonsensical cost of capital discussions, that —

CHARLIE MUNGER: I've never heard an intelligent one.

WARREN BUFFETT: Yeah. Yeah. (Laughter)

It's really true. I mean, and there's — that's another thing. I've been on boards and the CFO comes in and explains why we're doing this and it always gets down to, you know, it exceeds our cost of capital.

And he doesn't know what the hell his cost of capital is, and I don't know. And — but I don't embarrass him, you know?

So I just sit there and listen to this stuff and apply my own thing, and then still end up voting for it, probably, if I don't like it, although there have been a few exceptions to that.

The real test, you know, over time, is whether the capital we retain produces more than a dollar of market value as we go along.

And if we keep putting billions in and those billions, in effect, are worth, in terms of present value terms, in terms of what they add to the value of the business, more than what we're putting in, you know, we'll keep doing it.

We bought a company day before yesterday, I guess it was. And we are spending close to $3 billion U.S. It's a Canadian company.

And we think we will be better off financially because we did that and we thought it was the best thing that we could do with the $3 billion on that day. And those are the yardsticks that we have.

And what I do know is that I've never seen a CEO who wanted to do a deal where the CFO didn't come in and say it exceeded the cost of capital.

It's just — it's a game, as far as we're concerned.

And we think we can evaluate businesses. And we know the capital we have available. And we have things that we can sell to buy. Not businesses, but marketable securities that we can sell to buy businesses if we like.

And we are constantly measuring that opportunity cost that Charlie talked about in the movie. It's an important subject. And one that I think has had more nonsense written about it than about anything.

But I'll turn it over to Charlie to go over —

CHARLIE MUNGER: Well, a phrase like "cost of capital," which means different things to different people, and often means silly things to people who teach in business schools, we just don't use it.

Warren's definition of behaving in a corporation, so that every dollar retained tends to create more than a dollar of market value for the shareholders, is probably the best way of describing cost of capital. That is not what they mean in business schools.

The answer's perfectly simple. We're right and they're wrong. (Laughter)

WARREN BUFFETT: I look good compared to him, don't I? (Laughter)

15. Buying Nebraska Furniture Mart from the Blumkins

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Good morning. My name is Jonathan Fye (PH) and I'm from Denton, Texas, just up the road from the new Nebraska Furniture Mart that's going to be located in The Colony.

My question relates to your original acquisition of that business from the Blumkin family in 1983.

Based on the data you provided in this year's annual report, it appears you were able to purchase this business for roughly 85 percent of book value, or roughly two times earnings.

Can you comment on the factors or the environment in Omaha that enabled you to purchase this wonderful business for such a wonderful price?

WARREN BUFFETT: Well, I wish we had bought it that cheap, Jonathan, but no — we paid at the time, as I remember, probably 11 or 12 times after-tax earnings. It was not a discount from book value.

I'm not sure where those numbers come. Well, we bought 80 percent of the company. It was bought on the basis, as I remember, of 100 —of $60 million of purchase price.

So we —actually there was a second transaction involved in it. But 60 million was 100 percent value. We ended up with 80 percent.

The 60 million would've been more than book at the time. Not way more, but more than book.

And it would've been a multiple of 11 or 12 times earnings, as I remember. The sales were about 100 million. Pre-tax margins were in the 7 percent range.

So, it was about 7 million pre-tax. And, you know, 4 ½, probably, after-tax. That's ballpark.

So, it was not a bargain purchase. It was a great business. It was a wonderful opportunity to join as fine a family as I've ever met.

But it was — and incidentally, there was another company, I believe, from Germany, that was trying to buy it at the time.

And believe it or not, Erskine Bowles, of Simpson-Bowles, was representing them, my friend Erskine — I didn't know this at the time.

And then I went out on my birthday, August 30th, 1983. And had that contract, which is in the annual report.

And I gave it to Mrs. B. And — and she didn't read, but Louie, her son, told her what was in it.

And I never asked her for an audit. I just asked her if she owed any money. And I asked her if she owned the building. And she said yes. And we made the deal. But it was not a bargain purchase.

Now, if you want to talk about bargain purchases, we should talk about going out to the Nebraska Furniture Mart. (Laughter)

So far, in the three — we —in the days of this annual meeting, our sales, which were a record 40 million for the week last year, are up about — I think they're up about 7 percent now. And last year, of course, it was a record.

And on Tuesday, which was the first day, we did 7.8 million.

And Berkshire owns the largest home furnishing store in Sacramento, California. We own the largest one in Boise, Idaho. We own the largest one in Salt Lake City. We own the largest one in Las Vegas. Largest one in Reno.

Our sales at the Furniture Mart on Tuesday were larger than the monthly sales of any one of those stores I've just named, being the largest ones in places like Sacramento. So it is a remarkable organization. (Applause)

And the good news is there's still time for you to avail yourself of those prices. (Laughter)

I would like to put in a plug for the Dallas store, where — I was down there a week ago. And it's a plot of land like you wouldn't believe. It's a store like you wouldn't believe. It is 1,800,000 square feet under one roof. Over 40 acres.

It will do more volume, I predict, than any other home furnishing store in the world. And I wouldn't be surprised if I could add to that by a factor of at least two.

It's a remarkable store. And I toured around it. And we're, you know, we're putting in streets. We're — site preparation, utilities, racking, all these things. This wonderful woman, Michelle, who showed me around.

And the Blumkins later told me that she had started — worked for Nebraska Furniture Mart as a cashier, and she is in charge of this, you know, many hundreds of millions of dollar project. It's really — it's the good thing about America.

And at the end of the tour, she'd had this number two person working — walking around with us, who — she was explaining some things to us, too. And I learned at the end of the tour that number two was Michelle's husband. (Laughter)

Interesting pillow talk, you know? "How many cubic yards did you move today, honey," you know? (Laughter)

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

WARREN BUFFETT: OK. Carol.

CAROL LOOMIS: This question comes from Jason Rothman (PH) of Oklahoma City, who was the first shareholder to ask a question that subsequently was framed by a number of other shareholders as well.

In my mailbox, this was the most popular question asked.

“Mr. Buffett, you state in your annual letter to shareholders that in your will you have given instructions to the trustee who will be acting for your wife’s benefit to put 10 percent of the cash given her in short-term government bonds and 90 percent in a very low-cost S&P 500 index fund.

“My question is why are you advising the trustee to put 90 percent of the cash into an S&P 500 index fund instead of into Berkshire shares?”

WARREN BUFFETT: Well —

CAROL LOOMIS: “This might imply that you expect the index fund to outperform Berkshire in the future when the company is run by a new CEO and chairman. Please clarify.”

WARREN BUFFETT: Yeah, I’ll be glad to clarify. That letter didn’t come from Vanguard, by any chance, did — (Laughter)

When I die, incidentally, then all the Berkshire shares I have at that point will go to five different foundations. Every single share. I mean, there are no shares that have not been designated, mentally, to charity. A good many of them have been designated specifically to — in numbers and all that.

But — and they will be distributed over the ten years after my estate is closed. So figure over 12 years.

And I tell my — I tell the trustees that will be holding these shares, you know, “Don’t sell any Berkshire shares until they have to be sold.”

So my views, on Berkshire at least through 12 years after my death are as bullish as anybody could possibly come up with.

And incidentally, without those kind of instructions, anybody would say, “You know, you’re crazy to keep many, many billions of dollars all in one stock.” I can’t think of anything better to do it over those 12 years.

In terms of my wife’s situation, you know, that is not a question of maximizing capital. It’s just a question of total, 100 percent peace of mind on something that cannot get a bad result.

And, like I said, there’s way more money for her than she’ll ever use. As a matter of fact, those of you who know her, you know, may feel that I’ve added about three zeros too many.

But it is not designed for her to get even larger amounts of capital. And there’ll be capital, loads of capital left over on that part of it.

On the part that I care about maximizing, I have instructed the three trustees to not sell a single share until it has to be sold. So, that's good for 12 years after I die, as to my best advice as to what I want them to hold.

Charlie?

CHARLIE MUNGER: Well, Warren is a little peculiar in the way he distributes money in the family. And I think he's entitled to do what he damn pleases. (Applause)

Speaking —

WARREN BUFFETT: Do I — do I hear my — children applauding? Do I hear my children applauding? (Laughs)

CHARLIE MUNGER: And I've never had this feeling I had to starve the family down to a few trifles.

And Warren really — and Susie, when she was alive, was the same way.

He really is a meritocrat. He's really quite extreme in wanting to let most of his money go back to the civilization in which it was earned.

I like being associated with it. (Applause)

17. BNSF service problems are hurting earnings

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: The BNSF has done very well since Berkshire acquired it in 2010.

But its western competition of Union Pacific has actually grown its earnings more. And at the moment, the UP seems to be operating more smoothly for its customers.

Could you shed some light on the service challenges Burlington has experienced recently and perhaps discuss any differences between the two railroads in end markets, geography, and strategy that may have led to the divergent result?

Would it be fair to say that, in trying to aggressively sign up new business volume last year, that the railroad did not allow for a sufficient margin of safety in terms of what its capacity could handle, should there be a harsher than normal winter or other adverse circumstances?

WARREN BUFFETT: Yeah. It — we've handled more volume, actually, than in the past. I mean, in 2006, we had a peak of 219,000 carloads. That was in the late fall.

But no question that we've had a lot of service problems, particularly on our northern route.

We have been spending more money than Union Pacific, and they spend a lot, in terms of attempting to anticipate the kind of problems that can occur when you get a big increase in volume, on that one route particularly, from the boom in the — particularly the Bakken shale oil.

We've got a lot of unit trains that are running over those lines that weren't running five years ago.

I think I've got Matt Rose here — right — I think somewhere in the front. And he might address some of the problems of cold weather. I mean, want to get — there were a lot of days where it was 15 below or worse.

And in terms of sending people out to work on problems, under those circumstances, it can be really — it can be life threatening.

But Matt, do you have — oh, there he is. OK. Could you shine a light down on him, please, too? So he's right here in the front. In the front.

MATT ROSE: Warren. So last year, the industry grew at about 820,000 units. BNSF handled 53 percent of all those units.

And it's not what we wanted to take or what we didn't want to take. Quite frankly, it's the geographic nature of our franchise. And the oil came a lot faster than we were expecting and we've been spending money at a rapid clip to try and build into it.

The second issue was, you know, I had previously, prior to this past year, been in the CEO role for 13 years, and I have never seen a weather — a winter weather — like that.

We had 83 inches of snow in Chicago. We had multiple days, over 30 days, where it didn't get to zero in the Minnesota area.

So, you know, we know this is an outdoor sport. We get it, on the weather. But quite frankly, when we get to about 0 to 10 degrees below, things just don't work.

The weather's getting better. Last week, we handled 206,000 units. No other railroad has ever handled 205,000 units.

So the railroad's coming back. And we're making the significant investments to be able to handle all the business that's out there.

WARREN BUFFETT: Thanks, Matt. (Applause)

We will spend $5 billion on the railroad this year. No railroad's ever spent that kind of money, or even very close to it.

But I got a call — or I got a letter — from a fellow in North Dakota. And they were having a problem getting fertilizer. And I called and talked to him. And they sent it down to Matt.

But we've now put on — I think we're going to have 52 unit trains of fertilizer. And they will get there in time for the planting. And that's important. I mean, we take it seriously.

But cold in winter or floods in the summer, I mean, we're now really functioning a lot better and our earnings will be, in my view, are very likely to be a lot better.

But the thing that could disrupt that is, if for some reason, you had incredible floods. You're dealing with 22,000 miles of track. And if you get weak links, one of which, always, for all four big railroads, is Chicago, because that's where things get interchanged and that's where a lot of bottlenecks have been this year, and that's where weather was tough as well.

But you're right, Jon, in the comparative financials in recent months. And believe me, Matt's paying a lot of attention to them and Carl's paying a lot of attention to them, and I even pay a little attention to them.

So I have a feeling that they will be getting better over the remainder of the year.

18. Generating electricity with natural gas

WARREN BUFFETT: OK, station 4.

AUDIENCE MEMBER: Rosal Kerkhove (PH). I'm from Omaha, Nebraska. My question relates to our company's use of natural gas to generate electricity.

This past winter, natural gas in storage has declined substantially.

In the future, how do our companies assure that they have an adequate supply of natural gas to generate electricity?

And if the price of natural gas increases in multiples, how do our companies assure that they can sell the electricity at a satisfactory return on investment? Thank you.

WARREN BUFFETT: Yeah. We have — I'm going to ask Greg Abel to be more specific on this.

But we are the largest alternative generator of — using alternative sources — I think, in the country. And I think by the end of 2015, we will be capable of producing 40 percent of our needs in Iowa through wind, which will be unlike any other company you can find in the country. (Applause)

But I think I'll have Greg answer the specifics of any natural gas-dependent generating units we have.

I'm not worried about that thing, but I — about what you raised —but Greg would know a lot more about the mix on natural gas and the opportunity to shift to coal. And exactly the profile of the generating capacity.

Greg? Now, let's get a light down on him, if you can. He —

GREG ABEL: I think it's — okay, there it is.

WARREN BUFFETT: Yeah, there we go —

GREG ABEL: Yup. Sorry. So like Matt touched on, obviously, we had a very cold winter in the Midwest.

So our systems, for the first time, were challenged in a significant way. But very proud of how the resources were managed.

So if you look at the question around natural gas, and specifically the gas availability, there was substantial gas available to be utilized both to heat homes and produce the energy, because ultimately, we're worried about both, the — keeping the furnaces on and, equally, keeping the lights on.

So when you looked at the balance of supply, there was gas there.

But clearly, we have to continue to look at the unique situation as we continue to move towards using more gas in the United States.

Warren touched on an important point. This past year, as he highlighted — he highlighted 2015 — but if you look at just what we produced on the renewable side in Iowa, that was 39 percent renewable, i.e. wind. And that'll only get larger.

So as we continue to manage these multiple resources, there's clearly a way to meet the needs of our customers. And we're meeting it in an extremely cost-effective fashion.

I'd also highlight that when you think through the cost recovery side of it, we've got very unique mechanisms within our utilities.

When the underlying cost of gas goes up, where we have to purchase more than we had anticipated, we've got clear pass-throughs back to our customers. And we've negotiated those across each of our states.

So we're well positioned to service our customers long term, and equally protect the fundamental financials of the underlying businesses.

WARREN BUFFETT: The —

GREG ABEL: Thank you.

WARREN BUFFETT: The company that Greg runs has many subsidiaries. And our gas pipeline subsidiaries move about 8 percent of the gas in the United States.

And I think you said you were from Omaha. And the gas that comes into this area comes through a pipeline that we own. And we just renamed the company to Berkshire Hathaway Energy, from MidAmerican Energy. We changed it to Berkshire Hathaway Energy.

But, it's a point of some pride to us that that company, Northern Natural Gas, which originally came from Omaha, when we bought that from Enron a decade or so ago — actually, Dynegy had it in between — but its origin then was Enron.

You know, they'd skimped on maintenance, done all kinds of things. And it was ranked number 42 out of the 42 ranked pipelines in the United States at that time. And last year it was ranked number one.

So it went from last to first under Greg's management. And I tip my hat to him. (Applause)

And number two was our other pipeline — current pipeline. So we're running one, two at the moment.

19. Two heads running Berkshire are better than one

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Fred Ireman (PH) in Richmond, Virginia, and it's addressed to you, Warren.

He says that, "During the past several years, much has been written and many have speculated about your successor. I shall not even go down that path, as it would cause you to repeat yourself.

"However, has there been any discussion at your board meetings about a replacement for your partner, longtime friend, and co-chairman, Charlie Munger?

"Has it been determined Berkshire will continue to be led by a similar dynamic duo? Two magnificent investor minds, each providing a unique point of view, have been a major reason the business has performed magnificently over the decades and has delighted the shareholders."

WARREN BUFFETT: Well, Charlie is my — he's my canary in the coal mine. (Laughter)

Charlie turned 90. And I find it very encouraging how well he's handling middle age. (Laughter)

So I hope to be able to do the same thing myself.

No — you raised a point, which is — I hadn't thought about, but I'm a little sensitive now that you raised it.

They always talk about replacing me, but they never talking about replacing Charlie.

I do think — I think it's very likely, incidentally, that whoever replaces me as CEO probably has, over the years certainly, developed — they'll never be able to develop another Charlie — but they'll develop somebody that they work with very closely. It's a great way to operate.

Berkshire is better off because the two of us have worked together than if either one of us had been working individually, there's no question about that. (Applause)

And —but I do think, you know, we saw it with Roberto Goizueta and Don Keough at Coke, we saw it with Tom Murphy and Dan Burke at Cap Cities. I mean, these were magnificent companies.

And I think that in both cases that I just named, I think that they accomplished far more because they had two incredible people running them who admired and worked well with the other. And they were complimentary, in terms of the talents they brought.

In many ways, it's a great way to operate. You can't will it to somebody.

But I would be very surprised if, a few years after my successor takes over, or maybe sooner, that there isn't some relationship, a partnership, that enhances the CEO's not only — not only achievements — but the fun they have.

And — but so far, nobody's brought up, in the meeting, any successor to Charlie.

And frankly, I have a lot of trouble thinking of anybody that could be a successor to Charlie. (Laughs)

Charlie, you want to comment? I've got to give you a chance. (Laughter)

CHARLIE MUNGER: I don't think the world has much to worry about. Most 90-year-old men are gone soon enough. (Laughter)

WARREN BUFFETT: Well, the canary has spoken. OK. (Laughter)

20. Subsidiary shuffles aren't related to Berkshire succession plans

WARREN BUFFETT: Jay?

JAY GELB: I have a question on succession planning, as well.

Matt Rose recently shifted his role from CEO of the Burlington Northern unit, to executive chairman of Burlington. Does this change affect who will be the next CEO of Berkshire? And what is the succession plan for Ajit Jain at Berkshire's reinsurance unit?

WARREN BUFFETT: The only succession for Ajit would be reincarnation. (Laughter)

We will not get another Ajit. But fortunately, we won't have to for a very, very long time.

The situation with Matt, which was at Matt's suggestion, was designed to fit specifically the succession situation at BNSF and the wishes of certain people. It doesn't have any implications for Berkshire.

I have letters from every one of our managers telling me what I should — I keep — these are private, I don't share these with the board, even — telling me what I should do if something happens to them tonight.

So I have their ideas. In some cases, they talk about more than one person. In some cases, they tell me the strengths and weaknesses of the people.

But the — I would not try to make any judgments about the succession plans at the parent company from what is done in terms of succession planning at any of the subsidiaries.

Charlie?

CHARLIE MUNGER: Well, I always say, I'm not the least bit worried about it. If I — I wish my main problem in life was the fear about succession problems at Berkshire. I think we're in very good shape.

21. "Great" question, but no answer

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: I am Bill Melby from Northfield, Minnesota.

At the 2009 annual meeting, Mr. Buffett, you said that if you were required to invest your total net worth in one company, that that company would be Wells Fargo.

So in 2014, I ask the same company — or the same question. If you were required to invest your total net worth in one company, what would that be?

WARREN BUFFETT: When the question was asked in 2009, did you exclude Berkshire? Because I think I would've answered Berkshire. (Laughs)

But I wouldn't quarrel with Wells Fargo as a marketable security outside of Berkshire at that time.

Well, I guess he's checking his notes on — the — well —

AUDIENCE MEMBER: The question is other than Berkshire —

WARREN BUFFETT: Oh, other than Berkshire.

AUDIENCE MEMBER: —what would you invest in today?

WARREN BUFFETT: Yeah. Well, it's a great question, but it's not going to get an answer. (Laughter)

Charlie, do you want to answer?

CHARLIE MUNGER: No, no, I think you've given exactly the right answer. (Laughter)

WARREN BUFFETT: Yeah. Well, I'm sorry to disappoint you, but we've disappointed others when they've asked that question.

22. Shareholders aren't helped by rule requiring CEO pay disclosure

WARREN BUFFETT: OK, Andrew?

ANDREW ROSS SORKIN: Thank you, Warren. This question comes from Dave Hitchy (PH) from Auburn.

It's a long question. He says, "As a shareholder for about a dozen corporations in addition to Berkshire, I always see a number of proxy statements each year. In all, except Berkshire, the summary compensation table has the compensation listed for at least five or more of the highest paid executives. Berkshire lists three, Warren, Charlie and Mark.

"I assume that since Berkshire is a holding company structure, that's the way it is. I think it would be instructive to include at least two of the highest paid executives from the wholly-owned subsidiaries in the summary table, Ajit, Tony, or Greg, or Matt, to give the shareholders, your partners, a sense of how Berkshire compensates its strongest and highest-paid leaders, as other companies do.

"This would be particularly valuable since two-thirds of the current listees, Warren and Charlie, only receive nominal salaries of $100,000 per year, a figure that is vastly below the value they bring to the company.

"Would you, in the spirit of transparency, be willing to add at least two of the highest-paid subsidiary officers in the table in future years? And how much do you think the next CEO of Berkshire should be paid?"

WARREN BUFFETT: Well, the answer to the last is he certainly will be entitled to pay — get paid a lot. But their decision as to how much they accept is another question.

But I'm going to write about that very end question next year in the annual report because it has a lot of interesting ramifications.

We, obviously, are following the SEC rules, which I can't recite, in terms of the officers required to be in the proxy statement as to their pay.

But, you know, Andrew, in my sporting mood, I would say that Comcast probably has some people in the employ that make a lot more money — not at CNBC, we're not —but — that would exceed the salaries of the people that they list in the proxy statement, as well.

And there's a real question as to whether it's in the interests of the shareholders of the company to start listing, you know, how much the person who's the anchor of the nightly news or whomever it might be, gets paid because it might have a very negative effect, in terms of negotiating salaries with other people within the organization.

I would say that the — I would say the shareholders of Comcast would be hurt, actually, if you published the five highest salaries paid at the subsidiaries or at Comcast itself.

And certainly, if you carried it to every subsidiary there was. I mean, if you were to publish the five highest salaries at CNBC, I don't think the salaries overall would go down the following year.

So, I think that is a — I think that's a good reason for not — for us not publishing the salaries of, you know, say, our top ten managers of the company.

At Salomon — we mentioned that a little earlier — everybody — virtually everybody — was dissatisfied with what they were getting paid. And they were getting paid enormous amounts of money.

But they were disappointed, not because of the absolute amount. They were disappointed because they looked at somebody else in the place and it drove them crazy.

And as a matter of fact, the first big crisis we had in compensation was when the management made a — what was regarded as a secret deal, with the arb group, as I remember — whereby, John Meriwether and his crew got paid a lot of money, which I would argue they earned. I mean, I think they deserved it.

But as soon as that happened, it made compensation, which had always been a terrible problem, an even greater problem because of the jealousy that broke out among the people that weren't in John Meriwether's group.

I think it's been — I think it's very seldom that publishing compensation accomplishes much for the shareholders.

In fact, you can argue that much of what's going on in corporate America — well, I would put it this way: corporate CEOs, as a group, would be being paid a lot less money if proxy statements hadn't revealed how much other people were getting paid.

It is only human to look at a whole bunch of proxy statements and say, "Well, I'm worth more than that guy," and negotiate that way. And a comp committee is going to respond to that.

So, American shareholders are paying a significant price for the fact that they get to look at that proxy statement every year and see how much those top five officers are earning.

Charlie? (Scattered applause)

CHARLIE MUNGER: In the spirit of transparency, you're asking for something that wouldn't be good for the shareholders. And it's not going to happen unless the SEC makes it happen.

We're way better off without adding to the culture of envy in America.

WARREN BUFFETT: Yeah, there's no one that looks at —there's no CEO that looks at other proxy statements and comes away thinking, "I should get paid less." I mean, that — you know? (Laughter)

We haven't seen — have we ever seen them?

CHARLIE MUNGER: No.

WARREN BUFFETT: No.

CHARLIE MUNGER: No, I —

WARREN BUFFETT: Well, we're not old enough.

CHARLIE MUNGER: I would say that envy is doing the country a lot of harm. And our practices are envy dampeners.

23. Why Berkshire maintains $20B cash cushion

WARREN BUFFETT: OK. Greg. (Applause)

GREGG WARREN: Thank you. As you know, Berkshire's cash balances are an issue for some investors. Especially with excess cash being in the 25 to $30 billion range the last couple of years, and Berkshire having a more difficult time than it's had historically reinvesting capital as quickly as it comes in.

Although Berkshire did provide $3.5 billion of the $3.6 billion of cash that was used to acquire NV Energy last year, with MidAmerican funding the remainder with debt, was there something that kept Berkshire from providing all of the capital for the acquisition, perhaps via inter-company debt?

And on a separate note, can you provide with us some insight into the decision to allow MidAmerican to retain all of its earnings, while Burlington Northern, which spent $3 billion on capital expenditures last year and is on pace to spend $5 billion this year, continues to pay a distribution to Berkshire, all while it takes on additional debt to help fund capital spending?

WARREN BUFFETT: Yeah. MidAmerican, now renamed Berkshire Hathaway Energy — we'll call it BH Energy — will have multiple opportunities, I hope, and we've seen two of them in the last 12 months, to buy other businesses.

And, as you noted, we spent a substantial amount of money on NV Energy and two days ago we agreed to buy transmission lines in Alberta.

So, we will — we hope we will — and so far we've been able to — come up with really large businesses to buy at BH Energy.

That will not — at BNSF, we will spend a lot of money to have the best railroad possible. But we're not going to be buying other businesses.

So, we distribute substantial money out of BNSF and we will continue to do so because it'll earn substantial money. And it can easily handle the debt that it has and will incur.

Whereas, at Berkshire Hathaway Energy, we have pretty much the appropriate level of debt at both the subsidiary and the parent company level. So as we buy things, we need not only the retained earnings that we have, but occasionally we need some money from the shareholders.

And there are three shareholders of BH Energy. Berkshire owns 90 percent and then Greg and Walter Scott have the balance.

And so, if we make a large acquisition and we need a little more equity, we will have a pro rata subscription, which the other two shareholders are welcome to participate in. But if they don't — if they decided not to, it wouldn't hurt them. They'd still have an improvement in the value of their shares.

So those two companies are quite different that way.

I hope that more possible deals for Berkshire Hathaway Energy come along. And I think they will.

So we may invest many, many, many billions there. We will invest billions at the railroad, but it'll all be to improve the railroad. It won't be to buy additional businesses.

So far this year, if you think about it, counting yesterday — now, two of these deals started last year — but we've spent 5 billion on acquisitions, roughly.

And, of course, in the first quarter, we spent another 2.8 billion on property, plant, and equipment.

But we are finding — we are finding things to do that tend to sop up the cash.

We always will have $20 billion around Berkshire. We will never be dependent on the kindness of strangers. It didn't work that well for Blanche DuBois, either.

But in any event, the — we don't count on bank lines. You know, we don't count on — we don't count on anything.

There will be some time in the next 100 years, and it may be tomorrow and it may be 100 years from now, and nobody knows, you know, where we cannot depend on anybody else to keep our own strength and to maintain our operations.

And we spent too long building Berkshire to have that one moment destroy us.

I mean, we lent money, as you probably know, to Harley-Davidson at 15 percent. And we lent it at a time when short-term rates were probably a half a percent.

Well, Harley-Davidson is a fine company — but it, like Goldman Sachs and General Electric and a bunch of other companies —we lent money to Tiffany's — they — you know, they needed — when you need cash, you know, it's the thing — it's the only thing — you need. And it's because other people aren't coming up with it.

I've always said that, you know, cash is — available cash or credit — is a lot like oxygen: that you don't notice it — the lack of it — 99.9 percent of the time.

But if it's absent, it's the only thing you notice. And we don't want to be in that position.

So we will keep 20 billion. We will never go to sleep at night worrying about any event that's taken place that could hurt our ability to keep playing our game.

And above 20 billion, we'll try to find ways to invest it intelligently. And so far, we've generally done it. I mean, right — you know, we always had something above that.

But, you know, we've spent a fair amount of money so far this year. We'll probably spend more later in the year.

So, so far, I feel we could get the cash out at reasonable returns. We never feel a compulsion to use it though, just because it's there.

Charlie?

CHARLIE MUNGER: I think we're very lucky to have these businesses that can employ a lot of new capital at very respectable rates.

And if — earlier in the history of Berkshire, we didn't have such automatic opportunities. And now that we're so affluent, we really are way better off having these opportunities.

It's a blessing. I mean, who would want to get rid of MidAmerican and the Burlington Northern Railroad? Nobody in his right mind.

I mean, we love the opportunity to invest more capital intelligently in a world where short-term interest rates are half a percent, or lower.

WARREN BUFFETT: And we love the opportunity to go in with 3G at Heinz and —

CHARLIE MUNGER: Yes.

WARREN BUFFETT: —employ significant capital. We'll get the chances to use capital.

Eventually, you know, compound interest will catch up with us. And it's certainly dampened things.

But it hasn't delivered its final blow yet.

24. Buffett and Munger disagree, but never argue

WARREN BUFFETT: Station 6.

AUDIENCE MEMBER: Hi Warren, Charlie. John Norwood from West Des Moines, Iowa. Thank you so much for the annual meetings. And please don't move it to Dallas or some other place. I've got my system worked out here.

WARREN BUFFETT: We won't.

AUDIENCE MEMBER: Thank you. Hey, two quick questions.

One is allocation of capital and how you wrestle with the operating companies and how much cash comes up to the operating companies — or comes up to the mother ship — versus the operating companies.

And you and Charlie, do you ever fight or argue? And any lessons over the years for how you manage your partnership of two? Thank you.

WARREN BUFFETT: Yeah. Charlie and I have never had an argument. We met in 19 — when I was 29. He was 35. We're a little older now.

And in those years, 55 years, we've disagreed on a lot of things. And it's just never led, and never will, lead to an argument.

We argue with other people. (Laughs)

But it just — it hasn't occurred.

I called Charlie on the Coca-Cola vote, you know, and then said what the proxy statement said and everything. Said, "What do you think?" And we thought alike, you know?

Sometimes we don't think alike. And we never go away in the least bit mad if we don't, or —

CHARLIE MUNGER: Most of the time, we think alike. That's one of the problems. If one of us misses it, the other is likely to, too. (Laughter)

WARREN BUFFETT: Yeah. I would say that — well, there's no question. If you look at the really bad mistakes we've made, I've made them.

I'm probably a little more inclined toward action than Charlie. Would you say that's fair, Charlie? Or —

CHARLIE MUNGER: Well, you once called me the abominable 'no' man. (Laughter)

25. Berkshire's cash cushion is partially held by subsidiaries

WARREN BUFFETT: Now we've missed — what's the — what was the first part of the question? (Laughter)

AUDIENCE MEMBER: Capital allocation. How do you decide how much cash comes up from the operating companies —

WARREN BUFFETT: Yeah, that's —

AUDIENCE MEMBER: — to the mother ship?

WARREN BUFFETT: Yeah, that's pretty simple, in that we don't really care too much where that 20 billion minimum is.

We wouldn't — but we don't count the money in a regulated — well, in the energy business or the railroad.

So we really count the money that we could make a phone call and get.

With interest rates at these levels, we sit around sometimes with — every one of our companies, I would say, probably has more cash in it than if some other large conglomerate was running the place.

They would probably have sweep accounts and all of that. And we may get around to that at some point, but it just doesn't make that much difference, because if we had it at the parent company, we'd have it out at five basis points. And if it's at the — if it's down at the subsidiary, it's probably getting five basis points.

So we're not — it's not something we think about on a day to day or week to week or month to month basis.

I know where the cash is. And I know when we're going to need cash and I know what I'm thinking about doing, or may possibly do in the next few months, that maybe something's a 50/50 probability of happening.

And anything I am committing to do, I know where the cash is coming from.

But it doesn't mean that we try to get it all in the parent company, day by day or week by week like many companies do. We could change that procedure someday. Maybe a sweep account would make sense at some point. Probably would.

But we're not big disciplinarians of our subsidiaries day by day. We don't want them to feel that way.

And there’s one company I’m thinking of, where I’ve never been there. Probably only talked to the fellow who runs it three or four times in ten years. You know, and there’s a lot of cash around. And every now and then, he sends me some.

And if I really need it, I mean, I know where it is. And he’ll give it to me. But there’s — it doesn’t really make much difference, you know, whether it’s sitting there, whether it’s sitting at Berkshire.

I don’t want to encourage to our managers of our other subsidiaries who are listening to this a new way of behaving. But, I sort of adapt to the companies, except when we really need the money, and then I grab it. (Laughter)

Charlie?

CHARLIE MUNGER: That’s just fine.

26. Buffett admits he’s “slow to make personnel changes”

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question comes from an astute fellow named Richard Sercer of Tucson, who spotted an opening and is going for it.

And it actually reminds me of a question that you, Warren, or Charlie, could’ve thought up yourself.

“In an interview on April 23rd, 2014 about the Q&A session, Warren said, quote, ‘I hope we will get questions that probe at our weak points.’ My question is, what is our weak points and what can be done to address them?” (Laughter)

WARREN BUFFETT: Well, that would spoil all the fun for the journalists. (Laughs)

They’re the ones that are supposed to look for the weak points.

We have a lot of weak — we point them out. You know, I’ve just pointed out one.

Probably, I would say if you’d — if we’d — executed a sweep account for all our subsidiaries some years ago, you know, we would have a few more dollars than we have now.

You know, it — who knows what they’re doing with some of those balances in terms of — we wouldn’t — it wouldn’t be because we do riskier things. But we — you know — we are very disciplined in some ways. And by ordinary business standards, we’re sloppy in other ways.

And, oh, well, a clear weak point of mine would be I'm slow to make personnel changes. I mean, I like the managers we have.

And Charlie and I had a wonderful friend who couldn't have been a greater guy. And, you know, we were slow to make a change there. We loved the guy. And it wasn't killing us in our business.

And how long would you say we went beyond where somebody else would've acted in that case, Charlie?

CHARLIE MUNGER: Well, I don't know exactly.

But that, turning to the sweep account system, reminds me of a friend I had when I was in the Air Corps and he was a very skinny man. And he decided to give blood. And they put the needle into his arm and the blood stopped flowing.

And the nurse just started stripping his arm as though it were the udder of a cow. And he got the impression that he was going to — they were going to get that blood whether it took all he had. And he fainted.

It was a very unpleasant occurrence. And I don't think a sweep account is all that pleasant to sit there and just — every little dollar comes in, somebody sweeps it away.

WARREN BUFFETT: Charlie, our —

CHARLIE MUNGER: I like the tone of our business.

WARREN BUFFETT: Our managers are listening here. I mean, don't give them that illustration to use when I ask for money. (Laughter)

CHARLIE MUNGER: But, you know, I've seen people subject to — Teledyne and Litton, those people, swept every dime every day, basically.

And it was a little more economic, but it created a tone in the company that — which I think is less desirable than ours.

WARREN BUFFETT: We've waited too long on managers, though, sometimes, Charlie.

CHARLIE MUNGER: Well, sure. You and I participated in taking one man directly from an executive chair into a Alzheimer's home. There was no — (Laughter)

WARREN BUFFETT: You're hitting a sensitive subject here, Charlie. (Laughter)

CHARLIE MUNGER: We'd arranged that he could do no harm, and we loved him well enough so that we just made it easy for him.

I've never regretted it, have you?

WARREN BUFFETT: No. Not —

CHARLIE MUNGER: No.

WARREN BUFFETT: Not at all. Not at all. It —

CHARLIE MUNGER: On the other hand, I want to be pretty careful.

WARREN BUFFETT: It — we will be slow. And we — there will be times when what you might call our lack of supervision over subsidiaries, you know, we'll miss something.

Now, we think that giving our managers the degree of freedom that they enjoy will also accomplish a lot.

So someone will come along someday and say, "If you'd had many more checks and oversight and all of that sort of thing," you know, something — well, something will happen at Berkshire and they'll say, "That wouldn't have happened if you'd followed the procedure that some other company followed." And they'll be right.

But what they won't be able to measure is how much on the positive side we have achieved with dozens and dozens of people because we gave them that same sort of leeway.

I mean, we operate differently in terms of the level of control and supervision. You know, we don't have a general counsel's office at Berkshire. We don't have a human relations department at Berkshire.

And that would be almost unthinkable to other companies. And we're not saying that's a 100 percent benefit in all ways. We think — but we think on balance, it's a benefit.

But when the down side of such a procedure shows up, people will say, "Well, you should of done it differently and you should've been spending lots of money over the years and restricting the activities more of your subsidiary managers," and so on.

And our reaction will be that they are wrong. But we will look bad in that individual case.

Wouldn't you say that's true, Charlie?

CHARLIE MUNGER: Yeah. The — by the standards of the rest of the world, we over trust. And so far, our results have been way better because we carefully selected people because they were going to be over trusted. And it's worked very well for us.

And, I think a lot of places work better when they create a culture of deserved trust. And that's been our system. And some people regard that as a weakness.

And this modern accounting treatment, when everybody's measured on internal controls, I think it's going to do more harm than good. (Applause)

27. Trying, and failing, to expand See's Candies' geographic market

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: See's Candy is obviously small in the context of Berkshire's currently expansive operations, but has long been one of your favorite businesses.

And no wonder, given that its pre-tax profits grew consistently from less than $5 million in 1972 when Berkshire acquired it, to $74 million in 1999.

However, since 1999, profit growth appears to have stalled.

Can you explain why See's was able to grow its profits through the '70s, '80s and '90s, but not, so far, in this millennium?

Did something change about the business, for instance, the growth and demand for boxed chocolates or its market position?

Could you or Brad Kinstler discuss whether the relatively recent geographic expansion could help reignite See's growth? Thank you.

WARREN BUFFETT: Yeah, the boxed chocolate business is, basically, not growing.

I mean, if you go back 100 years, the — each city of any size was characterized by lots of candy shops. Chicago was a big leader. New York was a big leader.

Believe it or not, the predecessor company to Pepsi Cola was the — a company with the most — it was a company called Loft's — that had the most candy shops in New York City.

It was a candy shop company, originally, that a fellow that — what was his name?

CHARLIE MUNGER: [Charles] Guth.

WARREN BUFFETT: Yeah. What was it?

CHARLIE MUNGER: Guth.

WARREN BUFFETT: Yeah. He acquired Pepsi for a few thousand bucks, stuck it in Loft's.

And the corporate — the corporate name, if you go all the way back on Pepsi, is Loft's.

So there were loads of candy shops around everyplace. And including in Omaha.

Boxed chocolates have lost position dramatically. Primarily, I would guess, to salted snacks of one sort or another. Various things.

See's has done remarkably well, far better than any chocolate company in the country.

Russell Stover did very well for a while. Very well, with a different business model. But, you know, they ran into their problems as well.

So, we can't do much about increasing the size of the market. And we've tried a lot of ways. And we've tried moving out of our strong geography, multiple times.

I mean, Charlie and I looked at what we were earning in California in the '70s and said to ourselves, "If we could do this in 50 states instead of one, you know, we'll get very rich."

So we tried it and we didn't get very rich. It doesn't travel that well.

CHARLIE MUNGER: Well, sometimes it does and sometimes it doesn't. And you figure out whether it's going to work by trying it.

WARREN BUFFETT: Yeah. And we've tried it many times.

But so far — it's interesting. Two-thirds — people in the East prefer dark chocolate, two-thirds to one-third. In the West, they prefer milk chocolate, two-thirds to one-third.

They like miniatures in the East. They won't eat miniatures in the West. There's a lot of different things.

But in the end, there isn't a lot of boxed chocolates volume.

And we've done very, very, very well in See's. And it not only has provided us with earnings that we've used to buy other businesses, so we've added lots of earnings power through See's, beyond the earning power we've added at See's.

But it opened my eyes to the power of brands and probably you could say that we made a lot of money in Coca-Cola partly because we bought See's, or at least in my case, bought See's, because I'd understood brands to some degree, but there's nothing like owning one, and sort of seeing the possibilities with it as well as the limitations, to educate yourself about things you might do in the future.

And in 1972, we bought See's. And in 1988 we bought Coca-Cola.

And I wouldn't be at all surprised, if we had not owned See's, whether we would've owned Coca-Cola later on.

Charlie?

CHARLIE MUNGER: Yeah. There's no question about the fact that its main contribution to Berkshire was ignorance removal. And it's not the only big contributor to ignorance removal.

If it weren't for the fact we were so good at removing our ignorance, step by step, Berkshire would be practically nothing today.

What we knew originally wasn't enough. We were pretty damn stupid when we bought See's. We were just barely smart enough to buy it.

And if there's any secret to Berkshire, it's the fact that we're pretty good at ignorance removal. And the nice thing about that is we have a lot of ignorance left to remove. (Laughter)

WARREN BUFFETT: Well, that's what happens when I call on him. (Laughter)

28. Buffett explains deal to change Bank of America investment

WARREN BUFFETT: Station 7.

AUDIENCE MEMBER: My name is Ben Ottenhoff and I'm from Washington, D.C.

I was wondering if you could talk — I've read recently that the Bank of America investment, you changed it so they can now treat it as tier one capital.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: Can you explain a little bit why you did that and what benefit, if any, there is to Berkshire's shareholders?

And also, does it give you any pause that they can't calculate their tier one capital requirements properly?

WARREN BUFFETT: The — it came about some — really, a good many months ago, that Brian Moynihan called me and asked me whether we would be willing to change our preferred stock, five billion of it, from a cumulative preferred, to a noncumulative preferred.

Now, a non-cumulative preferred has certain defects, obviously, compared to a cumulative preferred. As, for example, the shareholder — the preferred shareholders — of Freddie Mac and Fannie Mae are finding out.

Noncumulative preferreds — Ben Graham wrote about them in the 1934 edition of "Security Analysis" — they're a terribly weak form of security.

But, partly because they are that weak form of security, they count different in capital with banks.

So Brian asked me to do that and then he said, "If you will do that" — and this requires approval by their shareholders and everything — but he said, "If you'll do that, we would be willing to make your preferred noncallable for five years."

Now, in a world of five-basis money — five-basis-point money — you know, practically nothing — no returns — I was very willing to make that trade-off.

It was — they felt it was good for them and I felt it was good for Berkshire.

So, I get five years at Berkshire of non-call of a 6 percent preferred, which I can always use as payment for the warrants we have.

So, I don't have a problem of being locked into it forever, into a noncumulative committed preferred, and the BofA gets the benefit of using it in their calculation of capital.

That was all done before this recent — I mean, a long time ago — before the recent, you know, week ago or so when they had the miscalculation involving some structured notes of Merrill Lynch.

That error they made does not bother me. I mean, it — you know, we work on our figures, you know, we've got that 20,000 page-plus tax return. We have 10-Ks, 10-Qs, going in and out. You do the best you can.

But I — that error did not affect their GAAP reported numbers or anything of the sort. And they wished they hadn't made it. And they'll pay a penalty, in the sense of their capital plan, because they did make it.

But it doesn't change my feeling about the Bank of America or its management one iota.

And I do think that this — they were going to pay the dividend anyway. You know, I mean, the probabilities that going to non-cumulative hurts us are very, very low. And the probability that making it noncallable for five years is a real plus to us.

So, it was an exchange I was happy to make. And I think that it was good for us and good for them.

Charlie?

CHARLIE MUNGER: Well, I agree with you.

WARREN BUFFETT: OK. (Laughter)

29. NetJets is "satisfactory," but don't expect big growth

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Frank Robinson in Madison.

And he asks, "Ten years ago, NetJets was mentioned at the annual meeting each year as an exciting growth opportunity for Berkshire. Five years ago, there were some problems which seem to have been addressed since they're no longer mentioned.

"What are the current prospects for NetJets? Is it a substantial contributor to growth and revenue and earnings?"

WARREN BUFFETT: Yeah, it's not a big grow — it's a very — it's a perfectly decent business.

The number — it peaked in new unit volume more or less coincident with what happened in the stock market in 2007 and '08.

I mean, there were a fair number of people whose income was dependent on stock market behavior, particularly hedge fund managers. But other — a lot of others.

And they gave us quite a boom in sales. And not only did their demand fall off, but when their contracts ran out — and they tended to run out in, like, 2011 and '12 — a lot of them did not renew.

Until the last — won't be totally accurate on this — but until the last six or eight months, net ownership in the U.S. was declining just slightly. And that's turned around now. Net ownership is growing month by month.

But it is not a huge growth business at all. I mean — it's a very large-size business. I mean, we are, you know, probably 60-some percent of the industry and there's nobody remotely close as a second. I mean, we are the premier product.

But I don't see the market being double or triple the present size.

We are going to China very soon. But that's a very, very long-range play. We are in Europe and that is not — that still is declining a little bit in unit volume.

Now, the flight hours have picked up a fair amount. So the owners are using the planes more in the last six months to a year, and that fell off a lot in the 2007- 8 period.

So I would not characterize NetJets as a big growth opportunity. But I would — but I'm glad we own it. And I think it's very — it's a very satisfactory business.

But it is not one I would expect to see a whole lot of growth out of.

Charlie?

CHARLIE MUNGER: Well, I demonstrated my optimism by buying 25 more hours. (Laughter)

WARREN BUFFETT: He was a tough sell, too, I got to tell you that. (Laughter)

I can think of a few more comments, but I won't make them.

30. Unlikely to use major stock holdings to pay for acquisitions

WARREN BUFFETT: Jay.

JAY GELB: This question is on acquisitions.

How large of an acquisition is Berkshire comfortable targeting currently?

And to what extent are Berkshire's major equity investments in Wells Fargo, Coke, American Express, and IBM realistically a potential source of funds for deals?

WARREN BUFFETT: Well, they could be a source of funds. But it's very unlikely they will be.

But — the — our goal is to buy really good businesses, and big businesses, and businesses where we like the management, and businesses that we think we can grow over time.

I mean, Berkshire is about building earning power. When we buy, as we did a day or two ago, agreed to buy that transmission line in Alberta, I mean, I'm looking at trying to add earning power to Berkshire.

And we try to do that every day or every week or every month. And we don't get opportunities that often.

But if the opportunities were large enough and we needed to raise some money, you know, we can dip into a huge reservoir of securities and still have, you know, huge investments thereafter.

It hasn't come to that. You know, when we've got 40-some billion of capital — or cash — and I'm willing to take it down to 20, it — you know, we've got a fair cushion there.

But if I needed to, we would do something, if it was attractive enough, and big enough, that it required us to.

So, that could happen. Could happen this year, could happen ten years from now. You never know.

Charlie, have you got any thoughts on that?

CHARLIE MUNGER: Well, no, I think the — our acquisitions have been irregular in the past. They'll be irregular in the future.

I do think we'll get more, sort of, automatic, intelligent redeployment of capital from our railroad and our utility subsidiary than we have in the past. And I think that's good, good for the shareholders.

WARREN BUFFETT: I think people may think that what we get turned on is by finding some stock we'd like to buy. That's fine.

But what really — there's no comparison — what really turns us on is finding a business that we want to buy, and that fits well for Berkshire, and that'll be earning money for Berkshire 10 and 20 and 50 years from now.

That's what we're — that's what we've been trying to build for 49 years.

And marketable securities have played a big part in that, because the profits that we've made from them have helped do that, and it's a great place to deploy capital on an — you know, it's easy to do there.

But if you — what we're really thinking about, at least Charlie and I — we've got Todd and Ted thinking about marketable securities — what we're really thinking about is buying businesses. And that's what it'll continue to be.

We're in no hurry to sell any of those stocks you mentioned. (Laughs)

They — there probably would be other stocks — if we were going to go out to raise five or 10 billion from stocks, they would not be the names you mentioned.

31. Still reluctant to borrow despite cheap money

WARREN BUFFETT: OK. Station 8.

AUDIENCE MEMBER: Hello Warren, Charlie. My name is Stefano Grasso (PH) and I come from Genova, Italy, all the way from there. It's a pleasure to be here today with you.

I have a question about increasing leverage for Berkshire in this day. This question is really to trigger a discussion and to hear your thoughts on that.

And also, this question was triggered by the fact that following the acquisition of BNSF, few years ago, which was partially financed by Berkshire stock, shortly after, there was plenty of cash around.

There could be different advantages for Berkshire to wisely increase leverage these days. Some generally true for all the companies. Some Berkshire specific.

And the Berkshire specific, most important one for me as a shareholder, is that the investment decision made to invest the funds would be made by the present team, you and the other managers.

Question is then, why not go out and ask for several billions in bonds with a long maturity, and maybe even with some earlier endorsement or callable options embedded at Berkshire discretion, and good — and make a good use of it? Thank you.

WARREN BUFFETT: Well, what you say makes great sense.

And it's the kind of thing Charlie and I used — I think if you'd asked Charlie and me 40 years ago, that if we were looking at the present set of interest rates and we had some wonderful businesses that were making a lot of money, whether we would have gone out and borrowed a whole lot of money for the long term. We would've said yes, right, Charlie?

CHARLIE MUNGER: Wouldn't have been a hard decision.

WARREN BUFFETT: But, we've got several reasons. We — A, we do have a good way of generating funds other than through equity: through float. And we've done that to the tune of 77 billion.

And we don't like the idea of operating a very conservatively-leveraged company, and then changing courses so that the people who bought bonds that were rated double-A, sort of find themselves with much lower rated bonds of the sort.

We don’t have any problem leveraging up the utility or the railroad. They deserve to have even a lot more debt than they do, but we keep it sort of in line with what the rating agencies think should be conventional ratios.

But they’re — if you look — if you analytically look at them — both of them could withstand a fair amount more debt.

At the parent level, we — you know, looking back on the BNSF deal, we borrowed some money that time and we used some equity.

I think using equity helped us make the deal. But it was, you know, it was not a smart thing to do, basically.

I should — and I could’ve always gone to the market and repurchased a bunch of stocks subsequently, and that’s probably what I should’ve done on that.

So I understand your point. I completely — you know, another 30 or 40 billion of debt at Berkshire would be nothing and it would cost very little.

We don’t actually have great places to put it now, as evidenced by the fact that we’ve got 25 billion or so of excess cash.

We’d be — we are reluctant to leverage it up a lot at the parent now, since we have these other sources of money that are really pretty attractive.

We are selling what we call structured settlements, for example, that have a very long duration. And they actually have an interest cost to us of less than if we were to sell bonds.

So we are doing certain things that are along the lines you urge, but not nearly as aggressively as you urge.

And you probably are right. And you’re certainly right if we saw a $50 billion deal and we passed on it for some reason because we were unwilling to take on some debt.

If we see a really good $50 billion deal, we’ll figure out a way to do it.

Charlie?

CHARLIE MUNGER: I think we’d welcome it. We’re — even though what you suggest is intelligent, we’re probably not going to do it in advance.

WARREN BUFFETT: You caught the last two words there.

32. Climate change threat doesn’t affect investment decisions

WARREN BUFFETT: Andrew.

ANDREW ROSS SORKIN: Question comes from Rory Holscher in Galena, Illinois. This question is about Berkshire's investments in climate change.

"On one hand, Berkshire's utilities have large commitments to wind and solar power. Berkshire also has an investment in BYD, an innovative transportation company that may be comparable in some ways to Tesla.

"On the other hand, Burlington Northern hauls a lot of coal. You point out in the 2013 annual report that its profits could shrink if coal burning was curtailed.

And then there's the reinsurance business.

How do these and other Berkshire investments align with your understanding of the risks and opportunities posed by climate change? How should we think about this as investors?"

WARREN BUFFETT: Well, I think that you've stated the facts on a whole bunch of businesses. And, I mean, if you own a railroad that's carrying a lot of coal, it'll carry a lot of coal for a long period. A very long period. But it'll probably carry less at some point. I don't think —I think that's very likely, too.

But, I get all these questions from people who tell me they want me to fill out lots of forms and everything about how it'll affect our insurance business. It doesn't — it just doesn't operate in that — in that time period.

I mean, we are not making — when Ajit and I talk about what we'll charge for catastrophe insurance, you know, whether it's hurricanes in Florida, or whether it's earthquakes in New Zealand, or whatever it may be, the year-to-year change in probabilities on that are, at least in our view, extremely low.

I mean, it doesn't come close to being anything that affects your prices in any material way in any given year.

And, you know, we will continue to develop alternative sources of energy. We'll continue to use coal in our coal generation plants until the utility commissions under which we operate tell us that we should do something different. We have no choice about that.

We, incidentally, have no — I mean, we're happy to carry the coal, but beyond that, we are a common carrier. I mean, we might love to turn away chlorine or ammonia or something like that because of the dangers in carrying it. And we can't get compensated adequately for that.

But we are a common carrier. So, we — by law, we're required to carry the freight that is offered to us.

So I — I don't think in making an investment decision on Berkshire Hathaway, or most companies, virtually all of the companies I can think of, that climate change should be a factor in the decision- making process. Charlie?

CHARLIE MUNGER: Yeah, I think a lot of the people who think they know how climate change is going to change weather patterns and hurricanes are overclaiming. (Applause)

We're sort of agnostic. It isn't that there isn't some global warming, because there plainly is.

But the people who think they know exactly what's going to happen and how many people are going to die from tropical diseases and so forth are mostly talking through their hats.

I think there's a class of people who like the idea they've got a calamity to worry about. And —

WARREN BUFFETT: Well, but — and when you say it, I mean, just in terms of being an economic variable in making a decision, this —

CHARLIE MUNGER: No. We're not saying, "How can we structure our whole investment program to take into account what we think we know about climate change?"

But I think we're very well located long term, no matter what happens.

I think that transmission lines and more or — we're going to have to produce a lot more electricity directly from the sun or indirectly through things like wind. And, we're beautifully positioned.

It's just like GEICO made a lot of money when the internet came along, that they didn't really plan on, I think we'll make a lot of money as more and more electricity is produced more directly from the sun.

So I think we're in a very good shape. But I don't think we deserve any great credit for it. We just stumbled into it.

33. Praise for portfolio managers Todd Combs and Ted Weschler

WARREN BUFFETT: Gregg?

GREGG WARREN: Since Berkshire started to transfer some of the responsibility for the company's investment portfolio over to Todd Combs and Ted Weschler, the two men have gone from managing around $3 billion each in early 2012, to managing more than $7 billion each earlier this year.

That said, this still represents less than 10 percent of the equity portion of your investment portfolio, with big legacy positions in Wells Fargo, Coca-Cola, American Express, IBM and Proctor & Gamble, overshadowing the rest of the holdings.

Can you give us an update on how much money each of your lieutenants is now running and how much you see that growing into over the next five years?

And given that both men have seemingly been involved in things beyond their roles as portfolio managers the last couple of years, how much do you expect their roles to expand over time?

And on a completely separate note, at what point can we expect to see Todd and Ted join you and Charlie up there on stage to talk about their efforts managing Berkshire's investment portfolio?

WARREN BUFFETT: I got through college answering fewer questions than that. (Laughter)

They are managing about —it's a little over 7 billion now. We will change that periodically and it will always be upward. But we don't change it month by month.

I mean, their portfolios may change in value month by month. But they will be handling more money in the future than they are now.

I think, to some extent, they, as well as I — you know, I've had the unpleasant experience of handling more and more money as the years go by — they are seeing that it does get a little more difficult as the sums get larger.

But it's still far better to keep moving money over to them and away from me as time passes. And that'll continue to be the case.

They're both terrific additions to Berkshire, beyond their investment skills in that they know — they each know — a whole lot about business. They know a whole lot about management.

And there are a lot of things that come across the desk at Berkshire that I get an idea on, but I just don't feel like carrying out myself, because they might involve a lot of time, particularly if they get involved in negotiating small points and that sort of thing.

So Ted and Todd have both, as I mentioned in the report, been very helpful in doing things beyond their investment management duties that have added a significant value to Berkshire. And I think it's a cinch that that will continue.

They want to do it. They enjoy doing it. They don't ask for extra compensation, at all, because they do it.

They're 100 percent attuned to Berkshire. They know how I think. And if I tell them, you know, "Here's a deal that I think makes sense if you can get it done," they'll know why it makes sense, and they'll know how to get it done, and they'll spend the time to do it.

So it's been a big, big plus for Berkshire to bring them onboard. And they'll be more important factors as the years go by. OK.

Charlie? I'm sorry, I'm —

CHARLIE MUNGER: Nothing to add.

WARREN BUFFETT: OK.

CHARLIE MUNGER: How's that?

34. Praise for Federal Reserve and Chairman Ben Bernanke

WARREN BUFFETT: Station 9.

AUDIENCE MEMBER: Good morning, Warren and Charlie. My name is Jason. I'm from Toronto and my question relates to the general financial markets.

We've been in an environment of virtually zero interest rates now for many years. In recent times, prolonged periods of low rates have led to asset bubbles, such as the housing bubble and, potentially, now a bond bubble.

If you were running the Fed, what would be your policy with respect to interest rates? Do you see a need for a hike? And what would be your time horizon for such a change? Thank you.

WARREN BUFFETT: Well, since it's — you're right about the — who would've guessed five years ago that you'd have had rates this low for this long?

You're — I would say that I'm surprised at, really, how well things are going.

I don't think I would be doing much differently. And I particularly say that because it's worked so well so far. So I would like to say that I would've done exactly the same thing and take credit for it.

I've been surprised at how well this worked. But as I said last year, this is really an interesting movie because we haven't seen it before. And what makes it interesting is also we don't know how it ends. But, I think Ben Bernanke was a hero, both at the time of the crash — or the panic — and subsequently.

I think he's a very smart man. I think he handled things very well.

What was interesting to me was when the minutes of the Fed from the period in 2007 and 2008 came out, it was interesting to me how a number of the members of the Fed were not getting it, as to what was happening.

That was really fascinating. It wasn't — there were a lot of them that didn't really understand, it seems that way, or some of them that didn't understand just how serious things were.

And so I give particular credit to Bernanke, considering the fact that he was really not getting a cons — certainly not a unanimous view from those surrounding him, that the kind of actions he knew were necessary, were really necessary.

And yet, he went ahead with them. And in my opinion, did a masterful job. And from everything I've seen of Janet Yellen, I feel the same way about her.

We will see how this movie plays out. You know, I do not know the answer as to what happens if you keep rates close to zero for a very, very long time. And keep absorbing more and more of the debt issuance of the country because so far, we've tapered, but we're still buying.

I'd be interested to hear Charlie's thoughts on it.

CHARLIE MUNGER: Well, nobody, for instance, in Japan would ever have anticipated that interest rates would go way down and stay down for 20 years.

And nobody would've expected common stocks to decline by huge amounts and stay down for 20 years.

So strange things have happened. And they're very confusing to the economics profession.

In fact, if you're not confused, you really probably don't understand it very well.

And at Berkshire, what I noticed is there aren't many long-term bonds being bought.

WARREN BUFFETT: Yeah. We — well, you know, in 2008, I wrote an article saying, you know, that — everybody was saying cash is king. Well, cash may have been king if you used it, but cash was the dumbest damn thing you could possibly own, you know, if you weren't going to use it.

And people cling to cash at — usually at the wrong times.

But it is — a zero interest rate policy has had a huge effect, both in rejuvenating the economy and — and in terms of asset prices.

It has not, in my view, produced a bubble. That doesn't mean it can't produce one. But this is not — this is not a bubble situation, at all, that we're living in. But it's an unusual situation that we're living in.

Any further thoughts, Charlie?

CHARLIE MUNGER: No, I'm as confused as you are.

WARREN BUFFETT: Oh good. Good. (Laughter)

That's why we get along so well.

35. How Berkshire benefits from being a conglomerate

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question concerns another uncertainty. It's from Chris Gotcho (PH) of Gotcho Capital Management in New York City.

"You've been looking for a credentialed bear to ask questions at this meeting. I'm not it. In fact, selling short on Berkshire would be quite silly.

"However, in the long term, Berkshire has a business model of owning over 70 non- financial, unrelated businesses — bricks and chocolate, for example — which is a model that has almost universally not worked well in the past 100 years of American business.

"The model has worked well for you two, Mr. Buffett and Mr. Munger, who are uniquely talented.

"But the question is, the probabilities do not seem likely to be favorable that their successors will be able to have it continue to work nearly as well."

So that is my question.

WARREN BUFFETT: OK. Actually, the — it's interesting.

The model has worked well for America. I mean, if you look at all these disparate businesses in America, they've done extraordinarily well over time.

So if you want to look at the Dow Jones average as one entity — now, it was a changing group of companies over a 100-year period — but, you know, any business unit that goes from 67 — or 66 — to 11,497 while paying you out a fair amount of money every year, actually is a model that's worked pretty well. But it hasn't been, of course, under one management.

But owning a group of good businesses is not a terrible business plan. A good many of the conglomerates were put together to perform financial magic of one sort or another.

They were based upon — you know, if you go back to the Litton Industries and the Gulf and Westerns and just — you could name them by the hundreds. They were really put together — Ling-Temp — LTV, and — on the idea of serial issuance of stock, where you issued stock that was selling at 20 times earnings to buy businesses that were at ten times earnings.

And it was the idea that somehow you could fool people into continuously riding along on this chain letter scheme, without the primary thought being given to what you were actually building in the management.

I think our business plan makes nothing but great sense, to own a great group, a group of great businesses, diversified, outstanding managers, conservatively capitalized.

And with one enormous advantage, which people don't really understand. I mean, capitalism is about, in an important way, it's about the allocation of capital. And we have a system at Berkshire where we can allocate capital without tax consequences.

So we can move businesses from See's Candy, to generate surplus capital, to other areas. It doesn't hurt See's in the process, and we can move it, as the textbooks say, to places where capital can be usefully employed, like wind farms or whatever it may be.

So we are — you know — there's nobody else really better situated to do that than Berkshire Hathaway, and it makes perfectly good sense.

But it has to be applied with business-like principles, rather than with stock promotion principles. And I would say a great many of the conglomerates have been — have had, as their underlying premise, stock promotion.

You know, you saw what happened with Tyco or — the serial acquirers were usually interested in issuing a lot of stock.

I think if you had to look at one of the primary indicators of what sort of species you're viewing, you would see whether somebody's issuing — if they're issuing stock continuously, one way or another, they've probably got a chain letter game going on. And that does come to a bad end.

I think our method of acquiring for cash, and acquiring good businesses, and building many, many sources of growing earning power, I think, is a terrific model.

Charlie?

CHARLIE MUNGER: Well, I think there're a couple of differences between us and the people who are generally thought to have failed at a conglomerate model.

One is we have an alternative when there's nothing to buy in the way of companies. We've got more securities to buy in the insurance company portfolios. And that's an option which most of the other conglomerates didn't have.

Number two, they were hell bent to buy something or other quite regularly. And we don't feel any compulsion to buy. We're willing to just sit until something makes sense.

We're quite different. We're a lot more like the Mellon brothers than we are like Gulf and Western. And the Mellon brothers did very, very well for what, 50, 60, 70 years.

And they were willing to own minority interest, they were willing to grow companies, they were a lot like us.

And so I don't think we're a standard conglomerate. And I think we're likely to continue to do very well, sort of like if the Mellon brothers had just kept young forever.

WARREN BUFFETT: Now you're talking.

CHARLIE MUNGER: Yeah. (Laughter)

36. Praise for Forest River's Pete Liegl

WARREN BUFFETT: Jonathan.

JONATHAN BRANDT: Forest River is one of Berkshire's better performing acquisitions. Since Berkshire purchased it in 2005, its sales have grown considerably faster than those of its principle competitor, Thor. And I believe it has taken the number one spot at retail for recreational vehicles.

Can you explain what Forest River is doing differently from Thor? And tell us whether Forest River is accepting lower operating margins than Thor's 7 percent to gain the share.

Does Forest River have any sustainable, structural advantages over Thor that will help it maintain its number one position?

Also, with three companies now accounting for about 80 percent of the share in the RV market, are there greater barriers to entry than in the past, or can a feisty upstart like Forest River, in its day, still come out of nowhere and gain a lot of share?

WARREN BUFFETT: Yeah. We bought a company called Forest River, run by a fellow named Pete Liegl, I'd say about ten years ago or so.

And it's interesting. Pete, who is not an MBA type at all, he's a terrific guy, he built up a — (Laughter)

That was not a statement, that was an observation. (Laughter)

Pete built up a very successful, but much smaller, RV business. And he sold it to a private equity firm in the mid-1990s. And they promptly started telling him how to run it. And he, very shortly thereafter, told them to go to hell.

And, not very long after that, it went broke, which is not an unusual — I would've predicted that.

So Pete then bought it out of bankruptcy, and rebuilt it, and then came to see me about ten years ago.

And in one afternoon — we went to dinner that night. He brought his wife and his daughter. And we bought the business.

And he made me a couple of promises then. He's very limited in his promises. I told him what I'd do. And we've lived happily ever after.

I've never been to Forest River. It's based in Elkhart, Indiana. I hope it's there. I mean, maybe they're just making up these figures — you know?

I could see that. Some guy saying, "What figures shall we send Warren this month, you know, ha, ha, ha." (Laughter)

Pete does a terrific job of running the company. We made a deal at the time he came, on incentive comp and base comp. He's never suggested a change, I've never suggested a change.

He's built the company to where it'll do over — I think it'll do over $4 billion of business this year.

I've probably had three or four phone calls with him in the whole time.

It's his company. And he does a sensational job.

I don't know about the Thor-Forest River situation in terms of how tough it is to go in to compete with him. I think it'd be tough to compete with Pete under any circumstances.

His IT department, for a $4 billion business, consists of six people. He just knows what's going on in the place.

And the important thing is that it's his company. I couldn't run an RV company, and we don't have anybody at headquarters that could run one.

It’s a tough business. And you do work on narrow margins, to get to your point on that, Jonny. The —it’s a business that runs with maybe 11 or 12 percent gross margins, and probably 5 to 6 percent of SG&A. So, you know, your margins are in that 6-or-so percent range.

We have a very good — both from his standpoint and from our standpoint — we worked out an incentive comp. Like I say, we worked it out that afternoon in Omaha when he came by.

And it’s worked for him. It’s worked for us. You know, it couldn’t be a better arrangement. I wish we had 20 like it.

And probably, most of our shareholders don’t even know we own Forest River. But that is a company that will do 4 billion of business this year, and I’ll bet will do more business over time. It’s the leader in its industry. The industry’s not going to go away.

And, you know, maybe we can even sell a little insurance on RVs. So that’s the story on Forest River.

37. Modest impact of Bakken oil shale on Berkshire

WARREN BUFFETT: Station 10.

AUDIENCE MEMBER: Hi, Warren, Charlie. My name is Vishal Patel (PH). I’m visiting from Toronto, Canada, and my question is about the oil sands.

Can you please share with the audience your view on the oil sands industry and their impact on Berkshire Hathaway?

WARREN BUFFETT: Well, in terms of —are you thinking of the oil sands or are you thinking of shale production?

AUDIENCE MEMBER: I’m thinking oil sands, Alberta.

WARREN BUFFETT: Alberta, yeah.

AUDIENCE MEMBER: Keystone XL.

WARREN BUFFETT: It’s not a huge impact. We have a crane business at Marmon that does a lot of business in oil development, generally. But, certainly, is active in the oil sands.

We will soon have a transmission operation that will cover 85 percent of Alberta. Alberta’s a big place. It’ll have 8,000 miles, or something like that, of transmission lines, for example.

But the oil sands business is — I mean, you know, oil sands are huge. And we own some Exxon Mobil, when they’ve got an operation in the oil sands, obviously.

One thing you might find kind of interesting, you know, we are moving 700,000 barrels a day of crude oil on our railroad. We've got — probably got — maybe, nine unit trains — now [BNSF Executive Chairman] Matt [Rose] can correct me on that — you know, that carry 100 cars or so.

And each one has 650 barrels, or so, of oil so that — oil, you may find interesting, not only is there a significant advantage in terms of the flexibility of where you take it, so that spreads are different in different places, and you can move it to refineries that you might otherwise have trouble moving it to. Rail's flexible that way.

But rail, actually, you know — mentally, you think of oil gushing through pipelines. But rail is probably, I would say, close to twice as fast in moving oil as is — as are pipelines.

But we recently bought a company from Phillips 66. We got it in an exchange for our Phillips stock. We bought a specialty chemicals company.

And its main product is a chemical additive that causes oil to move through pipelines about 10 percent faster than it would otherwise. So it may take a day off of a trip.

So we're actually in the pipeline business in a small way — the crude pipeline business — in a small way, through that.

I don't think — I think the oil sands are an important asset for mankind, obviously. There's a huge amount of oil there. They're an important asset for mankind, you know, in — over the centuries to come.

But I don't think there's — I don't think it will dramatically change anything at Berkshire.

Matt might have a different view on that. I'll ask Charlie to talk. And then if Matt would like to say anything, I'd be glad to hear from him, too.

CHARLIE MUNGER: Well, but, a lot of the oil sand production uses natural gas to produce the heavy oil.

So it's a very peculiar thing. It's economic only if oil stays at a very high price, and it's delightfully economic only if natural gas is too cheap.

So it's a very peculiar business. And it is good for mankind. But whether it's a great investment or not, I haven't the faintest idea.

WARREN BUFFETT: Matt, would you — do you have anything to add on the crude situation there?

38. Update on Buffett's hedge fund bet

WARREN BUFFETT: OK. We're at noon.

I promised a group — some people — six years ago I made a bet for charity on how a index — Standard and Poor's 500 index fund — would compare in performance to a group of hedge funds. And a firm in New York took me up on the bet.

And I promised that every year I would give the up-to-date results on how we're doing. And it's getting to be more fun to give these results every year. (Laughter)

We're now six years into the bet. And it's interesting, because the people who selected these funds are very decent people and smart people. And, obviously, the fund of funds gets paid based on the per — they get paid a fee, naturally.

But they also get paid an additional performance fee based on how the hedge funds they select do. So they have every economic incentive to come up with a wonderful group of hedge funds.

And underneath these fund — five funds of funds that are involved in the bet — there are probably, at least, 200 hedge funds that the fund of fund managers have carefully picked in order to enhance their own income. They got the ultimate motivation going for them.

So we are now five years — six years — into the bet. And the first year, the fund of fund groups, in a down market, did considerably better than the S&P.

But as you can see in the five years subsequently, the S&P has been running away, to some degree.

Interestingly enough, we bought — we each put in 350, or something, thousand dollars, and we bought zero-coupon bonds so there would be a million dollars in ten years.

We bought ten-year Treasurys, zero coupon. And we bought a million dollars principal. We each put up 350.

Well, the way interest rates changed after a few years to practically zero rates, it meant the bonds, even though they had no coupons attached to them, practically went to par.

So, a year or two ago, we sold the bonds at about 95 or 6, we got almost the full million dollars. We put that all in Berkshire stock. I guaranteed them that they would have a million dollars at the end of ten years, no matter what happened.

And so the prize looks like it's going to be quite a bit more than a million dollars when the ten years comes around, so. So, so far, everyone's happy.

Afternoon Session - 2014 Meeting

1. Record attendance

WARREN BUFFETT: OK, let's get ready to proceed.

We never get any precise figures, because people come and go from the meeting. But I did know that we sent out about 11,000 more tickets this year than in any other year, and we had all the overflow rooms filled. We're using space in a room over at the Hilton and everything, so clearly this year we have substantial more attendance than any year in the past, and I hope the spending patterns reflect that. (Laughter)

2. Risk of change to businesses

WARREN BUFFETT: So with that, we'll go to Becky. Assuming she's here.

BECKY QUICK: I am, I'm here.

WARREN BUFFETT: OK.

BECKY QUICK: Let's see, this is a question that comes, and I hope I pronounce your name correctly, Michael.

It's Michael — Michael Locheck (PH) and he says, "Energy Future Holdings' likely bankruptcy is a consequence of unexpected and dramatic decline in prices of natural gas prices caused by a revolution in drilling technology. To what extent do you believe other assets held in Berkshire's portfolio, debt, equity, et cetera, may be subject to disruptive technological or other changes that erode business models and barriers to entry?"

"For example, changes in consumer behavior and regulation could affect Coca-Cola. Revolution in payment systems could affect American Express, ever-increasing rate of change in technology and competitive landscape could affect IBM, wireless delivery of media content and urbanization could be disruptive to DirecTV.

"Could you also comment on whether participation of some sponsors of Energy Future Holdings, which include the very best of private equity, contributed to your decision to invest? Was it the degree of crowd mentality at play, and what lessons are to be learned from the experience?"

WARREN BUFFETT: Yeah, well. I would be unwilling to share the credit for my decision to invest in Energy Future Holdings with anybody else. I would think that's very unfair of anyone to insinuate that they had anything to do with that decision.

That was just a mistake on my part. It was a big — it was a significant mistake, and we will make mistakes in the future.

All businesses should constantly be thinking about what can mess up their business model. And with Energy Future Holdings it was a fairly simple assumption that was made that just turned out to be wrong.

I mean, the assumption there was that gas prices would stay roughly as high as they were or go higher, and instead they went a whole lot lower.

And at that point the whole place toppled. They had a lot of reserve holdings and they had some futures positions which kept them alive for a while. But that was a basic error.

We look at all of our businesses as subject to change. A classic case would be GEICO. I mean, GEICO set out in 1936 to operate at low costs and pass on those low costs to the customer through lower prices for something that was a necessity, auto insurance.

And they originally did it by mail offerings, U.S. Postal Service, two people who were government employees. That's where the name comes from, GEICO, Government Employees Insurance Company.

And they had to adapt over the years, and they adapted first to widening classifications. But they went from the U.S. mail, primarily, to the telephone, and later went to the internet, and onto social media.

But in there they stumbled one time, too, as they went to adapt, and they — when they left the government employees classification, at one point they became too aggressive about expanding and they almost — they really did go broke.

So there's — change is going on all the time, and it's going on with all of our businesses. And we want managers that are thinking about change, and what can — what's going to be needed for their business model in the future. And we know they're not going look the same five or ten years from now.

I mean, BNSF, something as basic as railroads, is looking big at LNG for its locomotives. Everything is going to change.

Our businesses generally deal from strength and they're generally not subject to rapid change. But they're all subject to change, and of course, slow change can be much harder to perceive, and can lull you to sleep easier, sometimes than when rapid change is clearly in sight.

So I would say, in answer to that question, A) I will make mistakes in the future. I mean, when you — that's guaranteed.

We do not make anything like "bet the company" decisions that will ever cause us real anguish. That just doesn't happen at Berkshire. But you're not going to make a lot of decisions without making some significant mistakes.

And occasionally they work out very well. Charlie and I, and Sandy Gottesman, in 1966, bought a department store in Baltimore. Now, there's probably nothing dumber than buying a department store in the mid-1960s. There were four department stores on the corner of Howard and Lexington Street in Baltimore in 1966, and none of them are there. And the number one store, Hutzler's, went broke a little later than our store went broke.

But fortunately Sandy did a great job of selling it, so the $6 million invested in that department store became worth about $45 billion in Berkshire Hathaway stock as we did other things with the money as we went along.

So you do have to be very alert to what is going on in your businesses, and we want our managers to do that. But actually, it's something that Charlie and I, and our directors, are going to think about, as well as our managers. Charlie?

CHARLIE MUNGER: Yeah, I spoke earlier about the desirability of removing your ignorance piece by piece, and there's another trick, which is scrambling out of your mistakes. And we've been quite good at both, and it's enormously useful.

Imagine Berkshire, a textile mill sure to go broke because power costs in New England were about twice as high as they were in TVA country, a sure-to-fail department store, and a trading stamp sure to be forced out of business by change in mode. Out of that comes Berkshire Hathaway. Talk about scrambling out of mistakes, I think of what we might have done if we'd had a better start. (Laughter)

WARREN BUFFETT: Yeah. The point was driven home to me — my great-grandfather started a grocery store here in Omaha in 1869. And my grandfather was running it in 1929, and he wrote my uncle who was going to be running it with him.

And the letter started out, this is in 1929, "The day of the chain store is over." And that is why we ended up with one grocery store, which went out of business in 1969.

It — you really have to face facts around you, and the wish being father to the thought was, unfortunately, what overcame my grandfather.

3. Heinz earning power

WARREN BUFFETT: OK, Jay?

JAY GELB: This question is on the Heinz transaction.

Berkshire's 50 percent ownership in Heinz is included in Berkshire's results, which can be meaningful to its earnings over time.

What is Heinz's current normalized earning power, after the substantial restructuring of the business, and what do you anticipate Heinz could earn within a few years?

WARREN BUFFETT: Yeah. Well, Heinz will be filing its own 10-Qs. In fact, I guess its first quarter would be — they went to a calendar year now — first quarter would be about due now. So you'll get to see Heinz's figures.

And I will say this, that Heinz was actually a very reasonably run food company with about 15 percent pre-tax margins for many years, and that's not an unusual operating margin in the food business.

And I would just invite you to look quarter by quarter and maybe next year, too, I think the margins of Heinz will be significantly improved from those historical figures. What Bernardo Hees and his associates have done there is — they've just restructured the business model.

And I think that the brands, which are all-important, are as strong as ever. And I think the cost structure is going to be significantly improved without cutting into marketing expenditures.

So I think you'll see a significant improvement, but I don't want to name a number on that. You'll find it out soon enough.

4. Buy companies or stock?

WARREN BUFFETT: OK. Station 11.

AUDIENCE MEMBER: Hi, Mr. Buffett and Mr. Munger. My name is Dev Contessaria (PH) and I'm a fund manager from Philadelphia.

You've touched on some of this already today, but I wanted to ask, if you could expand on how you think about comparing investment opportunity.

In the past, you haven't been afraid to make a single position a large portion of your portfolio, such as Coca-Cola.

So when there is a chance to buy more of your favorite names, as in 2008 and early 2009, how did the case of buying more of companies like Coca-Cola or even a Moody's, which had dropped from 75 to 15, as examples, compare with other things that you actually did?

Could Berkshire have achieved its historical returns with a more simple, concentrated portfolio of your favorite names with positive characteristics such as durable competitive advantage, pricing power, strong organic growth, et cetera, versus the larger, more complex collection of businesses which exist today? Thank you.

WARREN BUFFETT: Yeah. Well, depends which favorite name we might have hit harder back in the 2008 and 2009 period.

In the first instance, I spent a considerable part of our cash reserves too early, looking back, too early in the 2009 panic. The bottom of that was reached early in March in 2009, and that bottom was quite a bit lower than September and October of 2008 when we spent 16 or so billion.

Now, we were committed to finance Mars for 6.6 billion, and that commitment had been made many months earlier, so we didn't really have much choice in terms of the timing of that.

But we did fine on the expenditures we made during that period, but obviously we didn't do as well, remotely as well, as if we'd kept all of the powder dry and then just spent it all at once at the bottom.

But we've never really figured out how to do that, and we won't figure out how to do that.

So, the timing could have been improved dramatically. On the other hand, as late as the late fall of October of 2009, when the economy was still in the dumps, really in the dumps, you know, we were able to buy BNSF, which will be an enormous part of our future.

So, overall we did reasonably well going through that period. But looking back, the most money would have been made just by buying a bundle of stocks.

When we were buying Harley Davidson bonds at 15, looking back we should have been buying the stock. But that'll always be the case.

Overall, we would love the idea — what really we want to do at our present size and scope, and with the objectives we've got for our shareholders, is we want to buy big businesses with good management at reasonable prices and then try to build them over time.

I mean, when we start 2014, we've got a really good group of businesses, some of them very big. Those businesses will earn more over time, and then the — what we're trying to do is add onto them and make sure we don't issue any shares in the process. So it's not a complicated process.

And looking back we'll always be able to do it better than we've done it. That's just the nature of things. But I don't — I feel the game is still a very viable one, and will be for some time. It won't be forever, it can't be forever. But it's still got some juice left in it. Charlie?

CHARLIE MUNGER: Well, what's happened, of course, is the private businesses that we control have gotten to be a bigger and bigger percentage of the thing. For a great many of the early years we had more in common stocks than the total value of the company. And so we were — it was like a big portfolio of common stocks and a lot of businesses thrown in as extras.

And now, of course, the private companies are worth way more than the stocks. And, I would guess that that will continue, wouldn't you Warren?

WARREN BUFFETT: Sure, it'll continue. And the difference is when we're right about stocks, it shows up in market value and in net worth.

When we're right about businesses, it shows up in future earning power, which you can see, but it doesn't jump out at you the same way changes in stock values do. So it's a different sort of buildup of value, and one is somewhat easier to see than the other.

But the other is more enduring and does not require going from flower to flower. And they're both fine, but we've moved into phase two. Say that's fair, Charlie?

CHARLIE MUNGER: Yeah, well, if you're just investing moderate amounts of capital in the middle of some panic, you take the bottom tick, it's a very attractive price. But no significant volume of the shares could have been purchased at that price.

And so when we buy these businesses, we can get huge chunks of money into things. And now if we'd wanted to go much heavier into Moody's, we couldn't have bought that much anyway.

WARREN BUFFETT: No, no.

CHARLIE MUNGER: Yeah, so, we are sort of forced by our own past success, more into these bigger positions represented by the private companies.

But really, that's in the advantage of all of us, I think.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I love it when we buy transmission lines in Alberta. I don't think anything horrible is going happen to Alberta. And nor do I think transmissions —

WARREN BUFFETT: If it does, we won't know it.

CHARLIE MUNGER: Yeah, right, right. (Laughter)

And — no, I think we've adapted pretty well to changes in our circumstances.

And that, again, is part of life. I mean, since change is inevitable, how well you adapt to it is terribly important. And I would say the changes that many of you have watched in Berkshire over the years have been very much in our interest, and then there may be future changes that are just as desirable.

WARREN BUFFETT: We bought a fair amount of Wells Fargo, for example, really over the last few years. And because the economy came back, really, the most money, if you were buying at the bottom, came from buying the banks of lesser quality because they — their weaknesses drove them down even further in price, and they needed a good economy to come back.

But they were kind of like a marginal copper producer or something, that you make more money if copper goes up, not if you buy the best copper company but, usually, if you buy the worst one, because it — they have the highest marginal cost, but that gives it the biggest kick on profits.

To some extent that's been true, for example, the banks. But we felt 100 percent comfortable buying Wells Fargo, and we might have felt 50 percent comfortable buying some others and so we went where we were comfortable.

Looking back, you can say we should have just bought them all. And in fact, bought the ones that had had the worst record going into 2008 or '09, because they had the greatest recovery possible, simply because they'd fallen so far. Andrew?

5. Technology and GEICO's future

ANDREW ROSS SORKIN: — And it has to do with the future as well, and it relates to GEICO.

And the questioner asked, "Could you, and perhaps Tony Nicely, please explain how you think about usage-based pricing, tracking drivers electronically and charging premiums accordingly, and how that will affect the auto insurance industry in the U.S. in the next decade, and how these changes impact the moat at GEICO?

I'm also sure you've studied the potential impact of self-driving cars on GEICO. Google says it's now five years away. What does this mean to the future of the profit machine that is GEICO, and if the analysis showed a challenging future, would you ever sell?"

WARREN BUFFETT: Yeah. Well, the answer to the very last question is no.

The usage-based pricing is something that's popular with some companies that have done a lot of work on it. Probably the one most identified with it is Progressive doing something called "Snapshot."

And there's no question that knowing how customers drive, or policy holders drive, and how they use their cars is a valuable input to assessing the proper premium to people.

And insurance is all about comparing the propensity of loss to achieve — or evaluating the propensity of loss to establish the proper premium.

And it's very easy to understand in life insurance. I mean, if somebody is 90, they're more likely to die than 20, despite Charlie — situation. (Laughter)

Even at 83 they're more likely to die than somebody at 20.

The — so you know, that's obvious. Females live longer. That's not quite as obvious but it's been established.

So there are various variables in insurance, and you try to assess those variables and set the proper price for the policy holder. If you lived in a state, for example, where the population of the state was one instead of, you know, 100 million, there'd be a whole lot less chance of an accident, you know, than — because of the lack of density of driving and so on. There's all kinds of variables.

And through studying usage, by various methods, Progressive being probably the best known on it, they're attempting to look at some variables and hope they get better information about the propensity of that particular driver to — or the likelihood of that particular driver — to be in an accident.

And we look at lots of variables, they look at lots of variables. We think we've got a pretty good system, and so far I think that's been proven correct. But we'll continue to look at many variables.

I feel very, very, very good about GEICO, GEICO's management, and its ability to evaluate risk. And I think there are plenty of other people that are good at it, but I don't think there's — in my view, there's nobody better at it, in terms of auto insurance, than the GEICO people.

So — but we ought to keep asking ourselves, "Can we do it better?" And we do ask ourselves that.

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

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

CHARLIE MUNGER: Yeah, some of these things happen a lot more slowly than you might think. I went to a program at Harvard, oh, at least 30 years ago, describing how color movies were going come to the house on demand, and they were just around the corner.

Well, they've come, but it was 30 years later. I have a feeling that self-driving cars having a huge impact on the market may take quite a while. And so I'm not —

WARREN BUFFETT: That would be my guess, but we could be wrong, you know.

CHARLIE MUNGER: Yeah, it could be wrong.

WARREN BUFFETT: But — (Laughter)

CHARLIE MUNGER: But —

WARREN BUFFETT: But if we are wrong, we'll be wrong together. (Laughs)

It is hard to figure out how it could have a major impact in 10 years, but it may not work at all, who knows?

But GEICO will be doing more business, a lot more business, in my view, five years from now than now, and ten years from now.

You know, 30 years from now, you're young enough to find out, and I will go away peacefully without knowing.

OK. (Laughter)

6. More international acquisitions?

WARREN BUFFETT: Gregg.

GREGG WARREN: Thank you, Warren.

You've been pretty explicit about your acquisition criteria over the years, and some years ago, perhaps around the time of the ISCAR deal, you mentioned at one of the annual meetings that a concerted effort was being made to make non-U.S. companies more aware of Berkshire's positive attributes as a preferred acquirer.

Yet, despite the higher proportion of large family-owned businesses in places like Europe and the fact that over half of the world's listed market cap currently comes from outside of the U.S., Berkshire has deployed very little capital outside of the U.S. with just ISCAR, and more recently AltaLink, coming to mind.

Is the U.S. truly that much more attractive a destination for capital, or is there some other reason why the firm has not deployed serious capital outside of the region?

WARREN BUFFETT: Yeah, no, we've never turned down a chance to make a significant acquisition outside the United States because of any feeling we'd much rather be doing something in the United States. We just — you know, you mentioned the Alberta deal.

But we have not had as much luck getting on the radar screen of owners around the world as we have in the United States.

Our best bet, by far, in buying a business is to buy it from the family of a founder or the founder himself or herself. So we've, you know, that's our strong suit, and in the United States I think almost anybody that fits in that category with a business of size thinks of us. And a fair number would prefer us.

I don't think that same — I think there's some recognition outside the U.S. Certainly when we heard from ISCAR, that was in 2006, Eitan Wertheimer said, he wrote me a letter, I'd never heard of him before, I'd never heard of the company. And he said the family had thought about it, and we were the only company to which they wanted to sell, and if they didn't sell it to us, they weren't going to sell it.

So, there's some awareness. But I've been a little disappointed in that we haven't had better luck outside the country. And we'll keep working at it and see what happens.

Incidentally, I just talked to Jacob Harpaz, who does an incredible job of running ISCAR. I talked to him yesterday when I was touring the exhibition hall.

They set a new record in April. Now, that won't be the last new record they set. But that may have some slight meaning, in terms of how world business is doing, because they sell, you know, these tiny little cutting tools, and so on, that go into basic industry all over the world.

And people don't buy those because they — you know, they're going look pretty in their offices or anything else, they buy them because they're using them up. And, it was a record in April. March had been extremely good, too. So they are seeing strength in the business that certainly would make it hard to believe there's weakness going on throughout the industrial world.

ISCAR's been a wonderful company for us. The people have been sensational. The business is extraordinary. It just is — it fits us so well that I just wish I could find a few more like it out there.

But this year, aside from the one we announced yesterday, we have not been contacted by any significant ones that made sense. We have heard from people over the last five years, I mean, we've — fair number. But nothing that really makes sense. But we'll keep trying.

7. Knowing your "circle of competence"

WARREN BUFFETT: OK, station 1. We're back at — here we are.

AUDIENCE MEMBER: Hello, Mr. Buffett, and hello, Mr. Munger. Thank you for being extremely generous with sharing your wisdom. My name is Chander Chawla, and I am visiting from San Francisco.

In the past, you have said that people should operate within their circle of competence. My question is, how does one figure out what one's circle of competence is? (Laughter)

WARREN BUFFETT: Good question. (Laughs)

Some of the people in the audience are identifying with it, I can hear them.

The — it's — you know, it is a question of being self-realistic, and that applies outside of business as well.

And, I think Charlie and I have been reasonably good at identifying what I would call the perimeter of that circle of competence, but obviously we've gone out of it.

I would say that in my own case, I've gone out of it more often in retail than in any other arena. I think it's easy to sort of think you understand retail, and then subsequently find out you don't, as we did with the department store in Baltimore.

You could say I was outside of my circle of competence when I bought Berkshire Hathaway, although I bought it, really, to resell as a stock, originally.

I probably was out of my circle of competence when I decided that I should go in and buy control of the company. That was a dumb decision — which worked out.

The — being realistic in appraising your own talents and shortcomings, I think — I don't know whether that's innate, but some people seem a whole lot better at it than the others. And I certainly know of a number of CEOs that I feel have no idea of where their circle of competence begins and ends.

But, we've got a number of managers who I think are just terrific at it. I mean, they really know when they're playing in the game they're going win in, and they don't go outside of that game.

The ultimate was Mrs. B, at the Furniture Mart. She told me that she did not want stock, in terms of the Berkshire Hathaway deal. Now, that may sound like it was a bad decision. It was a splendid decision.

She did not know anything about stock, but she knew a lot about what to do with cash. She knew real estate, she knew retailing, and she knew exactly what she knew and what she didn't know, and that took her a long, long, long, long way in business life.

And that — that ability to know when you're playing the game in which you're going to win, and playing outside of that game, is a huge asset.

I can't tell you the best way to develop a great sense of that about yourself. You might get some of your friends that know you well to offer contributions. Charlie's given me a few contributions occasionally, saying, “What the hell do you know about that?” That’s one way of putting it, of course. (Laughs)

But Charlie, do — can you help him out?

CHARLIE MUNGER: Well, I don’t think it’s as difficult to figure out competence as it may appear to you. If you’re five-foot-two, you don’t have much of a future in the National Basketball League. And if you’re 95 years of age, you probably shouldn’t try and act the romantic lead part in Hollywood. (Laughter)

And if you weigh 350 pounds, you probably shouldn’t try and dance the lead part in the Bolshoi Ballet. And if you can hardly count cards at all, you probably shouldn’t try and win chess tournaments playing blindfolded, and so on and so on.

WARREN BUFFETT: You’re ruling out everything I want to do. (Laughter)

CHARLIE MUNGER: But competency is a relative concept. And what a lot of us need, including the one speaking, is — what I needed to get ahead was to compete against idiots, and luckily there’s a large supply. (Laughter)

WARREN BUFFETT: OK, Carol. (Laughter)

8. Comparing Berkshire’s book value to stock index

CAROL LOOMIS: This question comes back a little to a question asked earlier about your annual performance standard that you comparison.

“Mr. Buffett and Mr. Munger, I think of you as running a rational company. But when I look at your annual comparison of Berkshire’s book value per share versus the S&P average, I don’t see any rationality in that at all.”

“What is the logic of comparing a stock market index against the rise in an operating company’s book value? And an operating company is predominantly what Berkshire is these days, so why do you annually make this irrational comparison?”

CHARLIE MUNGER: Let me answer that one.

WARREN BUFFETT: OK. (Laughter)

CHARLIE MUNGER: The answer is you’re totally right, and we do that because Warren wants to make it eccentrically difficult for himself. So if you don’t understand people who like to wear hair shirts, you’ll never figure out why anybody would do such a thing.

It's a ridiculous way to make a comparison, but it makes it hard for Warren to look good. And he likes to climb mountains that are difficult. But it's insane, you're right. (Laughter and applause)

WARREN BUFFETT: Yeah, yeah.

Normally when he goes all wishy washy like that, I like to clarify. But I don't think I'll try. (Laughter)

9. ISCAR and Marmon deal valuations

WARREN BUFFETT: OK. Jonathan.

JONATHAN BRANDT: The multiple of pre-tax profit that Berkshire paid for minority interests in Marmon and ISCAR in 2013 were considerably higher than the multiples Berkshire paid for earlier purchases of majority stakes in those two firms.

Can you please explain why the valuation formulas changed, why the multiples weren't fixed for future increases in Berkshire's stake, which at least in Marmon's case were always contemplated, and why Berkshire was willing to accept meaningfully lower returns on the more recent purchases, not so many years after the first purchases?

WARREN BUFFETT: Yeah, well, the multiple with ISCAR was actually determined precisely on the basis of which the original purchase was made. In other words when we made the deal in 2006, we took multiples of earnings and allowed for cash and a few things.

But — and then we took that formula and we stuck that in as both a put and call option for the family or Berkshire. They had the put, we had the call. And we stuck that in to govern things for, you know, between now and judgment day, and so that there's no variation from the original formula.

We would never — shouldn't say never, but we had — our style would not be ever to call that from the family, even though we had the right to do it.

The put and call were at the same price, or at the same — following the same formula. But the family elected to put it to us, but they put it to us exactly on the same basis as what was involved in the original purchase of the 80 percent.

The Marmon deal is entirely different. The Marmon deal was an installment sale, and, in effect, to make the deal and buy the originals turned out to be 64 percent, we intended it to be 60 but gave them the option to do more.

That was simply an installment sale, and we looked at the consequences of the formulas being applied in the future. The family would not have sold us the 64 percent, which they did on the original piece, unless they had the formula applying to the second and third piece that was embodied in the contract.

And we looked at that as a single transaction, knowing that if the business improved we would be paying more money, and as the cash position improved, we'd be paying more money later on. But it was all built into the original deal, so one was one — was at exactly the same price, and one was part of a three-step deal, in effect. Charlie?

CHARLIE MUNGER: But the price went up because the value went up.

WARREN BUFFETT: Yeah, but it was — and because it was built into —

CHARLIE MUNGER: Yeah, and we'd agreed to — that that would be — we'd pay value.

WARREN BUFFETT: In both cases, I should say too, both with the Pritzker family at Marmon and with the Wertheimer family at ISCAR, it couldn't have been — they couldn't have behaved better — or the feelings are entirely good, everybody felt good about the transaction. The initial transaction and the subsequent transaction. So it pays to have to have deals in which people feel good when they —

CHARLIE MUNGER: Nothing that happened there is that — we got just an enormous respect for the intelligence of those two families. The more we looked at those businesses, the smarter and better those families looked. It was just amazing what each family had done, wouldn't you say, Warren?

WARREN BUFFETT: Right, right.

CHARLIE MUNGER: Absolutely amazing.

WARREN BUFFETT: And those were two important acquisitions. I mean, they — you know, they add up to lots of intrinsic value. And there, partly because of some accounting peculiarities, but the carrying value of the businesses is well below what the intrinsic business value is now.

CHARLIE MUNGER: And by the way, that Union Tank Car that's within Marmon is John D. Rockefeller's old business. The first John D. Rockefeller. It's amazing how some of these good businesses have lasted.

WARREN BUFFETT: Yeah, well, actually the corporate form it — the original corporation that is Marmon, I'm quite sure, is Rockwood and Company, which I did a cocoa arbitrage with back in 1955 or something, and that's where I met Jay Pritzker. So it — these things wind their way along.

It — one thing you learn in life, but also learn particularly in business, is that you're going to meet a lot of people and entities and experiences — in the future that — you may have thought were one shot —one stop shops originally in your life.

10. How to find what you love and do it

WARREN BUFFETT: Station 2.

AUDIENCE MEMBER: Mr. Bung — this — Mr. Buffett, Mr. Munger, my name is Nicholas Erdenberger. I hail from the beautiful Garden State of New Jersey. And I guess the — (laughs) — I guess the question —

WARREN BUFFETT: Withhold your applause, applause. (Laughter)

AUDIENCE MEMBER: So I guess this is a follow up question to the question before.

I really connect with the idea of not investing in industries you can't fully understand. Being a young guy who has limited ability to code and who can't build robots, tech is certainly not an industry I fully understand.

And yet these days, the concept of entrepreneurship is nearly synonymous with tech amongst people my age. So my question to you, Mr. Buffett, is if you were 23-years-old with entrepreneurial tendencies, what non-tech industry would you start a business in and why?

WARREN BUFFETT: I'd probably do just what I did when I was 23. (Laughs)

The — you know, I would go in the investment business. And I would look at lots of companies and I would go and talk to lots of people, and I would try to learn from them what I could about different industries.

One thing I did when I was 23, if I got interested in the coal business, I would go out and see the CEOs of eight or ten coal companies. And the interesting thing was I never made appointments usually or anything, I just dropped in. But they —they felt a fellow from Omaha who looked like me couldn't be too harmful.

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

And then I would say, after I got an answer to that, I would say, and if as part of that deal they had to sell short in the equivalent amount of money — in one coal company — which would it be and why?

And if I went around and talked to everybody in the coal business about that, I would know more about the coal companies from an economic standpoint than any one of those managers probably would.

So, I think there's lots of ways to learn about business. You're not going learn how to start another Facebook or Google that way, but you can — you can learn a lot about the economic characteristics of companies by reading, personal contact.

You do have to have — you have to have a real curiosity about it. I mean, you — I don't think you can do it because your mother's telling you to do it, or something of the sort. (Laughs)

I think you — it really has to turn you on. And I mean, what could turn you on more than running around asking questions about coal companies? (Laughter)

You have to maybe be a little odd, too.

But that's what I would do. And I might, in the process of doing that, find some industry that particularly interested me, in my case the insurance industry did, and you might become very well equipped, even perhaps, to start your own insurance company, but perhaps to pick the most logical one to go to work for.

If you just keep learning things, something will come along that you'll find extremely useful to do. I mean, it — but you've got to be open to it. Charlie?

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

WARREN BUFFETT: Well —

CHARLIE MUNGER: — there are a lot of tricks that people use.

WARREN BUFFETT: We did the same thing with Solomon, actually. It was a Saturday morning —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — when I call —and you were there, Charlie, weren't you? -

CHARLIE MUNGER: Yes —

WARREN BUFFETT: — I wasn't sure.

I called in, I don't know whether it was eight or ten of the manager — I had just gotten in there on Friday afternoon, and now it's Saturday morning and we had to open for business Sunday night in Tokyo, and I had to have somebody to run the place.

So I called in eight people and I said, you know, "Who besides you would be the ideal person to run this, and why?"

One guy told me that there was nobody compared to him. (Laughter)

He was gone from the firm within a few months. (Laughter)

But — the — it's not a bad system to use.

You can really learn a lot just by asking. I mean, it's starting to sound a little bit like a Yogi Berra quote or something, but it is — it is literally true that you — if you talk to enough people about something they know something about, and people like to talk. You know, and — here we are talking ourselves. (Laughs)

And you just have to be open to it. And you will find your spot. You may not find it the first day, or the week, or month, but you'll find what fascinates you.

I was very lucky because I found what fascinated me when I was seven or eight years of age. But — you know, some people find chess or music, you know, fascinates them when they're four or five.

If you're lucky you find it early, and sometimes it takes you longer, but you'll find it.

CHARLIE MUNGER: If it's a very competitive business, and it plainly requires the qualities that you lack, it should probably be avoided.

I could — when I was at Caltech I took thermodynamics, and Homer Joe Stewart, who was a genius, taught the course. And it was fairly apparent to me that no amount of time or effort would turn me into a Homer Joe Stewart. He was utterly, impossibly more talented than I could be.

Gave up. I immediately said I wasn't going try and be a professor of thermodynamics at Caltech. And I've done that with field after field, and pretty soon there was only one or two left. (Laughter)

WARREN BUFFETT: Yeah, I had a similar experience in athletics. (Laughter)

11. Hotel room economics during Berkshire meeting

WARREN BUFFETT: OK, Becky.

BECKY QUICK: This question comes from Darren Bordemier (PH). He says, "Warren, you've commented in the press that you are concerned about the hotel price gauging in the Omaha area during the Berkshire meeting weekend." (Applause)

Hold your applause, you haven't heard the rest. "Please elaborate further on that position, as it seems to contradict free market capitalism. Shouldn't the law of supply and demand apply in this case?"

WARREN BUFFETT: Absolutely. And so therefore, since we want to increase the demand, the proper thing to do is increase the supply, right? (Laughs)

And that's why we have encouraged, for example, Airbnb, to come in and — they supplied some rooms this year.

But it's very logical. If you think about most cities, the big events that come to their convention centers and use their hotels, they size themselves in deciding where to go. If you have a relatively small industry, they can pick a moderate-sized city and they can have their convention there, and they don't outstrip the supply of rooms.

If you have a very big industry and you're having a convention, you know, you have to go to some place like Vegas or some place that has a lot of rooms because otherwise you do throw the supply-demand out of whack.

So, if you have an event, which isn't sized by the people that are scheduling it, can't be sized by the people that are scheduling it, then you can totally outstrip rational supply of rooms.

I mean, you know, the great case would be something like the Masters tournament. I mean, Augusta can't size its hotel industry to Augusta, to the Masters, and the Masters isn't going move any place. Well, there — are certain events like that, but there aren't very many.

And Omaha cannot size its hotel supply to the Berkshire meeting. It sizes it to the kind of conventions it normally gets and all of that, but the Berkshire meeting has grown beyond what we anticipated.

So fortunately, there's developed — and for that reason people started putting in — what really bothered me were the three-day minimums. I mean, it — you know, I think there's something particularly irritating about somebody's coming in for a one-day event to have to buy — have a three-day minimum. And the prices were getting high.

Incidentally, the Omaha Hilton right across the street, they — they've been magnificent throughout this, as have many others. But there were a few that were really pushing things, and we didn't want to cut down on the demand. We didn't want to move to Dallas, even though we're opening a store there next year, it would be kind of fun for that.

But we're not going move to Dal — I mean, we want — Omaha people love this event, it's an economic boon for Omaha, but — and people get a good impression of Omaha when they come here, generally.

So it's — there's a lot of good things about having the meeting in Omaha, and we can't expect anybody to build new hotels to take care of three days a year. So, fortunately, something like Airbnb is sort of a flex supply arrangement that seems to me to make a lot of sense for it.

And I think that it will be more developed by next year, and I think that the hotels will do extremely well next year. But I don't think they can push it to the ultimate extreme of a total scarcity product. And we want them to do well, and that's why we've gone where we have. Charlie?

CHARLIE MUNGER: Nothing to add.

12. Will GEICO eventually overtake State Farm?

WARREN BUFFETT: Jay?

JAY GELB: This question is on GEICO. GEICO continues to gain the most market share of the large auto insurers while delivering attractive margins. It also has the largest advertising budget of the auto insurers while maintaining the advantage of being a low-cost operator.

My question is, will GEICO, with 10 percent market share currently in auto insurance, eventually overtake State Farm, which currently has 19 percent market share in auto insurance, keeping in mind that State Farm is also a major writer of homeowners insurance coverage?

WARREN BUFFETT: Yep. Well, that's a good question. Nobody knows the answer to that for sure. But I will tell you this, we passed Allstate this year.

And State Farm is a terrific company, I mean, it's one of the great histories — has one of the great company histories in America. It was started by a farmer who had no insurance experience to speak of when he was, I think, in his early 40s. There's a book called "The Farmer from Merna," I think it is, over in Illinois, and you know, he built this incredible business based on a better business model. And that was done around 1920 or so, I believe.

And then, of course, GEICO came out with an even better model, but State Farm was huge by that time. Allstate was very, very large. And it's taken us since 1936 to become number two.

Now, I have some projections that if I live to be 100, that we should be number one. And I tell GEICO, I'm going do my part. So the rest is up to them. (Laughter)

We will gain share, in my view. We will gain share month after month, year after year, as long as we never forget that our job is to take extremely good care of the customer, and as long as we can properly rate risks.

We've got some basic advantages that will enable us to do that as long as we take care of those two matters. And Tony Nicely has done a job that belongs in, you know, world's hall of fame, in terms of achieving that objective.

The 15 years prior to Tony coming — taking over — roughly 15 years, maybe 14 years — the market share had hovered around 2 percent. And you know, maybe two-one or two-two. And you know, since he took over in 1993, it's gone to ten-plus and it will keep going.

But State Farm has got a net worth of probably 70 billion now or there abouts, 60 to 70 billion, and they've got a strong presence in homeowners and they've got a strong agency force. They've got a lot of satisfied customers. So it won't come fast, but I do think it will come. Charlie?

CHARLIE MUNGER: Well, GEICO to me is very much like Costco. And one of the reasons it's succeeded is that they really feel a holy duty to have a wonderful product at a very low price.

A lot of people talk that game, but very few have it just right down under the body and soul of the company. But GEICO does, and companies like that do tend to grind ahead over time.

WARREN BUFFETT: One thing you'll find about it, I think this is true about Costco, too, it's certainly true about GEICO, is that people don't come and go from there as they — I mean, we have practically no one from the rest of the insurance industry that's come over to GEICO, and they don't leave us.

I mean, they really have their own idea about how it should be done, what should be done right. And it becomes very, very reinforced. And, of course, it becomes reinforced by success. Is that true at Costco, Charlie?

CHARLIE MUNGER: Oh, Costco's unbelievable. And it reminds me very much of GEICO, and I'm not surprised that both companies keep taking share.

It's easy to talk the game, but living the game is something else. I mean, it's against the human nature of many entrepreneurial people to try and get the price down and the service quality up all the time. I mean, it's like wearing the ultimate hair shirt and yet it works.

13. Has Buffett's frugality hurt Berkshire?

WARREN BUFFETT: OK, station 3.

AUDIENCE MEMBER: Mr. Buffett, my name is Neil Patel from Chicago. I greatly admire the way you have lived a frugal personal life even with your considerable wealth.

How do you think your frugality has helped Berkshire shareholders over the years? And Charlie, are there any instances where you think that Warren's frugality has hurt Berkshire and shareholders?

WARREN BUFFETT: Well, first of all, let's ask who is the more frugal between us. Charlie, who do you think — (Laughs)

CHARLIE MUNGER: Well, in personal consumption, Warren is more frugal. (Laughter)

WARREN BUFFETT: Would you care to give an example? (Laughs)

CHARLIE MUNGER: Warren lives in the same house he bought for a very modest price, what, in 1950-something?

WARREN BUFFETT: I bought in 1958, and you moved into yours about 1960, didn't you?

CHARLIE MUNGER: Yeah, and I paid more. (Laughter)

WARREN BUFFETT: But he designed his own —

CHARLIE MUNGER: Absolutely, I could get —

WARREN BUFFETT: — he designed his own house.

CHARLIE MUNGER: — he's more frugal.

WARREN BUFFETT: He did not pay an architect, right?

CHARLIE MUNGER: I did, I paid an architect $1,900. It was as much as 30 percent of the normal price.

WARREN BUFFETT: Yeah. Notice how he remembers the details. (Laughter)

No, I would — I have everything in life I want. It's a very simple thing. If there's anything that money can buy — there are things money can't buy, but if there's anything money could buy that I wanted, I'd do it this afternoon. I wouldn't have any problem with that at all.

I do not think that standard of living equates with cost of living beyond a certain point. I mean, up to a certain point there's no question that it does in — in terms of having good housing, good health, good health service, good food, everything. But — good transportation.

But there's a point I think, if anything, you start getting inverse correlation. My life would not be happier, and it'd be worse, if I had six or eight houses or, you know, a whole bunch of different things I could have. It just doesn't correlate.

And so I — having everything I have, I mean, you can't have more than that. And that doesn't really make any — it makes a difference up to a point. I mean, you could start thinking a lot differently when you got to X, but when you get to ten-X, or a 100-X, or 1,000-X, it just doesn't make any possible difference. Charlie, can you —?

CHARLIE MUNGER: The frugality, basically, has helped Berkshire. And I look out at this audience and I see a bunch of understated, frugal people, too. We collect you people. (Laughter)

WARREN BUFFETT: But forget about it this weekend. (Laughter and applause)

The more you buy the more you save at these prices, folks. (Laughter)

14. Berkshire doesn't "begrudge" paying taxes

WARREN BUFFETT: OK. Andrew.

ANDREW ROSS SORKIN: This question comes from Azhar Quader who's in the audience, Queens Court Capital, wants you to know that he's a Columbia B School grad just like you, Warren.

WARREN BUFFETT: Good.

ANDREW ROSS SORKIN: The question is the following, "Berkshire paid $8.9 billion in taxes in 2013. Pfizer is currently contemplating an acquisition that would allow it to move its technical holding company overseas and thereby save income tax expense and create shareholder value. Is this something you and Charlie would ever consider if it would create value for Berkshire shareholders?"

WARREN BUFFETT: I think the answer to that is no. What do you say, Charlie? (Applause)

CHARLIE MUNGER: I think it would be — I think it would be crazy to be as prosperous as Berkshire and get our tax to zero while we remain this prosperous. That would not be a legitimate ideal. (Applause)

WARREN BUFFETT: Yeah. We could not have done Berkshire in any other country except the United States, either. You know, and just look at what we've acquired and everything.

America has, in a very, very, very big way helped Charlie and I become very, very, very rich. (Laughs). Charlie?

CHARLIE MUNGER: I've got no complaints. And I look around at this group, I see you at breakfast, it's a very happy group of people. I don't think a lot of people are gnashing their teeth that somebody else has a little more.

WARREN BUFFETT: But we don't pay — I don't want to make it holier than thou, this stuff. We don't pay anything beyond that — when we get all through figuring out tax on our 20,000 page-plus return, we just don't — we don't add a tip of 20 percent or 15 percent or anything. (Laughter)

And we do certain transactions which are tax driven. We're in low-income housing tax credits, which actually George Bush 41 congratulated me for. So it's bipartisan.

We — the wind energy deals we do, the solar deals we do, they are tax driven to — I mean, they won't make economic sense otherwise.

So we follow the rules. But we don't begrudge the taxes we pay. We've earned a lot of money while paying U.S. taxes. (Applause)

15. Try for Mexico's rail freight market?

WARREN BUFFETT: OK, Gregg.

GREGG WARREN: Warren, Burlington Northern's main competitor in the west, Union Pacific, generates around 10 percent of its revenue from freight moving to and from Mexico. It also owns a 20 percent stake in the large Mexican railroad, Ferromex.

Given the expectation for strong auto production growth in Mexico with 30 percent more capacity coming online in the next two years, and the potential for additional near-sourcing manufacturing in Mexico, how attractive do you find the Mexican freight market?

And assuming that the answer to that question is positive, would it not be a greater benefit to Burlington Northern to own the smallest Class-I railroad at Kansas City Southern, which generates about half its revenue from its Mexican concession, whether than just receiving cargo from the firm?

WARREN BUFFETT: Yeah, Union Pacific has a big edge in terms of Mexico. I mean, their route structure is such, I think they cross the border at six different places. Their route structure is far better than ours in relation to Mexico.

And Kansas — it's true as you say, that Kansas City Southern has a very significant presence in Mexico.

But, in terms of what we can do with our money and what we see as the prospects — there are good prospects there, but there are good prospects elsewhere for traffic, too.

So it doesn't make sense for us. But, you know, maybe someday something will, but — the math does not work for Mexico. But we're continuously thinking about Mexico, but we're thinking about lots of other markets, too.

There are lots of possibilities for moving more freight on the BNSF over the years. And we won't forget about Mexico, but we won't do anything silly, either. Charlie?

CHARLIE MUNGER: I don't have anything to say.

You know, it's awfully easy to imagine combinations that just make you rich with sleight of hand. And, of course, the easiest transaction is buying a competitor. But most of that stuff, when you get to a certain size, you can't do. So why spend time even thinking about it? I'm afraid Burlington Northern is going have to get ahead on its own from here on.

WARREN BUFFETT: Wouldn't worry about that.

CHARLIE MUNGER: I'm not worried about it.

16. Intrinsic value and the Berkshire model

WARREN BUFFETT: Station 4.

AUDIENCE MEMBER: Hi, Warren and Charlie. Dan Hua from Los Angeles. My wife, Cora, and I are thrilled to be here.

WARREN BUFFETT: We're delighted to have you.

AUDIENCE MEMBER: Thank you. You earlier today discussed intrinsic value, and I'm a big fan of Graham and Fisher, especially "Security Analysis." What differences do you have, if any, for calculating intrinsic value, versus what was said in "Security Analysis?"

And for examples, how does management factor into that? You recently mentioned evaluating management is like dating, and recently you said, also, management does matter.

My second part is, which company do you fear the most? Why is it that no one else has done what you have done? I mean, Coca-Cola has their Pepsi. Thank you.

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

Now, I'm not sure who was the first one that came up with it, but — well, the first one that came up with it was Aesop, actually. But the intrinsic value of any business, if you could foresee the future perfectly, is the present value of all cash that will be ever distributed for that business between now and judgment day.

And we're not perfect at estimating that, obviously. (Laughs)

But that's what an investment or a business is all about. You put money in and you take money out.

Aesop said, "A bird in the hand is worth two in the bush." Now, he said that around 600 B.C. or something like that, but that hasn't been improved on very much by the business professors now.

Now the question is, you know, how sure are you that there are two in the bush, you know? How far away is the bush? There are all kinds of things. What are interest rates? But I mean, Aesop wanted to leave us something to play with over the next couple thousand years, so he didn't spell the whole thing out. But that's what intrinsic value essentially is.

And, we don't — Graham would say that, Phil Fisher would say that. Phil Fisher would say that in calculating that, he would want to look a lot harder at the qualitative factors of the business in making that estimate of how many birds were in the bush.

Graham would say he would want to see the bush — you know, $2 worth of cash in the bush, you know, and to pay a dollar for it now.

One emphasized quantitative factors and one emphasized qualitative factors, but neither one would have disagreed with the math.

And I started out very influenced by Graham, so I emphasized quantitative factors. Charlie came along and said I was all wrong, and that he'd learned more in law than I'd learned in financial studies and everything, and that I should think more about qualitative factors, and he was right. And Phil Fisher said the same thing.

But that's what intrinsic value is about, you know. if you buy a McDonald's franchise, if you buy General Motors, whatever it may be, the real question is, A) are you going to have to put more cash into after you buy it? But it's really cash in, cash out? When? What discount rate? All the standard stuff.

In terms of — if I had a silver bullet, what company would I shoot as being a threat to us? I don't really — I don't see any competitor to Berkshire. I see private equity buying lots of businesses and having an advantage in that they'll leverage up when we won't, and also that presently they can borrow money very cheap and all of that.

So I mean, there are always going to be people competing with us to buy businesses. But — which is our main business — main occupation for me and Charlie.

But I don't see anybody that's got a model, or trying to build a model, that will essentially go after what we're trying to achieve, which is to buy wonderful businesses from people that care about where their business goes, and who generally want to keep on running them. Charlie?

CHARLIE MUNGER: Well, as I've said earlier, I think the Berkshire model as now constructed will have — as said in show business, with legs. It will go a long time, and I think it will be quite creditable. And I think it has enough advantage that it will just keep going a long time. And I think most big businesses don't.

If you stop to think about it, all the great big businesses of yesteryear, how few of them have really gotten big and stayed big.

Of the really old businesses, only one stayed big and that was Rockefeller's Standard Oil. And so we're getting up into a territory where very few people keep going well.

But I think what we'll be more like Standard Oil, than we'll be like ordinary businesses, because I think we will just keep going. We will keep doing what we're already doing, and we'll keep learning from our mistakes.

And the people up here are no longer all that important. The momentum's in place, the ethos is in place. It's going to keep going. And to you young people in the audience, I always say, "Don't be too quick to sell the stock."

WARREN BUFFETT: Why don't we get more copycats?

CHARLIE MUNGER: It reminds me of our mutual friend, Ed Davis. He figured out how to do an operation that was so difficult that he operated the bottom of a dark hole with instruments of his own creation. He gave his own shots by Novocain, 87 of them, while he was operating. And it was a better operation. His death rate was 2 percent and everybody else was 20.

And the other surgeons came to copy him, and they watched him. And they just said, "Well, I don't think I'll try and copy that." (Laughs)

I think it looks just too hard to do. There's — nothing in the American business school teaches people to be like Berkshire.

WARREN BUFFETT: Eddie Davis is the guy that, in effect, introduced the two of us. He was a famous urologist here in Omaha, and —

CHARLIE MUNGER: But people didn't try and learn his operation. And it doesn't look all that easy. It's very different.

WARREN BUFFETT: It's slow, too.

CHARLIE MUNGER: And it's slow, it's — yeah, very slow.

WARREN BUFFETT: I think the slowness deters more people than anything else.

CHARLIE MUNGER: And the difficulty with being slow is you're dead before it's finished. (Laughter)

WARREN BUFFETT: Well, that's kind of cheerful. (Laughter)

Carol, let's come up with something a little — (Laughs)

CAROL LOOMIS: Well, for a more cheerful subject, mine is inflation. In it — (Laughter)

WARREN BUFFETT: Only compared to Charlie can inflation be cheerful. (Laughter)

17. Positive and negative effects of inflation

CAROL LOOMIS: This comes from Larry Pitkowsky and Keith Trauner at the GoodHaven Fund.

"In your 1981 shareholder letter, you discuss returns on equity, interest rates and inflation, and how difficult it was for many companies to function under inflationary conditions. Indeed that Berkshire itself was not immune and would be negatively — could be negatively affected.

"Today it seems like every central banker in the world is desperate to create inflation, something that is generally great for debtors, not so great for creditors, and difficult for owners and managers.

Should investors and business owners be thinking more about inflation and higher interest rates after 30 years of declines in both? How would Berkshire behave differently if it became apparent that the future was turning inflationary?"

WARREN BUFFETT: Well, inflation would hurt us, but it would hurt most businesses. It doesn't — there's certain assets that if highly leveraged, obviously, would benefit from inflation. But, well, it's just —

We'll set up an inflationary condition. Let's just assume tonight that drones are sent up over all of the United States and they happen to drop a million dollars in every household.

Now, the question is would the country be better off? Every individual would now have — or every family would now have a million dollars that they didn't have the day before.

The one thing I can guarantee you is that Berkshire would be worse off at that point, obviously. And obviously, what I've described would be wildly inflationary.

The trick in that circumstance is to find out that you've got a million dollars before anybody else finds out that they have, and you'll do very well if you're first.

But essentially, you don't create wealth by inflation or by having — you can move it around, but you don't create it by inflation, and you don't — a firm like Berkshire, you know, our earnings per share would go up. The intrinsic value of our business, measured in dollars, would go up. But under lots of inflation, unless we had leveraged those businesses, the value of your investment, in real terms, would go down. Charlie?

CHARLIE MUNGER: Well, we had a test of hyperinflation in Weimar Germany, and the people who owned stocks in places like Berkshire got through. And they didn't prosper joyously, but they got through. And everybody else, practically, life insurance policies, bank deposits, you name it, got wiped out.

And, of course, if you create so much misery that you get a Hitler, and a World War, and a Holocaust and so forth, it's not a good thing to let things go that far.

And so I'm — I don't like this huge confidence that all you have to do is just keep printing money and spending it. I think there's some limit to when that will work, and I am never going forget Weimar Germany. And I don't think any of the rest of us should either.

We can handle a little bit of subpar growth for some stretch or other. But it would be quite dangerous to let the whole damn thing blow up because a bunch of crazy politicians were printing money. (Applause)

WARREN BUFFETT: If you own a home, though, with a very large mortgage, and you have incredible inflation that wipes out the mortgage, then you've still got the home. I mean, it's just —

CHARLIE MUNGER: In Weimar, Germany, they gave you the mortgage back at the end. It was very interesting. That's the one thing they did right. (Laughs)

WARREN BUFFETT: He's way ahead of me, folks. (Laughs)

18. Why companies make "dumb" deals

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: In evaluating the after-tax returns Berkshire earns on its acquisitions of non-insurance businesses, whether it be the utilities, the railroad, or the manufacturing service and retailing business, in terms of choosing a benchmark, what would be your best estimate of the returns on acquisitions earned by an aggregate of all American industry, adjusted, of course, to exclude the impact of accounting write-offs and equalizing for leverage?

WARREN BUFFETT: That sounds too tough for me, but go ahead, Charlie. I'll be thinking. (Laughs)

CHARLIE MUNGER: Well, let me summarize. I think the sum total of all acquisitions done by American industry will be lousy. It's in the nature of corporations that are prosperous to be talked into dumb deals, and bureaucracy tends to feed on itself and create unnecessary costs.

So I think the history of acquisitions is that it's not an enormous way to wealth. Now, it has been for us, but we're very peculiar, and luckily a lot of people don't want to be peculiar in our way.

WARREN BUFFETT: Yeah, I would — it's really hard to, you know, come up with a useful answer on that. But I certainly —

CHARLIE MUNGER: But you don't have a great deal of optimism, do you?

WARREN BUFFETT: When we read that a company we don't control is going to make an acquisition, I'm much more inclined to cry than to smile.

But on the other hand, we love making acquisitions ourselves, so it's a little hard to get too harsh just because we don't like the other guy's acquisitions.

I have been — I have sat in on, probably, hundreds of acquisition discussions conducted by people I didn't control, as a director. And most of them have been bad ideas, but there have been some —

CHARLIE MUNGER: Some are mediocre. (Laughter)

WARREN BUFFETT: A great case is GEICO. I mean, it's really a great case study because GEICO had this wonderful business prior to going off the tracks in the early 1970s, but it'd been an incredible business and everybody — it was well known in the financial world.

And then it went off the tracks in its own business, got back on the tracks. And then in the next — after it got back on the tracks, it made a couple of acquisitions. And they weren't disasters, but they certainly weren't successes, and they tended to take people's — I think they took their eyes off the ball in terms of the potential of GEICO itself.

So the accounting costs of those — there were two acquisitions in particular — the accounting costs of those two acquisitions was not — it was poor, but it wasn't disastrous.

But if you look to secondary effects, it was huge. I mean, there were a dozen years there or so where all kinds of gains could have been made that weren't. And you don't get those years back.

Now, that was probably a net plus for Berkshire, you know, in the end, because we'd bought half of the company then we got to buy the other half later on. If they'd done wonderfully, we probably would have never bought the second half. Now, maybe the first half would have been worth that much more.

But it's human nature, to some degree, to, you know, keep wanting — I mean, normally the people who get to be CEOs are not shrinking violets, you know.

And they have animal spirits, as Keynes talked about, and they like to do things. And the supporting staff certainly senses that they like to do things. I mean, they often have people in charge of strategy or acquisitions, or all of those things.

What do you think those people are going to do? Sit around and suck their thumbs? No, they're going keep coming up with deals. And the investment bankers will be, you know, calling on them daily.

So there are all these forces that push toward deals, and if you try to push toward deals, you're going to get a lot of dumb deals.

We try very hard, Charlie and I, not to get eager to do a deal. We're just eager to do a deal that makes sense.

And that would be a lot harder if we had directors, strategy departments, whatever it might be, all pushing us toward, you know, what have you done in the last three months, or something of the sort.

So the setting in which you operate really can be very important. Charlie, anything further?

CHARLIE MUNGER: No, but it's — you know how much more tactful he is.

WARREN BUFFETT: Yeah, well the comparison isn't tough. (Laughter)

19. Prosecute individuals or corporations?

WARREN BUFFETT: Station 5.

AUDIENCE MEMBER: I'm Russell Narig (PH) from Neenah, Wisconsin. The — not another Packer fan.

The people in this hall tonight are here because of the invest into your money, in anticipation and hope that you and Charlie would make that investment grow.

We recognize that things go wrong and that we might lose money. But never, ever, has it ever crossed our minds that we'd be cheated out of their money.

Unfortunately, that — that's not — that's new — I'm sorry, having problems with this microphone. Unfortunately, particularly in the investment banking business, confidence, my confidence, and I'm sure the confidence of many people in this room, are falling.

Particularly distressing are reports in the "New York Times" in the last week or so about private meetings in the Justice Department, Securities and Exchange Commission, the Fed, and others, about the need or desire, the requirement, perhaps, to bring criminal charges against some of the largest banks dealing business, for, among other things, knowingly laundering billions of Iranian dollars through our U.S. banks, knowingly laundering billions of drug cartel money through U.S. banks, soliciting on U.S. soil deals which would include tax evasion by moving assets offshore, and even fixing the LIBOR.

The problem the Justice Department is having is that they are being told that if they bring criminal charges against those banks, and we can list those banks, they've been in the "New York Times," that those banks would be sorely hurt, may be required to go out of business, and require — and evolve into a new financial crisis of some sort. (Applause)

CHARLIE MUNGER: Now, we can't —

AUDIENCE MEMBER: My question — my question, though, to you is do you believe a financial crisis will be — come about as a result of bringing justice to criminal activity on a large scale? Or have we reached a new point where criminal activity in Wall Street is being institutionalized, sort of allowed to happen because they're too big to fail, too big to go to jail, and too big to be regulated, to follow the law?

WARREN BUFFETT: Charlie, you're the lawyer, you take it up. (Applause)

CHARLIE MUNGER: Well, I think behavior on Wall Street has enormously improved as a result of the trauma we've just been through. And so I think the worst of it is behind us.

But you're never going to have perfect behavior when a bunch of human beings live in a miasma of easy money. It's just this is always going happen to some extent, and —

WARREN BUFFETT: How do you feel about the prosecution of individuals versus the prosecution of corporations?

CHARLIE MUNGER: Well, I think there's hardly anything that changes behavior more than prosecuting individuals.

When they took Boy Scout leaders out of Pittsburgh or wherever it was and put them in the federal penitentiary for fixing steel prices, it really changed behavior of American businessmen. So I do think that a few criminal prosecutions do change behavior a lot. And it looks to me like we'll get a few.

WARREN BUFFETT: Yeah. I may be biased a little bit by the experience at Salomon, but — I lean way more toward prosecution of individuals than corporations.

You know, I literally saw, you know, a bad act, or maybe multiple bad acts, by just a couple of people and negligence in reporting by a couple more, you know, come close — certainly upsetting, hurting, and maybe destroying, you know, possibly thousands and thousands of other people's lives, forgetting about the financial investment.

And it is — it did seem to me, and that's — had that experience a couple of other times in what I've seen, that — that it really — it may be easy — it's way easier to prosecute the corporation. The corporation's going write a check, and you know, I mean, it's somebody else's money.

And the prosecutor knows he's going get a win, basically, if he goes against the company, whereas he's got a way tougher job going against individuals. The company's going to cave, it's just their calculus is such that it just doesn't make sense to fight if they can write a check, whereas the individual is fighting to stay out of jail.

So the prosecutor's got an easy case, or relatively easy case, and probably a headline-grabbing case, if he goes against the corporation. And he has a grinded-out type of thing, which he can very well lose and which really takes a lot of work, against individuals. So — but I still lean very much — toward going against individuals. And —

CHARLIE MUNGER: I do, too. That's what I meant when I said when antitrust violations were regarded as forgivable offenses, menial sins, we had a lot of them, and we still have some now that we prosecute people criminally. But we have really changed behavior on price fixing by the individual prosecutions, and we haven't had many of those prosecutions in finance yet. And we probably need some more. Don't you agree with that?

WARREN BUFFETT: Yeah, it's — absolutely, absolutely.

And I will tell you this: we have 300,000-plus people working at Berkshire. Somebody is doing something wrong now, I mean, that — you know, you cannot have a city of 300,000 people and not have somebody behaving badly.

And that's the thing — that is the one thing that — I don't worry about us making money, we'll figure out a way to do that. And it may be better or worse than we hope for. But it won't be a disaster, ever.

The disaster is if somebody is doing something wrong that, you know, that actually reflects badly on the whole organization.

And I know that's, to a degree, out of my hands. I can tell the managers, and they can tell the people that work for them that reputation is more important than anything else. And that's going to have an effect, and I think it's going to have more of an effect than having them — giving them some 200-page manual.

But it's not going cure everything. And what we hope is when there is something wrong that we find it out early, and then it's up to us to do something about it.

But we will have a problem of some sort, at some time, because it just — you know, 300,000 people are not going to all behave properly every day. It just doesn't happen.

But the individual prosecution, and I've written about that a little bit in the annual report in terms of — the way to change behavior is to have the fear, at least among people who may be doing the wrong things, is to have the fear that somehow it's going to come home to them and hit them hard.

And if the only fear is that the company's going have to write a big check, you're going to get way less change in behavior than if it'll hit home to the individual. Becky? (Applause)

20. Effect of major railroad accident on BNSF and Berkshire

BECKY QUICK: This comes from Mark Blakley from Tulsa, Oklahoma.

He says there's been a number of railroad accidents in the past year. In January, the Wall Street Journal published an article highlighting the lack of insurance to cover a worst-case accident scenario.

"Mr. [Matt] Rose of BNSF was mentioned as wanting to set up an insurance fund funded by the railroads to protect the industry in case of an accident, similar to a fund currently set up by nuclear power companies, but that idea has gained no traction.

"How would a worst-case accident scenario impact BNSF and Berkshire Hathaway? And if the industry is lacking insurance for such an event, how can the company protect itself, and what exposure does Berkshire have should a major accident occur?"

WARREN BUFFETT: Yeah, well we're on both sides of that because Ajit [Jain] has offered the rail industry some very high limits to all the major railroads. But they don't like his price, presumably. And I would say this, the four major railroads really have the financial capacity to pay a huge award if something really terrible happened.

The most — you know, I don't know which is the most dangerous — they have what they call hazmat, hazardous materials, and rails have to carry them. You're a common carrier, you're forced to carry them. And the railroads would really prefer they didn't carry them, but they do, they have to. And they probably can't get enough, ever get enough, in the way of payments per carload to really compensate them for the risk involved.

But the four major railroads, certainly have the — it might be a very, very significant financial hit to them, but I think they have the capability of, if something really drastic happened, I think they do have the financial capability to handle that size — kind of an award.

And if they feel that they don't, they can buy insurance from Ajit, but so far we haven't sold any.

The companies have insurance, but they don't like — they're not going talk about the amounts that they have or anything of the sort because that becomes a honey pot sometimes, and it's not advisable to discuss your insurance limits publicly.

But I would — it is true, as the writer mentions, that the nuclear risk — the government decided was too big, as they have with terrorism — decided it was too big to be borne by private industry.

I don't think the consequences of any conceivable accident — you could probably dream up one — but of any conceivable accident on rails would go beyond the capability of the major railroads to pay. But it could be very, very large, relative to their net worth and relative to their current earnings. Charlie?

CHARLIE MUNGER: Yeah, the big surprise for everyone, of course, was British Petroleum.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Nobody in their wildest dreams believed that a major oil company, from an accident in one well, would have a loss in so many tens of billions of dollars. And, of course, that's gotten a lot of attention.

I don't know about Warren, but after that happened, I would have less enthusiasm for drilling in the Gulf. It was just such a big loss compared to anything.

WARREN BUFFETT: And a gain, possible gain.

CHARLIE MUNGER: And gain — possible gain. And that was a big oil field they tapped into, but it wouldn't remotely pay for this accident. And so — but I — Matt will know, the biggest rail accident in the history of the rails, has it cost $200 million? Is Matt there?

WARREN BUFFETT: I don't think — I don't think Norfolk Southern has ever announced what that accident cost.

But we are not getting paid enough, I can tell you this, for carrying chlorine or ammonia or something like that. I mean, it — just — you know, to buy appropriate insurance just to cover those kind of products, compared to the revenue, I don't think it ever would make sense.

But we're required — they're going move from one place to another one way or another, either by truck or in some manner. And we are a common carrier.

But it is not — that's not one that keeps me awake nights from a financial standpoint. The big risk is some form of very effective terrorism or action by a rogue state in terms of nuclear, chemical, biological, or cyber.

And, you know, war acts are excluded in insurance policies. But you could have some kind of a terrorist act that would create damages, whether they're liable under insurance contracts is another matter, but could create damages like we have never seen. And there's a, you know, there's obviously a reasonable probability of that happening sometime in the next 50 years, and what that probability is I don't know. But it's not insignificant. Charlie?

CHARLIE MUNGER: Well, we saw what one pilot could do recently in this Malaysian airplane.

I think we live in a world where there are always going be big events, and I think we're lucky, to some extent, that we have some big corporations that can have elaborate safety programs and that can handle the losses when they occur. I don't think we'd be better off if we had a bunch of little Flivvers going around the airplanes.

21. Is commercial property-casualty insurance expansion too late?

WARREN BUFFETT: Jay?

JAY GELB: — question is on Berkshire's primary commercial property-casualty insurance business.

Berkshire plans to substantially expand the Berkshire Hathaway specialty insurance unit and has also become a major insurer of Lloyd's business through an Aon-brokered facility.

Why is Berkshire increasing its presence in commercial property-casualty insurance when pricing has peaked?

WARREN BUFFETT: We — it's the first one that's more important.

We entered the commercial insurance field the middle of last year, and we had some wonderful talent that wanted to join us. And we have a great amount of capital, a very, very good reputation, and we think we have the ability to both underwrite more intelligently than most, to keep larger limits than anybody, and to operate at costs significantly below average.

So if you put those elements together, and you throw in Ajit Jain overseeing the operation, I think it's a terrific opportunity.

And I think you will — and it wouldn't make any difference when we entered it. I mean, we entered it because we had the availability of some terrific people. That was the reason for the timing of it.

And we'll have — we've added to that group significantly. Peter Eastwood runs it, and I think we will build a very, very significant commercial insurance operation over time. And I believe that that operation will operate with better underwriting results than the great majority of our competitors.

Charlie?

CHARLIE MUNGER: Well, I think it's a very logical thing for us to do. And, of course, when something is logical we don't hold back because we think the business cycle might possibly be a little better. It's a long-term play.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: We're not going away based on the little short-term troubles.

WARREN BUFFETT: No, it's a forever play. And — when we see a chance to enter a business we like, basically, with outstanding people and with some very fundamental competitive advantages, we're going to play the game and we're going to play the game hard.

22. Buy a sports team or sports equipment company?

WARREN BUFFETT: Station 6?

AUDIENCE MEMBER: My name's Ed Boyle (PH) and I'm from Chicago. My question's for Warren and Charlie.

Do you ever have any plans, or would you be interested, in buying a professional sport team — (laughter) — or sports equipment manufacturing company, being that we're — sports is in a global world today? Or is this out of the Berkshire game?

CHARLIE MUNGER: Warren's already done it.

WARREN BUFFETT: I owned a quarter of a major — a minor-league team, but it's not responsible for my position on the Forbes 400. (Laughter)

The answer to your question about buying a sports team is no. In fact, if — Charlie and I — if you read that either one of us is buying a sports team, it may be time to talk about successors. (Laughter)

We are — we do — sports equipment has generally not been a very good business, although, you know, obviously Nike's done incredibly well in its overall operation.

But — we own Spalding. We own Russell. And you know, Spalding has been around a long, long time. A.G. Spalding, I forget when the hell he was — I think he was trying to take baseball to the rest of the world back in the, I don't know, the 1880s or something like that.

But it's — generally speaking, if you look at the people that have made golf equipment, footballs, helmets particularly, baseball gloves, baseballs, it's not been a particularly profitable business.

And certain aspects of it, like helmets, you know — the last thing Berkshire should do is own a helmet company. A helmet company should be owned by some guy that owes about a million dollars and doesn't have a dime to his name, because, you know, he is not going to be a target. And we would be the ultimate target.

That's the reason — we used to be involved in Pinkerton, but we'd had no interest in — and we got offered the chance to buy the whole place, and the idea of owning a business that provided guards at airports, you know, when anything went wrong, you know, you're going to say that it was the guard's fault. And here's this super-rich corporation around there that is a perfect target.

I mean, a guard company at airports, again, should be owned by somebody whose net worth does not get out to two figures. (Laughter)

So, you won't see much of us in the sports arena.

But Charlie here, are you looking at the Clippers or —? (Laughter)

Now I'm worried that he is. No — (Laughter)

CHARLIE MUNGER: Whatever Warren thinks about sports teams ownership, I like it less. (Laughter)

23. Secrecy, Bill Ackman, and activist investors

WARREN BUFFETT: OK. Andrew.

ANDREW ROSS SORKIN: OK, Warren. You have long advocated for transparency and disapproved of greenmailers. Bill Ackman compared his amassing his stake in Allergan in stealth ahead of Valeant's bid to your purchase of Coca-Cola in the 1980s.

Is that right? What do you make of the covert tactic Ackman is using from a policy perspective for the markets?

And just as important, what do you make of the larger trend of activism in corporate America?

WARREN BUFFETT: I hadn't heard that about Coca-Cola. I'm really not sure how that would come about. I mean, we bought stock in the open market, we never used a derivative transaction or any sort in buying it, or anything. I mean, and we certainly haven't taken it over yet. The — so I — I'm not sure — can you elaborate, Andrew?

ANDREW ROSS SORKIN: I don't have more from the —

WARREN BUFFETT: Oh yeah.

ANDREW ROSS SORKIN: — the question. I believe Bill Ackman went on television at one point, had commented that using his stake, or buying the stake, rather, he did it covertly, and I think he was perhaps suggesting that, I don't know, maybe I will adjust the question.

There have been times in the past when you have bought stakes in other companies and used specific rules through the SEC to do so with — to give you some room without disclosing. Maybe, will that adjust the question?

WARREN BUFFETT: It —

ANDREW ROSS SORKIN: Or you could just go to the activism question.

WARREN BUFFETT: Yeah, and tell me the activism question again, because we have never used derivatives or anything that would get us around the rules of reporting, I mean, it's that simple.

But what's the second part?

ANDREW ROSS SORKIN: I think that the second part is what do you make of the larger trend of activism in corporate America, given that it's in the news so much today?

WARREN BUFFETT: Well, I don't think it'll go away, and I think it scares the hell out of a lot of managers. (Laughs)

The — there are cases — certainly cases where corporate management should be changed. I mean, you can't have thousands of corporations without that being the case.

I think, generally speaking, that the — you know, the activists, if they get the price of the stock up one way or another, you know, that's going to end their interest in the business, so I don't think they're looking for — often they're not looking for permanent changes for the better in the business. But they're looking for a specific event that will result in a big price change, and —

They're certainly attracting more and more money. In other words, the funds flowing to activist hedge funds and so on is — multiply them, sure, by a significant factor, and that means they can play the game on a bigger scale.

And anything in Wall Street that looks like it's successful will generate a funds flow that will, you know, go on until it's no longer successful. Charlie?

CHARLIE MUNGER: Well, you're right that the activism is causing more of a stir in corporate management than anything has in years. Practically nobody feels immune.

When an activist comes into a company, 20 or 30 percent of the stock can change hands rather rapidly, and management that seemed entrenched is — suddenly is threatened. And, of course, that sort of thing causes a lot of anguish.

And on the other side, the activists, by and large, are making a fair amount of money. And, of course, in the culture we live in, most people don't care how the money is earned, they just care whether they get it or not.

And so that — that just grows like some — I don't know, the beanstalk of Jack. And so I think we have a very significant effect.

And some of the stuff — you'll find an activist who is not what you'd want to marry into the family, going after a company you would never buy into. And when that happens, it reminds me of Oscar Wilde's definition of fox hunting. He said, "The pursuit of the uneatable by the unspeakable." (Laughter)

And I think we're seeing some of that. It's — I don't think it's good for America, what's happening —

WARREN BUFFETT: What do you think —

CHARLIE MUNGER: — averaged out.

WARREN BUFFETT: What do you think it'll be three years from now?

CHARLIE MUNGER: Bigger.

WARREN BUFFETT: Wow.

CHARLIE MUNGER: Well, what's stopping it?

WARREN BUFFETT: Yeah. If it's bigger three years from now, it'll be a lot bigger. I mean, just the compounding of numbers.

CHARLIE MUNGER: It's really serious.

24. Buy smaller companies instead of waiting for an "elephant?"

WARREN BUFFETT: OK. Gregg. (Laughter)

GREGG WARREN: If Berkshire's size is expected to be an ongoing constraint for growth, does it make more sense for the firm to target a larger collection of smaller companies that are growing faster and can do so for a longer period of time, rather than looking to bag a big elephant that is in all likelihood already reached maturity, leaves the firm to sit on larger-than-normal cash balances for a longer period of time, even if it means paying a higher price for the growth?

And if the answer is no, then what is the opportunity cost to Berkshire shareholders for keeping a lot of excess cash on hand until the right deal comes along?

WARREN BUFFETT: Well, the answer to the first is one doesn't preclude the other. You know, we'd be delighted to buy some company for 2 or 3 billion that we thought would do very well over time.

But that applies to one for 20 or 30 billion. Now, if you get down to buying one for a couple hundred million, that may fit one of our subsidiaries to do that that knows the business.

But — we're not passing up anything of any size that can have any real impact on Berkshire. And like I say, our subsidiaries made 25 tuck-ins last year, and they'll keep making more. They'll see things that fit them.

But one, you know, one $30 billion deal is ten $3 billion deals, and a hundred $300 million deals. So, in terms of the reality of how we build a lot more earning power into Berkshire, which is what we're trying to do, our main emphasis should be on bigger deals. Charlie?

CHARLIE MUNGER: Well, I agree with that. The idea of buying hundreds and hundreds of small businesses —

WARREN BUFFETT: Not worth a damn.

CHARLIE MUNGER: — not as bolt-ons for what we already have, it would be anathema.

WARREN BUFFETT: Yeah, there's lots of competition for the small deals. I mean, private equity is going after all kinds of small deals. In fact they just keep selling them to each other to some degree.

We don't feel envious when we look at what they're doing, in the least. But that doesn't mean we can't find an occasional small business that fits in and that will do well.

It's not going be the future of Berkshire, though. But I want to emphasize one does not preclude the other.

25. The most intelligent question you've been asked?

WARREN BUFFETT: Station 7.

AUDIENCE MEMBER: Willy Larsen (PH) from San Francisco.

You both mingle with the smartest investors in the country, something that I don't have the opportunity to do. So to my question, what is the most intelligent question you have been asked recently on investing, and what was your answer to that question? (Laughter)

WARREN BUFFETT: Charlie, you can go first on that while I think.

CHARLIE MUNGER: Well, I've already done that when I answered the young gentleman who said he couldn't understand why Warren compared his — or Berkshire's book value increase to stock market index performance.

In other words there are a lot of interesting questions that don't get much attention where there's a lot of irrationality.

WARREN BUFFETT: The question you asked, I get that frequently from the college students that come out. They say, "What's the most intelligent question that you've gotten in the past." And I never come up with a good answer, and I'm not coming up with one today —

CHARLIE MUNGER: I don't like the question, do you?

WARREN BUFFETT: No. (Laughter)

That's why we changed —

CHARLIE MUNGER: I don't think it's quite fair.

WARREN BUFFETT: That's why I let you go first. (Laughter)

CHARLIE MUNGER: Yeah.

26. MidAmerican energy return on assets

WARREN BUFFETT: OK, now we've hit 54 questions. So now we start going around to the stations in order. All of the journalists of each had six apiece, so we'll go to station 8.

AUDIENCE MEMBER: Philip Case, Manchester, New Hampshire.

My question pertains to the MidAmerican Energy segment. On page 64 of our annual report, you provide us with segment data for each business.

For the MidAmerican Energy segment, when I take earnings before interest and taxes and add back depreciation expense and subtract capex, the result is negative operating cash flow.

When I repeat that exercise for each of the past five years, in its best year the segment generates $308 million of operating cash flow. When I divide that by tangible assets, the result is a return on tangible assets of 0.86 percent.

Why are we allocating capital to a business that in its best year generates a return on tangible assets of less than 1 percent?

WARREN BUFFETT: You were doing great until you got to return on tangible assets. The — we love the math that you just described, as long as we are going to get returns on the added capital investment. And we are in businesses, whether it's wind energy in Iowa or whether with PacifiCorp after we bought it, there were lots of opportunities for capital investment. And the energy which we bought, we're looking forward to putting more capital in because as long as we get treated fairly by the regulators in the states that we operate, we will get appropriate returns on that.

And the return is not measured by the cash minus the increased capital investment we're making. It's measured by the operating earnings after depreciation. And there will be times in our businesses where no net investment may be required. But we actually prefer the ones where net — in the utility business — where net investment is required because we like the idea of getting more capital out at reasonable returns.

Now, the bet we are making is that regulatory authorities will treat us fairly in the future. And we've got every reason to believe that's true in the jurisdictions in which we operate. And one of the reasons we believe it's true is because we've done so much better than, really, the great majority of utilities in delivering electricity at lower rates than are charged by most utilities.

We have a situation in Iowa, for example, where there is one stockholder-owned competitive utility, and some other municipal-owned ones, and if you look at our rates, they are significantly below those of our competitors.

And in fact, one of our directors has a farm where he buys from two different sources, one being us. And his rate from us is dramatically lower than the one from the cooperative arrangement that exists.

So, we have a deserved good reputation with the regulators that we're dealing with. We've improved the operations, including safety, incidentally, dramatically from the conditions that existed before we purchased the utilities. That's why they welcome us when we come to new states.

And so if we can put more money into useful projects in those states, we've got every reason to believe we will get returns that are appropriate.

But if you compute net cash generated from those, you will see nominal or negative figures for a considerable period as we add to our investment and we make those utilities even more useful for people in those jurisdictions. I think we'll get a fair return.

We have somewhat similar situation at the railroad, too. But we're very happy about both of those businesses. Charlie?

CHARLIE MUNGER: Yeah, if the numbers you recited came from a declining department store, we would just hate it. But when it comes from a growing utility, we like it because we have such confidence that the reinvested money is going to do exceptionally well. It's just that simple.

WARREN BUFFETT: Yeah.

Greg —

CHARLIE MUNGER: They're two different kinds of businesses.

WARREN BUFFETT: Greg? Is Greg here? You want to — you might be able to give him a few figures that I don't remember off the top of my head in terms of comparative — how our prices compare, and give him a little more of a flavor on how the utility commissions do regard us and how they treat us fairly.

GREG ABEL: Sure. When you look at our rates across each of the regions, effectively we're generally the low-cost provider, or in the low quartile.

Your example, Warren, in Iowa was a great example. The last time we had a rate increase there was 1998. We've just currently had one this past year, so it's the first one in the past 16 years. And we don't see another one in the foreseeable future. And when you create that type of model with our regulators, obviously they're very supportive of the various projects we've introduced.

So this past year we introduced a project in Iowa, it's a 1,000 megawatt project, $1.9 billion being incurred. And if you go to the gentleman's comment, yes, we're going put the — we'll deploy that $1.9 billion over the coming two years, but we'll earn 11-and-a-half percent — 11.6 percent return on it.

Generally when we look at our utilities, we do pay attention to our capital, we try to keep it very close to our depreciation. That's what we put back into the business. We'll even earn on that capital, but the reality is the lion's share of our capital right now is growth capital. And we earn a very nice return on that.

WARREN BUFFETT: Greg, you might comment, just a minute, I think they'd find it interesting, on what's happening in Iowa with the tech companies, simply because of what we're doing in the electric field. Or not simply, but in part because of what we're doing in the field of electricity.

GREG ABEL: Right. So when you look at the tech companies and the data centers that exist, if you just go across the river, we service Google in Council Bluffs.

They've got a site that was initially a relatively small data center. They're looking at taking it to 40 to 50 megawatts, which is a small size of a power plant. But the reality is they're talking about ultimately building that to 1,000 megawatts. And we're seeing that replicated time after time in the state.

And it's really due to two things. One, we've got these exceptionally low rates. And then the fact that a significant portion of our energy, as Warren highlighted earlier and I touched on, comes from renewable energy. They want those credits, they want to be associated with a utility that's producing green power.

27. Education market's future in U.S. and China

WARREN BUFFETT: OK. Station 9, please. (Applause)

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Gao Ling Yun and I came from Shanghai, China. I focus on the education investment.

Today, my co-worker, Yi Nuo Education Company and I have a question. What do you think about the education market in America and China in future? Thank you.

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Well, I didn't catch those last two words. In what?

WARREN BUFFETT: He wanted to know what we thought of the education market in U.S. and China, but he didn't —

CHARLIE MUNGER: But in what? He said in some — is it health care?

AUDIENCE MEMBER: In future.

CHARLIE MUNGER: In the future, I see.

Well, we certainly are getting the easy questions late in the day. (Laughter)

WARREN BUFFETT: Yeah. Yeah. (Laughter)

CHARLIE MUNGER: I think America —

WARREN BUFFETT: Whatever he says, I agree with. (Laughter)

CHARLIE MUNGER: I think America made a huge mistake when they allowed the public schools, and many particularly big school systems, to just go to hell. (Applause)

And I think the Asian cultures are less likely to do that. So to the extent that Asian cultures are avoiding some of our mistakes, why, I just wish we were more like them.

WARREN BUFFETT: OK. (Applause)

28. Buffett's joke about Munger's hearing

WARREN BUFFETT: I probably shouldn't tell you this. When Charlie was having a little trouble there on those last two words — I get a little worried about Charlie, don't know whether I should talk about this, but — (Laughter)

I thought maybe he was losing his hearing and I didn't want to confront him with it. I mean, we've been pals for a long time, so I went to the doctor and I said, "Doc, I've got this wonderful partner, but I think maybe his hearing is going on him.

"And I want to talk to him about it. I mean, how do you say that to somebody you've known that long? And what should I do?" He says, "Well, you stand across the room, talk to him in normal course of — tone of voice, and let me know what happens."

So the next time I was with Charlie, I stood across the room and I said, "Charlie, I think we ought to buy General Motors at 35, do you agree?" Not a flicker.

I go halfway across the room. I say, "Charlie, I think we ought to buy General Motors at 35, do you agree?" Nothing.

Get right next to him, in his ear, "Charlie, I think we ought to buy General Motors at 35, do you agree?"

He said, "For the third time, yes." (Laughter and applause)

So speak up, speak up. (Laughs)

29. Is housing lending reform needed?

WARREN BUFFETT: Station 10.

AUDIENCE MEMBER: Yes, this is — Glen Green (PH) from Chicago.

First of all, I want to thank you for allocating capital so well all these years, very much appreciated.

The question has to do with housing and housing reform more specifically, and there's clearly legislation in Washington, D.C. right now talking about reforming the GSEs, specifically Fannie and Freddie. Do you think we need housing reform? What would be a reasonable approach to do it, and if private participants were involved, would that make sense for Berkshire given Ajit's actuarial skills and your ability to allocate capital?

WARREN BUFFETT: Well, I think that — and Charlie may disagree with me on it, I think that the 30-year fixed-rate mortgage is a terrific boon to home owners.

It's not necessarily such a great instrument to own as an investor, but I think it's done a lot for home ownership. May have been abused in some cases, but overall it's done a terrific job for home ownership in the country. Let people get into homes earlier than they might have been able to otherwise, kept costs down to quite a degree.

And so I would hope that — and the government guarantee part of it does keep the cost down. Nobody — no private organizations can do it. I mean, home mortgages are an 11 trillion-or-so dollar market, and there's not the insurance capacity, or remotely the insurance capacity, for private industry to do the job, and the rates would be much higher.

So I think you keep the government in the picture. Now, the question is how you keep the government in the picture without keeping politics in the picture? And we've found some of the problems with that, in terms of not only Fannie and Freddie being — doing a lot of dumb things on their own, but being prodded into doing some of those things by politicians.

And I think there could be a way — I wrote an article 20, or 30 or — probably 30 years ago, an op-ed piece that appeared, I think, in the "Washington Post," when the F-D-I — well, when FSLIC, the savings and loan guarantee operation was essentially falling apart, and suggesting for the FDIC some way to get the private sector into pricing and evaluating the risk, in that case, of banks, but essentially the government being the main insurer.

There could be — there could well be a way that that model, and it's being explored now, that model works in terms of home mortgage insurance.

I don't think we would likely be a player, because I think that other people would be more optimistic than we would be in setting rates.

In the end, the government would have to be the main insurer. You might have a situation where private industry priced 5 percent of it and the government took the other 95 percent and, in turn, even guaranteed the 5 percent by the private industry once the private investors went broke.

But I do think it's very important to get housing, the mortgages for homes — to get that a correct national policy. I know it's being worked on. And I think, you know, I think it's very unlikely that Berkshire Hathaway would play any part in it.

Charlie, what are your thoughts?

CHARLIE MUNGER: Well, when private industry was allowed to take over pretty much the whole field, we got the biggest bunch of thieves and idiots that you can imagine screwing up the whole system and threatening all of us. So I'm not very trustful of private industry in this field.

And so, as much as I hate what politicians frequently do, I think the existing system is probably pretty sound.

At the moment, Fannie and Freddie are being pretty conservative and they're making almost all the home loans. I think that's OK, and I'm not anxious to go back to where the investment banks were in a big race to the bottom, in terms of creating phony securities.

WARREN BUFFETT: Yeah, and I think — one question is whether you let Fannie and Freddie just run off as is, and I don't know —

CHARLIE MUNGER: Instead of keep doing just what they're doing.

WARREN BUFFETT: But I think — I think you may — I think certainly one of the things that led Fannie and Freddie astray was the desire to serve two masters and increase earnings at double-digit ranges. And to do that, they started doing big portfolio activities.

I think if Freddie and Fannie had stuck to insuring mortgages and not become the biggest hedge funds in the country, because they did have this capability of borrowing very cheap, very long, and therefore could get a reasonable — what looked like a reasonable spread on a huge portfolio action. I think that was a big contributing factor to —

CHARLIE MUNGER: Well, they became, in effect, private corporations. But they're not anymore, Warren. They're —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — and they are at the moment being fairly conservative.

WARREN BUFFETT: There are people who want them to return to being private corporations, though.

CHARLIE MUNGER: Yeah, but I think that's a mistake because when they really got lousy, it's because the private companies were taking over the whole mortgage market as bad lending drove out good. And Fannie May and Freddie Mac, to hold up their volumes, joined in the rush to laxity and fraud and folly. And so —

WARREN BUFFETT: Would you let them have portfolio activities at all?

CHARLIE MUNGER: I don't see any need for it.

WARREN BUFFETT: Yeah, I don't either. And I think that did get them into quite a bit of trouble. And I think those were done in order to keep the earnings per share game going.

CHARLIE MUNGER: No, I think that particular experiment in privatization was a total failure. (Applause)

WARREN BUFFETT: OK. Station 11, and —

CHARLIE MUNGER: And we made a billion dollars out of it, if you remember.

WARREN BUFFETT: Well, I wasn't going mention that. (Laughter)

30. "Fortunate" to partner with 3G and Jorge Paulo Lemann

AUDIENCE MEMBER: Good afternoon. Whitney Tilson, shareholder from New York City.

I've just started reading "Dream Big," the book recently released about your new Brazilian partners and I'm really enjoying it. Their track records are unbelievable, and as a long-time Berkshire shareholder I'm delighted that you've partnered with them, and hope that Heinz is the first of many elephants that you bag together.

WARREN BUFFETT: Can I interrupt you just for one second, Whitney? I appreciate that sentiment, and that book is available in — (Laughter)

I should have mentioned it earlier. The book was written in Portuguese and it was a best seller in Brazil for the last year. But it just got translated very, very, very recently and it is available at the Bookworm. So — Whitney, you can go on from there, but I did want to mention it's available.

CHARLIE MUNGER: Why would you assume that all of our shareholders don't read Portuguese? (Laughter)

AUDIENCE MEMBER: I'll also mention that it is only available on Amazon via Kindle. The only hard copies in the world in English that I'm aware of are available downstairs, so that will create quite a run on the book, I think.

WARREN BUFFETT: We will raise the price. (Laughter)

AUDIENCE MEMBER: So I have two questions related to this. First, I know you've known these gentlemen probably for a couple decades, and I'd love to hear your observations on what's their secret sauce? It's got to be more than zero-based budgeting, which we all hear about. What are the key things they do that produces such extraordinary returns?

And secondly, when I look at some of the biggest, best deals that you've done in recent years, important factors seem to be your longtime personal relationships, for example, with Jorge Paulo Lemann in the Heinz deal, or your brand name.

The Warren Buffett stamp of approval mattered a lot to some of the deals you did with, for example, Goldman or GE during the financial crisis. And I just wonder what your thoughts are on whether your successors will have the same opportunities to do wonderful deals like this?

WARREN BUFFETT: It will become the Berkshire brand. I mean, the first year or so people will wonder about it, but the person that follows me will bring the same qualities, including the ability to write a very big check. But other things besides that, and it will be a Berkshire brand that may have started with me, but that will continue.

Going on to our Brazilian friends, they're very smart, they're very focused, they're very hardworking and determined. They're never satisfied.

And as I said earlier, when you make a deal with them you've made a deal with them. They don't overreach, they don't overpromise. They've got a lot of good qualities. And if you read the book, I think you'll probably learn a lot more about the qualities that made them what they are.

But we are very fortunate to be associated with them, and we're very fortunate to be associated with a number of the managers that have joined us, too.

We want to be a good partner ourselves because it attracts good partners. And that is a reputation that Berkshire deserves. I mean, Charlie and I do our part toward keeping that reputation intact, but that takes a lot of other people also behaving in a way that causes people to want to join them, causes people to want to trust them. And that will be part of a Berkshire brand. Charlie?

CHARLIE MUNGER: Yeah, I always say the way to get a good spouse is to deserve one. And the way to get a good part —

WARREN BUFFETT: What's your second way? (Laughter)

CHARLIE MUNGER: — and the other — well, but to get a good partner you deserve a good partner. It's an old-fashioned way of getting ahead. And the interesting about it is it still works in these modern times. Nothing changes, if you just behave yourself correctly, it's amazing how well it works. (Applause)

WARREN BUFFETT: You have any further thoughts on the Brazilians?

CHARLIE MUNGER: On what?

WARREN BUFFETT: On the success of Jorge Paulo and his associates, beyond what I laid out?

CHARLIE MUNGER: Well, there — you can't skirt the fact that they're very good at removing unnecessary costs.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: And I do not consider that in any way immoral or wrong or something.

WARREN BUFFETT: Not in the least.

CHARLIE MUNGER: I think removing unnecessary costs is a service to civilization. And I think it should be done with some — what do they call it? Mercy, really.

WARREN BUFFETT: Sensitivity.

CHARLIE MUNGER: Yeah, sensitivity. But I don't think it's good for our system to have a lot of make-work and what have you. So —

WARREN BUFFETT: If it was, we'd love government, right?

CHARLIE MUNGER: Yeah, and so, generally speaking, I think they're an interesting example to all of us.

WARREN BUFFETT: Yeah, we're learning from them.

CHARLIE MUNGER: Everybody is.

WARREN BUFFETT: OK —

CHARLIE MUNGER: Some reluctantly.

31. We'll decide what to do with "too much" cash when we get there

WARREN BUFFETT: OK. Station 1.

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. My name is Walter Chang (PH) and I came from Taiwan for this meeting.

Seven years ago, I named my first-born son after you, Warren, so the second one hasn't come yet —

WARREN BUFFETT: How's he — how's he —

AUDIENCE MEMBER: — so sorry —

WARREN BUFFETT: — how's he — how's he doing?

AUDIENCE MEMBER: He's doing great.

WARREN BUFFETT: OK.

AUDIENCE MEMBER: So he says hi. He always says, "Warren Buffalo," so, sorry — (Laugher) — sorry about that.

WARREN BUFFETT: I've been called — I've been called worse. (Laughter)

AUDIENCE MEMBER: My question is for both of you. We wish you continued good health, and when both of you break Mrs. B's record of working to 103 years old, that will be 20 years from now.

If Warren — or sorry, if Berkshire breaks that record and basically doubles over the next ten years and doubles again, you'll have a market cap of $1.2 trillion.

What do you think Berkshire will look like at that time and can you get there sooner? (Laughter)

WARREN BUFFETT: We may have to. Your original hypothesis may not hold up.

I do plan on writing about that next year, but there's no question that at some point we will have more cash than we can intelligently deploy. And then — in the business — and then the question is what do we do with the excess? And that will depend on circumstances at the time.

I mean, if the stock can be bought in at a price that makes sense for continuing shareholders, in other words that their value is enhanced by the repurchase, you know, if I were around at that time I would probably be very aggressive about repurchasing shares. But who knows what the circumstances will be. Who knows what the tax law will be then, you know.

What I do know is that we will have more cash than we can intelligently invest at some point in the future. That's built into what we're doing, and I hope that isn't real soon, and I don't think it probably will be.

But it's not on a distant horizon. I mean, the numbers are getting up to where we will not be able to deploy intelligently everything that's coming in.

But then we can deploy — it may be that we can deploy very intelligently and repurchase the shares. Who knows what the circumstances will be?

All I can tell you is that whatever is done will be done in the interest of the shareholder. That, you know, that is what every decision starts from, from that principle. Charlie?

CHARLIE MUNGER: It's not a tragedy to succeed so much that future returns go down. That's success, that's winning.

WARREN BUFFETT: Well, he'll name his next child after you. (Laughter) OK.

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

WARREN BUFFETT: Station 2.

AUDIENCE MEMBER: Afternoon. My name's Michael Sontag (PH) and I'm from Washington, D.C.

My question's about the sharing economy. What larger implications do you expect companies like Uber and Airbnb to have on their sectors, and do you think this business model is here to stay?

WARREN BUFFETT: Well, they are obviously trying to disrupt some other businesses, and those businesses will fight back in competitive ways, and they may try to fight back through legislation.

You know, when anybody's threatened, or any business is threatened, it tries to fight back.

If you go back to when State Farm came on the scene in 1921, that the — or '20, or whenever it was, the agency system was sacrosanct, in terms of insurance. It'd been around forever and the big companies were in Hartford or New York and they fought over having the number one agency in town.

So if you came to Omaha and you were at Travelers or Aetna, or whomever it might be, your objective was to get the agent. And the policy holder really wasn't being thought about.

And then State Farm came along and they had a better mouse trap, and then GEICO came along with a better mouse trap yet.

And so, every — the industries originally — the insurance companies fought back in a lot of ways. But one of the ways they tried to do it was to insist, you know, on various state laws involving what agents could do and what could not be done in insurance without agents and all that.

It's — that's standard. And you'll see that, and in the end the better mouse trap usually wins. But the people with the second or third-best mouse trap will try to keep that from happening.

The ones you name, I don't know anything about. I mean, I know what they do, but I don't their specific prospects, which is why we kind of stay away from that sort of thing because we don't — we know there'll be change, and we don't know who the winners will be. And we try to stick with businesses where we know the winners.

We know — and there are energy companies that — a railroad. A lot of our businesses are very, very, very likely to be winners, and that doesn't mean they don't have some change involved with them, but they're going to be winners.

And then there's other fields where we can't pick the winners, and so we just sit and watch. We find them interesting but we don't get tempted. Charlie?

CHARLIE MUNGER: Well, I think the new technology is going to be quite disruptive to a lot of people. I think retailing, in particular, is facing some very significant threats.

And you heard Greg Abel talk about a power plant in Iowa that was huge to serve one Google server farm. When you get computer capacity all over the world on this scale, it is changing the world. I mean, you're talking about —

WARREN BUFFETT: Fast, too.

CHARLIE MUNGER: Yeah, fast. So — and I think it's going to hurt a lot of people just as all the past technology investments hurt a lot of people. I think Berkshire, by and large, is in pretty good shape.

WARREN BUFFETT: Where do you think we're most vulnerable?

CHARLIE MUNGER: Well, I don't think I want to name them.

WARREN BUFFETT: OK. (Laughs)

Now you've got them all wondering, Charlie. (Laughs)

33. Teach financial literacy to children in school?

WARREN BUFFETT: Section 3.

AUDIENCE MEMBER: Good afternoon. My name is Diane Wieland (PH), and I'm from Hollywood, Florida.

I've worked in public education for over 35 years. My concern is that I think that we need to do more to proactively prepare our children and youth to be financially literate, especially in light of the serious financial stresses many adults in our society face on a daily basis.

My question is, do you think that financial literacy should be a standard part of the curriculum in our nation's schools and, if so, how early do you think it should begin and what do you think some of the most important learning goals would be?

WARREN BUFFETT: Well, certainly the earlier the better. I mean, habits are such a powerful force in everyone's life, and certainly good financial habits.

You know, I see it all the time. I get letters every day from people that have committed some kind of financial lunacy or another, but they didn't know it was lunacy and, you know, they didn't get taught that. Their parents didn't teach it to them.

And digging yourself out of the holes that financial illiteracy can cause, you know, you can spend the rest of your lifetime doing it. So I'm very sympathetic to what you're talking about.

We've done a little bit. I don't know whether you saw our "Secret Millionaire's Club" exhibit in the exhibition hall.

And you want to talk to people at a very young age. Charlie and I were lucky. I mean, we got it in our families so that, you know, we were learning it at the dinner table when we were — before we knew what we were learning. And that happens in a lot of families, and in a lot of families it doesn't happen.

And, of course, you mention about childhood financial literacy. Then there's a big problem with adulthood, adult financial illiteracy. And it's harder to be smarter or have better habits than your parents unless the schools intercede or —probably, you know, the schools are your best bet, but it can be done — a lot can be done on television or through the internet.

But it is really important to have good financial habits, and I think anything you can do very early through the school system, you know, would certainly have my vote. Charlie?

CHARLIE MUNGER: Well, I'm not sure if the schools are at fault. I would place most of the fault with the parents. I think the most powerful example (applause) is the behavior of the parent, and so if you're —

WARREN BUFFETT: Well, I agree with — the most important thing is the parents, but not everybody gets the right parents.

CHARLIE MUNGER: Yeah. Well, it's very hard to fix people who have the wrong parents. (Laughter)

WARREN BUFFETT: Well, let's just say you have the job of fixing people that have the wrong parents. What would you do about it?

CHARLIE MUNGER: Well, what's the — if you had the job of living forever, what would you do about it? It gets to be so impractical. (Laughter)

Who would ever believe that I would have any ability to fix all the people that have the wrong parents?

WARREN BUFFETT: How about a few? (Laughs)

CHARLIE MUNGER: I don't think I'm good at that, either. The only thing I've ever been slightly good at in my life is raising the top higher. It's just — they left the talent out of me.

I don't scorn it. I think it's a noble work. I just — I'm no good at it.

I don't think you're so hot, either. (Laughter)

WARREN BUFFETT: If he hadn't been in public, it would have been stronger. (Laughs)

Stop by our "Secret Millionaire's Club," though. You may get some ideas.

CHARLIE MUNGER: By the way, the main troubles with education in this field are probably not in the grade schools. They're probably in the colleges.

There's a lot of asininity taught in the finance courses at the major universities, and even the departments of economics have much wrong with them. So, if you really want to start fixing the world, you shouldn't assume that when it gets highfalutin, it's a lot better.

WARREN BUFFETT: Well — (Applause)

There was certainly a period of at least 20 years, I would say, when I think the net utility of knowledge given to finance majors was negative in major universities. I think maybe it's getting better now, but it is a —

CHARLIE MUNGER: Imagine it. Net utility was negative. It was (unintelligible) asinine.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I wish you'd use normal English. (Laughter)

WARREN BUFFETT: I'm worried about what English you're going to use. (Laughter)

I don't want to egg him on.

The — it was — frankly, it was fascinating to me because here was something I understood.

And to watch — I mean extraordinary universities that, essentially, were teaching people some very, very dumb things. And where even to obtain the positions in the departments of those schools, you had to subscribe to this orthodoxy, which made no sense at all.

And it got stronger and stronger, and then — now it's changing to quite a degree. But it may have soured my feeling on higher education to an unwarranted degree because that — you know, it may have been particularly bad in the area that I was familiar with, but it was bad.

Have I got — is my language okay, Charlie?

CHARLIE MUNGER: You would have liked academics better if you'd have taken physics instead of finance. (Laughter)

WARREN BUFFETT: Yeah. Well, I'm glad I didn't. (Laughs)

34. "There's no advantage to breaking Berkshire into pieces"

WARREN BUFFETT: OK. Area 4.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger. First of all, great party last night. I stood there for half an hour and still couldn't get a drink, so great crowd. Oh, by the way this is Zhang Xiaozhu (PH) from Ottawa, Ontario.

My question relates to the age-old question about dividends and also valuation. I think you guys are penalized by the great success of your enormously successful company. It's huge, so no one knows how to properly valuate it, and also because of your yardstick you picked, which is not quite fair.

Every year I see some of the old shareholders, and they are waiting to get a dividend, using some of the monies to supplement their retirements.

I do not feel it's essentially fair for them to sell their shares. I remember the case study you had in last year's letter to the shareholders. You did a case study comparing issuing dividends or having the shareholders selling their shares directly.

Because of the shares are so depressed, I do not feel it's very fair. So I'm wanting to ask, is there a practical way for you to break up the company into four logical groups, as you report in every year's AGM, and unlock some of the values and still allow you to allocate the capital freely, please?

WARREN BUFFETT: We would lose — we would not unlock value. We would lose significant value if we were to break it into four companies.

There are large advantages in both capital allocation, occasionally in the tax situation. There's — Berkshire is worth more as presently constituted than in any other form that I can conceive of unless we engaged in something to de-tax the whole place, which we're not going to do and which would probably be impossible anyway, but even if it was possible, we wouldn't be doing it.

But the — we did have this vote, and it's now time to adjourn and then we'll come back in a few minutes for the annual meeting. But we did have a vote, and unfortunately we — there's not a way to deliver a dividend to a few shareholders and not to others, although — whereas there is a way to — for shareholders to maintain an even and greater dollar investment in Berkshire, in terms of the underlying assets, and still cash out annually some portion of their investment, just like they would with a partnership, and incur fairly little tax in the matter. And I wrote about that last year and you've read that.

But there's no advantage to breaking Berkshire into pieces. It would be a terrible mistake. Charlie?

CHARLIE MUNGER: Well, generally I think that you're not being deprived when the stock goes from 100 to 200, and you didn't get a dividend that year.

WARREN BUFFETT: Yeah. Well, it isn't going to go up every year, though. I mean, it's going to —

CHARLIE MUNGER: Or two years or whatever it was.

WARREN BUFFETT: Yeah. We had, by a 45-to-1 vote, we had people — which actually surprised me. We had people say that they prefer the present policy to a change in that policy, so it would be a big mistake to change.

And with that we will end the Q-and-A session. We'll be back in about ten or so minutes, and we'll have an annual meeting. Thank you. (Applause)

35. Berkshire's formal annual meeting

WARREN BUFFETT: OK. If you'll take your seats, we'll get on to the meeting.

OK. I have a script here that I'll read from and make sure everything's proper.

The meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company, and I welcome you to the 2014 annual meeting of shareholders.

This morning, I introduced the Berkshire Hathaway directors that are present. Also with us today are partners in the firm of Deloitte & Touche, our auditors. They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Sharon Heck is secretary of Berkshire Hathaway. She will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting. She will certify that the count of votes cast in the election for directors and the motion to be voted upon at the meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

WARREN BUFFETT: Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

SHARON HECK: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 5, 2014, there were 857,848 shares of Class A Berkshire Hathaway common stock outstanding with each share entitled to one vote on motions considered at this meeting and 1,179,267,338 shares of Class B Berkshire Hathaway common stock outstanding with each share entitled to one ten-thousandth of one vote on motions considered at this meeting. Of that number, 601,494 Class A shares and 682,365,717 Class B shares are represented at this meeting by proxies returned through Thursday evening, May 1.

WARREN BUFFETT: Thank you. That number represents a quorum, and we will, therefore, directly proceed with the meeting.

36. Approval of last year's minutes

WARREN BUFFETT: First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place the motion before the meeting.

WALTER SCOTT: I move that the reading of minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions?

We will vote on this motion by voice vote. All those in favor say, "Aye." Opposed? The motion is carried.

37. Election of Berkshire directors

WARREN BUFFETT: The next item of business is to elect directors. If a shareholder is present who did not send in a proxy or wishes to withdraw a proxy previously sent in, you may vote in person on the election of directors and other matters to be considered at this meeting. Please identify yourself to one of the meeting officials in the aisle so that you can receive a ballot.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors.

Are there any other nominations? Is there any discussion? The nominations are ready to be acted upon.

If there are any shareholders voting in person, they should now mark their ballot on the election of directors and deliver their ballot to one of the meeting officials in the aisles.

Ms. Amick, when you are ready you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 660,619 votes for each nominee.

That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick.

Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Don Keough, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer have been elected as directors.

38. Advisory vote on executive compensation

WARREN BUFFETT: The next item on the agenda is an advisory vote on the compensation of Berkshire Hathaway's executive officers. I recognize Mr. Walter Scott to place a motion before the meeting on this item.

WALTER SCOTT: I move that the shareholders of the company approve, on an advisory basis, the compensation paid to the company's named executive officers as disclosed pursuant to Item 402 of the regulation S-K, including the compensation discussion and the analysis and the accompanying compensation tables and the related narrative discussion in the company's 2014 annual meeting proxy statement.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that the shareholders of the company approve, on an advisory basis, the compensation paid to the company's named executive officers.

Is there any discussion? I believe there may be on this. Do we have anyone?

OK. Ms. Amick, when you are ready, you may give your report.

BECKI AMICK: The report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 666,751 votes to approve, on an advisory basis, the compensation paid to the company's named executive officers.

That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick.

The motion to approve, on an advisory basis, the compensation paid to the company's named executive officers is passed.

WARREN BUFFETT: The next item on the agenda is an advisory vote on the frequency of a shareholder advisory vote on compensation of Berkshire Hathaway's executive officers. I recognize Mr. Walter Scott to place a motion before the meeting on this item.

WALTER SCOTT: I move that the shareholders of the company determine, on an advisory basis, the frequency, whether by annual, biannual, or triannual, with which they shall have an advisory vote on the compensation paid to the company's named executive officers as set forth in the company's 2014 annual meeting proxy statement.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion.

WARREN BUFFETT: It has been moved and seconded that shareholders of the company determine the frequency with which they have an advisory vote on compensation of named executive officers with the options being every one, two or three years. Is there any discussion? I believe on this one there is a — somebody wishes to speak? Yes.

AUDIENCE MEMBER: — Boston, Massachusetts. I suggest a vote of one year in order to change the policy of named executives.

In addition to Warren, Charlie, and Marc, the company should report Ajit Jain's salary. He is irreplaceable, and Warren works integrally with him in setting insurance rates.

Since —five — there should be five members of management, either another insurance manager or someone from the capital-related industries group, from BNSF or MidAmerican, should also be added.

You are so lean at corporate, the group managers should be named. Two should be named, but at least Ajit should be added.

The CEOs of former Fortune 500s used to disclose what is their compensation now. There is no retirement age at Berkshire, which is fine, but there should be more depth of disclosure, and this should be done next year, not three years from now.

WARREN BUFFETT: Is there anyone else that — doesn't appear to be.

I personally actually agree with a one-year frequency on this, normally, but it does seem in the case of Berkshire that considering what's required and considering what the numbers are and everything, that it probably doesn't make a whole lot of sense. But I generally feel one year is not a bad idea.

I do not think it's a good idea to start selecting people among the managers to give compensation for the reasons discussed earlier.

OK. Ms. Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast 113,530 votes for a frequency of every year, 2,412 votes for a frequency of every two years, and 552,309 votes for a frequency of every three years of an advisory vote on the compensation paid to the company's named executive officers. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick.

Shareholders of the company determined, on an advisory basis, that they shall have an advisory vote on the compensation paid to the company's named executive officers every three years.

39. Proposal to set greenhouse gas reduction goals

WARREN BUFFETT: The next item of business is a motion put forth by Meyer Family Enterprises, LLC, a Berkshire shareholder represented by Brady Anderson and Linda Nkosi.

The motion is set forth in the proxy statement. The motion directs Berkshire Hathaway to establish quantitative goals for reduction of greenhouse gases and other air emissions at its energy generating holdings and publish a report to shareholders on how it will achieve those goals.

The directors have recommended that the shareholders vote against the proposal.

I will now recognize Brady Anderson and Linda Nkosi to present the motion. To allow all interested shareholders to present their views, I ask them to limit their remarks to five minutes.

LINDA NKOSI: Good afternoon, Mr. Buffett, Mr. Munger, ladies and gentlemen. My name is Linda Nkosi from Swaziland, and this is Brady Anderson from Iowa.

We are students of economics and finance at Wartburg College in Iowa and are here representing a delegation of students who manage a $1.2 million portfolio that includes shares of Berkshire Hathaway. We very much appreciate the opportunity to take part in this celebrated event.

We stand to represent Investor Voice SPC of Seattle on behalf of the Meyer Family Enterprises to move Item 4 on page 12 of the proxy, a proposal that Berkshire establish goals for greenhouse gas reduction at its energy holdings.

We applaud Berkshire Hathaway Energy for having the largest renewable energy portfolio in the country.

That said, it is also true that BH Energy generates close to half its power by burning coal, which makes BH Energy a huge emitter of greenhouse gas. Given these facts, it would benefit BH Energy to have a carbon reduction plan.

Sixty-six percent of U.S. electric utilities have greenhouse gas reduction goals. Berkshire Hathaway Energy is not among them, despite stating on its website, "We will set challenging goals and assess our ability to continually improve our environmental performance."

As shareholders are aware, climate disruption creates profound financial risk for the global economy as well as for Berkshire. The Investor Network on Climate Risk, whose members manage more than $11 trillion, and the Carbon Disclosure Project, representing more than $80 trillion in assets globally, have called on companies to disclose risks related to climate change, as well as to take steps to reduce that risk.

BRADY ANDERSON: The SEC has stated that climate risks are financially material and that they must be disclosed. This is because a high-carbon approach creates risk, whereas a low-carbon approach avoids risk, both now and into the future.

Without planning and a set of forward-looking goals, neither management nor investors can truly know where they stand.

In addition, Berkshire's core businesses are vulnerable to climate disruption. Why? Because many of the most negative financial impacts of climate disruption are borne by insurance companies.

Berkshire's GEICO took its single largest loss in history from Superstorm Sandy, a $490 million loss due to claims on more than 46,000 flooded vehicles.

Berkshire's reinsurance business is likely to bear significantly more risk from the trends towards increasingly extreme weather.

For a time, some portion of these costs may be pushed onto customers in the form of higher premiums, but it is a prudent — it is (not) a prudent or sustainable long-term strategy to impose on customers the cost of not planning for the greenhouse gas reductions that climate scientists agree are urgently needed.

In summary, hundreds of the world's largest institutional investors, representing trillions of dollars of invested assets, call on companies to set greenhouse gas reduction goals. Such goals are key tools for reducing the profound business risk that climate change creates.

More than two-thirds of United States utilities already have such goals, and institutional proxy advisory firms repeatedly recommend voting for goal setting and disclosure of this sort.

Therefore, please join us in voting for this common sense proposal, which not only benefits the planet, it will preserve, if not boost, Berkshire profits by avoiding risk.

Thank you for this truly amazing opportunity to share our concerns.

WARREN BUFFETT: OK, and thank you. (Applause)

I assume that the fact the lights went off, there's nobody additionally that would like to speak on the motion for or against?

Hearing nothing, I'll say that the motion is now ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballot on the motion and deliver their ballot to one of the meeting officials in the aisles.

Ms. Amick, when you're ready, you can give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast 49,553 votes for the motion and 561,642 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares outstanding, the motion has failed. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick. The proposal fails.

40. Shareholder proposal to pay a dividend

WARREN BUFFETT: The next item of business is a motion put forward by David Witt. The motion is set forth in the proxy statement. The motion requested the board of directors consider payment of a dividend. The directors have recommended the shareholders vote against the proposal.

Mr. Witt available?

As neither Mr. Witt nor his representative is present to present their proposal for action, the motion fails.

41. Meeting adjourned

WARREN BUFFETT: OK. Does anyone have any further business to come before this meeting before we adjourn? If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second?

VOICE: I second the motion to adjourn.

WARREN BUFFETT: The motion to adjourn has been made and seconded. We will vote by voice.

Morning Session - 2015 Meeting

1. Buffett's opening joke

WARREN BUFFETT: Thank you. Thank you. Thank you.

I'm Warren; this is Charlie. He can hear. I can see. We work together. (Laughter)

In just a couple of minutes we'll move onto the questions and answers and follow the same procedures as in previous years.

2. John Landis and "Trading Places"

WARREN BUFFETT: But first, there's just a couple of special introductions I'd like to make. And I'd like to start it off with John Landis. Do we have a spotlight that we can pick out John?

John is the man that directed, conceived, et cetera, of the Floyd Mayweather fight.

And John, as you know, directed "Coming to America,"" Animal House," and the one I particularly like is "Trading Places."

If you haven't seen "Trading Places," by all means get it. It has Dan Aykroyd, and Eddie Murphy, and Charlie's favorite, Jamie Lee Curtis. (Laughter)

And it's a truly great movie.

It brought back Ralph Bellamy and Don Ameche.

Don Ameche had disappeared. Have we got a light on — can we get a light on John? Where's John? He should be right down here. (Applause)

We're going to find — over here? Come on.

Well, John, thank you, thank you, thank you. He did all that and now came to the meeting. We really appreciate it.

3. Thank you, Carrie Sova

WARREN BUFFETT: The other person I want to say — have a special thanks for — is a young, 30-year-old woman who has a 1 1/2-year-old baby at home and manages to put on this whole event with the help of hundreds that come from our various companies, and that's Carrie Sova.

I hope Carrie is here, that we can give her a thanks. (Applause)

Carrie, a few months ago, while she was already working on this meeting, I said to Carrie, "I think it would be kind of nice if we had a commemorative book, sort of a retrospective on the 50 years." And I said, "Would you mind turning out a book, you know, in your spare time during these couple months while you're putting together the meeting?"

And she put together what I think is an absolutely terrific book, which we have outside. We printed up — we thought we printed 15,000 copies, but I think there's not quite that many. We sold 5,000 yesterday and then held back copies.

But it's really a nice history of Berkshire Hathaway. And the credit, 100 percent, goes to Carrie for putting that together. So I'd just like to thank her personally and I hope you'll thank her.

4. More people than seats

WARREN BUFFETT: Now, we'll have the annual meeting at 3:30, and at that time we will be voting on directors, but many of you won't be here at that time, although we'll have a full house in here.

I should mention all of the overflow rooms in — here at the CenturyLink — are full now.

There may be seats — we've got the grand ballroom and the second ballroom over at the Hilton — and there may be some seats left over at the Hilton. So if you can't find a seat here at the CenturyLink, either here or in the overflow rooms, at least give it a try over there at the Hilton.

We've got all the rooms we could possibly get, but I think the attendance may have outrun the seats this time.

5. Berkshire directors introduced

WARREN BUFFETT: I'd like to introduce the directors, and, like I say, you'll vote on them at a little after 3:30.

And if they'll stand — and we'll get a light down here — and withhold your applause until the end, and you can withhold it then, if you would like. (Laughter)

And we'll do this alphabetically.

You've met Charlie, of course, but we'll start with Howard Buffett, Steve Burke, Sue Decker, Bill Gates, Sandy Gottesman, Charlotte Guyman, Tom Murphy, Ron Olson, Walter Scott, and Meryl Witmer. They're a great bunch of directors. (Applause)

We're missing one of our great directors, Don Keough, my neighbor from over 55 years ago.

He was a coffee salesman, then, for Butter-Nut Coffee, for those of you around Omaha.

He broadcast Nebraska football games and around 1950 had a radio show on WOW, for 15 minutes.

He was followed by a fellow named Johnny Carson, who had another 15-minute program. And Don, when I would see him in later years, he'd always say, "What happened to that Carson fellow?" (Laughs)

And Don died a few weeks ago, but we are very grateful that his wife, Mickie Keough, has joined us together, so let's have a hand for Mickie Keough. Mickie, will you stand? (Applause)

Mickie practically raised our kids, so if they have any faults, talk to Mickie about it. (Laughter)

6. Q1 earnings

WARREN BUFFETT: OK. We have just — we have one slide that relates to our quarterly earnings that — if we could put up.

We released these yesterday afternoon, and nothing particularly remarkable.

The railroad, BNSF, did dramatically better last year, not only in earnings, but in all kinds of performance measures, in terms of train velocity, and on time, and you name it, so that the —

You know, we got behind last year, early in the year, and there's been lots of money, and more important, lots of effort, spent to get the railroad operating like it should be.

And in the first quarter those efforts paid off. We gained share. Our earnings, relative to other railroads, improved dramatically, so, you know, we got the trains running. We're going to spend a lot of money making sure we get even better.

But the improvement has been huge, and I want to thank Matt Rose and Carl Ice for a really extraordinary performance and having our railroad running the way it should be running. So thanks, Matt and Carl. (Applause)

VOICE FROM AUDIENCE: (Inaudible)

WARREN BUFFETT: I didn't quite get, it but I'll assume it was complimentary. (Laughter)

7. Rotating questioners

WARREN BUFFETT: OK. I think we're ready to move on to our questioners.

We'll handle it the same way as before. We start with the journalists, we move to the analysts, and then we move to the audience, and we keep doing that until about noon.

And at that time, we take a break for about an hour, and then we come back and we repeat the procedure.

After we get through a — I think it's either 48 or 54 questions, then we just take them all from the audience. We have various zones where people have been selected, by drawing, to ask questions personally.

8. Carol Loomis introduction

WARREN BUFFETT: But we start off the first one with a woman who retired after 60 years, setting a longevity record for all of Time Inc. — she retired at Fortune — been my friend for many years, and in my opinion the best print business journalist in the world, Carol Loomis. That doesn't soften her up at all, folks. (Applause)

CAROL LOOMIS: I'll make my customary, very short speech.

The three of us have been getting questions for two months, and there have been a lot of them.

Warren and Charlie have no idea what our questions are going to be, and some of them are very tough. Warren is right that I don't normally soften them up.

And we're sorry, we got hundreds of questions, literally, many hundreds, and we're sorry if we didn't pick yours, which doesn't mean it wasn't a good question. It's just that the — our ability to ask as many as you'd like — as you would like to get yours in — was limited.

9. Defending Clayton Homes from predatory lending accusations

CAROIL LOOMIS: So, my first question is from a man in Timpson, Texas, who happens to have a familiar name, Frank Gifford, but wants to make it clear that he isn't the football Frank Gifford, but rather a travel photographer.

And his question is a hard one. He says, "I've been a shareholder for 15 years, but I'm now suffering heartburn. Until recently I considered Berkshire an ethical company, benefiting society through" — and here he mentions two Berkshire companies headquartered in his home state — he says, "— through BNSF and ACME Brick.

"Two points call that opinion into question now: One is the Seattle Times story on predatory practices at our Clayton Homes subsidiary.

"Clayton mainly responded with platitudes to this article and would not answer questions, so I have to assume the facts in the story are correct.

“The other point that I want to mention is our growing partnership with 3G Capital. I sold my Tim Horton stock in disgust before 3G gutted 20 percent of the corporate staff and plunged this well-run company deep into junk territory.

“Other takeovers 3G has made have been still more brutal.

“You and Charlie have made many statements about upholding Berkshire’s reputation, and you have avoided anti-social investments like tobacco and gambling.

“Your efforts years ago to keep Berkshire’s textile mills running show you once aspired to balance capitalism with compassion.

“I cannot make the moral case for practices at either Clayton or 3G, and I wonder how you can do so.”

WARREN BUFFETT: OK. Let’s talk first about the Clayton article because there was some important mistakes in that, but I think it’s first — it’s better to back up even to the situation in mortgage lending that’s taken place, and why Clayton follows a pattern that, actually, is exemplary and rather extraordinary, in the home building and mortgage business.

If you look back at the housing bubble in — well, ending more or less in 2008, one of the great problems, in fact, maybe the greatest cause, was the fact that the mortgage holder became totally divorced from the mortgage originator and from the home builder.

In other words, the home builder built a house and sold it, took his profit, and that was that. It didn’t really make much difference who he sold it to.

And the mortgage originator would originate a mortgage but then package those, securitize them, and often sell them around — even around the world — so people thousands and thousands of miles had no connection with the original transaction.

And the mortgage originator suffered no loss if the loan went bad.

So we had these two parties: the one that connected with the home buyer, and the one that originated the mortgage, and they had no connection with the actual outcome of whether it was a good mortgage or not.

At Clayton, unlike virtually anybody — there’s a few — we offer the — we offer mortgages to all the buyers of our homes. And we have retained roughly 12 billion of mortgages on 300,000 homes.

Now, when a mortgage goes bad, two people lose: the person that owns the house loses, and the person that owns the mortgage loses.

And in our case, we have this identity of interest. We have no interest in selling anybody a house, and having that mortgage default, because it is a net loss to us. It is a net loss to the customer.

And like I say, that's not true of most home builders. It's not true of most mortgage originators.

So you — and there's been much talk, in terms of possible changes in mortgage rules, to try and get the mortgage originator to keep some skin in the game. And they've talked about them retaining maybe 3 percent of the mortgage or something like that, just so they would have an interest in, really, what kind of a mortgage they were putting on the books.

Well, we keep — in many cases — we offer to everybody, but we keep — probably in half the cases, we keep 100 percent of the mortgage, so we have exactly the same interest as society has, and as the home buyer has, in not making mortgage loans to people who are going to get in trouble on those loans.

Now, it's true that manufactured housing hits the lower end of the market, in terms of house values. Of the homes selling for $150,000 — new homes selling for $150,000 or less — 70 percent of them are manufactured houses.

And some of those people — most — many — of those people do not qualify, on a FICO score, to obtain loans that are government guaranteed. Some do, but most don't.

And the question is: can you lend intelligently to people who have a good chance of making the payments, keeping that house?

And Clayton has been exemplary in doing that. About 3 percent of the mortgages default in a year, you know, and when they do, we lose money and the person who bought the house loses money.

But 97 percent don't, and most of those people would not be living in the kind of houses that you can see right here at the auditorium, without the financing availabilities that Clayton makes available, and others make available.

And I invite you to go out and look at that house for $69,500. That house will be transported and erected, ready to go — you have to have the land and that — and I'll get to that in a second — but for 69,500, you have that house with appliances, with air-conditioning, with a couple bedrooms, 1200 square feet. And probably you'll put another 25,000 or so in the house, but — in terms of the land and preparation there — so maybe it will be $95,000.

But I just — you know, you can make your own judgment as to whether that's a decent value. And I know most of you are not living in $95,000 homes, but there are an awful lot of people that aspire to do that.

And we help them, with our own money at risk, to move into those homes. And if we make a mistake, it hurts them and it hurts us. And that is a very unusual arrangement in the financial industry.

Now, I read that story, and in it, there was an item in it, which, reading through the story, I just knew wasn't true. I mean, nobody that knew anything about manufactured housing could have put that up.

I'd like to put that up on the slide, where it says, "Another Clayton executive said in a 2012 affidavit that the average profit margin on Clayton homes sold in Arkansas between 2006 and 2009 was 11,170 — roughly 1/5 of the average sales price of the homes."

So this fellow is quoting somebody as saying that we're making a 20 percent profit on home sales.

Well, I knew that that was nonsense, so I asked for the affidavit. And I read the affidavit about three times, and nowhere in that affidavit was it — was this statement made.

Now, what was said was what I'll show in the next slide. It's hard for me to see what's up there, but it should show Item 6, where it says Clayton Manufactured Homes sold 2,201 homes, and Item 7, that four percent of the gross profit from the home sales totaled 983,000.

So if we'll move to the next slide. I did a little arithmetic and, sure enough, if you take 25 times the commission for — the commission is 4 percent, so you take 25 times — and then you divide by the number of homes, you come up with 11,170.

But, that statement in the affidavit said gross profit, and gross profit is not the same thing as profit. I'm not sure that the fellow that wrote the story understood that.

So I have put on the next page the difference, for example, of a couple other retailers. I put Macy's and Target.

And Macy's has a 40 percent gross profit margin, but a pretax margin of 8 1/2 percent, after taxes of 5.4.

Gross profit is what you — if it's the case of Macy's, what they pay for a sofa or something, and what they sell it for. But they also have the expenses of paying salespeople, rent, utilities, advertising, all kinds of other things.

So the idea that gross profit and net profit are the same thing is — you know — anybody that understands accounting would never make a mistake like that.

In our particular case, on the next page, our gross margin is what the fellow said in the affidavit, and he used the word "gross," of 20 percent. But the writer of the story turned that into a profit margin, and our profit margin is actually three percent. So I'd just like to point out the mathematics on that particular subject.

There's one other item you should see — and, again, I have trouble seeing the — what's up there — but we have a — in every retail Clayton establishment, we have a lender board which shows exactly what a variety of lenders are willing to do and what their terms are.

And we also have a sheet, which I think will be put up there, and it's less than a full page, and it sets out the lenders who are available.

And at the very top — I'm just looking to see whether I can find that right here — at the very top of it, it basically says, you know, check out more than one lender, and you can send the application to any of these people. And we have people sign at the bottom, and there's no small print on it. I can't see it here, but — it may look like small print — but it's one page, and multiple lenders are put on that sheet.

Sometimes people borrow — if there's a credit union in San Antonio that's very big, the local bank is very big, and we also will lend money to the buyer of the home, if they wish.

If you buy that home that's out there, we'll give you a list of four or five lenders, probably including your local bank, and you will probably take the loan that offers you the best terms.

So, I make no apologies whatsoever about Clayton's lending terms.

I get letters from people complaining about our subsidiaries in various ways. I mean, some people call the office, some people write in. I can say, in the last three years I have not received one call — we've got 300,000 loans — I've not received one call from any party in connection with a Clayton Home.

Moreover, we are — at Clayton — we are regulated in almost every state — every state in which we have financing, which is practically every state.

And in the last three years, we have had — I think its 91 examinations by the state, 91 examinations.

They come in. They look at our practices. They make sure that they conform with the laws.

And in those 91, we — I think the largest fine we've had has been $5,500, and the largest group of refunds we had was about $110,000.

Yeah, there were — and, you know, those were regulated, not only by those states, were regulated by HUD, all kinds of people.

When we can, we try to get people an FHA loan, because that's the best loan for them to get.

But, as I say, most of our borrowers are below the 620 FICO score. And it's true that three percent or so will lose their homes in a year. It's true that 97 percent of those people will have a home where their average principal and interest payment is a little under $600 a month, and that takes care of having a two- and perhaps three-bedroom house, well equipped. I invite you to go through it.

And Clayton has behaved, in my book, extraordinarily well.

The article talked about 30-year mortgages. Over 4 1/2 years ago, I said we're not going to have 30-year mortgages. So we don't have them, except for the FHA-guaranteed ones, which, of course, have a very low rate.

So I have no — I'm proud of the Clayton management. I'm proud of the fact they put, this year, maybe 30,000 people in homes at a very low cost, a very good home. And a very high percentage of those people are going to have those loans paid off, probably in 20 years, and have a home that has cost them — has been a real bargain, basically.

I'll get to the other question — the 3G question, too — in just a second, but we'll give Charlie a chance to say what he'd like to.

CHARLIE MUNGER: I don't know a lot about the mortgage practices at Clayton, but I certainly know that we've sold an enormous number of houses and we have a big share of the total market in manufactured.

WARREN BUFFETT: About 50 percent.

CHARLIE MUNGER: Fifty percent.

And it's a very constructive thing. Personally, I've always wondered why manufactured houses don't have a bigger share of the market. It's such an efficient way of creating quite usable houses.

Part of the reason is that the track builders, under capitalism, got so efficient. And isn't Clayton now doing some track building itself?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I think so, yes.

So, Clayton is a very productive part of the economy, but we can't make lending to poor people who buy houses 100 percent successful for everybody. We wouldn't be running the business right if the foreclosure rate was zero. Too many people would deserve credit that wouldn't get it.

WARREN BUFFETT: Yeah. The big causes of default are the loss of a job, death, and divorce. And, you know, that happens with high-priced houses as well, but it happens more often with people that are living closer to the edge.

But I don't think that's a reason to deny them a house, and particularly when so many — it turns out so well for so many.

The 2008 recession was — and '9 — was very interesting, because all kinds of securitized deals, involving houses costing hundreds and hundreds of thousands of dollars, the default rate on those was many, many, many times what happened in our own case.

And similarly with delinquency rates. Our delinquency rates are running 3 percent, currently.

And, you know, it — the people want to live in those houses, and I think they deserve the right to.

Incidentally, we had a — a few years ago we had a couple houses here, we called them the "Warren" and the "Charlie."

The "Charlie" sold first, and it sold to one of the cameramen who was in the credits on the movie you just saw. And you can check with Matt, and he's — Matt Mason — he is very, very happy with that house he bought four or five years ago.

10. Defending 3G from accusations of excessive job cuts

WARREN BUFFETT: The second question was about 3G, and I don't think you can ever find a statement that Charlie and I have ever made, in terms of Berkshire's companies or anybody else's, where we said that there should be more people working than are needed in a company.

And the 3G people have been successful in building marvelous businesses. And it is true that they have entered into some purchases where there were considerably more people running the business than needed. And the interesting thing is that after they reduced the headcount to the number needed, the companies have done extremely well.

I mean, you've seen Burger King outgrow its main competitor by a significant margin. You've seen Tim Horton have some very good figures in the first quarter.

And I don't know of any company that has a policy that says we're going to have a lot more people than we need. But a good many companies end up in that position, and if 3G buys into one, they quite promptly — and treat people well in terms of the severance — but they get it down to what they need.

And I hope our Berkshire companies are not being run with more people than they need, either. They usually aren't when we buy them, and, you know, we look for those companies that are well managed.

3G is — will — if they find out that 100 people are doing what 50 people can do, they'll get it to where 50 people are doing it. And I think that actually makes sense throughout American business. Charlie?

CHARLIE MUNGER: Well, the alternate to the system of having your company right-sized, the right number of people, is what eventually happened in Russia. And there, everybody had a job. And the way it all worked out was some workers said, "Well, they pretend to pay us and we pretend to work," and the whole damn economy didn't work. Of course, we want the right number of people in the jobs.

WARREN BUFFETT: It's interesting. In the railroad business — in the railroad business after World War II, in 1947 or thereabouts — I think there were about 1.6 million people in the railroad business, and it was a lousy business. And capital was short for any kind of improvements.

And now there are less than 200,000. So they've gone from a million-six to less than 200,000, carrying more freight, more distance, and doing it in far safer conditions. Safety has improved dramatically in the railroad industry.

And if somebody thinks it would be better to be running the railroads with a million-six, you know, people doing it, you would have a terrible railroad system. You wouldn't have anything like you have today.

Efficiency is required over time in capitalism, and I really tip my hat to what the 3G people have done.

11. Will Van Tuyl move away from negotiations in auto sales?

WARREN BUFFETT: OK. Jonny Brandt?

JONATHAN BRANDT: Thank you, Warren, for allowing me — inviting me — to be part of this 50th anniversary celebration. I have a question about Van Tuyl.

Van Tuyl is a fabulously productive auto dealer that has, since its founding, used a traditional negotiated model with a particular successful emphasis on profitable add-on insurance and financial products.

Meanwhile, at least some other auto dealers, CarMax and Don Flow among them, have adopted, or are moving towards, models which emphasize fixed prices, transparency, and low sales pressure.

Given the evolving regulatory environment and changing consumer preferences, will Van Tuyl eventually need to adapt to this new mode of selling, or do you feel the traditional method of selling cars will be viable for decades into the future?

If the market requires a new way of selling, how hard is it for a sales culture that has been successful for decades doing business one way to change to another?

WARREN BUFFETT: Yeah. If a change is required, it will be made. And I don't know the answers to which way it's going to go on that. The — it's true that people are — have been — and that's not new — that's been experimented with before — where people have tried a one-price system and no negotiating, no haggling and everything.

And I think a very large number of people would like to see that system, except when they actually get into it, it seems to break down for some reason.

It — there's negotiation going on in a lot of businesses that — and it always amazes me. People say they don't like it, but it's what ends up happening.

And so Van Tuyl will adapt to what the customer wants. We'll see how some of these experiments go. And I don't think there would be any problem at all if the world goes in that direction and Van Tuyl going to it.

But I wouldn't be surprised if five or ten years from now the system is pretty much the same. I wouldn't be totally surprised if it changes, either, but I can't predict the outcome.

I can predict that Van Tuyl, and the subsequent auto dealerships we buy, I can predict that they will be a very important part of Berkshire and I think will be quite profitable in relation to the capital we employ in the business.

Charlie?

CHARLIE MUNGER: Well, I very much like that acquisition, partly because I think we can do a lot more like it. I —

WARREN BUFFETT: Do you think you'll be negotiating on cars ten years from now, when you buy a new one?

CHARLIE MUNGER: It's been amazingly resistant to change for my whole lifetime.

WARREN BUFFETT: Yeah. Happens in the jewelry business, too.

I mean, there's certain items — well, it happens in real estate. I mean, let's just say that some real estate firm said we're only going to take listings where you can't negotiate.

Do you think? — I'm not sure how it would do, in terms of obtaining both listings and customers.

People seem to want to negotiate. If they hear a house is priced at 200,000, they're not going — unless it's some unusual situation — they're not going to step right up and pay the 200. They're going to bid.

When people are dealing with a big ticket item — a lot of people — their natural tendency is to negotiate and they particularly will do so if they think that's built into the system.

So I'm not sure how it changes, but we'll do fine, whatever direction it goes.

12. Company characteristics for predictable earnings

WARREN BUFFETT: OK. Now we go to the shareholder at Station 1.

AUDIENCE MEMBER: Hi, Warren. Hi, Charlie. Great to be here. This is my first time here, incredibly lucky to have my question answered.

So my question is this: can you name at least five characteristics of a company that gives you confidence to predict its earnings ten years out in the future? And can you also use IBM as a case study, how we check all those boxes?

WARREN BUFFETT: Charlie, what are your five? (Laughter)

CHARLIE MUNGER: We don't have a one-size-fits-all system for buying businesses. They're all different, every industry is different, and we also keep learning. So what we did ten years ago, we hopefully are doing better now. But we can't give you a formula that will help you.

WARREN BUFFETT: Now, if you're looking at the BNSF railroad as we were in 2009 or if you're looking at Van Tuyl in 2014, there are a lot of things that go through our minds. And most of the things that go through our minds are things that will stop us from going further.

I mean, there's — the filters are there. And there are a lot of things that, if we see it in a business, including, maybe, who we're dealing with, will stop us from going on to the next layer. But it's very different in different businesses.

We are looking for things where we do think we've got some reasonable fix on how it's going to look in five or ten years, and that does eliminate a great many businesses. But it's not the same — it's not the same five questions at all.

Certainly, when we're buying a business where we're going to have somebody that's selling it to us continue to run it for us, you know, a very big question is, you know, do we really want to be in partnership with this person and count on them to behave in the future when they don't own the business, as they behaved in the past when they do own the business. And that stops a fair number of deals.

But I can't give you five — we don't have a list of five. Or if we do, Charlie has kept it from me. (Laughter)

WARREN BUFFETT: You want anything more?

CHARLIE MUNGER: No.

13. Munger supports IBM stake purchase

WARREN BUFFETT: Becky?

BECKY QUICK: This question is for Charlie. It comes from John Baylor (PH).

He says, "Charlie, you broke Warren of his cigar butt buying habits. With the significant innovation that is occurring in technology, is IBM similar to those textile mills in the 1960s, and did you try to talk Warren out of buying IBM?"

CHARLIE MUNGER: The answer is no.

I think IBM is a very interesting company. It totally dominated Hollerith machines, you know, the punch card computing. And then when they invented electronic computing, it dominated that for a while.

It's very rare that when a technological change comes along that people adapt as successfully as IBM did that time.

Well, now they have the personal computer, and that's been a mixed bag. And — but I think IBM is a very credible company.

We own a lot of companies that have temporary reverses, or once were mightier in some ways than they are now.

IBM is still an enormous enterprise, and I think it's still a very admirable enterprise, and I think we bought it at a reasonable price.

WARREN BUFFETT: When we bought it, it was a two-to-nothing vote. (Laughs)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: OK. (Laughter)

14. Why we don't "talk up" our investments

WARREN BUFFETT: Incidentally, there's one thing I always find interesting.

We get asked questions about investments we own, and people think we want to talk them up, you know, or —

We have no interest in encouraging other people to buy what — the investments we own.

I mean, we are better off, because either we or the company is likely to be buying stock in the future. Why would we want the stock to go up if we're going to be a buyer next year, and the year after, and the year after that?

But the whole mentality of Wall Street is that if you buy something — even if you're going to buy more of it later on, or if the company is going to buy its own stock in — the people seem to think that they're better off if it goes up the next day, or the next week, or the next month, and that's why they talk about "talking your book."

If we talked our book, from our standpoint, we would say pessimistic things about all four of the biggest holdings we have, because all four of them are repurchasing their shares, and, obviously, the cheaper they repurchase their shares, the better off we are. But people don't seem to get that point.

Do you have any idea why, Charlie?

CHARLIE MUNGER: Warren, if people weren't so often wrong, we wouldn't be so rich. (Laughter and applause)

WARREN BUFFETT: He's finally explained it to me. OK. (Laughter)

15. "Three extraordinary pieces of luck" with insurance

WARREN BUFFETT: Gary?

GARY RANSOM: Thank you.

In his letter, Charlie talked about Berkshire's insurance success, quote, "being so astoundingly large that I believe that Buffett would now fail to recreate it if he returned to a small base while retaining his smarts and regaining his youth."

Do you agree that you could not repeat that success today? And if so, what do you think are the conditions in the insurance industry today that would inhibit a repeat of that performance?

WARREN BUFFETT: Well, I had many, many, many pieces of luck, but I had three extraordinary pieces of luck, in terms of the insurance business.

One was, when I was 20 years old, having a fellow on a Saturday, a fellow named Lorimer Davidson, be willing to spend four hours with some 20-year-old kid who he never heard of before, explain the insurance business to him.

So I received an education at age 20 that was — I couldn't have gotten at any business school in the United States. And that was just pure luck. I mean, I just happened to go to Washington. I had no idea I would run into him. I had no idea whether he would talk to me, and he spent four hours with me. So just chalk that one up, the chance of that happening again.

In 1967, I got lucky again when Jack Ringwalt, who, for about five minutes every year wanted to sell his company, because he would get mad about something, some claim would come in that he didn't like or something of the sort. And I told my friend Charlie Heider, I said, "Next time Jack is in the mood, be sure to get him to my office." And Charlie got him up there one day, and we bought National Indemnity.

We couldn't have done that — we not only couldn't have done it a day later, we couldn't have done it an hour later. You know, that — that was lucky.

And then I really got lucky in the mid '80s when, on a Saturday, some guy came in the office and he said, "I've never worked in the insurance business, but maybe I can do you some good." And that was Ajit Jain. And, you know, how lucky can you get?

So, if you ask me whether we can pull off a trifecta like that again in the future, I'd say the odds are very much against it.

But the whole — the whole thing in business is being open to ideas as they come along, and insurance happened to be something that I could understand. I mean, that was in my sweet spot.

If Lorimer Davidson had talked to me about some other business, you know, it wouldn't have done any good. But it just so happened he hit a chord with me on that in explaining it. I could understand what he was talking about. And I could understand what National Indemnity was when Jack had it for sale.

And that's — there's an awful lot of accident in life, but if you keep yourself open to having good accidents happen, and kind of get past the bad accidents, you know, some good things will happen. Might not happen in insurance — you know, it can happen in some other field — probably would happen in some other field — if you were to start in today.

So, no, we could not have — you couldn't expect to have three lucky events like that happen, and there were many more along the way.

But, you know, we — I think if we were starting over again, we'd find something else to do. What about it, Charlie?

CHARLIE MUNGER: Yeah. I don't think we would have that kind of success.

You know, mostly we bought wonderful businesses and nourished them. But the reinsurance division was just created out of whole cloth right here in Omaha, and it's a huge business. Insurance has been different for us.

16. Berkshire's culture "runs deep"

WARREN BUFFETT: OK. Station 2? And if you'll say where you're from too, please?

AUDIENCE MEMBER: Dear Warren, dear Charlie. I'm Lawrence from Germany, and in my home country, you two are regarded as role models for integrity. And at Berkshire, its culture is its most important competitive edge.

Hence, my question: how can we, as outside investors, judge the state of Berkshire's culture long after you depart from the company?

WARREN BUFFETT: Well, I think it's fair that you do, you know, come with a questioning mind to the culture, post-me and Charlie, but I think you're going to be very — I don't think you should be surprised, but I think you will be very pleased with the outcome.

The culture — I think Berkshire's culture runs as deep as any large company could be in the world.

It's interesting you're from Germany, because just three or four days ago, we closed on a transaction with a woman named Mrs. Louis, in Germany.

And she and her husband had built a business [Detlev Louis Motorrad-Vertriebs GmbH]. Over 35 years, they'd spent developing this business of retail shops, dealing with motorcycle owners, and lovingly, had built this business.

Her husband died a couple years ago. And Mrs. Louis, in Germany — it came about in sort of a roundabout way — but she wanted to sell to Berkshire Hathaway. And, you know, that would not have been the case 30 or 40 years ago.

So it does — it's a vital part of Berkshire to have a clearly defined, deeply embedded culture that pervades the parent company, the subsidiary companies. It's even reflected in our shareholders.

And, you know, when you have 97 percent of the shareholders vote and say we don't want a dividend, I don't think there's another company like that in the world.

So we have a — our directors sign on for it and, there again, we behave consistently. Instead of having a bunch of directors who are — love to be a director because they'd like to get $2- or $300,000 a year for showing up four times a year, we have directors who look at it as a great opportunity for stewardship, and who want their ownership, and have their ownership, represented by buying stock in the market, exactly like you do.

So we — it's — we try to make clear and define that culture in every way possible, and it's gotten reinforced over the years to an extreme degree. People who join us believe in it; people who shun us don't believe in it, so we — it's self-reinforcing.

And I think it's a virtual certainty to continue and to become even stronger, because once Charlie and I aren't around, it will be so clear that it's not the force of personality, but it's the — it's institutionalized that, you know, nobody will doubt that it will really continue for decades and decades and decades to come.

Charlie?

CHARLIE MUNGER: Well, as I said in the annual report, I think Berkshire is going to do fine after we're gone. In fact, it will do a lot better, in dollars. But, percentage-wise, it will never gain at the rate we did in the early years, and that's all right. There's worse tragedies in life than having Berkshire's assets and have the growth rates slow a little.

WARREN BUFFETT: Name one. (Laughter)

CHARLIE MUNGER: Warren and I have one not very far ahead.

WARREN BUFFETT: OK. Yeah, yeah. (Laughter)

OK. Andrew?

I should say culture is everything at Berkshire. And if you run into a terrible culture, it's — you know, the Salomon thing was up there on the screen, and it would be hard to turn Salomon into a Berkshire. I don't think we could have done it, Charlie.

CHARLIE MUNGER: I don't think anybody's ever done it on Wall Street.

WARREN BUFFETT: No. It's just — it's a different world.

And that doesn't mean that Berkshire is a monastery, by any means, but it does mean that — I can guarantee you that Charlie and I, and a great, great many of our managers, are more concerned — and Carrie Sova who put this meeting together and everything — they are more concerned about getting a good job done for Berkshire than what they get out of it themselves.

And, you know, it's great to work around people like that.

17. Health concerns about sugar won't stop Coca-Cola's growth

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: OK, Warren. This question comes from Simone Wallace (PH) in New York, New York.

And she writes, "Over the last 50 years, we Berkshire shareholders have, effectively, been long sugar consumption, through directly owned companies, such as See's Candies, Dairy Queen, in funding Heinz, and publically-traded investments, such as Coca-Cola today.

"Yet, from improvements in scientific research, we as a society have become increasingly attuned to the true costs of greater sugar consumption, in the form of rising health-care costs.

"We are seeing this awareness of sugar's impact in changing consumer behavior. Carbonated soft drink volumes are declining, and consumer packaged goods companies, focused on the center aisles of supermarkets, are struggling with organic growth.

"If we have reached — have we reached an inflection point in human behavior in how consumers view sugar consumption? And do you think Coca-Cola's moat, and potentially that of Heinz's or Kraft's, is narrowing? And if not, what news would it take you to be convinced that it is?"

WARREN BUFFETT: Well, I think it's an enormously wide moat, but I think it's also true that the trends you described are happening.

But, you know, there will be 1.9 billion eight-ounce servings of Coca-Cola products, not Coca-Cola, but Coca-Cola products, consumed in the world today.

I don't think you're going to see anything revolutionary, and I think you will see all food and beverage companies adjust to the expressed preferences of the consumers as they go along.

No company ever does well ignoring its consumers.

But there will be — I would predict — 20 years from now there will be more people — there will be more Coca-Cola cases consumed — than there are now, by some margin.

Back in the late 1930s, Fortune ran an article saying that the growth of Coca-Cola was all over.

And when we bought our Coca-Cola stock in 1988, you know, people were not that enthused about growth possibilities for the product.

I sit here as somebody who, for the — in the last 30 years, one-quarter of all the calories I've consumed come from Coca-Cola. (Laughter)

And that is not an exaggeration. I am one-quarter Coca-Cola. I'm not sure which quarter.

But — and, you know, if you really — I don't think there is this choice. I think there's a lot to be said about being happy with what you're doing.

If I'd been eating broccoli and Brussels sprouts, and all that, all my life, I don't think I'd live as long. You know, I — (Laughter)

Every meal, I would approach, thinking, you know, it's like going to jail or something. (Laughter)

No. I think — I think — Charlie? (Laughter)

Charlie's 91, and his habits aren't that different than mine. They're slightly better, but —

CHARLIE MUNGER: There's no question about it. The way I look at it is, sugar is an enormously helpful substance. It prevents premature softening of the arteries. (Laughter)

And the way I look at it, is that, if I die a little sooner that will just be avoiding a few months of drooling in a nursing home. (Laughter)

WARREN BUFFETT: Charlie and I have enjoyed every meal we ever had, virtually, except when I was eating at my grandfather's and he made me eat those damn green vegetables.

There, obviously, are some shifts in preferences, although it's remarkable how durable items are in this field.

We — Berkshire Hathaway — I believe, was the largest shareholder of General Foods from about 1981 or thereabouts, to about 1984 when it was bought by Philip Morris.

And, you know, that's 30-plus years ago, and those same — those same brands — you know, they went through Philip Morris, they got spun out as Kraft, they broke Kraft into two pieces. But now, we're going to own those brands, and they're terrific brands.

Heinz — Heinz goes back to 1869. The ketchup came out a little later. They went bankrupt, actually, when they were counting on the horseradish or whatever it was.

But the ketchup came out in the 1870s. Coca-Cola dates to 1886. It's a pretty good bet that an awful lot of people are going to like the same thing.

And when I compare drinking Coca-Cola, you know, to something that somebody would sell me at Whole Foods —(Laughter)

I don't know — I don't see smiles on the faces of people at Whole Foods. (Laughter and applause)

So I like the brands we're buying, Andrew.

18. Why Buffett likes local auto dealerships

WARREN BUFFETT: OK. Gregg Warren?

GREGGORY WARREN: Thank you, Warren. I just wanted to circle back and add on to Jonathan's question on Van Tuyl Group.

What is it that attracted you most to the deal? Potential for consolidation in a highly fragmented industry, which would allow you to put some of your excess capital to work, or the unique positioning in the auto chain of the auto dealer sector, which has its hands not only in auto sales but financing insurance and parts and services?

I know that Charlie just said that he'd like to do more deals like it, but where do you feel the greatest return will come from longer term? Rolling up auto dealerships or tapping into the advantages that are inherent in the full service model?

WARREN BUFFETT: Yeah. There are not any huge advantages of scale, at least that I'm aware of, in owning lots of dealerships. But running dealerships well is a very good business. It's a local business.

So I don't see that having some — there's 17,000 dealers in the country, and if you ask the people here in Omaha to name a bunch of dealers, they'd come up with a bunch of local names.

And I don't think that you widen profit margins, particularly, by having a thousand dealers versus having a hundred or even having one very good dealer.

So we will be buying, I hope, more dealerships, but it will be based on local considerations.

We don't see the finance business, in dealers — we don't bring anything to that party.

[CEO] John Stumpf is here from Wells Fargo. I think they're the biggest auto finance company in the United States. And they have a cost of funds advantage over Berkshire.

Berkshire is able to borrow money at a low price, but I forget whether John's liabilities cost him something like 12 basis points or something like that last quarter. And we can't come up with money as cheap as the banks can, and they're the natural lenders for loans, so we're not going to be in the finance business.

We will keep looking for dealerships, maybe groups of dealers. It doesn't give us a buying advantage from a manufacturer. And we will hope that we run those local operations very well and that they're regarded by the people who buy cars as a local business, not some part of some giant operation.

So, I think you'll see us buying more, but I don't think you'll see us widening out margins from what existed before, except in the cases where we can run a local dealer better.

Charlie?

CHARLIE MUNGER: Yes. And Van Tuyl has a system of meritocracy where the right people get the power and get some ownership.

So on the — it reminds me a lot of the Kiewit Company, an Omaha company and whose headquarters Berkshire resides as a tenant. And the Van Tuyl and Kiewit are kissing cousins. Those are very successful cultures, and I think they've got a very good thing going for them. The right people are prospering in Van Tuyl.

19. Building culture and values at Berkshire

WARREN BUFFETT: OK. Station 9? And if you'll identify where you're from, please.

Oh, I'm sorry. Station 3. You're number 9. I apologize.

AUDIENCE MEMBER: Apology accepted. (Laughter)

WARREN BUFFETT: We'd have cut off your mic if you hadn't. (Laughter)

AUDIENCE MEMBER: Fair enough.

My name is Stuart Kaye, and I'm from Stamford, Connecticut.

And I wanted to follow up on the questions that have been asked about culture and stewardship at Berkshire Hathaway, because I'm currently in year five of helping build a firm called Matarin Capital Management, and we discuss values and culture quite a bit.

And so I'd like some tips from you about what characteristics you thought about 45 years ago when you were building the culture and values at Berkshire Hathaway.

WARREN BUFFETT: Yeah, well I think culture has to come from the top, it has to be consistent, it has to be part of written communications, it has to be — you know, has to be lived, and it has to be rewarded when followed, and punished when not.

And then it takes a very, very long time to really become solid.

And obviously, it's easier — much easier — to do it if you inherit a culture you like, and it's easier in smaller firms, I think.

I can think of a lot of companies — very big companies — in this country, and I don't think if Charlie and I were around them for ten years we'd be able to accomplish much of anything.

So it — you know, it is a grain of sand type of thing. And people — just like your child, you know, sees what you do rather than what you say, it's the same thing in a business, that people see how those above them behave and they move in that direction.

They don't all move that way. We've got 340,000 people now working for Berkshire, and I will guarantee you that there's, you know, some number —a dozen, maybe 50, maybe 100 —that are doing something today that they shouldn't be doing.

And we — what you have to do is when you find out about it, you have to do something about it.

I didn't like, for example, making 30-year mortgages at Clayton five years ago. And I said, "We're not going to make 30-year mortgages, you know, unless they're government guaranteed."

And when we bought Kirby, there was some sales practices we didn't like, and we particularly didn't like them with older people. So we put in a golden age policy where, if you're over 65 and you bought a Kirby and for any reason you didn't like it, any time up to a year, you could send it and get all of your money back. And I encouraged people to write me if they had a problem on anything like that.

So it takes a lot of time, and you'll — you know, at GEICO we're going to — you know, we're going to settle millions and millions and millions of claims. And I will guarantee you that when two people are in an auto accident, they don't agree 100 percent of the time on whose fault it was, so they may go away and be unhappy for a time.

But we work all the time at trying to behave with other people as if our positions were reversed. That's what Charlie's always advised in all our activities, and we've tried to follow it. And we're certainly far from perfect at it, but if you keep working at it, it does get results.

Charlie?

CHARLIE MUNGER: Yeah. I think the one thing that we did that's worked best of all is we were always dissatisfied with what we already knew and we always wanted to know more. And Berkshire, if Warren and I had stayed frozen in time, particularly Warren, it would have been a —

WARREN BUFFETT: I'd like to do it, understand.

CHARLIE MUNGER: It would have been a terrible place. It's what we kept learning that made it work, and I don't think that will ever stop.

20. Any company with an economist has "one employee too many"

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question comes from Mona Dyan (PH). And it concerns two indicators, Warren, that you have discussed in the past about the general level of the stock market.

The first one is the percentage of total market cap relative to the U.S. GNP, which you have said is probably the best single measure of where valuations stand at any given moment.

This indicator is at about 125 percent. That is the ratio of total market cap to U.S. GNP, and that's about what it was when Warren talked about this back in 1999 just before the — shortly before — the bubble broke.

The second indicator, which you mentioned in a famous 1999 speech that subsequently became an article in Fortune, is the corporate profits — is corporate profits — as percent of GNP.

You had said at the time that that number ranged between 4 percent to 6 1/2 percent over a long period of time, which I believe was 1951 to 1999.

Well, as of Friday, it is about 10 1/2 percent, according to the St. Louis Federal Reserve site. That is way above the range you had mentioned.

Are the current levels of either one, or both, of these indicators a matter of concern for the general investing public?

WARREN BUFFETT: Yeah. Well, the — it might be — the second figure, which is the profits as a percentage of GDP, might be a concern for other segments of society because what it indicates is that American business has done wonderfully well in recent years.

And I know it says how — what a terrible disadvantage it has, because of U.S. tax rates and a host of other things, you know, the facts are that American business has prospered incredibly.

And the first comparison is very much affected by the fact that we live in an interest rate environment, which Charlie and I probably would have thought was almost impossible, not too many years ago.

And, obviously, profits are worth a whole lot more if the government bond yield is 1 percent, than they're worth if the government bond yield is 5 percent.

So it gets back — and, you know, Charlie in that movie talked about alternatives and opportunity cost. And for many people, the opportunity cost is owning a lot of bonds, which pay practically nothing, or owning stocks, which are selling at fairly high prices historically, but they weren't selling at those historic prices with interest rates like this.

So I would not — I look at those numbers, but I also look at them in the context of the fact that we're living in a world that has incredibly low interest rates, and the question is how long those are going to prevail. Is it going to be something like Japan that goes on decade after decade, or will we be back to what we thought was normal interest rates?

If we get back to what are normal interest rates, stocks at these prices will look pretty high. If we continue with these kinds of interest rates, stocks will look very cheap. And now I've given you the answer and you can take your pick. (Laughs)

Charlie?

CHARLIE MUNGER: Well, since we failed to predict what happened, and what exists now, why would anybody ask us what our prediction is in the future? (Laughter)

WARREN BUFFETT: Yeah, yeah. We — incidentally, the one thing I can assure you, Charlie and I, to my knowledge, or my memory, I can't recall ever us making an acquisition or turning down one based on macro factors that — you know, and we talk about deals when they come along, but whether it was See's Candy, or whatever it might have been, the Burlington Northern we bought at a terrible time, in general economic conditions.

But we don't — it just doesn't come up, because we don't — we know we don't know what the next 12 months, 24 months, 30 — we know we don't know what that's going to look like. But it doesn't really make any difference if we're buying a business to hold for a hundred years.

What we have to do is figure out what's likely to be the average profitability of the business over time and how strong its competitive mode is and that sort of thing.

So, people have trouble believing that. They think we talk about it. We think any company that has an economist, you know, certainly, has one employee too many. (Laughter)

Charlie? Can you think of anything rude to say that I haven't said? (Laughter)

CHARLIE MUNGER: Well, it would be hard to top that one. (Laughter)

WARREN BUFFETT: I know. OK. (Laughter)

21. Effect on BNSF of new crude-by-rail safety rules

WARREN BUFFETT: OK. Jonathan?

JONATHAN BRANDT: There's been an awful lot written about what should be done to improve the safety of the crude-by-rail infrastructure. Both this week and last month, federal regulators introduced new standards. These new standards include thicker tanks, better fire protection, electronically controlled pneumatic brakes, and speed limits in more populous areas to reduce the chance of derailments near where people live.

The railroad association has complained that the brakes are too expensive, while others have complained about what they view as an overly-long timetable to switch out the old tank cars.

Given the tank car industry's limits on manufacturing and retrofitting capacity, and the impact on overall rail network velocity from speed limits, do you think the new rules strike the right balance between efficiency and safety?

For Berkshire, what impact will these new rules have on the operations of Marmon's Union Tank Car subsidiary and on the BNSF Railroad?

Can you also update us on the BNSF initiative to purchase up to 5,000 of its own oil tankers — oil tank cars — which is a departure from historic industry practices, and what drove that decision?

WARREN BUFFETT: Yeah. Well, you've asked all the questions I'll be asking.

But I think those rules just came out, what, two days ago now? Yeah. And they're 300 pages. And little as I have to do with this meeting and everything, I have not read those, although I have talked very briefly to Matt Rose and also Frank Ptak who runs our — the company that manufactures and leases tank cars.

You know, our interest — actually, the interest of our railroad and our tank car manufacturing and leasing operation may diverge in various ways.

Clearly, we've got an interest — the country has an interest — in developing safer cars, and we found that the — some cars we thought were safe have turned out to be less safe than we thought going in.

The most dangerous kinds of thing we carry, of course, are — as a common carrier, we have to carry chlorine, we have to carry ammonia, and we're required to carry that. We'd rather not carry it.

There are dangerous products that have to get transported in the country, and they're — it's more logical to transport them by rail than either truck or pipeline, and some of those we'd rather not carry but we do carry.

I would say that the — probably everybody will be somewhat unhappy with the rules, but the — you know, it's up to — it is up to Washington, and the government, to devise the rules under which something that is potentially dangerous is transported.

And transporting by pipeline has its problems. Transporting by rail has its problems.

And railroads have gotten dramatically safer over the years. Our safety figures — and Burlington Northern leads the industry in safety — but the safety figures get better and better year after year.

And — but you are — but you're going to have derailments, and you better have very safe cars carrying that, and nothing will be perfect.

Charlie?

CHARLIE MUNGER: Yeah. Well, big companies and successful companies, like Burlington Northern and Exxon and Chevron and so on, have a lot of engineers and they have long histories of trying to be way safer than average and knowing a lot about how to do it. And none of that is going to change.

You'd be out of your mind to own these big companies and not run them with big attention to safety. And we're not out of our minds and neither are the people who run Burlington Northern. The safety is going to be improved continuously, and should be.

WARREN BUFFETT: Yeah. And it has been consistently, but —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: But there are new problems. For one thing, the Bakken crude has been proven to be quite a bit more volatile than most of the crude that is —

CHARLIE MUNGER: It's not really crude. It's condensate. I mean, it's almost misnamed, to call it crude. It is more volatile.

WARREN BUFFETT: Yeah.

I can tell you — and I may write about this next year in the report, though — that Burlington Northern has the best safety record among the big railroads. And Berkshire Hathaway Energy, it's extraordinary, their safety record, in terms of utilities. And every new utility we purchase at Berkshire Hathaway Energy, we've brought — the safety statistics, they've gotten far better after Greg Abel has taken over.

CHARLIE MUNGER: After they bought the Omaha pipeline, which had been mismanaged and safety had been improperly ignored, we watched those people, the Berkshire employees, just work day and night improving the safety. They didn't want more pipeline explosions.

WARREN BUFFETT: Yeah. We went from last out of 40-some — I think it was — to either second or first. And if we were second, it was because our other pipeline was first. (Laughter)

22. "Lucky" to have avoided business school

WARREN BUFFETT: OK. Station 4?

AUDIENCE MEMBER: Hello, Mr. Munger and Mr. Buffett. Nirav Patel from Haverhill, Massachusetts.

What advice would you give to someone who's trying to network with influential people but doesn't have access to the alumni network of a top business school?

CHARLIE MUNGER: Let me take that one. I think you should do the best you can — (Laughter)

— playing the hand you've got.

WARREN BUFFETT: Charlie is very Old Testament on this. (Laughter)

He didn't get much past Genesis. (Laughter)

Was his question that he didn't have a lot of associations because of —?

CHARLIE MUNGER: Well, he'd like to have you help him —

WARREN BUFFETT: — tap into —

CHARLIE MUNGER: — tap — do well without business school training. I never had any business school training, why should you have any? (Laughter)

WARREN BUFFETT: And actually, I would say the business school training, particularly in investments, was a handicap about 20 years ago when they were preaching efficient market theory because essentially they told you it didn't do any good to try and figure out what a company was worth because the market had a price perfectly already. Imagine paying, you know, 30 or $40,000 a year to hear that. (Laughter)

CHARLIE MUNGER: You were very lucky to avoid a lot that you've avoided. (Laughter)

WARREN BUFFETT: How do you feel about your law school training, Charlie, while we're on it? (Laughter)

CHARLIE MUNGER: Well I have a son-in-law who recently explained how modern profit-obsessed law school — law firms — work. He said it's like a pie eating contest, and if you win, you get to eat a lot more pie. (Laughter)

23. Railroad accidents, insurance, and BNSF

WARREN BUFFETT: OK, Becky. You're on.

BECKY QUICK: This question is a follow-up to the one that Jonathan Brandt just asked. It's an appropriate follow-up for that, though.

It comes from Mark Blakley in Tulsa, Oklahoma, who says that one risk to Berkshire and BNSF appears to be a large railroad accident.

"It appears many recent accidents have occurred in rural areas. However, how would a worst-case scenario, perhaps one in a more urban area or a BP-type accident, impact BNSF and Berkshire Hathaway? And is the company insured or protected against such losses?

WARREN BUFFETT: Our insurance — reinsurance — unit actually went to the four major railroads offering very high limits. I think we — this is from memory, I could be off on this somewhat, but I think we offered something like $5 or $6 billion, excess — or maybe a billion and-a-half or something like that that the railroad retained.

So we — there's no question about it. If you had the exact wrong circumstances, you know, a train with a lot of ammonia or chlorine or something, you know, right in some terrible urban area, the possibility always exists that that can happen.

It can happen — you know, you can have plane crashes. There are things that are very small probabilities.

But if we run trains millions and millions of miles, year after year, something will happen just like, you know, they happen in every other possible accident way.

So you minimize it. You obviously — you run trains slower in urban areas. They've already instituted that with crude. I think they've brought it down to 35 miles an hour in towns of 100,000. That's the maximum.

So you're always working to be safer; you'll never be perfectly safe.

We do not — we have some insurance at Burlington Northern, but we don't need insurance at Berkshire. You know, we've got the capability to take any loss that comes along. So we actually would be more likely to be offering that insurance, and we did offer that insurance, and the railroad industry didn't like our rates, which is understandable, and so they haven't bought it. But that doesn't mean they won't at some time in the future.

I should add one thing that I forgot to say to Jonathan. The — I don't think we will be buying the 5,000 railcars. I think — I don't know that for sure, but, you know, there's going to be a lot going on in terms of retrofitting.

Our Marmon operation has actually taken on a new facility that will be working very hard — once we know what the retrofit requires — we will be, I'm sure, working three shifts on retrofitting cars, probably our own, probably some other people's. We'll be building new cars. The industry has been waiting to see what the requirements would be before moving ahead.

The first quarter of 2015, there were practically no tank cars ordered. There's a backlog, but there's — no tank cars were ordered, because we need to see what the regulations are.

But we'll be very active in retrofitting and in manufacturing new cars, but I don't think we'll be — historically the railroads have never really owned tank cars. That goes back to the Rockefeller days.

And I think the present method of having car lessors, such as the one we own, I think will continue in the future rather than having the railroads own them.

24. Why move assets around insurance subsidiaries?

WARREN BUFFETT: OK. Gary?

GARY RANSOM: I have a question on intercompany transactions within the insurance companies.

In the last couple of years, you've had a number of them, including 50 percent of the business ceded up to — from GEICO — to National Indemnity.

You did something similar with MedPro and with GUARD. You also moved some of the companies — or the subsidiaries — like Clayton Homes, out of the Geico sub and up into the holding company.

It seems like a lot more activity than normal, and I'm just asking, what is the main purpose of all those movements, what financial flexibility might it provide you, and why now?

WARREN BUFFET: Yeah. Well, there are a lot of things at Berkshire that the 'why now' is answered by — going to be answered by the fact, well, we just got around to it.

The huge chunk of capital, in the insurance companies, is at National Indemnity. So we have moved through these, quote, "share arrangements," we moved premium volume that is generated at GEICO or MedPro or different companies, we've moved that up to the parent, because that's where all the — there's a — you know, there's just extra layer after extra layer after extra layer of capital there, and it makes it a little simpler that way.

It makes it a little simpler just in keeping all the money invested, as opposed to having 50 pockets or 75 pockets to look at it, if you have a couple of main pockets to look at it.

There's no real change in the certainty of payment of policies or anything of the sort.

It really makes life a little — just a little easier — in terms of managing the money by having most of the — most of the funds concentrated in National Indemnity.

So there's no mastermind to it. We ended up with a few companies in GEICO Corp, which was a holding company for GEICO itself. And it just seemed that we probably ought to get those up to the parent company level and we put them there.

But our general approach is just to keep every place loaded with more capital than anybody could possibly conceive of us needing. And that's going to result, more and more, probably, in the funds being concentrated in National Indemnity.

25. "Dollar will be the world's reserve currency 50 years from now"

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: Good morning, Warren. Good morning, Charlie. My name is David Tollefson (PH) from Minneapolis, Minnesota.

Currently, the U.S. is not a prospective founding member of the Asian Infrastructure Investment Bank, where many European countries are. The AIIB is relatively small, but if this is part of an ongoing trend in the next 50 years, how will that impact the U.S. multinational corporations? Thank you.

WARREN BUFFETT: Well, that's a subject I know absolutely nothing about, so let's hope Charlie does. (Laughter)

CHARLIE MUNGER: I know a little less than you do. (Laughter)

WARREN BUFFETT: I really apologize to you, in terms of your question, but, you know, if we started talking about it, we'd be bluffing.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Do you have a second question? (Laughter)

AUDIENCE MEMBER: Off the top of my head, how about the dollar as a reserve currency? Do you have any issues or concerns in the next 50 again — I know we're in a good position now — but with us losing that position?

WARREN BUFFETT: I think the dollar will be the world's reserve currency 50 years from now, and I think the probabilities of that are very high. Nothing certain, but I would bet a lot of money on that one.

Charlie?

CHARLIE MUNGER: Well, I have a little feeling on that subject. I'm probably more nervous than a lot of people about printing a lot of money and spending it. There are times when you have to do it, I'm sure, and we just came through one.

But I'm happier when we print money and use it improving infrastructure than I am when we just spread it around with a helicopter. (Applause)

WARREN BUFFETT: So what do you think is going to happen if we keep spreading it around with a helicopter?

CHARLIE MUNGER: I think it's always more dangerous than the economic profession thinks.

26. Subsidiaries using the Berkshire Hathaway name

WARREN BUFFETT: OK. With that, we'll go to Andrew.

ANDREW ROSS SORKIN: This question comes from a local shareholder, Max Rudolph, who writes in:

"Recently, several subsidiaries were renamed to include Berkshire or BH in their name, which Mr. Buffett has avoided doing previously, at least due in part, I imagine, to increased reputational risk should something go wrong.

"Can you discuss how you decide which subs are allowed to rebrand, and discuss those risks, given that Clayton, NetJets, and others, have received negative publicity this year?"

And attached to that question, Steve Rider (PH) of Chicago asks, "Will Fruit of the Loom become Berkshire Undergarments?" (Laughter)

WARREN BUFFETT: Well, if it does, we won't pay him a royalty for the idea. (Laughter)

The — we did create a Berkshire Hathaway HomeService operation, which is a franchise operation.

We bought two-thirds of the Prudential franchise operation a couple of years ago, and we have a contract where we can buy the — where we will — buy the remaining third in another couple of years.

And so we were going to lose the rights to Prudential over time. And Greg Abel asked me about using Berkshire Hathaway, and I told him that they could use it, but that if I started hearing of any abuses of it or anything of the sort, we would yank it, and that maybe that would be a useful tool in making sure that people behaved like we wanted them to. And so far, that's worked out fine.

We've had no idea that we wanted to take Berkshire Hathaway into becoming a household name and that that would create extra value, but we were going to rename a large franchising operation.

And, like I say, as long as the name does not get abused, that will be fine. And the Van Tuyl Auto — we're calling it the Berkshire Hathaway Automotive Group.

Certain of the dealers will have the right to use that as a tag line and others won't. And, again, if there's problems connected with it, we'll change it.

But in a sense, that isn't bad. If there are going to be problems, I'd just as soon hear about them. If I hear about them because the name is "Berkshire Hathaway," that may mean that I get on top of them faster than I would otherwise.

We have no — we have — a good many of our companies, at the bottom of their letterhead or something of the sort, they say a "Berkshire Hathaway Company," and that's fine.

But we have no — we do not anticipate that we're going to turn it into some huge asset by branding a bunch of products that way.

Charlie?

CHARLIE MUNGER: We'd be crazy to try and sell Berkshire Hathaway peanut brittle instead of See's. Those old brand names are worth a lot of money.

27. MidAmerican's embrace of wind power

WARREN BUFFETT: OK. Gregg?

GREGGORY WARREN: This question is on the energy business.

During last year's meeting, we touched briefly on the topic of distributed generation, a method of generating electricity on a small scale at the point of consumption, from renewable and nonrenewable energy sources. Much of this has come around the last several years due to the growth of renewable energy sources like solar and wind.

Up until now, though, it has been difficult, if not cost prohibitive, for self-generators to store this energy.

Now that Elon Musk has joined the fray this week with his idea of batteries for the home, for his new Tesla Energy initiative, which could lead the way for larger systems, and realizing that disruptive technologies can, at times, upend an industry's business model and competitive positioning, how long do you believe it will be before distributed generation becomes a meaningful threat to your utilities, especially if power can be stored more easily at the end user's place of business or home?

WARREN BUFFETT: Well, you put your finger on storage being the key. And Charlie follows storage a little bit more than I do, and maybe I'll have Greg Abel talk about it.

But obviously, distributed energy is something we pay a lot of attention to.

One of the — probably the best defense is to have very low-cost energy, and MidAmerican has done a terrific job in that respect. And the figures, in terms of people who have adopted solar in our territories, are just minuscule and will stay that way.

But huge improvements in storage would make a difference in a lot of ways. And, Charlie, what are your thoughts on that?

CHARLIE MUNGER: Well, obviously, we're going to use a lot more renewable energy because the fossil fuels aren't going to last forever. And, obviously, Berkshire is very aggressive and very well located, in terms of this development.

You know, I grew up here in this part of the world, and to have 20 percent of the power of Berkshire utilities in Iowa coming from the wind, I regard as a huge stunt.

And it's, of course, very desirable, in a windy place like Iowa where the farmers like the extra income, to be getting a lot of power out of the wind. And, of course, we're going to have a lot better storage, and the technology has been improving.

And this is — it's not a threat, it's a huge benefit to humanity, and I think it will be a huge benefit to Berkshire. And everything is working for us.

I love owning MidAmerican in an era where we're going to have more storage, more wind, more solar, more grid.

And I think we're so lucky. What the hell would we do if the fossil fuels run down, if we didn't have the sun to use indirectly in these forms?

And, of course, the — it's going to be a lot more storage. And, of course, there will be some disruption in the utility industry, but there will be more opportunity, I think, than disruption.

WARREN BUFFETT: Just in the last week, we've announced two different — we're already the leader — and we've announced two different projects.

One in Nebraska — I think it's 400 megawatts in Nebraska. That will be the first time we've had a wind farm here.

And then, we just got approval in the last couple days for, I think, a billion-and-a-half-worth more of wind in Iowa.

And I think Charlie mentioned 20 percent, but if we could — if Greg Abel could take the microphone, I think it's a lot greater percentage than that now. It's a moving target. So I may not have kept Charlie posted on the number.

But, Greg, would you bring people up to date on what percent we will be in Iowa when the present projects are completed, and also what has happened in Nevada and a few places like that? Greg?

GREG ABEL: So, I'd love to provide an update. Actually, as it's been touched on, we announced our tenth project in Iowa. That brings us to more than 4,000 megawatts built over the last ten years in that state.

And at the end of 2016, we will now have 58 percent of our energy — approximately 58 percent — of our energy that we provide to our customers coming from wind.

And then, if you continue to — thank you. (Applause)

And then, if you continue to look at our other utilities and our unregulated businesses — Warren, you've touched on this in the past — we now have more than $18 billion committed to renewable assets across our different utilities.

And if you look at NV Energy, our Nevada utility, for example, we've committed to retire 76 percent of their coal by 2019, and a large portion of that will be replaced with renewable energy. So, clearly a continued commitment to that. (Applause)

CHARLIE MUNGER: Greg, in our utility business, do you think we have more disruption to fear, or more opportunity to love?

GREG ABEL: Distributed generation and solar bring great opportunities for all of our different utilities, and we'll embrace it.

CHARLIE MUNGER: The answer is, you couldn't be luckier, is what I'm telling you.

WARREN BUFFETT: And one thing that has helped in this respect, is that wind and solar are — the development of wind and solar at present — are dependent on tax credits.

In other words, the federal government has made a decision that the market system would not produce solar or wind under today's economics, but it has an interest, as a society, in developing it. So they have established a credit — I think it's one-point — electric is 1.9 cents a kilowatt — for ten years.

And because Berkshire Hathaway Energy is part of the consolidated tax return of Berkshire Hathaway Incorporated, it has been able to invest far more money than it would make sense to invest on a stand-alone basis.

Among electric utilities in the United States, there's really no one situated as well as MidAmerican Energy is, because it's part of this consolidated tax return, to really put its foot to the floor, in terms of developing wind and solar.

So it's become the biggest developer, by far, among the utility industry, and it — I think it's very likely to continue to be, simply because most utilities really don't pay that much income tax and, therefore, they're sort of limited in how far they can push development of wind and solar.

28. Buffett's most memorable failure

WARREN BUFFETT: OK. Station 6?

AUDIENCE MEMBER: Hello. I'm Linen Cygaloski (PH). I'm from Chicago, Illinois, and Berkeley, California.

I'd like to thank you for giving the opportunity to ask this question. This is my first meeting. I plan to attend once every 50 years. (Laughter)

And also, for your essay on the — both of your essays — on the past, present, and future of Berkshire.

As we reflect on the last 50 years, I'd like to ask you this question: what was your most memorable failure and how did you deal with it? Thank you.

WARREN BUFFETT: Yeah. Well, we've discussed Dexter many times in the annual report, where I — back in the mid-1990s — I looked at a shoe business in Dexter, Maine, and decided to pay 400-or-so million dollars for something that was destined to go to zero in a few years, and I didn't figure that out.

And then on top of that, I gave the purchase price in stock, and I guess that stock would be worth, I don't know, maybe 6 or 7 billion now. It makes me feel better when the stock goes down because the stupidity gets reduced. (Laughter)

Nobody misled me on that, in any way. I just looked at it and came up with the wrong answer. But I would say almost any time we've issued shares, it's been a mistake. Wouldn't you say that, Charlie?

CHARLIE MUNGER: Of course.

WARREN BUFFETT: Yeah. (Laughter)

CHARLIE MUNGER: We don't do it much anymore.

WARREN BUFFETT: No.

We probably could have pushed harder, particularly in the earlier years.

We've always been — well, we've had all of our own net worth in the company, we've had all our family's net worth, and we've had all these friends that came out of our partnership, many of whom put half or more of their net worth with us, so we've been very, very, very cautious in what we've done.

And there probably were times when we could have stretched it a little and pulled off something quite large, that we made a mistake, looking back.

But, I wouldn't want to take a 1 percent chance, you know, of wiping out my Aunt Katie's net worth or something. It's just not something in life that I could live with.

So I would rather be, you know, a hundred times too cautious than 1 percent too incautious, and that will continue as long as I'm around.

But people looking at our past would say that we missed some big opportunities that we understood, and could have swung, if we wanted to go out and borrow more money.

Charlie?

CHARLIE MUNGER: Well, it's obviously true. If we had used the leverage that a lot of successful operators did, Berkshire would be a lot bigger.

WARREN BUFFETT: A lot bigger.

CHARLIE MUNGER: A lot bigger.

And — but we would have been sweating at night. It's crazy to sweat at night. (Laughter)

WARREN BUFFETT: Over financial things.

CHARLIE MUNGER: Over financial things, yes. (Laughter and applause)

WARREN BUFFETT: Well, we won't pursue that.

29. Surprised that low rates haven't sparked inflation

WARREN BUFFETT: Carol? (Laughter)

CAROL LOOMIS: In your 2008 annual letter, you mentioned that a likely consequence of the Treasury and Federal Reserve's action to stabilize the economy would be, quote, "an onslaught of inflation."

Now that we are presumably nearing the time when the Federal Reserve will begin raising interest rates, could you share your thoughts regarding both the likelihood of accompanying high inflation, and the consequences that might follow?

And if high rates of inflation did occur, how would the consequences for Berkshire compare to those for most large companies?

And this question, I say belatedly, came from James Cook (PH) of Waterville, Maine.

WARREN BUFFETT: Well, so far we've been very wrong — or I've been very wrong. Charlie has probably been a little bit wrong, too. (Laughs)

CHARLIE MUNGER: Of course.

WARREN BUFFETT: Yeah. The —

No, I would not have predicted that you could have five or six years of, you know, close to zero rates, and now get negative rates in Europe, and run fairly large deficit, although the current deficit is not that large. I mean, the country could sustain on average, you know, 2 or 2 1/2 percent deficits forever and not increase the ratio of debt to GDP. So the word "deficit" is not a dirty word. But very large deficits, and sort of uncontrollable, are scary.

But, you know, we've taken the Federal Reserve balance sheet up from a trillion to over 4 trillion, and we've done a lot of things that weren't in my Economics 101 course, and so far nothing bad has happened, except for the fact that people who saved and kept their money in short-term savings instruments have just totally gotten killed, in terms of their — the income that they received from that.

But it's still hard for me to see how if you toss money from helicopters that eventually you don't have inflation.

Certainly, if the money supplied grows faster and faster relative to the output of goods and services, something like that is supposed to happen.

But I've been surprised by what's happened. I've been — you know, when Poland issues bonds at negative interest rates, you know, I did not have that list — in my list — of forecasts a few years ago.

And so I think we're operating in a world that Charlie and I don't understand very well and that —

And to the second part of the question, I think Berkshire, in almost any kind of environment, will do better than most big companies.

I mean, we are prepared for anything. We'll always be prepared for anything. And if we see really unusual opportunities, we're also prepared to act. And that gives us a real advantage over most big companies.

We don't count on anybody else. We're sitting with over 60 billion right now. I'd rather be sitting with 20 billion and made a great $40 billion acquisition.

But we will — you know, we will be very willing to act if economic turbulence of any kind occurs, and we'll be prepared and most people won't be.

Charlie?

CHARLIE MUNGER: Yeah. We have made very little progress in life by trying to outguess these macroeconomic factors. We basically have abdicated.

We're just swimming all the time, and we let the tide take care of itself.

WARREN BUFFETT: And we really don't see — we've not seen great successes by others who have been all involved in macro predictions. I mean, they get a lot of air time, but that's about all that happens.

CHARLIE MUNGER: The trouble with making all these economic pronouncements is that people gradually get so they think they know something. (Laughter)

It's much better just to say, "I'm ignorant." (Laughter)

WARREN BUFFETT: Yeah. We will find things, though, under any circumstances.

They don't come at an even flow. They may not — and, you know, you cannot predict the size or anything — but you can be sure that over the next ten years, you'll see a lot of things you didn't think were possible.

And we will occasionally see something that makes sense for Berkshire, and we will be prepared to do it both psychologically and financially.

30. Deferred taxes aren't a "hidden form of equity"

WARREN BUFFETT: OK. Jonathan?

JONATHAN BRANDT: For a variety of reasons, bonus depreciation on fixed assets investments in the noninsurance businesses perhaps being the most important, Berkshire's cash taxes have been meaningfully lower than reported taxes for the last several years.

The cumulative difference between cash taxes and reported taxes, which could be viewed as another form of float, now stands at around 37 billion.

Do you consider any portion of the cash flow from annual increase in deferred taxes to be economic earnings?

Is this a sustainable dynamic, or do you expect the relationship between cash and reported taxes to ever flip, for instance, if bonus depreciation ever expires?

Given Berkshire's massive appetite for capital spending at the utility and the railroad, is it possible, instead, that its deferred tax liability will never have to be paid, no matter what Congress does with bonus depreciation? And is it perhaps even likely that this form of float will continue to grow?

WARREN BUFFETT: Probably the most likely answer — there's two forms of float from deferred taxes.

One is the unrealized appreciation on securities, and they're — who knows what happens? I don't think the appreciation is going to disappear, but we may decide to realize some of it from time to time. In fact, we could realize a lot of it.

If you move over to the depreciation, which you're talking about, on the 37 billion — because the total deferred taxes, as I remember, maybe 60 billion or something like that — that is a factor of accelerated depreciation. And one form or another of accelerated depreciation has been around a long time.

Occasionally the — I think the bonus depreciation one year went to 100 percent. I could be wrong on that.

The — certainly in our utility business, that helps our customer and it doesn't help us, basically. I mean, we get a — we will get a return on equity, and that is not — that's not free equity to us, or anything of the sort.

The regulatory commissions take that into account. Return on invested capital, in terms of how the surface transportation board would look at it, again, I don't think we benefit enormously by that.

But it does mean there's less cash going out the door and we, therefore, don't need to borrow as much money for capital investment as otherwise.

But I don't think I would look at that as a hidden form of equity. I'd rather have the deferred taxes than not have them, but it's not meaningful there.

Now what could happen, is that, overwhelmingly, those deferred taxes were probably, entirely even — to the extent they're in the United States — were accrued at a 35 percent rate.

So if the corporate rate changed, then you would have a major change in the deferred tax item. And there's always a possibility of that.

CHARLIE MUNGER: But it would be a book entry. It wouldn't mean much.

WARREN BUFFETT: It wouldn't mean much. Yeah, yeah.

We do — the float from the insurance business, we regard as a terrific asset. The deferred tax liability is a plus, but it's not — it's not a big asset.

31. Lessons on hidden incentives from Teledyne's Henry Singleton

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Hi. My name is Dan Hutner from Vermont.

I was wondering if you could talk about Henry Singleton's Teledyne, and whether you learned lessons from that, used it as a model, and what you think about how it ultimately unwound, and how you might want Berkshire to continue differently?

WARREN BUFFETT: Yeah. That's a very good question. And Charlie knew Henry Singleton. I knew a lot about him. I mean, I studied him very carefully, but Charlie knew him personally, as well as studying him.

So I'm going to let Charlie answer that. But there's a lot to be learned from both what Singleton did in his operating years and then what happened subsequently.

CHARLIE MUNGER: Henry Singleton was very interesting. He was a lot smarter than either Warren or I.

Henry was the kind of guy that always got 800 on every test and left early. And he could play chess blindfolded, at just below the grand master level, when he was an old man.

That said, I watched him invest, and I watched Warren invest, and Warren did a lot better. He just worked at it.

Henry was thinking about inertial guidance, and Warren was thinking about securities. And the extra work enabled Warren to get by with his horrible deficit of IQ, compared to Henry. (Laughter)

And the interesting thing —

WARREN BUFFETT: But let's not quantify it. (Laughter)

CHARLIE MUNGER: No. The interesting thing about Singleton is he had very clever incentives on all the key executives, and they were tough, and they were important, and they were meaningful.

And in the end, he had three different Defense Departments that got into scandals.

He wasn't doing anything wrong. He wasn't trying to hurt the Defense Department on purpose. But the incentives got so strong, and the culture of performance got so strong, that people actually — it went too far — in dealing with the government, Teledyne did.

And so, we haven't had any trouble like that, that I know of. Can you think of any, Warren?

WARREN BUFFETT: No. And Charlie and I, we really believe in the power of incentives. And there's these hidden incentives that we try to avoid.

One — we have seen, both of us, more than once, really decent people misbehave because they felt that there was a loyalty to their CEO to present certain numbers — to deliver certain numbers — because the CEO went out and made a lot of forecasts about what the company would earn.

And if you — if you go and say — if I were to say that Berkshire's going to earn X per share next year, and we have a bunch of executives in the insurance business that set loss reserves and do all kinds of things, or companies in other areas that can load up channels at the end of quarters, at the end of years, I've seen a lot of misbehavior that actually doesn't profit anybody financially, but it's been done merely because they don't want to make the CEO look bad, in terms of his forecast. Or he's done it, because he doesn't want to look —

When they get their ego involved, people do things that they shouldn't do.

So we try to eliminate incentives that would cause people to misbehave, not only for financial rewards, but for, you know, ego satisfaction.

I think that's probably pretty unusual to even be considering that in the business, but we've seen enough, so we do consider it.

CHARLIE MUNGER: I might also report that at the end, Henry wanted to sell his business to Berkshire for stock, so he was very smart right to the very end.

WARREN BUFFETT: We had a case at National — it's interesting.

You really have to understand — should understand — human behavior, if you're going to run a business, because when National Indemnity — we're going back to the late 1960s —

Jack Ringwalt was a marvelous man, and he ran it, and he had another marvelous man who worked for him, his tennis partner, and that fellow was in charge of claims.

And when the claims man would come in to Jack and say, "I just received a claim for $25,000" or something, for some long-haul truck or something, Jack would say — Jack — it was just his personality.

He would start berating the fellow and say, "How could you do this to me?" and "These claims are killing me," and all of that, and he was joking.

But the fellow he was joking with couldn't take it, really, and he started hiding claims. And he just didn't — he stuck them in a drawer.

And that caused us to not only misreport fairly minor figures, but it also caused us to misinform our reinsurers, because they had an interest in the size of claims.

And the fellow that was hiding the claims had no financial interest in doing it at all, but he just didn't like to walk into the office and have Jack kid him about the fact that he was failing him.

And you really have to be very careful in the messages you send as a CEO. And if you tell your — if you tell your managers you never want to disappoint Wall Street, and you want to report X per share, you may find that they start fudging figures to protect your predictions.

And we try to avoid all that kind of behavior at Berkshire. We've just seen too much trouble with it. (Applause)

32. Berkshire isn't "too big to fail"

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Anthony Sterochi (PH) in Lincoln, Nebraska.

He says, "If government regulators deem Berkshire Hathaway's reinsurance business too big to fail, how would government regulation of the reinsurance business affect Berkshire Hathaway?"

WARREN BUFFETT: Yeah. The question — there's two, essentially, regulatory aspects to it.

One is there's the European — and I hope I'm describing this right — I may be wrong, a little bit, on some technicality — there's a European group that is looking at insurers, generally, and has designated, I believe, nine or so insurance companies as — I'm not sure what they call them — but they deserve special attention, I'll put it that way. There's a technical name for it.

The one that's more relevant in the United States is the Financial Stability Oversight Committee, I believe they call it, which designates so-called SIFIs, systemically important financial institutions.

And large banks are in that category. And then the question is, what non-banks are in it?

And they designated General Electric, and Prudential, and recently, Metropolitan, and Metropolitan is fighting the designation.

The question is whether — question isn't just whether you're large. I mean, Exxon Mobil is large, Apple is large, Walmart's large, and nobody thinks about them as SIFIs.

The definition on a non-bank SIFI would be 85 percent of revenues coming from financial matters, and we don't come remotely close on that. I mean, we're 20 percent or thereabouts.

But the real question is whether problems that Berkshire might encounter could destabilize the financial system in the country. And we have not been approached. Nobody's ever called me.

They spent a year with Metropolitan, even before they designated them. So there's — we have no reason, in logic, or in terms of what we've heard, to think that Berkshire would be designated as a SIFI.

I mean, during the last time of trouble, we were about the only party that was supplying help to the financial system, and we will always conduct ourselves in a way where the problems of others can't hurt us in any significant way.

And I think we're almost unique, among financial institutions, in the layers of safety that we've built into our system, in terms of both cash, and operating methods, and everything else. So, it's a moot question.

It — the law exists. We haven't been approached about it as we — as I know — as I mentioned.

Apparently it takes a year or so, even if they approach you while they listen to your presentation and look at your facts. And I do not think Berkshire Hathaway comes within miles of qualifying as a SIFI.

Charlie?

CHARLIE MUNGER: I think that's true. But I think that, generally speaking, there is still too much risk in a lot of high finance. And the idea that Dodd-Frank has removed it all permanently is nonsense. And people like hanging onto it.

You know, trading derivatives, as a principle, if you're shrewd, is a lot like running a bucket shop in the '20s or a gambling parlor in the current era. And you have a gambling parlor that you have a proprietary edge in, and you say it's sharing risk, and helping the economy, and so forth. That's mostly nonsense.

The people are doing it because they like making money with their gambling parlor, and they like favorable labels instead of unfavorable labels.

So, I think there's still danger in the financial system. And I also think our competitors don't like it that they deserve regulation and we don't. And I think there's danger in that too.

WARREN BUFFETT: Yeah. One thing that may not be — (Applause)

I haven't read much about it, but my understanding is that Dodd-Frank actually weakens the power of the Fed, and to some extent the Treasury, too, to take the kind of actions they took in 2008, primarily.

And those powers were needed to keep our system, in my view, from really going into utter chaos.

The ability to say, and have people believe you when you say it, that whatever needs to be done, will be done, has resided in the Federal Reserve and with the Central Bank — the European Central Bank.

And the fact that people believed when Hank Paulson said that the money market funds are going to be guaranteed, that stopped a run on 3 1/2 trillion of money market funds that had lost 175 billion in deposits in the first three days, there, back in September of one week.

If that — if people hadn't believed that, you would have seen that 175 billion turn into a trillion very quickly. I mean, the system would have gone down.

So the — when you have a panic, you have to have someone, somewhere, who can say and be believed, and be correctly believed, that he or she will do whatever it takes.

And you saw what happened in Europe when Draghi finally said that, and you saw what happened in the United States when Bernanke and Paulson, more or less together, said it.

And if you don't have that, panics — they will accelerate like you cannot believe.

You know, in the old days, the only way you could stop a run on a bank was, basically, for somebody to come and pile up gold. I mean, they used to race it to the branches that were having a problem. I remember reading the history of the Bank of America on that, and how they would put out runs before the Federal Reserve existed, and the only thing that stopped it was to pile up gold.

I mean, if the CEO of the bank came out and said, you know, our Basel II ratio is 11.4 percent, the line would just lengthen. It would not get the job done.

Gold got the job done. Bernanke and Paulson got the job done, but the only way they got it done was saying, "We're guaranteeing new commercial paper. We're guaranteeing that the money market funds won't break the bank. You know, we're going to do whatever's necessary."

I think Dodd-Frank weakens that, and I think that's a terrible thing to weaken. (Applause)

33. Selling workers' comp insurance online

WARREN BUFFETT: OK. Gary?

GARY RANSOM: You have started a direct workers' comp operation online, BHDWC.com. It looks a little bit like you're Geico-izing some of the commercial lines.

What's the overall strategy of that effort, and how big do you think it can grow, and what concerns might you have on channel conflict with GUARD, who uses independent agents?

WARREN BUFFETT: Yeah. We — well, Progressive did pretty well with the channel conflict between direct writing and agents.

We will find out what the consumer wants. But we are experimenting with online workers' comp. As you can tell, we've done pretty well with online direct auto over the years.

We'll find out. I don't think that — I don't think the channel conflict is a big problem for us. It might be a bigger problem for some other companies, but I don't think that's a big problem.

It's a trickier thing. We write commercial auto through GEICO, and that's grown and it's not small, but it hasn't achieved private passenger auto proportions at all. So we'll find out.

But we believe in experimenting at Berkshire, and we've got the know-how to write that business in direct, and we'll find out if the customer wants to buy it that way.

We've got an awfully good insurance business, but the nature of the insurance business has changed. I mean, GEICO was all direct mail back in 1936, when Leo Goodwin and his wife sat there and stuffed envelopes.

And the basic idea of saving people money on auto insurance continues to this day, but it went from direct mail to — it went to the TV and the phone, went to cable TV, and then went to the Internet and — and goes to mobile and it — you know, the world moves on.

And the key is to be able to save people money and give them good service. And whatever way does that in the most effective way is going to be what wins 20 or 30 or 50 years from now, and we'll try to stay on top of it.

34. Question you've never been asked

WARREN BUFFETT: OK. Station 8.

AUDIENCE MEMBER: Hello. My name is Paula, and I'm from Gainesville, Florida.

And I would just like to ask Mr. Buffett, after all these years of interviews and meetings, what is the one question that you've never been asked that you would like to answer now? (Laughter and applause)

WARREN BUFFETT: Well, I can think of the question I haven't been asked, but I'm not sure I want to answer it now. (Laughter)

I think I've been asked almost all of them, and many of them, time after time after time.

Charlie, do you have anything that you're just dying to be asked?

CHARLIE MUNGER: Well, if this lady will first tell us the worst thing she ever did in her life. (Laughter)

AUDIENCE MEMBER: Those secrets are not —

WARREN BUFFETT: Paula, I wish we could help you. Have you got another question you'd like to throw at us?

AUDIENCE MEMBER: I could ask you another question.

WARREN BUFFETT: Good.

AUDIENCE MEMBER: Can I buy you lunch? (Laughter)

WARREN BUFFETT: I think she's talking to you, Charlie. (Laughter)

He always wins. You saw him in the movie. He always gets the girl.

CHARLIE MUNGER: Yeah. I'm so heavily involved with those girls in the movie, I just don't have room on my list. (Laughter)

WARREN BUFFETT: Thank you, Paula. (Laughs)

35. Buffett: We run Berkshire almost as tightly as 3G would

WARREN BUFFETT: OK. Andrew.

ANDREW ROSS SORKIN: This is a toughy, and I should say we've probably got — or at least I got — several dozen emails on 3G, and so this is a follow-up to what you talked about on 3G earlier.

And specifically, actually, it's two questions in one that actually came from the audience after your response about 3G. So just to put it in perspective, those shareholders are in the audience, and they asked not to be named, so here we go.

This shareholder writes, "I intend no disrespect to 3G's money making abilities and, as a Berkshire shareholder, like the partnership very much. However, you took more than a decade to shut down the Berkshire mills.

"You take great pride in letting Berkshire's managers run their companies for you, and as Charlie says, almost to the point of abdication. And that approach has made Berkshire a very attractive home for companies.

"You've even bought newspaper groups in the face of the internet tidal wave, and acknowledged they didn't have the same investment characteristics of other Berkshire businesses.

"Are you actually saying 3G's management method is congruent with yours?

"Asked another way, if 3G ran Berkshire, would there not be significant layoffs and consolidation among the companies and intense focus on short-term profits?"

WARREN BUFFETT: No. I think there would be — there would be some companies they'd make changes in. But I would say that GEICO, for example, 33,000 employees, or whatever the number is, is run just as efficiently as 3G would run it.

I would say our home office, with 25 people — we could have a home office with 500 people. We could have floors devoted to strategy, and floors devoted to human resources and comparing the salaries of everybody at all our different companies, and so on.

If they walked into that situation, they'd cut it back. I don't know whether they'd get it down to the 25 we have, but we do not believe in having extra people around.

And our newspapers, you know, unfortunately, you know, they have had to cut back, as revenue has kept shrinking.

And the idea that you run a fat operation just because you're making a lot of money — we cut back on our textile business — I closed the Waumbec mill considerably before we closed the Berkshire mills. It was only when it became apparent that it was just hopeless, we gave up on it.

But in the meantime, every time at Berkshire — I had a drawer full of proposals that said if we put in this kind of a loom, we'll be able to get rid of eight people, and we put in the loom.

I mean, we were trying to reduce our labor complement all the time because we were in competition with people that were doing the same thing.

So I don't think there's any — I don't think there's anything in — we do have some businesses that probably have more people than we need, and I don't do something about it.

But I don't encourage it in any way and most of our managers don't operate that way.

And it's true, if 3G were running our operations, they would get more active at that than I will. But that doesn't mean that I endorse it. It just means that I basically tolerate it where I've got a manager that I think well of.

I think better of the 3G way — method — of operation than I do of our operators where they really have excess people in it. We've got very few of those, but we do have a few.

So, I would never advocate running a business at a loss. If you — where it's going to continue. And you'll see that in our economic principles that's been in the back of the book — back of the annual report — for 30 years or so.

And the same goes for having excess people around, and I think you'll see our attitude toward excess people best expressed in our office here that has 25 people, and Charlie's office in Los Angeles that has two, counting him.

CHARLIE MUNGER: I'd say we've got two-thirds of one. (Laughter)

We're getting by with practically nothing.

WARREN BUFFETT: Yeah.

36. "Great brands will survive and the great retailers will do well"

WARREN BUFFETT: OK. Gregg?

GREGGORY WARREN: This is sort of a follow-on to the 3G question.

When we look at the body of work that the firm has put together in the consumer staples universe, Anheuser-Busch, InBev, Burger King, Tim Hortons, and now Kraft Heinz, one gets the sense that they view the average consumer staples firm as being undermanaged, with a potential for substantially greater levels of profitability.

Given the ongoing struggles of many packaged food firms, most of which compete in a mature category against private label and/or store brand offerings that undercut them in price and diminish the value of their brands, and many of them having to deal with large retailers, like Walmart, that provide meaningful sales volumes but are also quite demanding and continuously pushing for the lowest price available, do you see the potential for further consolidation in the industry with a firm like Kraft Heinz emerging as a big consolidator? Or do you feel that Nestle's more recent squawking about the deal, and 3G Capital's reputation as being a bit heavy-handed with cost cutting, being enough to keep further consolidation at bay?

WARREN BUFFETT: Well, there will be deals in the future. I mean, there are bound to be.

But the strong brands — you know, just look at the ones that General Foods added in the 1980s and the ones that Kraft has now that come from that same company.

And, I mean, Coca-Cola sold more cases of beverages last year than any year in their history and they'll sell more this year. I mean, it's — a strong brand is really potent stuff.

I mean, take Heinz Ketchup or something of the sort. It's 60 percent brand share in the United States, but it's much higher in many other countries.

So you'll always have the fight between the retailer and the brand, and the retailer is going to use all the pressure they've got and, therefore, the brand has to stand for something in the consumer's mind.

Because, in the end, the retailer may want to shift to a house brand, a private label, but — and they — private labels have been around forever in the soft drink field. I mean, I can remember when I was looking at Cott Beverage and all of those and thinking, what will it do to us?

I remember when Sam Walton sent me the first six-pack. He told me, it's the first six-pack of Sam's Cola, 20 years ago, and believe me, Walmart has plenty of power, but so does Coca-Cola.

And the brand — you've got to nourish them. You know, you've got to take very, very, very good care of them. They have to stand for the promise that's in people's mind about them.

But a lot of people have tried to — I don't know how many dozens, or maybe hundreds, of cola beverages there have been over the years. RC Cola. You know, they came up with the first diet product back in the early '60s, and that looked like a big maneuver.

Wilkinson came up with the blade back in the '60s after Gillette, but Gillette ends up with 70 percent, by dollar value, worldwide of razor blades after 100 years.

So there's all — you've got to protect a brand. You've got to enhance it in every way. You've got to get a promise in people's minds that gets delivered that way.

But that's the question Charlie and I faced in 1972 when we looked at See's. See's was selling for $1.95 a pound, Russell Stover was selling a little cheaper, and you had to decide how much damage could a Russell Stover do if they came after See's, and they copied our shops, and all that sort of thing.

If you protect a brand — if you got a terrific brand and you protect it, it's a fabulous asset.

But you'll always have trouble dealing with Costco and Walmart and the rest of the guys — Kroger, you name it, you know, they're tough, too.

But the great brands will survive and the great retailers will do well.

Charlie?

CHARLIE MUNGER: Well, we've almost exhausted this topic. The — there's no question about the fact that waves of layoffs frighten people. A job is a very important part of a person's life, and it's no small thing to lose it.

So — but on the other hand, I don't think you — what would our country be if we kept everybody on the farms? All this prosperous group would be pitching hay and milking cows at 4:00 in the morning. No, we need — we need our businesses to be right sized.

37. Value investing in China?

WARREN BUFFETT: Station 9?

Better have some fudge, Charlie.

AUDIENCE MEMBER: Very exciting to see my superstars here. I'm Leo (inaudible) from China and a loyal fan of you and Charlie.

Many Chinese investors feel all kinds of performance pressure, question, and even laughing, at value investing.

Many also believe that value investing, that doesn't apply to China, where the stock market just doubled over the last six months.

I would like to ask Mr. Buffett, do you think value investment can be widely applied in all markets, or just the (inaudible) markets, just as the ones in the United States?

Do you have any suggestions for value investors to hold against pressure and to be much happy? Thank you.

WARREN BUFFETT: I'm not sure I got all of it, but Charlie will help me.

I certainly think investment principles do not stop at borders. So if I were investing in China or any place else — India, UK, Germany — I would apply exactly the same sort of principles that I learned from "The Intelligent Investor."

I would think of stocks as a small piece of a business. I would think of investment fluctuations being there to benefit me, rather than to hurt me. And I would try to focus my attention on businesses where I thought I understood the competitive advantage they had and where they would — what they would — look like in five or ten years.

So I don't think I would change the principles at all. I'm not sure I got all of the question.

Maybe Charlie can elaborate on the rest.

CHARLIE MUNGER: Well, the Chinese have a history of being very entrepreneurial and gambling very heavily when they have the opportunity, and it has created great volatility in the Chinese stock markets.

And when things get bouncy and prosperous, like our Internet craze here in the United States, China looks a lot like Silicon Valley.

I think China would be way better to be more value investor minded and less absorbed in waves of speculation.

So I think the more China copies the way Berkshire operates, I think the better it will be for China. (Applause)

WARREN BUFFETT: Yeah. There's a certain irony, in that we will — we would — do the best, over decades, if we operated in a market where people operated very foolishly.

And the more people respond to short term events and exaggerated things or — anything that causes people to get wildly enthusiastic or wildly depressed, actually, is what allows people to make lots of money in securities.

And, on the other hand, it's not the greatest thing for a society. And Charlie and I have benefited enormously by the fact that over a 50-year period, there have been a few periods, probably the most extraordinary being 1973 and ’74, where you could buy stocks unbelievably cheap, cheaper than happened in 2008 and 2009.

And, you know, it doesn’t make sense to have that much volatility in the market, but humans behave the way humans behave, and they’re going to continue to behave that way in the next 50 years.

I mean, if you’re a young investor, and you can sort of stand back and value stocks as businesses and invest when things are very cheap, no matter what anybody is saying on television or what you’re reading, and perhaps, if you wish, sell when people get terribly enthused, it is really not a very tough intellectual game. It’s an easy game, if you can control your emotions.

And as Charlie says, we’ve talked about a little bit that the Chinese market may be more — there may be more speculative influences in it, even than in the United States, because it’s a relatively new development and it may lend itself to greater extremes, and that should produce great opportunities. Charlie?

CHARLIE MUNGER: Yeah. But there’s great opportunities for excess and nasty contractions after unnatural booms and so on.

I think China is wise to dampen the speculative booms and to — and I think the Chinese — I don’t think that value investing will ever go out of style. Who in the hell doesn’t want value when you buy something? How can there be anything else that makes any sense except value investing?

WARREN BUFFETT: It never gets that popular though. (Laughs)

CHARLIE MUNGER: People are looking for an easier way.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And that’s a mistake. It looks easier, but, in fact, it’s harder. And there’s a lot of misery to be obtained by misusing stocks.

WARREN BUFFETT: Yeah. Nobody buys a farm to make a lot of money next week or next month, or they buy, you know, an apartment house. They buy it based on what they think the long-term future is. And if they get a — if they make a reasoned calculation of that and the purchase price looks attractive, they buy it and then they don’t get a quote on it every day or every week or every month or even every year, and that’s probably a better way to look at stocks.

38. U.S. needs to protect against catastrophic terror attacks

WARREN BUFFETT: Carol?

CAROL LOOMIS: "Mr. Buffett, you have expressed your optimism about the future of America many times and have often made the point that the U.S. simply has a superior economic system.

"But my question" — and this is from Christopher Gottchio (PH) of New York City — "my question concerns the risk of chemical, nuclear, biological, and cybersecurity problems and the audience should reflect on the initial letters of those words when I tell you that Mr. Buffett has sometimes dubbed that C-N-B-C." Sorry, Becky. (Laughter)

WARREN BUFFETT: I just do that to tease people, but the —

CAROL LOOMIS: Wait a minute. One more. "How do these threats affect your outlook?"

WARREN BUFFETT: Well, they are the great threat to the United States. The — we will have — we have, and will have, a wonderful economic system.

You know, your children are going to live better than you do, and your grandchildren are going to live better than they do. That is — there are fits and starts and ups and downs. But just go outside or — as you fly home, just imagine what you're flying over looked like in 1776, and everything since then is profit.

I mean, the farms are incredibly more productive. The cities have grown. It's all here, you know, and that's all come from unleashing the energies and brains of the American people and the system that has worked quite well despite all the deficiencies that we talk about all the time. So that hasn't been lost at all.

And, you know, people get upset because we're having 2 percent growth. Well, 2 percent growth with 1 percent population growth means 20 percent gain in a generation, and 20 percent on 54,000 of GDP per capita is another 10,000 of GDP per capita coming in the next generation.

This country has a wonderful future, but as the questioner pointed out, that can all be nullified by either madmen, or rogue states, or religious fanatics, or sociopaths, or whatever it may be, who have — who wish to have — access to weapons of mass destruction.

And to nuclear, which, as I used to think was the primary one, you know, you can now add biological and chemical and cyber.

And there will be an increasing number — there already are a huge number — of people that would wish harm, and particularly on the United States, although on others as well.

And those people aren't going to go away, and they're going to look for more ingenious ways of utilizing the raw materials that they have access — or might get access to — and better delivery systems.

And we need an extremely vigilant security operation in the United States, and we will have threats. I can't — I do a little bit about those things in a few ways — but that's something we live with.

But we also live in a country that is going to do extraordinarily well. And if we successfully ward off those threats, or at least minimize their impact on us, I still maintain that the luckiest person ever born in history, on a probabilistic basis, is the baby being born in the United States today. (Applause)

Charlie?

CHARLIE MUNGER: Well, of course, we were a favored place, and we've had a favored outcome, and we've been lucky too.

I think I probably lived in the most ideal era that any man in human history could have been born into. I think you have, too, Warren.

WARREN BUFFETT: Right.

CHARLIE MUNGER: But I don't think we should get too smug. China has come up a lot faster than any other big nation ever came up, and —

WARREN BUFFETT: But that's good for us.

CHARLIE MUNGER: Oh, I think — I can hardly think of anything more important than future close collaboration between the United States and China.

I think you're talking about the two most important nations in the world going forward. And I think it is very important that we like and trust one another, and have very good relations, and work together to avoid bad consequences that come from other people's mistakes and misbehavior.

So I'm — (Applause)

I think both China and the United States would be crazy not to collaborate and increase trust.

I don't think there's anything more important that we could do for our respective safety and for the general benefit of the world. (Applause)

WARREN BUFFETT: If you had your choice, would you rather be born now with all the qualities you've got, or when you were born?

CHARLIE MUNGER: Well, I must say it's very interesting now, but it was always interesting.

And I think that's too tough a question. I don't like these very theoretical questions. (Laughter)

I'd rather think about something where I might gain some advantage or help somebody else to gain an advantage.

39. Unlikely that one person will run both investments and operations

WARREN BUFFETT: OK. Then we'll move on to Jonathan. (Laughs)

JONATHAN BRANDT: Warren, you have up to this point said that Berkshire in the future will have a chief executive officer and one or more chief investment officers.

You haven't explicitly said that a chief investment officer cannot be the CEO, but that has, for me at least, been implied.

Berkshire has been successfully managed for 50 years by a chairman and vice chairman whose principal experience was in allocating capital amongst a number of businesses and industries with which they were familiar and whose attributes they could compare.

Since capital allocation is the key skill needed for a company structured the way Berkshire is, why couldn't the company's principal decision maker in the future also be someone who is experienced in choosing among different reinvestment options, with perhaps a second outstanding person expert in operations acting as chief operating officer, albeit a route of the hands-off one, given Berkshire's extreme decentralization?

WARREN BUFFETT: That's a very good question.

It's not inconceivable. It's very unlikely, Jonny, that — but as you say, the — a chief investment officer has a — will have — or should have — a significant array of skills that would be useful, also, for a chief executive officer.

But I would say, also, that I would not want to move — if I were voting on it — I would not want to vote to put somebody whose sole experience had been investments in charge of an operation like Berkshire, who had not had any, also, significant operating experience.

I've said that I'm a better investment manager because I've been an operating manager, and I'm a better operating manager because I've been the investment manager.

But the — you — operations — I've learned a lot through operations that I wouldn't have learned if I'd stayed in investments all my life. I would not have been equipped to run it.

I learned a lot of things about operations by being in operations. So if you had somebody that had the dual experience and was very good at investments, but had a lot of experience in operations, that would be conceivable. Otherwise, I wouldn't vote that way.

Charlie?

CHARLIE MUNGER: Well, every year at Berkshire, as now constituted, the owned and controlled businesses get more and more important, and the measurable securities are relatively less important.

So, I think it would be crazy not to go with the tide to some extent.

And we need more — we need expertise beyond that of a typical portfolio analyst.

WARREN BUFFETT: Yeah. But the CEO should have some real understanding of investments and investment alternatives and all that.

I've seen a lot of businesses run by people that really don't understand the math of investing or capital allocation very well. So having a dual background is useful, but actually our operating managers know — some of them know — a lot about investing.

40. Weschler and Combs are good investors and good people

WARREN BUFFETT: OK. Station 10,

AUDIENCE MEMBER: Hello. Warren, Charlie, it's a pleasure to be here. My name is Douglas Coburn. I'm originally from Caracas, Venezuela, but I'm here with a large group from Columbia Business School. (Cheers)

My question —

Thank you.

My question is regarding Ted Weschler. Can you please share your views regarding his investment philosophy, his investment process, and the qualities that he brings to Berkshire?

WARREN BUFFETT: Yeah. Well, both Ted and Todd [Combs], the two investment managers, aside from myself, at Berkshire, are very, very smart about businesses and investments.

I mean, they understand the reality of business operations. They understand what makes for competitive strength, and all of the things that you'd learn in business school or learn through investing.

And on top of that, they have qualities of character which are terribly important to me and Charlie.

We have seen dozens and dozens and dozens of investment managers with great records over the years. We used to drop in and see some of those guys, you know, that were running — I'm talking back in the 1960s and '70s.

And when I gave up my partnership, I knew probably 20 people with great records from the previous six or eight years, but I picked Bill Ruane to handle the funds of my partners going forward.

And he set up a fund called Sequoia Fund, and 10,000 put in that fund has become over $4 million now.

Well, Bill was a terrific investment manager, but he was a terrific human being. And we really want people where they do more than their share, where they don't claim credit for things they don't do, where they — you know, they — just every aspect of their personality is such that you want to be around them, and you want to hand responsibility over to them.

And Ted and Todd fit that bill, and there's plenty of investment managers in Wall Street with great records that don't fit that bill, in our view. So that's about all I can tell you.

Charlie met — he met Todd first. I met Ted first. And we both — when we talked about them, we talked about their record and the kind of stocks they owned, but we talked a whole lot more about what kind of people they were and we haven't been disappointed.

Charlie?

CHARLIE MUNGER: Yeah, I think the whole thing is working pretty well. And I think those people will be constructive around Berkshire for reasons apart from their expertise in handling securities. In fact, they already are.

WARREN BUFFETT: They already very are.

CHARLIE MUNGER: Oh. They're — they've just — each one has helped buy a business recently.

WARREN BUFFETT: Yeah. And they will help oversee it, too, the businesses. They're smart about business, and they know just exact — they know the right touch to apply in terms of how much they get involved.

I mean, Todd worked on Charter Brokerage. He worked on an acquisition we made from Phillips.

Ted just worked on this operation over in Germany, went over there a couple of times.

And he's just smart. You know, he's got good sense. He knows how to deal with people. You know, if a deal is to be made, he'll get it made.

And we — Charlie and I run into more dysfunctional people with 160 IQs, probably, than anybody alive.

But Salomon gave us a head start on that, as a matter of fact. Wouldn't you say that —?

CHARLIE MUNGER: We've specialized in it.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: We've absolutely specialized in it.

WARREN BUFFETT: We've seen — take the Salomon — we've seen a group of people whose IQs far surpassed those of people at Berkshire, and we've seen them self-destruct to make money they didn't need, when they were already rich. You know, I mean, see, that's madness.

But a lot of people are just incapable of functioning well day after day, even though they're capable of brilliance from time to time.

And we're looking — we've got very solid people in Ted and Todd. They're very bright and they identify with Berkshire and not with themselves, and that's a — it's a huge factor over time.

Any more, Charlie, on that?

CHARLIE MUNGER: Well, yeah. And that trustworthiness is more important than the brains. It's not that they don't have the brains, but we wouldn't hire anybody, no matter how able, if we didn't trust them.

WARREN BUFFETT: Yeah. Very occasionally — (Applause)

Yeah. We'll get disappointed on that occasionally, but not very often.

41. Update on Buffett's hedge fund wager

WARREN BUFFETT: We're approaching noon. We'll come back at 1:00.

I promised — seven years ago I made this bet, which was originally to produce a million dollars for the charity of the winner, and another fellow who was in the hedge fund business — and I offered this bet to anybody. Only one person took me up on it.

And we made this bet where a million dollars goes to the winner's charity, as to whether a group of five hedge funds, the funds would beat the S&P Vanguard fund.

And my point being that the fees would not overcome — would not be overcome — by managerial brilliance and that the hedge funds would fall short.

And the other fellow betting, essentially, that paying people 2-and-20, and having an override to the fund of funds, was nothing to pay for the brilliance of getting Wall Street to manage your money.

And I promised that every year I would report the update.

And the first year I fell far behind, but we reported it then.

So we'll put that slide up. And as you can see, seven years into it, it's interesting that just buying Vanguard fund, you know, with no — nothing but putting the S&P 500 in there, has now given a cumulative return of 63 1/2 percent, and the hedge funds are at 19 percent.

The interesting thing is, some of that is underperformance, but the hedge fund managers have done very well during that period. If they were managing a billion dollars, for example, at 2-and-20, you get $20 million a year just for coming to the office.

It's — you know, it's been — the hedge funds haven't done bad. It's the investors in the hedge funds have paid a very big price. And the — (Applause)

We originally funded this with zero-coupon bonds. We each bought about 350,000 of zero-coupon bonds that would be worth 500,000 at the end of the period.

We converted it to Berkshire Hathaway stock — so — a few years ago, the fellow on the other side of the bet did it with me. So now it now looks like the winner will get appreciably more than a million dollars.

And if you want to entertain yourself, you can go to Long Bets — on search, just put in Long Bets, and you'll find this organization out in Washington that sort of acts as the stakeholder, sets the rules for these long bets.

And now there's hundreds of them up there, and they're on all kinds of predictions, and you can go there, and if you want to disagree with one of the parties on there, you can make these bets that pay off in 50 years or 25 years.

Afternoon Session - 2015 Meeting

1. Didn't get Clayton Homes question in advance

WARREN BUFFETT: OK. Everybody will settle down, we'll move right along.

I want to clear up one thing. My daughter told me that because we had all those — I had — all those slides that were in answer to Carol's first question, that Carol [Loomis] and I had discussed it ahead of time.

I will guarantee you that I've discussed no questions with anyone on the panel, and they will tell you the same thing.

But I knew I was going to be asked questions about Clayton, so I prepared the slides.

It was an accident that it turned out to be the first question, but it was certain to be in the first few.

So, Carol did not — Carol in 60 years has never tipped me off on anything, nor have the other panelists.

And everything — but we were — but I was — prepared for the fact that people would be asking questions about Clayton.

OK. Let's move right along, and we'll go to Becky.

2. Businesses that do best in high inflation

BECKY QUICK: OK. This is a question — oops, that's not the question. Hold on.

Here it is. This is a question from John Wells, right here in Omaha, and he says, "You've described inflation as a gigantic corporate tapeworm. Which of Berkshire's businesses are best suited to thrive during a period of high inflation and why? Which will suffer the most and why?"

WARREN BUFFETT: Yeah. Well, the best businesses during inflation are usually the best — they're the businesses that you buy once and then you don't have to keep making capital investments subsequently.

So you get — you do not face the problem of continuous reinvestment involving greater and greater dollars because of inflation.

That's one reason real estate, in general, is good during inflation. If you built your own house 55 years ago like Charlie did, or bought one 55 years ago like I did, it's a one-time outlay, whereas if you're — and you get the — you get an inflationary expansion in replacement capital without having to replace yourself.

And if you've got something that's useful to someone else, it tends to be priced in terms of replacement value over time, so you really get the inflationary kick.

Now, if you're in a business such as the utility business or the railroad business, it just keeps eating up more and more money, and your depreciation charges are inadequate and you're kidding yourself as to your real economic profits.

So, any business with heavy capital investment tends to be a poor business to be in in inflation and often it's a poor business to be in generally.

And the business where you buy something once — a brand is a wonderful thing to own during inflation.

You know, See's Candy built their brand many years ago. Now, we've had to nourish it as we've gone along, but the value of that brand increases during inflation, just as the value of, really, any strongly branded goods.

Gillette bought the entire radio rights to the World Series in 1939. And as I remember, it cost them $100,000, and for that they got to broadcast the Yankees, I think, versus the Reds in 1939.

And think of the number of impressions they made on minds in 1939 dollars for $100,000, and they were getting in the minds of young guys like myself. I was eight or nine. And millions of people — and they did it in those dollars then.

And, of course, if you were going to go out and try out and do — have similar impressions on millions of minds now, it'd cost a fortune. And part of that is due to inflation. Part of it's due to other things.

But it was a great investment, which could be made in 1939 dollars that paid off, in terms of selling razors and blades in 1960 and 1970 and 1980 dollars.

So that's the kind of business you want to own.

Charlie?

CHARLIE MUNGER: Well, yeah, but if the inflation ever goes completely out of control, you have no idea how it's going to end up.

If it weren't for the Weimar inflation, we might never have had Adolf Hitler. It was the twosome of the great German inflation followed by the Great Depression that brought us Hitler. And think of the price that the world paid for that one.

We don't want inflation because it's good for See's Candy. (Laughter)

WARREN BUFFETT: I didn't quite realize I was —

CHARLIE MUNGER: No, I wasn't criticizing you.

WARREN BUFFETT: What's good for See's Candy is good for the United States. (Laughter)

3. Organic growth vs. acquisitions

WARREN BUFFETT: OK. Gary?

GARY RANSOM: Three years ago you noted that you had looked at a large commercial lines insurance company as a possible acquisition, and now you've started up Berkshire Specialty, which seems to be off to a good start.

What are your thoughts on whether that has replaced the idea of taking over — of buying or acquiring a large company, or is Berkshire Specialty doing well enough that you're content with that —

WARREN BUFFETT: Yeah.

GARY RANSOM: — organic growth?

WARREN BUFFETT: I would say that it's almost certain that we — I don't want to say 100 percent certain — but it's almost certain we will not take over a large commercial insurance company.

We've got the ideal operation, in my view, in Berkshire Hathaway Specialty.

We've got the right people running it. We've got Ajit overseeing it. We've got more capital than any commercial insurance company in the world so that our securities are — and, therefore, our policies — are really better than anyone else's.

So, we've got all these things going for us. And if we bought a big operation, we would have paid a very substantial nondeductible acquisition premium, and this way we've actually made money while we're in the building stage.

And I think it can be a very, very big operation five or 10 years from now. So it's almost zero probability that we'll buy somebody else.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with you.

WARREN BUFFETT: OK. The — that's how he keeps his job. (Laughter)

We'll go to — incidentally, all the overflow rooms, including at the Hilton, got filled. I'm not sure where a couple — where station 11 is — but we always lose a fair number at lunchtime.

So I'm sure everybody can find a seat, but we do apologize to those who could not find a seat this morning.

4. Munger on reputation and behaving well

WARREN BUFFETT: Station 11?

AUDIENCE MEMBER: Yes. Hey, Warren and Charlie. How are you guys? Congratulations on 50 years.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: So, in this year's annual letter, Charlie wrote about the peculiar attributes that made the Berkshire system, and the leader of the system, a historically organizing entity — organizational entity.

So, my question to both of you is what practical mental model or mental models would you impress upon a young, enterprising individual at the infancy of their career to build an important enduring enterprise of that particular distinction and impact?

And if you could give, like, maybe some contrasting examples, like why is a Microsoft able to build itself into a dominating monolithic company, versus a See's Candy, which can be a great enterprise to spin off cash flow but not necessarily be an enduring — or not necessarily enduring — but an impactful enterprise to the level of a Berkshire or Microsoft?

CHARLIE MUNGER: Thank you, Warren. (Laughter)

WARREN BUFFETT: You're the guy that wrote it. (Laughter)

This is pineapple juice, incidentally. People were questioning that. (Laughter)

They say it's good for your throat if you're going to talk a long time.

CHARLIE MUNGER: Yes. Well, of course, reputation you get over a long period of time.

Very few people are like Charles Lindbergh where you just suddenly have a great reputation.

Most of us have to acquire one very slowly, and that was true in Berkshire's case.

And any individual you just have to get the best reputation you can in the years you're allotted and the time available.

And it may work out well, it may work out poorly. But it's a wise investment.

I see, all the time, opportunities come to people where it's the credibility they've gotten in the past that causes them to have the new opportunity.

So, I think hardly anything is more important than behaving well as you go through life.

And — I think we actually try to behave better as we got more prosperous, and I think you'd be crazy if you didn't.

So, I'd certainly recommend that you follow those old-fashioned principles.

And I don't think there's any way of guaranteeing a total powerhouse brand, nor can — if a result is a one in 50 million-type result, you're probably not going to get it.

WARREN BUFFETT: Gianni Agnelli of Fiat, back in — I think it was 1988 — I was at dinner with him one time, and he said something to me that stuck with me. He said, "When you get old," he says, "You'll have the reputation you deserve." He says, "For a while you can" —

CHARLIE MUNGER: Fool people.

WARREN BUFFETT: — "fool people," but he says, "When" — he was talking about himself at the time — but he said, "When you get to be my age," he said, "Whatever reputation you have, it's probably the one you deserve."

And I think the same is true of companies. And, frankly, you know, it has helped Berkshire a whole lot that it has gotten a reputation to be a somewhat different sort of company.

I mean, I don't think we set out to do that, exactly, but it has worked out that way.

5. Climate change risk for insurance subsidiaries

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Warren, you have said that global warming has not increased Berkshire's payouts for weather-related events. Yet, other insurers, including Travelers, have cited climate change as a risk factor that they use.

Are Berkshire's models different and, if so, how?

WARREN BUFFETT: Yeah. No. I've seen the — of course, the SEC requires you put in all these risk factors, and the lawyers will tell you to put in, you know, everything possibly you can think of, you know, that you'll develop Alzheimer's or whatever it may be.

They just want you to have a laundry list so that it's all been covered in case of later litigation or something of the sort.

So people do put in weather risk, and maybe they put it in because they've got some model that shows it. But, you know, we price our business — basically, we price it every year.

It's not like a life insurance company. A life insurance company you make a contract that — so much a thousand. And if you buy whole life insurance, you've set a price for — if you're 20, you may have set a price for 60 or 70 years in the future. But that is not the property casualty insurance business, which we're in.

We set it one year at a time. And I see nothing that tells me that on a yearly basis that global warming is something that should cause me to change my prices a lot, or even a small amount.

That doesn't mean that it isn't a threat to humanity or — you know, and terribly important. It just means that if I'm going to sell a one-year insurance policy, and I'm going to sell it on a $1 billion plant, I may care enormously about the fire protection, and other various other kinds of protection, within that plant.

I may care about what's going on adjacent to that plant, and all kinds of things, but I am not thinking about global warming. It does not change the situation, in a material way, in any one-year period of time, in my judgment.

And, you know, it — if I was writing a 50-year wind storm policy in Florida, I would think very hard about what global warming might do in that case to the incidence and the intensity of potential hurricanes.

But I do not think it has any material effect on the likelihood of — or the intensity — of a hurricane in Florida or Louisiana or Texas or — next year.

So, it is not a — it's not something I would put in the 10-K as a threat.

Charlie?

CHARLIE MUNGER: I don't think it's totally clear what the effects of global warming will be on extremes of weather. I think there's a lot of guesswork in that field, and a lot of people like howling about calamities that are by no means sure.

WARREN BUFFETT: Yeah. Do you think — would it change your one-year prediction as to what the rate should be?

CHARLIE MUNGER: No.

WARREN BUFFETT: No. It wouldn't change mine either, so I don't really understand why they put that in there.

CHARLIE MUNGER: A lot of people get very invested. It's like a crazy ideology.

It's not that global warming isn't happening. It's just that you can get so excited about it you make all kinds of crazy extrapolations that aren't necessarily correct.

WARREN BUFFETT: Yeah. Look at it this way. Would you change the rate for tomorrow on insurance because — from the rate today — for global warming? I doubt it very much.

Now, you know, would you change it for 50 years? Might very well.

But I think that one year is much closer to one day than it is to 50 years, in terms of focusing on that factor.

So, I do not want our underwriters to sit there thinking a lot about — in terms of writing a risk or the price at which to write that risk — I do not want them thinking about global warming. I want them thinking about whether there's a moral risk involved and who owns the property.

I mean, that can be very significant. There used to be one fellow called "Marvin the Torch," that if you insured "Marvin the Torch," global warming didn't really make much difference. His building was going to go. (Laughter)

Marvin had a marvelous way of looking at it, though. He said, "I don't burn buildings; I create vacant lots." (Laughter)

6. More oil & gas investments possible despite poor record

WARREN BUFFETT: OK. Gregg?

GREGG WARREN: When we look back at some of your bigger stock purchases during the past decade, two names actually stand out: ConocoPhillips and ExxonMobil.

In the first instance, you bought shares near the height of the spike in oil prices in 2008, later acknowledging that this was a mistake given how dramatically oil prices fell during the crisis.

While you've been able to swap some of those holdings, post a spinoff of Phillips 66 into operating assets, most of what you sold the last six years, by our estimates, has been at a loss.

Given that experience, it surprised some of us to see you take a meaningful position in ExxonMobil during the summer of 2013.

While it looks like you were able to eliminate that stake at cost as oil prices fell last year, these types of investments, which can be negatively impacted by the volatility in oil prices, don't really seem to fit well with the other types of investments in your stock portfolio, many of which are built on strong franchises with unique competitive advantages.

With that in mind, and given the track record that Greg Abel and his team at Berkshire Hathaway Energy have had acquiring and investing in energy assets, does it make more sense to leave future energy-related investments in their hands?

WARREN BUFFETT: Well, there's nothing we like better than to back up Greg in buying utility properties.

And — but they — we call it energy, but it's not oil and gas in Berkshire Hathaway Energy, and they're really in a dramatically different business than ConocoPhillips or ExxonMobil.

But we are looking, constantly, for opportunities for Berkshire Hathaway Energy to spend big money, and it will.

Berkshire Hathaway Energy, we paid $35.05 per share in 1999 to buy the stock.

I was at $35, and I don't change my prices and Berkshire — the company was then called MidAmerican — they hired some investment bankers to come out from New York, and investment bankers spent a week here doing nothing.

But they felt — before they went home, they said, you know, "You've got to give us something because we're going to send a big bill." And I said, "Well, in that case, we'll pay $35.05 and you can say you got the last nickel out of me." (Laughter)

So my ambition ever since has been to have Berkshire Hathaway Energy earn $35.05 per share. It's never paid a dividend.

It will probably earn about $30 a share this year, which is a great tribute to Greg and his management. But we will get the 35 or better because he will make some good deals.

It's not at all analogous to the ConocoPhillips or ExxonMobil investments. As it turned out, we wrote ConocoPhillips down because we were required by the auditors to do it.

We actually, by the time we got all through, we made some money in it, and we made a little money in ExxonMobil, too.

But we will not be buying, very often, oil and gas stocks, but we will — we probably haven't bought the last one.

In the end, we look at the cash, we look at available opportunities, both in investments and businesses, and we make decisions, occasionally, on buying something and sometimes we change our mind.

And that will continue that way. It's been going on that way for a lot of years.

And we have not distinguished ourselves, at all, in the oil and gas field, although we've made a little money, and we passed up one or two where we could have made a lot of money.

Charlie?

CHARLIE MUNGER: Yeah. And with interest rates being so low and the dividend on ExxonMobil being the size it was, it was not a bad cash substitute, if you think only in those terms.

WARREN BUFFETT: Yeah. It worked out OK. There were other things we could have done a lot better, but that's always been true and will continue to be true.

7. No "tears" for corporations on taxes

WARREN BUFFETT: Station 1.

AUDIENCE MEMBER: Mr. Chairman, Mr. Vice Chairman, my name is Andy Peake, and I'm from New York City.

First, congratulations to you on a remarkable 50 years, and second, thank you for hosting a one-of-a-kind annual meeting where you patiently answer questions from shareholders. I believe you are both — (Applause)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: I believe you are two of the most knowledgeable and authoritative people on planet Earth on the U.S. tax code.

Our tax code is obviously broken at both the individual and the corporate levels.

Today, we have 2.1 trillion in offshore corporate cash sitting there not being brought home. We have the highest corporate tax rates in the world, and for high-income earners in the U.S., other than hedge fund managers, in states like New York and California, an all-in rate greater than 50 percent.

What can be done to effect real change to bring about a simpler, more rational tax code? Thank you.

WARREN BUFFETT: Well, it takes 218 members of the House of Representatives and 51 U.S. senators, and a president that will sign the bill.

The question is: how much you think the country should spend and then from whom do you get it?

And I would point out that despite the tax rates that all the corporate chieftains complain about, the share of earnings — share of GDP — accounted for by corporate profits is at a record.

Corporate taxes 40 years ago were 4 percent of GDP. They're now running about 2 percent. They've decreased significantly while payroll taxes have increased.

You know, it's a real question.

And once you get special provisions in the code, it is really hard to get rid of them, absent a major revision of the code.

I actually think — I may be an optimist on this, but I'm — I think both Ron Wyden and Orrin Hatch, the two ranking members, Senate Finance Committee, I think they're capable of working out something that they — neither one of them likes — but they both like it better than what exists now, and I think it can be made considerably more rational.

But in the end, if we're going to spend 21 or 2 percent of GDP, we should probably raise 19 percent of GDP.

We can take a gap of a couple percent without getting further into debt as a proportion of GDP than we are, so we've got that leeway.

But, you know, you take 19 percent of 17 1/2 trillion, or thereabouts, and you're talking, as Senator [Everett] Dirksen said one time, real money.

And how much you get from corporations, how much you get from individuals, how much you get from estate taxes, you know, it's a fight up and down the line.

So I — and in terms of the cash abroad, basically you can bring it back, you just have to pay tax at U.S. corporate rates. And our corporate rates are 35 percent.

Charlie and I, a good bit of our life, operated with corporate rates of 52 percent, later at 48 percent, and the country grew well. American business prospered during that period.

I don't shed any tears for American business, in terms of the tax rate overall. I think there could be a much more equitable code, in terms of the corporate tax, but I do not think that the 2 percent of GDP that's being raised from corporate taxes, which is far lower than was the percentage 30 or 40 years ago, I do not think that's an onerous number.

And for people who are getting 1/4 or 1/2 percent on their CDs, who have retired, and with American business earning, on tangible equity, which is the way they measure it, you know, probably averaging close to 15 percent, I think equity holders are getting treated extraordinarily well compared to debt holders in this economy. (Scattered applause)

Charlie?

CHARLIE MUNGER: Well, I agree with you, and I don't die over these little differences in the tax code, either.

I live in California, of course, where — there's, like, a 13 1/2 percent tax on long-term capital gains, nondeductible for federal purposes. That's a ridiculous kind of a tax to have in California because it drives rich people out.

Hawaii and Florida have enough sense to know that rich people don't commit a lot of crimes, they don't burden the schools, and they provide a whole lot of medical expenditures that are good for everybody else's income.

I think California has a really stupid tax policy. But I don't think the U.S. — but I don't think the U.S. policy is — (applause) — I don't think the U.S. policy is bad at all.

WARREN BUFFETT: And it's nondeductible because of the alternative income tax —

CHARLIE MUNGER: Yes, exactly.

WARREN BUFFETT: Yeah. That really wasn't the case before, but it —

CHARLIE MUNGER: No, it's always —

WARREN BUFFETT: — kind of slipped in.

CHARLIE MUNGER: No, they did it on purpose. (Laughter)

No, they did it on purpose.

WARREN BUFFETT: Early stages of paranoia. (Laughter)

CHARLIE MUNGER: Yeah. But it is — it's amazing. The idea of driving the rich people out, Florida is so much smarter than California on that subject. And it is really demented.

Who in the hell doesn't want rich people coming in and spending in their state?

WARREN BUFFETT: Yeah, yeah. Remember that as you come here to Nebraska for the meeting. (Laughter)

I would say I really do think there's some chance this year — and not a tiny chance.

I know both Ron Wyden and Orrin Hatch. They're patriotic, they're smart, they want to do the right thing. They've got different ideas about what the right thing is, there's no question about that, but they also know they can't get any place without cooperating.

But I think the real opportunity is if they work out of the public eye in doing — in working on something — and I wouldn't be surprised if they are. I think that's the way to get it done.

Charlie has always pointed out, what would have happened if the Constitutional Convention back there in Philadelphia had been held with every delegate running out immediately to tell the TV cameras how right he was and how wrong everybody else was.

It doesn't accomplish much to dig in on positions, and not be in a position to compromise, because it takes a lot of compromise to write something when you have two different — fundamentally different — views on some important aspects of the tax code.

But those are two good guys, and I would not — I don't think it's impossible that we have a new corporate tax code within a year.

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

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: This question, which is a little bit offbeat, comes from Jordan Shopof (PH) of Melbourne, Australia.

"Mr. Buffett, in the forward to the sixth edition of Benjamin Graham's 'Security Analysis,' you identified four books that you particularly cherish.

"Three of these books were authored by Graham himself, and their influence on you is well-known.

"The contributions of the fourth book to your thinking, however — that book was Adam Smith's 'The Wealth of Nations,' published in 1776 — what that book meant to you is seldom discussed.

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

WARREN BUFFETT: Well, it doesn't shape my investment philosophy, but I certainly learned economics from it. And my friend Bill Gates gave me an original copy of it. I was able to study this.

Adam Smith wrote it in 1776. It's — you know, there's just — if you read Adam Smith and if you read Keynes, Ricardo, and then — and if you also read that little book we've got out there called "Where Are the Customers' Yachts?" you will have a lot of wisdom.

I forgot to mention, I was supposed to mention, too: we didn't want to put it on sale earlier because it would have given away the movie, but we do have "Berkshire Bomber" underwear out there, or sweatshirts, or whatever it may be, so Fruit of the Loom has those.

And we have Fred Schwed's "Where Are the Customers' Yachts?" book, which contains an incredible amount of wisdom and very few pages and very entertaining.

But if you want to go for — if you want to not only get a lot more wisdom but appear more erudite, you should read "The Wealth of Nations," also.

Charlie?

CHARLIE MUNGER: Adam Smith is one of those guys that has really worn well. I mean, he is rightly recognized as one of the wisest people that ever came along.

And, of course, the lessons that he taught way back then were taught again when communism failed so terribly, and places like Singapore and Taiwan and China, and so forth, came up so fast.

The productive power of the capitalist system is simply unbelievable, and he understood that fully and early, and he's done a lot of good.

WARREN BUFFETT: I took an idea of his on the specialization of labor, you know, and he talked about people making pins or something, but I applied that, actually, to philanthropy.

You know, I mean, the idea that you let other people do what they're best at and stick with what you're best at, I've carried from mowing my lawn to philanthropy, and it's a wonderful thing to just shove off everything and say somebody else is better than I am at that, and then work in the field that's most productive for you.

CHARLIE MUNGER: Yeah. You didn't do your own bowel surgery, either.

WARREN BUFFETT: No. (Laughter)

I'm not sure I have any reply to that. (Laughter)

9. Subsidiaries aren't too focused on short term

WARREN BUFFETT: OK. Jonathan?

JONATHAN BRANDT: Warren, you have told the managers of your businesses to think of their businesses as something they will own forever and that their first priority should be to widen the moat and take care of their customers.

In more than one case, according to people I've spoken to, Berkshire's subsidiaries that were formally publicly traded have run into trouble by — now this is on the margin, mind you — trying to maximize calendar year earnings and dividends to the parent, as opposed to focusing on the long-term health of the business.

Do you find that managements of formally public companies, through force of habit, perhaps, have more trouble making decisions with only minimal concern for short-term results than would be the case for formally private companies?

If this dynamic is a real one, is there something more that can be done to combat it?

And I'm curious, are most of Berkshire's compensation structures based on 12-month results or are they already based over multiyear periods?

WARREN BUFFETT: Yeah. I don't think we've had any particular problem with public companies versus private companies that we've bought.

I mean, if you took the aggregate of the public companies we bought and matched them up against the private companies, I don't know which group I would rather own or which has delivered the greater returns.

CHARLIE MUNGER: I don't know where he gets the idea.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: It's not apparent to us.

WARREN BUFFETT: Yeah. Well, you've heard Charlie. And I can't think of it myself.

And, you know, if we tell them to think about 100 years, we mean think about 100 years, and I think they know we mean it. They certainly know we run Berkshire, you know, in terms of our own decisions that way.

So, I think we set the right example, and I think we use the words to convey that belief as strongly as we can, and we try to reinforce — we try to put it in the annual report, we try to talk about it in meetings like this.

We believe in sort of hammering the same message out there over and over again.

Now, we don't ignore yearly results at all, it's just we don't live by them. But I get figures every month on virtually every business, and I read them with great interest, and, you know, I'm thinking about them all the time.

I don't think they're unimportant, but we don't live by them. And I think what really counts, you know, is where we're going to be three years, five years, or 10 years from now.

But I also — I wouldn't — if we're subpar in some area, I wouldn't accept the fact that we're working to maximize things in 10 years mean that we should be throwing away money, or anything like that, in the short run, or not paying attention to the business.

But I'd have to say what Charlie has, I don't really agree with the premise.

10. Buffett's interest in German companies

WARREN BUFFETT: OK. Station 2.

AUDIENCE MEMBER: Dear Warren, dear Charlie. Thank you for 50 great years. I'm a happy shareholder and hope to have you continue long.

My name is Victoria Von Tropp (PH). I'm from Bonn in Germany.

And my question is, you own companies both here in the U.S. as well as in Germany. What differences in corporate culture and in performance do you see between German and U.S. starter companies?

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Differences between what —

WARREN BUFFETT: I know the question. I'm just looking to you for the answer, not the question. (Laughter)

CHARLIE MUNGER: Now that he can hear so much better, he —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Well, we — we've had a hard time buying things in Europe. It's been quite rare.

And I think the traditions, and the family traditions, are different in Europe than they are in the United States, and in some other countries.

And Germany, of course, has a long tradition of being very good at technology and capitalism, and that's been a godsend to Germany. And we've always admired the way the Germans have performed.

The Germans actually work fewer hours than a lot of other people and produce a lot more and, of course, Warren and I are pretty good at that. (Laughter)

So we're — we admire the Germans, particularly the engineering side, and — but we've been thinking about owning good German companies for a long time and we finally bought one.

WARREN BUFFETT: Yeah. But I'll make a prediction. I will predict we buy at least one German company in the next five years.

I think that — I think we are far more on the radar screen than we were just a few years ago in Germany. I think we now have a woman over there who brought, through somebody else as well, but brought Louis to our attention.

I think she is going to hear about more things because of her association with us on the transaction and the fact that we tried to get the word out as to her help with us.

So, I would really be surprised if we don't make at least one deal in Germany in the next five years, and I would look forward to it. I mean, we'll be very, very happy with — you know, we have to get a business, we understand.

I've had, probably, four or five letters in the last couple months, ever since the Louis deal was announced, but they've been very small businesses in practically each case.

But we'll get one. We're eager, we've got the money, and we do fit the family situation, occasionally.

And prices may be a little more attractive there than in the United States, although I haven't seen anything yet that we've bought.

But I would say that there's a reasonable chance that the price of something we're offered over there might catch my attention more than U.S. prices, currently.

11. Why competitors sometimes underprice GEICO

WARREN BUFFETT: OK. Becky.

BECKY QUICK: This question caught my attention not because I think it's a complaint, but I think it's an actual question about the actuarial models that you use at GEICO.

It comes from Stan Zion (PH). And he says, “My wife and I are stockholders of Berkshire Hathaway. I’m 78 and she’s 74. We have a long-time accident-free driving record.

Yet, when we applied to GEICO with our stockholder discount, GEICO was unable to beat our rates for comparable coverage with other fine companies. Why?”

WARREN BUFFETT: Well, it’s the reason that we probably can beat the rate maybe 40 percent of the time with people who contact us and 60 percent of the time we can’t.

No company is going to be the lowest in all cases. And we have our own underwriting criteria that involves many variables, one of which is age, but it wouldn’t be a dominant one at that age.

But we have many, many variables. And we make our calculations, and very good competitors like State Farm and Allstate, USAA, and so on, they have somewhat different underwriting weightings and sometimes they come in below us.

But I don’t think any company, of size, will be the lowest more often than GEICO.

We give out quotes on the telephone to many, many thousands of people every week. I get the figures every week, and I get the number of quotes, and I get the number of policies sold.

And I can tell you the percentages are very substantial that we sell. And we’re not selling them if we’re charging them more than the people before them. So it — different people have different weightings for different variables.

And the couple you referred to sound like they should get a very good rate from somebody, but they apparently got a better rate from somebody else other than us. And that’s going to happen, perhaps 60 percent of the time, and 40 percent of the time we’re going to get the business.

And since we’re only 11 percent of the whole market now, it means we’ve got a lot of policyholders yet to gather.

The — it’s an interesting question when you’re looking at how to evaluate drivers. You know, we know that 16-year-old boys are about as bad as they get; 16-year-old girls are a better class.

Does that mean they’re better drivers? Not necessarily.

It may mean they don’t have the same tendency to show off. It may mean they don’t drive as many miles. It may mean a whole lot of things.

So we ask a lot of questions, and other people ask different questions, and we will come up with different rates. But it’s definitely worth 15 minutes to call GEICO. (Laughter)

Charlie?

CHARLIE MUNGER: Well, I would say besides if — when you get into the older people's group and you find you're not deteriorating as fast as most of your contemporaries, you may be paying an unfair price for the insurance, but it's a good tradeoff. (Laughter)

WARREN BUFFETT: Gary.

I haven't thought of it that way before. (Laughter)

12. Reinsurance business getting worse due to "facades"

GARY RANSOM: The reinsurance market has changed dramatically over the last two or three years, a lot of alternative capital coming into the business, making it much harder to make the assumption that there would be a big opportunity after the next big catastrophic event.

What is it that you and Ajit are planning to change, or do, to take advantage of whatever opportunities might be there?

WARREN BUFFETT: Well, wouldn't our competitors like to know? (Laughs)

The reinsurance business is not as good as it was, and it's unlikely to be as good as it was.

There's a lot of money that's come into reinsurance, not because they want to reinsure people, but because it's become either a fashionable asset class for people that are looking for so-called noncorrelated investments and may not know what they're doing, but it's something you can sell people, you know, that's an attractive line to go to pension funds with.

And then, secondly, it's a beard for doing — for asset management. So, if you go to Bermuda and start a reinsurance company, you can actually run a hedge fund, and you need a little business to make it look like you're doing something other than running a hedge fund, and locating it offshore so you don't pay any tax, but that's the primary motivation.

So when you get a whole lot of people that are bringing money in and they sort of need your facade of reinsurance to cover up what their real motivations are, you're likely to get less attractive prices in reinsurance.

And that's been happening on a fairly large scale, and I would say that I would expect the reinsurance business in the next 10 years to not be as good as it has been — I'm talking about the whole industry — as it has been, you know, in the last 30 or something like that.

It's a business whose prospects have turned for the worse, and there's not much we can do about it.

We do find things to do. There are certain things that only Berkshire can do, and we've — I mentioned in the annual report that there have been eight—I think it was eight—contracts written with premiums of a billion dollars or more, and we've written all eight of them.

So, we do — there's a certain corner of the world that we've got a strong position in, and there's a few other things we will do, but it's not as good as it was.

Charlie?

CHARLIE MUNGER: Well, I think, generally speaking, of course, it's going to be harder and, of course, this competition from promotional finance is getting more and more intense and they're more optimistic.

They're searching for a robust narrative. We're not searching for a robust narrative so we can sell something. We're playing the game for the long pull and other people just pretend to be doing so.

WARREN BUFFETT: Yeah. We could — we've had the opportunity over — for a long period of time — to go out and promote reinsurance-type money, and really take advantage, you know, of people on it, because we would have the best reputation in the field, and we could attract a ton of money, and we could get a big overwrite on it.

But it's not our game.

CHARLIE MUNGER: And we don't particularly admire the way it's being played.

13. How to win friends and influence people

WARREN BUFFETT: Station 3.

AUDIENCE MEMBER: Mr. Buffett and Mr. Munger, my name is (inaudible) from South Florida, and I'm currently in seventh grade.

My question is how do you make lots of friends and get people to like you and work with you?

WARREN BUFFETT: That's not a bad question. (Applause)

Very good question.

CHARLIE MUNGER: Well, you know, I was pretty obnoxious when I was your age and asked a lot of impertinent questions, and not everybody liked me.

And so the only way I could get the people to like me a little bit was to get very rich and very generous. (Laughter)

That will work.

WARREN BUFFETT: People will see all kinds of virtues in you if they think you'll write a check. (Laughter)

Yeah. The two of us — both Charlie and I were on the obnoxious side early on, but you should get a little smarter about human behavior as you get older.

And I turned out to have some pretty good teachers as I went along, in terms of what worked.

I mean, I have looked at other people during my lifetime and at these wonderful teachers. They weren't teachers in the standard definition, but they were people I admired and I thought to myself, "Why do I admire these people?" And if I want to be admired myself, you know, why shouldn't I take on some of their qualities?

So, it's not a complicated proposition, you know. If you look around you at the people you like in your school, write down three or four things they do that make you like them, and then look around at the three or four people that turn you off, and write down those qualities, and decide that you're going to be a person you, yourself, would like, that you'd take on the qualities of the person on the left.

You're generous, you're friendly, you know, you accept things with good humor, you don't claim credit for things you don't do, all of these things. And they're all possible to do.

And if you like that in other people, people are going to like it in you. And if you find things that are kind of obnoxious, you're always late, you're always claiming credit for more than you do, and you're kind of negative on everything, and you don't like those in other people, get rid of them in yourself and you'll find out it works pretty well. (Applause)

CHARLIE MUNGER: And it really works in marriage. If you can change yourself instead of trying to change your spouse, that's a good idea. (Laughter)

WARREN BUFFETT: Charlie has said the most important thing in selecting a marriage partner is that you don't look for intelligence or humor or character. He says you look for someone with low expectations. (Laughter)

14. NetJets wasn't a mistake despite labor problems

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: OK. This is a question about NetJets. We received several related to NetJets. We've combined these two.

The first is, can you comment on the lengthy dispute with NetJets' pilots who are picketing outside, and Whitney Tillson asks, "What type of return on investment do you expect from the billions on order in aircraft for NetJets," and in a very pointed way, he writes, "Was buying NetJets a mistake?"

WARREN BUFFETT: No, I don't think buying NetJets was a mistake. We've had a few things where it looked like a mistake for quite a while and some of them turned out to be a mistake.

But NetJets is a very decent business. We have a good business; the pilots have a good job.

And the — it's not really the right way to look at it, I don't think, in terms of return on investment in the billions of dollars of orders we have because we resell those planes to owners.

And we do have a core fleet that represents an investment, but the investment is held, in very large part, by the owners themselves. I own — what do I own? Three-sixteenths, or something like that, of one type of plane that my children use. I own an eighth of another plane that I use. But that's my investment; it's not the NetJets investment.

The — labor relations — at Berkshire we've had hundreds of labor unions over the years, literally hundreds. In fact, we probably have hundreds at the present time.

And we've only had — in 50 years — we've had three strikes that I can remember. I don't think there have been any others. There could have been some one-day walkout, maybe.

But we had a four-day strike at a Berkshire Hathaway textile operation, we had a four-day or so strike at the Buffalo News 30 years ago, and we had another strike at See's Candy one time.

So, we have no anti-union agenda whatsoever, and we think we have sensational pilots.

I mean, I've flown NetJets, my family has flown NetJets, now for 20 years, and we've had nothing but professional pilots and friendly pilots.

And it's not — you know, it's in human nature to have differences, sometimes, about what people get paid.

Our pilots make an average of 145,000 a year. They worked — they work seven — they have options, but one of the options, and the main option, is seven days on and seven days off.

We pay for their time to get to where they're based. They can live anyplace in the country. And compared to our competitors at Flexjets or Flight Options or so on, or in charter, we pay well.

But it's perfectly understandable that employers and employees have some differences from time to time. And we'll get it worked out, but that doesn't necessarily come in a day or a week or a month.

And our volume is up, in terms of flying. Our volume is up, in terms of owners in the United States. Europe is flat. But the United States is the bigger end of it.

So it's a business I'm very glad we own. I'm proud we own it. It's a first-class operation. We give our pilots more training, I believe, than anybody else.

I'm flying on NetJets. My kids are all flying on NetJets. Our managers, in many cases, are flying on it, so nobody cares more about safety.

This is not a company where the CEO flies on his own jet and other people fly in other ways. So I — and I get the same — I get the same planes that the other people get and the same pilots. I mean, there's no special arrangements.

So we've got this intense interest in safety, and we've got very professional pilots. And at the moment, we've got a difference of opinion about a contract, but that will get settled, in my view.

Charlie?

CHARLIE MUNGER: I have never, in all the years, had a NetJets pilot who didn't affect me as a wonderful fellow and a very skilled, able, and dutiful, reliable person.

And I would say most — I can think of no NetJets pilot that has ever in any way indicated that he's dissatisfied with his life, and a lot of them say they just love it, because of the — I'm not at all sure the union is fairly representing the pilots.

WARREN BUFFETT: OK. (Applause)

He said fellows. Actually, we have a lot of women pilots, too.

15. Tax code helped Duracell-P&G deal

WARREN BUFFETT: Gregg?

GREGG WARREN: Warren, looking at your acquisition of Duracell from Procter & Gamble, at the time of the deal, you noted that Duracell is a leading global brand with top quality products. You're obviously familiar with the business, which was initially acquired by Gillette in 1996.

While Duracell does provide fairly steady cash flows and has a strong brand in market position, its core business is in decline, with advances in technology making alkaline batteries far less relevant than they were 20 years ago.

Looking back historically, you've been willing to hang onto businesses operating in declining industries as long as they continue to generate some cash for Berkshire overall, so having Duracell in the portfolio is not necessarily out of the ordinary.

The question I have is, how much of a role did tax planning actually play in doing this deal, given the extremely low-cost basis on your P&G shares, some of which you've been selling the last several years?

And would you have done this deal without tax considerations? And, if so, at what price?

WARREN BUFFETT: Well, both Procter & Gamble and Berkshire Hathaway had tax advantages in doing the deal this way, so they probably wouldn't have sold it at the price at which the deal took place, and we wouldn't have bought it at the price, without the tax benefits that each enjoyed.

And this is something — we had to have held our stock for over five years in Procter & Gamble.

It's something that's been in the code a long time that we've had nothing to do with it being in the code, but it's part of the code.

And it's somewhat similar to the real estate exchange arrangement, where you can exchange real estate and defer any tax.

And we don't get a new tax basis on the Duracell; we keep the old lower tax base, just like on — what do they call it? Is it section 1231 or —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — real estate exchanges. So it's analogous to that, and the answer is that there wouldn't have been a transaction from Procter & Gamble's standpoint and there wouldn't have been a transaction, probably, from Berkshire's standpoint, if it hadn't been for the fact that we could do an exchange arrangement.

As to the declining business part, the battery business will be a declining business, but it will be around for a very, very, very long time on a worldwide basis.

And Duracell has a very strong position. It's a very good business. And, like you say, I was familiar with it when I was on the Gillette board.

But the — you know, it will have unit declines over a period of time, but I think we'll do fine with the Duracell investment. I'm looking forward to getting the deal complete, which probably won't take place until the fourth quarter because we have to get it detached from a lot of other things like the IT and distribution centers and everything else that it's involved in with P&G.

But P&G has been great to work with. They're making the transition — you know, they couldn't be better to work with during that period, and I'll be very happy when we own it.

16. Why I'm giving away most of my wealth

WARREN BUFFETT: Station 4.

AUDIENCE MEMBER: Hello, Warren and Charlie. I am Marvin Blum, an estate planning lawyer from Fort Worth, Texas, home to four of your companies.

And by the way, we're excited about the new Nebraska Furniture Mart and the Berkshire Hathaway Automotive Group in the Dallas/Fort Worth area.

Next to Omaha, we hope you think of Fort Worth as your second home.

WARREN BUFFETT: It's been good to us. And actually, we have five companies down there. MiTek just bought one.

AUDIENCE MEMBER: All right. Even better.

At the annual meeting a couple years ago, I asked about your estate plan and your idea of leaving kids enough so they can do anything, but not so much that they can do nothing.

Today, I'd like to ask you about your decision to sign the Giving Pledge, promising to give away at least one-half of your assets to charity.

Can you talk about your views on philanthropy, and how to balance leaving an inheritance to your family versus assets to charity?

WARREN BUFFETT: Well, it depends very much on the individual situation. And actually, I promised to give over 99 percent, in my case. But that still leave plenty left over. (Applause)

As you know, the estate tax exemption has been moved up substantially here in the last couple years, so you — I might have a very different feeling if I'd had a child that worked actively, helped me build the business, and all that sort of thing, and it was a small business, and I wanted to give it to them. But that can be really done without any estate tax these days, particularly if a little planning is used ahead of time.

It’s a very individual thing. I — as Charlie — you know, when you get to the — figuring out what you do with your money, the options get very — fairly — limited. And as Charlie said the other day, you know, he said where he’s going it won’t do him much good anyway. (Laughter)

There’s no Forbes 400, you know, in the graveyard.

So the question is, where does it do the most good? And I think it does limited amounts to do some real good for my children, so I’ll be sure that they have that, or they already have it, to a degree.

And, on the other hand, when I look at a bunch of stock certificates in a safe deposit box that were put there 50 years ago or so, they have absolutely no utility to me, zero. They can’t do anything for me in life.

I mean, they can’t let me consume 7,000 calories a day instead of 3,000. They can’t — there’s nothing they can do.

I’ve got everything in the world I want, and I’ve had it for decades. If I wanted something additionally, I’d go buy it.

So, here these things are that have no utility to me and they have enormous utility to some people in other parts of the world. I mean, they can save lives. They can provide vaccines. They can provide education. There are all kinds of utility.

So why in the world should they sit there for me or for, you know, some fourth generation down of great-grandchildren or something, when they can do a lot of good now?

So that’s my own philosophy on it, but I think everybody has to develop their own feelings about it and should follow where they go.

I do think — I do think they might ask themselves, what — you know, where will it do the most good?

And it can be pretty dramatic between what it can do for millions of people that don’t really have remotely the same shot at having a decent life that I’ve had, or what it, you know, what it can do for me.

I mean, if it — I could have 10 houses, but, you know, I could buy a hotel to live in, you know. But would I be happier? It would be crazy.

Charlie and I both like fairly simple lives. But the one thing we do know is we know what we like and what we don’t like, and we don’t judge it by what other people like.

So I don’t have too much advice for anybody, but I would say start thinking about it.

When I call people on the Giving Pledge, you know, some of them — I'll get some 70-year-old and he says, "You know, I don't want to think about it yet." And I always tell him. "Are you going to make a better decision when you're 95 with some blond on your lap?" (Laughter)

That actually was tried a few years ago, as you may know. (Laughter)

Charlie?

CHARLIE MUNGER: No, but it does occur to me that that fellow that was complaining about the tax system should remember that when — they recently changed the estate tax rules, so you can leave 5 million to your kids, and so forth. I think that's a very constructive change in the law.

So I don't think we should assume that our politicians are always going to be totally crazy. That was a very desirable change, I think.

17. Distribute long-term stock holdings to shareholders?

WARREN BUFFETT: OK. Carol.

CAROL LOOMIS: The questioner's name is Andre Bartel (PH), and he's a Berkshire shareholder.

"Would it make sense" — and I'm going to add my own edit here to say, and would it be legally permissible — "for Berkshire to distribute, at some time in the future, any or some of the long-term equity investments, for example, Coca-Cola or American Express, to the shareholders in a tax-sufficient way, as Yahoo is planning to do with the Alibaba stake, for example?

"The idea would be to return capital to shareholders using assets that Berkshire is not actively managing, that is, has not bought or sold for some time, and has very low incentive to sell because of income tax implications, while not taking away resources—cash—that could be reinvested by the Berkshire management better than by its shareholders."

WARREN BUFFETT: Yeah, I don't think Yahoo solved it, actually. Charlie, you follow that, too.

CHARLIE MUNGER: I don't think that we can do that with American Express and so forth. It's a bad example. We've got no way of doing that.

WARREN BUFFETT: No. There used to be a way to do that many years ago, and it was done. I don't mean by us, but I saw other examples of it.

But, under the code, there's no way to use appreciated securities to redeem your own shares, to — you can do it for something like acquiring, where you're exchanging it for like asset type thing on the Duracell arrangement, but there's no way to distribute it to shareholders without paying the full capital gains tax. And —

CHARLIE MUNGER: Yeah, spinoffs of whole businesses to shareholders, if you held them a long time, but that's about the only thing you can do.

WARREN BUFFETT: Yeah, but even there, I mean, what Yahoo has done has not got rid of the tax.

CHARLIE MUNGER: I don't know anything about Yahoo.

WARREN BUFFETT: Yeah. No. The — or what they're planning to do.

It may give them some other option if Alibaba wants to eventually redeem it themselves.

I mean, there could be something where they could work out a deal with Alibaba. I do not see how that they've gotten rid of the tax, unless they do a subsequent transaction of some sort with Alibaba, but maybe they have different tax advice than I've seen.

I mean, I know all kinds of cases where people — where corporations — have unrealized — large unrealized — gains in marketable securities, and I have not seen, in recent years — although I did see it early in my career when the law was different, but I've not seen in recent years any way that people have gotten that money into the hands of the shareholders without paying a tax at the corporate level.

Charlie?

CHARLIE MUNGER: No. That's — that's what we say.

18. Is reduced household formation by young people permanent?

WARREN BUFFETT: Yeah. Jonathan?

JONATHAN BRANDT: Berkshire owns many companies that benefit from single-family home construction: ACME, Johns Manville, Benjamin Moore, MiTek, and Shaw among them, not to mention the railroad.

After the financial crisis, you said that young adults who are postponing household formation by living with parents or in-laws would eventually get sick of that arrangement and we would start to see normal rates of household formation once the job market improved or even if it didn't.

Jobs are now more plentiful. Yet, household formation still continues to be below rates thought to be normal, whether because of high student debt, a shift in attitudes about homeownership, or stricter mortgage terms for first-time buyers.

Could something more secular be going on where household formation rates, relative to the population, could continue to be lower than historical rates?

Could the U.S. become more like Europe where many adult children live with their parents or in-laws for quite some time, or do you think, still, that the subdued rate of household formation is a mostly cyclical phenomenon, and that the rate will eventually revert to the historical mean, boosting single-family home starts and earnings for this group of companies?

WARREN BUFFETT: Yeah. I don’t know the answer, obviously, but I think the latter is more likely.

I may be wrong. When’s the last set of figures you’ve looked at in that connection? I’ve heard that it’s turned up a fair amount in the last six months, but — have you seen anything on that, Jonny?

JONATHAN BRANDT: Nothing really recently, no.

WARREN BUFFETT: Yeah. I should know the figures, but I don’t, for the last six months or nine months. But my impression was they had turned up somewhat.

I did my best on selling that ring in the movie to that guy, and they’re going to form a household here in another month or two to which I’ve been invited.

But the truth is I don’t know, the — you know, what’s going to happen on household formation.

I would expect — but I expected it earlier than this — I would expect it to turn up. It always turns down in a recession, and you could argue that we’re not all the way back from the recession yet.

Your guess would be as good as mine.

Charlie?

CHARLIE MUNGER: I feel exactly the same way, but I think I speak for a lot of members of the audience when I say I have some grandchildren that I wish would marry somebody suitable promptly. (Laughter)

WARREN BUFFETT: What’s the reason for your interest, Charlie?

CHARLIE MUNGER: I don’t think it’s healthy for these people to hang around looking for pie in the sky or whatever in hell they’re doing. (Laughter)

WARREN BUFFETT: Are they in attendance today?

CHARLIE MUNGER: I don't know. Some of them may be. I don't want to name names. (Laughter)

WARREN BUFFETT: No. I think you've already been pointed enough.

19. Why individual over corporate philanthropy?

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: Gentlemen, thank you for a great day.

My name is Mark Roy (PH), and I am the executive director of the Immanuel Vision Foundation here in Omaha.

Earlier today, I sat up in the corner and spoke to my son who is working and living in Indonesia, among the poorest of the poor, funded, incidentally, by the Gates Foundation.

The contrast between where he is sitting today and where I am sitting could not be more dramatic.

You have been a model of philanthropic caring for the needs of others. You have demonstrated that it's not how many shares we have but how we share with others.

So following up on the last speaker, I want to ask, how can corporations be encouraged to make an even greater impact in the lives of those who are not shareholders?

WARREN BUFFETT: Yeah. I agree, you know, entirely with your motivation about increasing philanthropy.

I am much more of a believer, however, in individual philanthropy than corporate philanthropy.

I really feel that I've got everything I need, but I do also feel that I'm working for the shareholders and they should determine their own philanthropic activities, that it's their money. (Applause)

Now, we participate in — I mean, I encourage all our companies to continue the philanthropic behavior that they had before we've acquired them, and, you know, we want them to participate in their communities and to help the entities that help their employees and their customers.

But I don't really think it's my business, ever, to write a check to my alma mater or whatever it may be, and do it on company funds. I just — I don't feel it's my money.

I really look at this as a partnership. We've always looked at it as a partnership. And we had a system some years back where all the shareholders could designate contributions, and I felt that was quite a good system. And then we had to give it up for reasons that — I hated to give it up, but we had to do it.

The interesting thing about philanthropy — I mean, I have never given a penny to any organization that has cost me anything in my life. I mean, I've never given up a movie, I've never given up a trip, I've never given up a vacation, I've never given up a present to my kids.

You know, people give money this Sunday, you know, that really, actually, changes their lifestyle in a small way, and that hasn't happened with me. Everything I've given has been ungodly surplus, you know, and I'm glad I can do it.

But it's people like your son, you know, that I really admire.

Charlie? (Applause)

CHARLIE MUNGER: Well, my taste for giving away somebody else's money is also quite restrained. (Laughter)

WARREN BUFFETT: I was on the board one time of an organization that needed to raise a fair amount of money, and it wasn't church affiliated or anything like that.

And so they asked me to call on four or five corporate chieftains and they said, "Be sure not to ask them to give anything personally, just ask them to give corporate money."

And just — I said, "I'm not going to do it," basically. If they're not — if they won't put up their own money, why should they write checks on behalf of all their shareholders?

So I've got real reservations about corporate philanthropy for the personal reasons, to some extent, of the CEO, or the directors.

20. Euro can survive eurozone changes

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from Felipe, and he asks, "Do Charlie and you think that the euro currency has had a positive or negative effect overall on the eurozone economy, and do you think it would be a good decision for France to quit the euro currency and go back to the franc?

WARREN BUFFETT: Well, that's too easy for me to answer, so I'll give it to Charlie. (Laughter)

CHARLIE MUNGER: I haven't got the faintest idea. (Laughter)

I think the euro had a noble motivation and had promise of doing a lot of good and it undoubtedly has done a lot of good.

But it’s a flawed system, in some ways, to put countries that are so different together, and it’s straining at the moment. The big strains aren’t in France.

WARREN BUFFETT: No.

CHARLIE MUNGER: The big strains are in Greece and Portugal and so on.

And I do think they created something that was probably unwise. They got countries in there that shouldn’t have been there.

You can’t form a business partnership with your frivolous, drunken brother-in-law, you know. (Laughter)

I mean, you have to make your partnerships with somebody else. And I think they lowered their standards a little and it’s caused strains.

WARREN BUFFETT: I think — (laughs) — everything here is off the record, understand. (Laughter)

They — I think it’s a good idea that needs a lot of work, still.

And I think it has been a good thing, net, to this point.

But it — you know, it is flawed and the flaws are appearing, but that doesn’t mean it can’t be corrected.

I mean, we wrote a Constitution in 1789 that, you know, still took a few amendments, you know, and some of them didn’t happen for a long time in respect to some very important factors.

So, I don’t think the fact that it wasn’t perfectly designed initially should condemn it to being abandoned, but I think that if there are flaws, you have to face up to them. And I think that maybe the events that are happening currently will cause that.

We could have had — presumably — we could have had a common currency with Canada and probably have made it work, I mean, if we decided —

CHARLIE MUNGER: Sure, we could have made it work.

WARREN BUFFETT: Yeah. We could have had a North American currency with Canada and, you know, we’d have worked it out, and it might have even been useful.

But we couldn't have had a hemisphere-wide currency with Venezuela in it or —

CHARLIE MUNGER: With Argentina.

WARREN BUFFETT: Yeah. (Laughter)

And so — he loves to name names. (Laughter)

Praise by name; criticize by category. (Laughter)

And I actually think it's probably desirable to have a euro currency properly designed and enforced so that — you know, that the rules really apply. There were rules, originally, on the euro, which got broken very early on, by not the Greeks, but by the Germans and the French, as I remember. So —

CHARLIE MUNGER: The investment bankers let them — they helped them prepare phony financial statements.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: They — actually, it was investment banker-aided fraud.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Not exactly novel. (Laughter)

WARREN BUFFETT: So, returning to our main point, I think the euro can and probably should survive and I think it's going to take some real changes and maybe some examples to enable it to do so.

I hope it really — I mean, it's going to go in the direction of more cohesion or less, and very soon, probably. And I think if it can figure out a way to do it with more cohesion, overall it will be a good thing for Europe.

But it certainly, you know, in its present form it's not going to work.

Charlie? I don't know why I'm giving you another shot, but — (Laughter)

CHARLIE MUNGER: I think I've offended enough people.

WARREN BUFFETT: Right. (Laughter)

There's two or three in the balcony. (Laughter)

21. Munger: GEICO synergies are "dumb idea"

WARREN BUFFETT: OK. Gary.

GARY RANSOM: With the Van Tuyl acquisition — or now Berkshire Hathaway Automotive — there may be some natural synergies with GEICO, if it's nothing more than just putting a gecko on the salesman's desk.

Would you expect to do anything in that regard to encourage getting more customers through that relationship?

WARREN BUFFETT: Yeah, I don't think so.

You always have these things that the investment banker will tell you will produce synergy and all that. Most times that doesn't work.

And historically, selling auto insurance through dealerships hasn't been particularly effective. And if we were to do that, we would probably have to compensate people who did the insurance work — or made the insurance sales — out of Van Tuyl. That would add to costs.

I mean, GEICO is a low-cost model, and it's a wonderful low-cost model. And [CEO] Tony Nicely has done an incredible job of keeping those costs down and our — and you can see it in our expense ratios.

We spend a lot of money on advertising. But its success depends on delivering first-class insurance at a better price than other people can get, and the more people we put in distribution system or anything —

So, I would doubt very much that we do anything along that line. I think that those two companies will do better if run as two independent businesses than if we try to push through something.

We — Charlie and I have seen a lot of things on paper that involve that sort of a proposition and very, very few succeed.

Charlie?

CHARLIE MUNGER: Well, I agree. It's a very dumb idea, and we're not going to do it. (Laughter)

22. Buffett doesn't follow silver market anymore

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Mr. Buffett, in this environment of quantitative easing, low interest rates, and an overvalued stock market, what value in silver at these prices do you see, and do you still follow the silver market?

WARREN BUFFETT: I really don't follow it much anymore. But at one time, we owned over 100 million ounces of silver, and I knew a fair amount about the supply and demand for it, and the prospective supply and demand.

But I really don't — I haven't paid much attention to it for a long, long time.

CHARLIE MUNGER: That's a very good thing too. (Laughter)

We didn't do that well.

WARREN BUFFETT: Yeah. We made a little money.

CHARLIE MUNGER: Yes.

WARREN BUFFETT: The — you know, photography — the interesting thing about silver is that there are some pure silver mines, but overwhelmingly, silver is produced as a by-product, you know, in terms of copper mining and that.

So it — it doesn't respond as much to its own supply and demand characteristics — that's still a factor — as it does in terms of the supply and demand characteristics of the things of which it's a by-product, like copper.

So, it's a very small market, too. But we came out better than the Hunt brothers, but other than that, we don't think about silver anymore.

23. Could activists take control after Buffett?

WARREN BUFFETT: OK. Andrew.

ANDREW ROSS SORKIN: Charlie, question about activism.

Activism continues to grow and, as Charlie stated at the 2014 annual meeting, he sees it getting worse instead of getting better.

So the question is, we hope that Charlie and Warren will both be around forever, but, unfortunately, there will be a time when they're no longer here to manage the store.

WARREN BUFFETT: I reject such defeatism. (Laughter)

ANDREW ROSS SORKIN: If Warren is giving away his shares to charity over a ten-year period through his estate plan, and activists become increasingly more powerful, how will Berkshire defend itself from activists in the near and far future?

And would you consider it a failure if Berkshire were broken up in the future and shareholders received a significant premium? And for you to consider it success, what would the premium need to be?

WARREN BUFFETT: Well, if it's run right, there won't be a premium in breaking it up.

It may look like it. I mean, people will say there's subsidiary A that would sell at 20 times earnings and the whole place would sell, like, at 15. But the whole place won't sell at 15 if you spin off the one at 20.

I mean, it — I laid out in the annual report — there are a lot of benefits to Berkshire, in terms of having the companies in the same corporate tax return.

So I think it's unlikely that, on any long-term basis or intermediate-term basis, that the value of the parts will be greater than the value of the whole.

The best defense against activism is performance. But lately, there's been so much money pouring into activist funds, because it's been easy to raise money for that — I mean, it's been a successful way of handling money for the last few years, and institutional money then starts flowing into it, and the consultants recommend it, and all of that sort of thing.

And so, I would say that much of what I see as activism now, people are really reaching, in terms of what they're — of the kind of companies that they're talking about and the claims of what they can do and that sort of thing.

I think the biggest — you know, if you're talking about my shares getting dispensed over 10 years after my estate is settled, and the voting power they have, and I think, by the time that gets to be a reality, I think the market value of Berkshire is likely to be so great that even if all the activists gathered together, they wouldn't be able to do very much about it.

Berkshire is likely to really be a very, very large organization 10 or 20 years from now.

CHARLIE MUNGER: Besides, the Buffett super-voting power is going to last a long time.

WARREN BUFFETT: Last a long time, yeah.

I always — I've got these friends that call me — other companies and they've got an activist, and they're worried about it. I just tell them to send them over to Berkshire. We'll welcome them.

We'd love to have them buy our stock because they're not going to get anyplace. And that's going to be the situation for a long, long time.

We should be a place where people can dump their activists. (Laughter)

Charlie?

CHARLIE MUNGER: Well, the thing that I find interesting is, in the old days when many — most — stocks sold for way less than they were worth, in terms of intrinsic value, it was very rare to find an American corporation buying the stock in.

WARREN BUFFETT: Oh, yeah.

CHARLIE MUNGER: Now, in many cases, the activists are urging corporations to buy the stock in heavily, even though it's selling for more than it's worth.

This is not a constructive activity, and it's not a desirable change, and it's not a very responsible activity for the activists.

WARREN BUFFETT: There's been more stupid stuff written on such a simple activity as stock repurchase. Both stupid stuff written and stupid stuff done.

I mean, it's a very simple decision, in my view, as to whether you repurchase your shares. You know, you repurchase them if you're taking care of the needs of the business and your stock is selling for less than it's intrinsically worth. That — I don't see how anything could be more simple.

If you had a partnership and the partner wanted to sell out to you at 120 percent of what the business is worth, you'd say forget it.

And if he'd want to sell out to you for 80 percent of what it's worth, you'd take it. It's not complicated.

But there's so many other motivations that entered into people's minds about deciding whether to repurchase shares or not. It's gotten to be a very contorted and kind of silly discussion in many cases.

And Charlie is right. The — if you look at the history of share repurchases, you know, it falls off like crazy when stocks are cheap and it tends to goes up dramatically when stocks get fully priced.

But it's not what we'll do at Berkshire. At Berkshire, you know, we will presently — you know, we would love to buy it by the bushel basket at 120 percent of book, because we know it's worth a lot more than that.

We don't know how much more, but we know it's worth a lot more.

And we don't get a chance to do that very often. But if we do get a chance, we'll do it, big time.

But we won't buy it in at 200 percent of book, because it isn't worth it.

You know, it's not a complicated question, but people that — I've been around a lot of managements that announce they're going to buy X worth and then they buy it regardless of price.

And a lot of times the price makes sense. But if it doesn't, they don't seem to stop, and nobody tries to — seems to want to stop them.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with you.

WARREN BUFFETT: OK.

CHARLIE MUNGER: I don't think it's a great age, this age of activism.

WARREN BUFFETT: Want to expand on that? (Laughter)

CHARLIE MUNGER: Well, I — it's hard for me to think of any activists I want to marry into the family. (Applause)

WARREN BUFFETT: I better stop before he names names. (Laughter)

24. American Express & credit card history

WARREN BUFFETT: OK. Gregg.

GREGG WARREN: Warren, American Express, which is Berkshire's third largest stock holding, has relied on powerful network effects and its valuable brand to generate economic profits over the years.

It has created a virtual cycle with its collection of cardholders being desirable to merchants, who have been willing to pay higher transaction fees with those fees ending up funding rewards programs and services for American Express's cardholders.

More recently, though, competitors have turned this model against the firm, targeting its cardholder base with ever-increasing levels of rewards and services, while charging merchants lower fees than American Express does.

The company also saw its image of exclusivity take a bit of a hit earlier this year when Costco ended a 16-year relationship with the firm, a move that affects one in 10 American Express cards in circulation and which will impact results this year and next.

With restrictions on interchange fees and the growth and acceptance of mobile payment technologies likely to impact future revenue streams, and moves by the firm to go down-market in pursuit of transaction volume potentially diminishing the brand, how does American Express defend its moat?

WARREN BUFFETT: Well, American Express has been pretty good at that, and particularly when Ken Chenault's been running it.

The — it will be — you know, it — all aspects of payments will be subject to lots of innovation and various modes of attack.

I think that American Express is still a very special company. And like I say, Ken has done a sensational job in anticipating a lot of these trends and guiding it into different markets. As you mentioned, it's going down in the — into debit cards, effectively, and things of that sort.

I think there's a lot of loyalty with American Express cardholders. I do think a proprietary card is worth more than a co-branded card, but I think that — I probably shouldn't get into the specifics of Costco. I've got a Costco director sitting next to me.

But we're very happy with American Express, but we'd be even happier if the stock goes down and the 4 or 5 billion they spend a year buying in stock buys even more shares.

Charlie?

CHARLIE MUNGER: Well, I like it a little better when they had a little less competition, but that's life. (Laughter)

WARREN BUFFETT: Incidentally, you'll find in this 50-year history of Berkshire, you know, American Express did wonders for us back in the 1960s. And there's a little history in there on the fact that it was an assessable stock until 1965, which nobody paid any attention to until 1963 on.

But the company has an incredible history of adapting. I mean, they started out as an express company, you know, move trunks around, and valuables around.

And then the railroad came around and started doing the same thing, so they went to traveler's checks as a way to — very handy way — of moving money around the world.

And then the credit card came along, Diner's Club came along, in the 1950s, and that threatened the traveler's check and then they moved into the Travel and Entertainment card, as it was called then.

And the interesting thing is that Diner's Club, who was first — Ralph Schneider and Al Bloomingdale priced their card at, as I remember, $3, and they looked like they were sewing up the market.

And American Express came along and did something very interesting. They priced their card, I think, at $5, and actually established a better image.

I mean, people that pulled out their American Express card at a dinner table, they looked like J.P. Morgan.

And the guy that pulled out a Diner's Club card, they'd have a whole bunch of flashy things on it, he looked like a guy who was kiting his expense account or something of the sort. So you just automatically felt like a more important person with your American Express card.

They have been very nimble, and very smart, and particularly in recent years, under Ken, in terms of meeting all kinds of challenges. And I think they'll have plenty of challenges in the future, and I'm delighted we own 15 percent of the company.

25. Why children need good financial habits

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Hi. My name is Chang, originally from Seoul, South Korea, and working in Los Angeles, California.

I've been traveling more than 27 countries, and last year I taught financial literacy lesson in one of the local elementary school in (inaudible) city.

Today here, we're talking about investments in capital markets, but young students in developing countries, they don't know how to save money, or they don't know the concept of interest.

So, in order to overcome the educational challenges, I would like to provide volunteer opportunities to talented Americans to teach in South American schools to overcome the — while they are traveling.

So, what do you think about my plan or do you have any advice? Thank you.

WARREN BUFFETT: Charlie, do you have any advice?

CHARLIE MUNGER: Well, I failed in this activity with some of my relatives, so I don't think I can improve South America. (Laughter)

No, I think if you don't — if you don't know how to save, I can't help you. (Laughter)

WARREN BUFFETT: No, but the important thing is to get good habits early on.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: You really — you know someone said the chains of habit are too light to be felt until they're too heavy to be broken. And habits really make an enormous difference in your life.

So Andy and Amy Heyward have developed the "Secret Millionaires Club," which I've helped out with a little, and our goal is to, in an entertaining way, present good habits to young kids through a kind of a comedy series.

And I think that's — it's actually having a pretty good effect. And here in a few days, we're going to have a — here in Omaha — we're going to have eight finalists in young kids from around the country that have developed businesses of their own, and I'm always enormously impressed with these kids.

But the importance of developing good habits yourself, or encouraging good habits in your children very early on, in respect to money, can change their lives.

And, you know, I was 9 or $10,000 ahead when I got out of college, and I got married young and had kids very fast.

And if I hadn't had that start, my life would have been vastly different. So it — you can't start young enough on working on good money habits.

And I do think the "Secret Millionaires Club" is very good, but there could be lots of other good ways of teaching those lessons.

26. No plans to change debt level

WARREN BUFFETT: OK. We now have moved solely to the audience, so we'll go to station 8.

AUDIENCE MEMBER: Hello, Warren, Charlie. My name is Stefano Grasso (PH), and I come from Genova, Italy. It's great to be here today for the 50th anniversary.

Last year, I asked you what was the right level for leverage at Berkshire Hathaway, and why not to increase it. I argued that increasing liability more at the cheap level would benefit Berkshire, thanks to the investment capabilities of the present management.

This year, I would like to get your view on the possibility of working on the other side of the balance sheet and using part of the cash sitting on bank chair — bank accounts — to reduce some of the liabilities currently on its balance sheet.

For example, the index puts at Berkshire sold between 2004 and 2008, generated a premium of almost 5 billion.

Few years down the line, Berkshire benefited from the float. The indexes are higher and the time to maturity of the put got shorter.

The question is, if the unwinding of the puts were acceptable by the counterparts which bought them, would you consider unwinding them at a reasonable price? Thank you.

WARREN BUFFETT: Are you speaking — you're speaking specifically of the equity put options we have?

AUDIENCE MEMBER: I'm speaking about them, but as just an example. I'm talking also of maybe reducing debts or doing other —

WARREN BUFFETT: Yeah. Well, what we hope, of course, is that what we call the excess cash, which is cash beyond 20 billion that we can put to work buying a business. But you can't do, you know, one a week or one a month. So it's opportunistic.

And I don't know whether the phone call that's going to result in the next deal will come in next week or it may come in a year from now.

We will get calls and we will put money to work. You know, we just — we can't do it at an even flow. And we have, you know, virtually no debt.

If someone had told the two of us 50 years ago that we'd be able to borrow money in euros with a long duration of 1 percent or something like that, we would have felt we would have ended up with a way different balance sheet than we have today.

But, I mean, money is so cheap that it causes people to do almost anything on the asset side, and we try to avoid doing that because we don't, you know, we don't want to drop our standards too fast just because the liability side is costing us so little.

But I don't think — obviously, if we can unwind a derivative trade on a basis where we thought we were mathematically ahead by a significant amount, we would do it.

But I think that's very unlikely with the contracts we have now, so we'll probably — I think it's very likely they just run out over time.

We carry a liability of well over — I think it's getting somewhere between 3 1/2 and 4 billion — for something that has a settlement value today of 400 million.

So it's very hard for us to — it's very hard for us on the other side of the contract to arrive at a price that we both would be happy with.

We’re not going to deleverage Berkshire. There isn’t that much leverage to start with.

I mean, the float really is, essentially, very close to permanent. I mean, it can decline a couple percent in a year, but it can also increase a few percent.

So, I see no drain on funds of any consequence from the float for as far as the eye can see, and we have very little debt out. So I would not want to pay down the debt we have now.

Logically, we probably should take on more debt at these prices, but that’s just not something that appeals to us.

Maybe if we find a really big deal, we might take on a little more. I would like to at least have that as something I was thinking about.

Charlie?

CHARLIE MUNGER: We’d love to have something come along where we actually felt a little capital constrained. We haven’t felt capital constrained for a long time.

It’s a problem we’d love to have, something so attractive that we —

WARREN BUFFETT: We’d stretch a little.

CHARLIE MUNGER: We’d stretch a little. That would be glorious.

And it could happen, by the way.

WARREN BUFFETT: And it could happen.

27. No economies of scale for auto dealers

WARREN BUFFETT: OK. Station 9.

AUDIENCE MEMBER: Hi, Mr. Buffett and Mr. Munger. My name is George. I’m translating for my father, (inaudible), from Shanghai, China.

Last year it was my father standing here asking his question, and this year it’s me. I feel so lucky.

I know at the end of last year, you purchased a car sales dealer. This year, you said in your public letter that you are going to continue to buy. The ultimate purpose of investment is to seek the return.

So my question is, whether the rate of return can be necessarily higher with the scale of the dealers?

If so, why we cannot see that happen in China? How come the differences with the dealership business of the same nature in the United States and China? Thank you.

WARREN BUFFETT: Yeah. I don't know the dealership situation in China.

I would say — I think I mentioned this a little earlier — that I don't think we're going to get significant benefits of scale as we buy more units in the auto field. I just don't see where it would come from.

But we don't need it. What we really need is managers in those individual dealerships that have skin in the game of their own, and that run them, you know, as first-class businesses, independently.

And that's what we'll be looking for. We'll not be looking for scale. I don't know the situation in China. Maybe Charlie knows more about that. I think he does.

CHARLIE MUNGER: No. But I don't think we'd be very good at running dealerships in China. And I think the people who run Van Tuyl are very good at running the ones here, so —

WARREN BUFFETT: Yeah with 17,000 here and we've got 81 of them, there's a little room to expand.

The problem is going to be price. Our purchase probably caused people to move up their multiples by one or two — people that have them — and we paid a full, but fair, price for Van Tuyl and we'll be using that price, more or less, as a yardstick.

And we really thought we bought the best there, so, if anything, we would be hoping to buy others, maybe for a bit less.

So we will not — we may buy a lot of them, we may buy very few, just depending on price developments.

The — we're having a big car year and profits are good in the dealership field. But when profits are good, we want to pay a lower multiple.

I mean, because, if we're going to be in the car business forever, we're going to have some good years and we're going to have some bad years. And we would rather buy at a 10 or 12 times multiple of a bad year than buy at an eight times multiple of a good year.

And that's not necessarily the way that sellers think, although they probably understand it, but they don't want to think that way. So we'll see what happens.

28. Buffett values internet more than private jet

WARREN BUFFETT: OK. Station 10.

AUDIENCE MEMBER: Hi. Mr. Buffett and Munger, very excited to be here.

My name is (inaudible), also from Shanghai, China. Because now (inaudible) a company providing wealth management to the high-net wealth individuals in China. The company name is North, from North Ark (PH), listed at (inaudible).

You two are my idols. What's your secrets of keeping so young, so energetic, and so quick?

Please don't say because of Coca-Cola. (Laughter)

And as someone says that old papa could not understand the internet, but I don't believe that.

What's your opinion? Will you pay more attention to internet? Could I invite both two gentlemen to answer my question? Thank you very much.

WARREN BUFFETT: Charlie, I didn't get all that, so you —

CHARLIE MUNGER: Well, he asked are we going to be using the internet.

Warren is a big internet user compared to me. And — but —

WARREN BUFFETT: I love it. (Laughs)

CHARLIE MUNGER: He plays bridge on it.

WARREN BUFFETT: I use a lot of — I use search. It's been a huge change in my life, and it costs me a hundred dollars a year, or something like that.

If I had to give up the plane or I had to give up the internet: the plane costs me a million-and-a-half a year, the internet costs me a hundred dollars a year. You know, I wouldn't want to give up either one of them, but I'd give up the plane.

CHARLIE MUNGER: Interesting. (Laughter)

WARREN BUFFETT: Charlie's given up both.

CHARLIE MUNGER: Are we going to be doing more — I think everybody's going to be doing more things on the internet. It is growing in importance. And so like it or not, we're dragged into modern reality.

WARREN BUFFETT: Doesn't sound like he likes it, does it? (Laughs)

CHARLIE MUNGER: No, I don't like it.

I don't like multitasking. I see these people doing three things at once, and I think, God, what a terrible way that is to think.

I am so stupid, though, I have to think hard about a thing for a long time. And the idea of multitasking my way to glory has never occurred to me. (Laughter)

But at any rate, the internet is here and it's going to be more and more important and everybody's going to think more about it and do more about it, like it or not. And, of course, the younger people are way more prone to use it than we are.

But Berkshire — you have what, how many Bloombergs now?

WARREN BUFFETT: In the office?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Do we have two or three. Mark?

I don't know. They don't tell me about them. They sort of hide them when I come in the room.

CHARLIE MUNGER: We're into the modern world.

WARREN BUFFETT: We have — [CFO] Marc Hamburg tells me we have three — but we'll reevaluate that situation when I get back to the office. (Laughter)

What's that?

Oh, we're not paying for one. I like that. (Laughter)

Let's see if we can not pay for two. (Laughter)

No, the internet — and it's changed many of our businesses. I mean, it's changed GEICO's business very, very dramatically. And it's affecting — it affects them all, to one degree or another.

It's amazing to me — I mean, people get pessimistic about America. Just think in the last 20 or 25 years—well, just 20 years on the internet—how dramatically it's changed your life.

You know, the game is not over yet. There's all kinds of things that are going to happen to make life better.

And Charlie may not think the internet makes life better, but when I compare trying to round up three other guys on a snowy day to come over to my house to play bridge, versus snapping the thing on and having my partner in San Francisco there and two other friends, and so on, in 10 or 20 seconds, I think the world has improved.

CHARLIE MUNGER: Well, if I had your partner, I'd think it had improved, too. (Laughter)

29. Raise earned income tax credit instead of minimum wage

WARREN BUFFETT: OK. Station 11.

AUDIENCE MEMBER: Hi. I'm Whitney Tillson, a shareholder from New York.

Mr. Buffett, I know many shareholders have felt irritation, to put it mildly, when you've weighed in on social issues such as tax policy, or endorsed and raised money for a particular candidate, but I, for one, applaud it.

I think everyone, but especially people who've achieved wealth and prominence and thus have real ability to effect change, have a duty to try and make the world a better place, not just through charitable donations, but also through political engagement, and I'd say that even to people whose political views are contrary to my own.

My question relates to one of the big issues today: rising income inequality, and related to that, the campaign to raise the minimum wage, which has had some recent successes with some of the largest businesses in the country like Walmart and McDonald's.

How concerned are you about income inequality? Do you think raising the minimum wage is a good idea? And do you think these efforts might meaningfully affect the profitability of corporate America?

WARREN BUFFETT: Yeah. I think income inequality is — I think it's extraordinary, in the United States, to see how far we've gone.

Well, just go back to my own case. Since I was born in 1930, the average GDP per capita in the United States has gone up six for one.

Now, my parents thought they were living in a reasonably decent economy in 1930, and here their son has lived to where the average is six times what it was then.

And if you'd asked them at that time, and they'd known that fact, that it would go from 8 or $9,000 in today's terms to $54,000, they would have said, "Well, everybody in America is going to be enjoying a terrific life," and clearly they're not.

So, I think it is a huge factor. There are a million causes for it, and I don't pretend to know all the answers, in terms of working towards solutions.

But I do think that everybody that is willing to work should have a reasonably decent livelihood in a country like the United States, and — (applause) — how that is best achieved — I'm actually going to write something on it pretty soon.

I have nothing against raising the minimum wage, but to raise it to a level sufficient to really change things very much, I think, would cost a whole lot of jobs.

I mean, there are such things as supply and demand curves. And if you were to move it up dramatically, I think you would — it's a form of price fixing. I think you would change the opportunities available to people very dramatically.

So I am much more of a believer in reforming and enlarging the earned income tax credit, which rewards people that work, but also takes care of those whose skills don't fit well into a market system. So I think you put your finger on a very big problem.

I don't think — I don't have anything against raising the minimum wage, but I don't think you can do it in a significant enough way without creating a lot of distortions.

Whereas, I do think the earned income tax credit makes a lot of sense and I think it can be improved. There's a lot of fraud in it. It pays out this lump sum, so you get into these payday type loans against — I mean, there's — a lot of improvements can be made in it.

But I think the answer lies more in that particular policy than the minimum wage. And, like I said, I think I'm going to write something on it pretty soon. And if there's anybody I haven't made mad yet, you know, I'll take care of it in the next one.

Charlie?

CHARLIE MUNGER: Well, you've just heard a Democrat speaking and here's a Republican who says I agree with him.

I think if you raise the minimum wage a lot, it would be massively stupid and hurt the poor, and I think it would help the poor to make the earned income credit bigger. (Applause)

30. "Ridiculous argument" that college boosts lifetime earnings

WARREN BUFFETT: Let's go to station 1.

AUDIENCE MEMBER: Hi. I'm Michael Monahan (PH) from Long Island, New York.

Warren, Charlie, the higher education system has expanded, covering almost everyone who would like to receive a college education. This demand has translated into rising college costs.

As a high school junior, I'm looking at prestigious institutions such as UPenn, Villanova, NYU, Fordham, and Boston University.

On the other hand, my parents are experiencing sticker shock. All of these schools have a sticker price of over $60,000, with some students, as shown in a businessinsider.com article, can pay over $70,000, as the case at NYU.

How will the average American family be able to pay this in the future and, more importantly, how do you two feel about this?

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: Well, the average American family does it by going to less expensive places and getting massive subsidies from the expensive places.

If we had to give our college education to only people who could write cash checks for 60 or $70,000 a year, we wouldn't have that many college students.

WARREN BUFFETT: No.

CHARLIE MUNGER: So most people are paying less or getting subsidies. And — but I think it is a big problem, that education has just kept raising the price, raising the price, raising the price.

And they say, but college educated people do better. It's a big bargain. But maybe they do better because they were better to start with before they ever went to college, and they never tell you that. (Applause)

WARREN BUFFETT: It's a ridiculous argument.

CHARLIE MUNGER: And so —

WARREN BUFFETT: I think that's one of the silliest statistics that they publish, I mean, to say that a college education is worth X because people that go to college earn this much more than the ones that don't. You're talking about two different universes.

And to attribute the entire difference to the one variable, that they went to college as opposed to the difference between the people who want to go to college and have the ability to get into college —

CHARLIE MUNGER: It's completely nutty —

WARREN BUFFETT: — it's a fraud

CHARLIE MUNGER: — and about 70 percent of the people believe in it. So it gives you a certain hesitation about relying on your fellow man. (Laughter)

So I think most people have to struggle through with the system the way it is.

There's a big tendency to have prices rise to what can be collected. And people just rationalize that the service is worth it. And I think a lot of that has happened in education, and, of course — (applause) — a lot is taught in higher education that isn't very useful to the people who are learning it and, of course, a lot of those people would never learn much from anything.

So it's really wasting your time, and that's just the way it works. So I think there's a lot wrong.

What I noticed that was very interesting is that when the Great Recession came, every successful university in America was horribly overstaffed and they all behaved just like 3G. They all, with a shortage of money, laid off a lot of people. And the net result was they all worked better when it was all over with the people gone.

And so this right-sizing is not all bad. I don't think there's a college in America that wants to go back to its old habits. And — but you put your finger on — it is a real problem to look as those sticker shocks.

It's like any other problem in life. You figure out your best option and just live with it.

We can't change Villanova or Fordham. They're going to do what they're going to do. And as long as it works, they'll keep raising the prices.

WARREN BUFFETT: And it will keep working.

CHARLIE MUNGER: Yes. And that's pretty much the way the system works.

When it really gets awful there's finally a rebellion. In my place in Los Angeles, the little traffic accident got so it cost too much to everybody because of so much fraud, and the chiropractors, and some of the plaintiffs' attorneys, and so on.

And finally, the little accidents were costing so much that they worried about the guy who lived in a tough neighborhood who couldn't afford to drive out to get a job. And the auto insurance companies thought, my God, with prices going up like this, they'll have legislation creating state auto insurance or something.

So the net result is they put the plaintiffs' attorneys to trial in every case, and that fixed it. And maybe something like that will happen in higher education. But without some big incentive, I think higher education will just keep raising the prices.

31. Bullish on China

WARREN BUFFETT: On that cheerful note, we'll move to station 2.

AUDIENCE MEMBER: Thank you for taking my question.

My name is Brendan Chin (PH). I'm form Taipei, Taiwan.

My question is, China is undergoing a number of structural changes. What do you — when you take the pulse of the Chinese economy, what do you read and what advice would you give? Thank you.

WARREN BUFFETT: Charlie's the China expert. I think China's going to do very fine over a period of time.

CHARLIE MUNGER: Yeah. I'm a big fan for what's happening in China.

And as a matter of fact, I've just ordered — prepared — a bust of Lee Kuan Yew, the recently deceased ex-prime minister of Singapore, because I think he's contributed so much to fixing, first Singapore, and then China.

And one of the things Lee Kuan Yew did in China — in Singapore — was to stop the corruption, including cashiering some of his close friends.

And China is doing the same thing. And I consider it the smartest damn thing I've seen a big country do in a long, long time, and I think that to — it's hard to set the proper example if the leading political rulers are kleptocrats.

You know, you don't want to be run by a den of thieves. You want responsible people.

And what Lee Kuan Yew did is he paid the civil servants way better and recruited very good people. And he just created a better system and, of course, China is widely copying him. And it's a wonderful thing they're doing.

So I'm very high on what's going on in China, and I think it's — I think it's very likely to work. If you — they've actually shot a few people. That really gets people's attention. (Laughter)

WARREN BUFFETT: Now we're starting to get some practical advice here. (Laughter)

What has happened in China, you know, over the last 40 or so years, I mean, I — it just strikes me as totally miraculous. I don't think — I would not have believed that a country could move so far so — a country of that size, particularly — so far so fast. And it's —

CHARLIE MUNGER: It never happened before, in the history of the world, that a company so big had come so far. When I was a little boy, 80 percent of the population of China was illiterate and mired in subsistence poverty and agriculture.

Now just think — and they've been through horrible wars and look at them. It's one of the most remarkable achievements in the history of the Earth.

And a few people made an extreme contribution to it, including this Chinese politician in Singapore.

And I give the Communist Party a lot of credit for copying Lee Kuan Yew.

That's all Berkshire does is copy the right people.

WARREN BUFFETT: Yeah. In 1790, the United States had 4 million people. China had 290 million people.

They were just as smart as we were. They worked as hard, similar climate, similar soil. And for 200 — close to 200 — years, you know, the United States went with those 4 million people to close to 25 percent of the world's GDP and China really didn't go anyplace.

And then those same people, in 40 years — and they're not working harder now than they were 40 years ago — they're not smarter now than they were 40 years ago, in terms of the basic intelligence — and just look at what's been accomplished.

I mean, it does show you the human potential when you find a system that unleashes it, and we found a system that unleashed human potential a couple hundred years ago and they found a system that unleashed human potential 40 or 50 years ago.

And, you know, when you see that example, you know, it has to have a powerful effect on what happens in the future.

And it's just amazing that you can have people go nowhere, basically, in their lives for centuries and then just — it explodes. And it just blows me away to see it, and you make it — it's the same human beings, but they've — they found a way to unlock their potential and I congratulate them for it.

And as Charlie said earlier, China and the United States are going to be the superpowers for as far as the eye can see. And it is really good for us, in my view, that the Chinese have found the way to unlock their potential.

And I think its imperative for two countries with nuclear weapons that, in this kind of world, that they figure out ways to see the virtues in each other rather than the flaws.

We'll have plenty of disagreements with the Chinese, and they will with us, but remember that on balance, we're both better off if the other one is doing well. That's just my own view. OK. (Applause)

32. "We just kept reading … and went with our instincts"

WARREN BUFFETT: Station 3, please.

AUDIENCE MEMBER: Hello, Mr. Buffett and Mr. Munger. My name is Chander Chawla and I'm from San Francisco. Thank you for the last 50 years of sharing your wisdom and being an exemplar of integrity.

Fifty years ago, when you were starting out or getting into new industries, how did you figure out the operational metrics for a new industry where you did not have previous experience?

WARREN BUFFETT: Well, we — A) we didn't have it thought out that well, in a sense, at that time.

But we basically looked for companies where we thought we could understand what the future would look like 5 or 10 or 15 years hence. And that didn't mean we had to do it to four decimal places or anything of the sort, but we had to have a feel for it, and we had to know our limitations. So we stayed away from a lot of things.

And at that time, prices were different, so we — in terms of knowing we were getting enough for our money, it was a much easier decision than it is currently.

But it wasn't — they weren't elaborate — well, there were no planning sessions or anything of the sort. We just kept reading and we kept thinking and we kept looking at things that came along, as Charlie described it in the movie, and you know, comparing Opportunity A with Opportunity B.

And in those days, we were capital constrained, so we usually had to sell something if we were going to buy something else. And that always makes for — you know, that's the — an interesting challenge, always, when you're measuring something you hold against something that has come along and to see which is more attractive.

And we probably leaned very much toward things where we felt we were certain to get a decent result than where we were hopeful of getting a brilliant result.

Went with our instincts, and kept putting one foot in front of the other.

Charlie, what would you say?

CHARLIE MUNGER: Well, that's exactly what we did, and it worked wonderfully well. And part of it is because we were such splendid people and worked so constructively, and part of it is we were a little lucky. We had some good fortune.

Now, Warren says he was lucky to go to GEICO, but not every 20-year-old was going down to Washington, D.C., and knocking on the doors of empty buildings to try and find something out that he was curious about.

So we made some of our luck by being curious and seeking wisdom, and we certainly recommend that to anybody else.

And there's nothing that produces wisdom more thoroughly than really getting your own nose whacked hard when you make a mistake, and we had a firm amount of that, didn't we?

WARREN BUFFETT: We had plenty of them. If you read this book, you'll see about a few of them.

We thought we knew the department store business in Baltimore and we thought we knew about the trading stamp business.

We've had a lot of experience with bad businesses, and that makes you appreciate a good one. And to some extent, it sharpens your ability to make distinctions between good and bad ones.

And we've had a lot of fun along the way. That helps too. If you're enjoying what you're doing, you know, you're likely to get a better result than if you go to work with your teeth clenched every morning.

CHARLIE MUNGER: I think we were helped because we came from families where there was some admirable people, and we tended to identify other admirable people better than we would have coming from a different background.

So, my deceased wife used to say, you can't accomplish much in one generation.

We owe a considerable amount, both of us, to the families we were raised in. I think the family standards helped us to identify the good people more easily than we would have if we'd had a more disadvantaged background.

Do you agree with that, Warren?

WARREN BUFFETT: Yeah. Have you still got your father's briefcase?

CHARLIE MUNGER: I've still got it, but I don't know where it is. (Laughter)

Can't carry it anymore. It's worn out. It's got holes in it.

WARREN BUFFETT: I've got my dad's desk from 75 years ago.

33. How Buffett found his first investors

WARREN BUFFETT: OK. Station 4.

AUDIENCE MEMBER: Hi, Warren and Charlie. This is Cora and Dan Chen from Talguard in Los Angeles, and we're thrilled to be here again.

Thank you for planting the seeds for which my generation can sit under the shade, and for my children's generation with "The Secret Millionaires Club," so that they can sit under the shade. I walk amongst giants.

WARREN BUFFETT: Go on. Go on. (Laughter)

AUDIENCE MEMBER: That's all I have. (Laughter)

WARREN BUFFETT: Don't hold back.

AUDIENCE MEMBER: Seriously though, thank you so much for everything you've taught us.

WARREN BUFFET: Thank you.

AUDIENCE MEMBER: How were you able to persuade — (applause)

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: How were you able to persuade your early investors, all early on, besides your family and friends, to overcome their doubts and fears and to believe in what you're doing?

There's a lot of other asset classes out there, such as — a lot of people believe, real estate, bonds, gold. How were you able to get over that? And something I've been really dying to ask you —

CHARLIE MUNGER: We didn't do very well until we had a winning record. (Laughter)

AUDIENCE MEMBER: Prior to the early winning record, how were you able to get them to buy into what you were trying to do?

I mean, no one has ever done what you're doing, and no one has, still. And I've been really wanting to ask you, in the past, you said you're 90 percent Graham and 10 percent Fisher. Where does that percentage stand today?

Thank you again from a grateful student of your teachings, and my children love what you do, too. They wrote you a letter.

WARREN BUFFETT: Thank you. Thank you. (Applause)

A lot of it — you know, I started selling stocks here when I was 20 years old. I got out of Columbia. And although I was 20, I looked about 16 and I behaved like I was about 12.

So I was not — I did not make a huge impression selling stocks. I used to just walk around downtown and call on people, which is the way it was done, and then I went to work for Graham.

But when I came back, the people that joined me, actually — one of my sisters, her husband, my father-in-law, my Aunt Alice, a guy I roomed with in college, and his mother, and I've skipped one — but in any event, those people just had faith in me.

And my father-in-law, who was a dean at the University — what was then the University of Omaha — he gave me everything he had, you know, and to quite an extent they all did.

And so it was — they knew I'd done reasonably well by that time. That would have been 1956, so I'd been investing five or six years. And actually, I was in a position where when I left New York and came back to Omaha, I had about $175,000 and I was retired.

So I guess they figured if I was retired at 26, I must be doing something right and they gave me their money.

And then it just unfolded after that. An ex-stockholder of Graham-Newman, the president of a college came out, Ben Graham was winding up his partnership for his fund and he recommended me.

And then another fellow saw the announcement in the paper that we formed a partnership and he called me and he joined, and just one after another.

And then, actually, a year or two later, a doctor family called and they were the ones that ended up with me meeting Charlie.

So a lot of stuff just comes along if you just keep plodding along.

But the record, later on, of the partnership attracted money, but initially it was much more just people that knew me and had faith in me. But these were small sums of money. We started with 105,000.

Charlie?

CHARLIE MUNGER: Well, of course that's the way you start, and — but it's amazing. We've now watched a lot of other people start. And the people that have followed the old Graham-Newman path have one thing in common: they've all done pretty well. I can hardly think of anybody who hasn't done moderately —

WARREN BUFFETT: Everybody did well, yeah.

CHARLIE MUNGER: So, if you just avoid being a perfect idiot — (laughter) — and have a good character and just keep doing it day after day, it's amazing how it will work.

WARREN BUFFETT: Yeah. It was accident, to a significant extent.

If a few of those people hadn't have said to me, you know, "What should I buy?" And I said, "I'm not going to go back in the stock brokerage business, but I will — you know, we'll form a partnership and, you know, your fate will be the same as mine and I won't tell you what I'm doing."

And they joined in, and it went from there.

But it was not — it was not planned out in the least. Zero.

I met Charlie, and he was practicing law, and I told him that was OK as a hobby, but it was a lousy business. (Laughter)

And so he —

CHARLIE MUNGER: Fortunately, I listened. (Laughter)

It took a while, however.

WARREN BUFFETT: Yeah.

34. Munger: rationality is a moral virtue

WARREN BUFFETT: OK. Station 5. We've got —

AUDIENCE MEMBER: Hi. My name is Arthur. I'm from Los Angeles. I want to thank you for having us in your hometown.

And we've all been listening to your business prowess and all your successes. There's no question that you're good at business and finance and have fun doing it.

But there are comments that you've made on income inequality, giving away 99 percent of your wealth, and I'm led to believe that you're motivated by more than just amassing wealth or financial gains.

So, I'd like to speak to your value core and ask what matters to you most and why?

WARREN BUFFETT: Charlie, what matters to you most?

CHARLIE MUNGER: Well, I think that I had an unfortunate channeling device.

I was better at figuring things out than I was at everything else. I was never going to succeed as a movie star, or as an athlete, or as an actor, something, so — and I, early, got the idea that — partly from my family, my grandfather, in particular, whose name I bore, had the same idea — that really, your main duty is to become as rational as you could possibly be.

I mean, rationality was just totally worshiped by Judge Munger, and my father and others.

And since I was good at that and no good at anything else, I was steered in something that worked well for me and — but I do think rationality is a moral duty.

That's the reason I like Confucius. He had the same idea all those years ago. And I think Berkshire is sort of a temple of rationality. What's really admired around Berkshire is somebody who sees it the way it is. Wouldn't you agree with that, Warren?

WARREN BUFFETT: Yeah, that —

CHARLIE MUNGER: More than anything, more than —

WARREN BUFFETT: You better see it the way it is.

CHARLIE MUNGER: Huh?

WARREN BUFFETT: You better see it the way it is.

CHARLIE MUNGER: See it the way it is.

And so, that's the way I did it.

But that goes beyond a technique for amassing wealth. To me that's a moral principle.

I think if you have some easily removable ignorance and keep it, it's dishonorable. I don't think it's just a mistake or a lack of diligence. I think it's dishonorable to stay stupider than you have to be, and so that's my ethos.

And I think you have to be generous because it's crazy not to be. We're a social animal, and we're tied to other people.

WARREN BUFFETT: Well, I would say — this doesn't sound very noble, but the — what matters to me most now, and probably has for some time — I mean, there are things that matter that you can't do anything about, I mean, in terms of health and the health of those around you and all that — but actually, what matters to me most is that Berkshire does well.

Basically, I'm in a position where we've probably got a million or more people that are involved with us, and it just so happens that it's enormously enjoyable to me so I can rationalize it, the activity.

But I would not be happy if Berkshire were doing poorly. That doesn't mean whether the stock goes down or whether, you know, the economy has a bad year.

But if I felt that we weren't building something every year that was better than what we had the year before, I would not be happy.

And, you know, I get this enormous fun out of it and I get to work with people I like and —

CHARLIE MUNGER: But that's very important. Truth of the matter is it's easy for somebody like Warren or me to lose a little of our own money, because it doesn't matter that much, but we hate losing somebody else's.

It's — and that's a very desirable attitude to have in a civilization.

Don't you hate losing Berkshire money?

WARREN BUFFETT: Yeah. That would be the only thing that would keep me up at night. (Laughs)

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. We won't do it.

We can lose money on individual things, obviously. We can have bad years in the economy, and we can have years the stock market goes down a lot. That doesn't bother me in the least.

What bothers me is if I do something that actually costs Berkshire, in terms of its long-term value, and then I feel, you know, I do not feel good about life on that day.

But we can avoid most of that, fortunately. We do get to pick our spots. We're very fortunate with that.

CHARLIE MUNGER: Well, a good doctor doesn't like it when the patient dies on the table, either, you know. (Laughter)

Not a new thought. (Laughter)

35. No help for "the most intelligent question"

WARREN BUFFETT: OK. Let's go to — let's go to station 6.

AUDIENCE MEMBER: Hi, Mr. Buffett and Mr. Munger. My name is Petra Bergman. I'm from Stockholm, Sweden, in northern Europe. I work at something called EFN.SE.

I wanted to ask you, from my point of view, what would be the answer to the most intelligent question I could ask you right now? (Laughter)

CHARLIE MUNGER: Everybody tries that question, and it would be wonderful if that would solve all your problems. But I don't think it's a very good question. (Laughter)

Or perhaps I should say —

WARREN BUFFETT: Let's phrase that differently, Charlie.

CHARLIE MUNGER: Well, what I mean is, you're asking too much of somebody when you — you ask him to honestly say what is the most enlightening question he can answer.

WARREN BUFFETT: Yeah. I get that asked by the students a lot. And I've had a lot of practice in hearing it asked, but I haven't had very much success in answering it.

So I'll have to beg off on that one.

36. Buffett on fun and "the game"

WARREN BUFFETT: How about 7?

AUDIENCE MEMBER: Good afternoon, Warren and Charlie. Congrats on 50 years. My name is Jim and I'm from Brooklyn, New York.

This is kind of a follow-on to a recent question. You both had success in investing, even before Berkshire Hathaway, as investors and as fund managers.

While it's well known you closely followed Graham's teachings, others, like Walter Schloss and his son, also had success with similar teachings, yet different strategies.

What would you cite as the most important reason for your early success with small amounts of capital, and given hindsight today, what might you have done to improve your strategy with these small funds?

WARREN BUFFETT: Yeah. Well, I had a great teacher, I had exceptional focus, and I had the right sort of emotional qualities that would help me in being an investor.

I enjoyed the game. You do give it all back in the end. It wouldn't make any difference if I — you know, that was not the key thing.

The game was enormously fun. And I think Gene McCarthy said about football one time, you know, it's just about, you know, hard enough to be interesting but not so hard as to be beyond the capabilities of people understanding it, and that's kind of the way this game is.

I mean, it's not like Henry Singleton, kind of questions he took on. It's actually a pretty easy game, and it does require a certain emotional stability.

And I went at it hammer and tong. I went through the manuals and everything, but I was enjoying when I did it.

And, like I say, I started out — between ages seven and about 19, I had that same enthusiasm, but I didn't really have any guiding principle.

And then I ran into "The Intelligent Investor" and Ben Graham. And then at that point, I was able to take all this energy and everything, and enthusiasm for it, and now I had a philosophy that made a lot of sense — total sense — and I found that I could employ, and so the game became even more fun. But it wasn't really more complicated than that.

Charlie?

CHARLIE MUNGER: Well, I don't have anything to add.

I do think that it's an easy game if somebody has the temperament for it and keeps at it because he's — likes it and it's interesting — interested in it.

I have a problem that Warren has less of. I don't like being too much an example to people who want to get rich by being shrewd and buying and passively holding securities.

I don't think that's enough of a life. If you wrest a fortune from life by being shrewder than other people and buying little pieces of paper, I don't think that's an adequate contribution in exchange for what you're taking.

So, I like it when you're investing money for an endowment, or a pension fund, or your relatives, or something, but I never considered it enough of a life to merely be shrewd in picking stocks and passively holding them.

WARREN BUFFETT: Yeah. Running Berkshire has been far, far more fun than running, in my case, multiple partnerships, or just an investment fund. I mean, that —

CHARLIE MUNGER: You'd be less of a man. If you'd run that partnership —

WARREN BUFFETT: It would be a crazy way to go through life.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. I mean, it just — you know, Berkshire is incredibly more satisfying.

CHARLIE MUNGER: So if you're good at just investing your own money, I hope you'll morph into doing something more.

37. Dow Jones's big missed opportunity

WARREN BUFFETT: OK. We'll do 8 and then we'll move onto the annual meeting.

AUDIENCE MEMBER: My name is John Boxtose (PH). I'm from South Dartmouth, Massachusetts.

My question was regarding an interview that you gave, Mr. Buffett, several years ago.

You made a very interesting point. It was about the old Wall Street Journal, if you will, the one before it was purchased by News Corp.

You mentioned in the interview that Wall Street Journal, at some point in the past, had very significant competitive advantages, but a number of them were largely unrealized.

I was just wondering if you could elaborate on that, what the advantages were, how they were unrealized, et cetera. Thank you.

WARREN BUFFETT: Well, Dow Jones, which owned the Wall Street Journal, you know, in the '60s and '70s, going into the era of the enormous spread of financial information — and value of financial information — you know, they basically, they owned the field.

They had the news ticker and they had the Journal, which, you know, anybody interested in finance in the country identified with.

And they — starting with that, in what would be an incredible growth industry, finance, you know, for the next 30 or 40 years they — I forget a couple of those ventures they went into, and they bought a chain of small newspapers, I remember, one time — and they just totally missed what was going to happen.

You know, here comes Michael Bloomberg and, you know, takes away financial information. They had such an advantage. And they didn't really see various areas that they could have pursued, which could have turned that company into something worth many hundreds of billions of dollars, in all probability.

And, you know, they had a situation where a family owned it, and a lawyer essentially controlled the family's behavior, and they were sitting pretty. You know, they were all getting dividends, but there was nobody there with any imagination as to what could be done in the financial field.

So, starting with this position, they were a trusted name, they were in every brokerage firm in the country with a news ticker.

I mean, I went to Walter Annenberg's house one time and he had the Dow Jones ticker there — it just — or the news ticker.

And it was — they couldn't have been in a better place. They couldn't have started with a stronger position. They had a very good balance sheet. And they just let the world pass them by.

Now, Rupert is changing it into a different newspaper. He's going into — he's basically going into competition with the — or he's gone into competition — with the New York Times, so he — but that's the game he likes. And it makes for a very interesting competitive situation.

Charlie?

CHARLIE MUNGER: Well, they did end up with 6 or $7 billion, so they may have blown their opportunities, but they didn't destroy their fortune.

WARREN BUFFETT: If you'd had the hand — if Tom Murphy had had the hand —

CHARLIE MUNGER: Oh, yeah.

WARREN BUFFETT: — it would have been in the hundreds of billions, wouldn't it?

CHARLIE MUNGER: Well, I don't know. I'm not sure if we had had that hand we would have —

WARREN BUFFETT: Well, I'm not so sure. I'm talking about Murph. (Laughs)

There were a lot of opportunities there.

CHARLIE MUNGER: Well, I think even Murph is more like us than he is like Bill Gates.

WARREN BUFFETT: Well, I'm not sure where that goes, but... (Laughter)

CHARLIE MUNGER: Well, but I think it's hard to invent new — entirely new — modalities and so on.

WARREN BUFFETT: I think Bill would have done well with Dow Jones, too.

CHARLIE MUNGER: Yes. He might —

WARREN BUFFETT: I'd like to buy into that retroactively.

38. Q&A concludes

WARREN BUFFETT: OK. 3:30 has arrived. We're going to go to the annual meeting in about five minutes. We've got a certain amount of formal business to take care of. And I thank you all for coming. (Applause)

39. Berkshire's formal annual business meeting

WARREN BUFFETT: Let's reassemble and we'll conduct the business of the meeting.

The meeting will now come to order. I'm Warren Buffett, chairman of the board of directors of the company, and I welcome you to this 2015 annual meeting of shareholders.

This morning I introduced the Berkshire Hathaway directors that are present.

Also with us today are partners in the firm of Deloitte & Touche, our auditors. They are available to respond to appropriate questions you might have concerning the firm's audit of the accounts of Berkshire.

Sharon Heck is secretary of Berkshire Hathaway, and she will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting. She will certify to the count of votes cast in the election for directors and the motion to be voted at this meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding, entitled to vote, and represented at the meeting?

SHARON HECK: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 5, 2015, the record date for this meeting, there were 824,920 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 1,227,069,442 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to one ten-thousandth of one vote on motions considered at the meeting.

Of that number, 592,750 Class A shares and 736,403,387 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 30.

WARREN BUFFETT: Thank you, Sharon. That number represents a quorum, and we will therefore directly proceed with the meeting.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

VOICE: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. Are there any comments or questions?

We will vote on this motion by voice vote. All those if favor say “Aye.”

AUDIENCE: Aye.

WARREN BUFFETT: Opposed? The motion is carried.

40. Election of Berkshire directors

WARREN BUFFETT: The next item of business is to elect directors.

If a shareholder is present who did not send in a proxy or wishes to withdraw a proxy previously sent in, you may vote in person on the election of directors and other matters to be considered at this meeting. Please identify yourself to one of the meeting officials in the aisle so that you can receive a ballot.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors.

WARREN BUFFETT: Is there a second?

VOICE: Second.

WARREN BUFFETT: It has been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors.

Are there any other nominations? Is there any discussion? The nominations are ready to be acted upon.

If are there any shareholders voting in person, they should now mark their ballot on the election of directors and deliver their ballot to one of the meeting officials in the aisles.

Ms. Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 657,744 votes for each nominee. That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick. Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer have been elected as directors.

41. Adjournment of formal Berkshire annual meeting

WARREN BUFFETT: Does anyone have any further business to come before this meeting before we adjourn?

If not, I recognize Mr. Scott to place a motion before the moving.

WALTER SCOTT: I move that this meeting be adjourned.

WARREN BUFFETT: Second?

VOICE: Seconded.

WARREN BUFFETT: A motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say “Aye.”

AUDIENCE: Aye.

Morning Session - 2016 Meeting

1. Charlie Munger always "gets the girl"

WARREN BUFFETT: Good morning. I'm Warren Buffett. This is Charlie Munger. (Applause)

I'm the young one. (Laughter)

You may notice in the movie, incidentally, that Charlie is always the one that gets the girl, and he has one explanation for that. But I think mine is more accurate.

As you know, every mother in this country tells her daughter at an early age, if you're choosing between two very old and very rich guys, pick the one that's older. (Laughter)

2. Welcome webcast viewers

WARREN BUFFETT: I'd especially — we're webcasting this for the first time, so I'd especially like to welcome our visitors from all over the world.

We're having this meeting simultaneously translated into Mandarin. And that poses certain problems for me and Charlie, because I'm not sure how sensible all our comments will come out once translated into Mandarin.

In fact, I'm not so sure how sensible they come out initially sometimes. (Laughter)

But we're delighted to have people around the world joining us.

3. Meeting agenda

WARREN BUFFETT: Now the drill of the day is that I'll make a couple of introductions, and we'll show a couple of slides, and then we'll go on to questions from both our two panels and from the audience, we'll rotate them. And we'll do that until about noon.

Actually, about a quarter of twelve, I'll give you a rundown on a bet that was made that we report on every year.

But then I'll also, in connection with that, explain, and it ties in with it, what I really think is probably the most important investment lesson in the world. So we'll have that about a quarter of twelve and I hope that keeps you around.

And then we'll break at noon for an hour for lunch. We'll reconvene at one o'clock.

We'll proceed until 3:30 with questions. We'll then adjourn for fifteen minutes and at 3:45 convene the formal meeting.

4. Introductions

WARREN BUFFETT: I'd like to just make a couple of introductions.

I hope Carrie Sova is here. Do we have a spotlight? Carrie puts this whole meeting together. There she is.

Wonder Woman. (Applause)

Carrie joined us, Carrie joined us as a receptionist about six years ago, and I just kept throwing more and more problems at her.

And she'd put together the 50th anniversary book, which we've actually expanded further this year. We have a revised edition.

Charlie and I autographed a hundred of them. We interspersed them among the group being sold.

And Carrie, while doing that, she also had a young baby girl, her second baby, late in January. But then she's gone ahead to put on this whole annual meeting.

It's a remarkable achievement and I really want to thank her, it's been terrific. (Applause)

Actually, we have one surprise guest. I think my youngest great-grandchild, who will be about seven months old, is also here today and if he happens to break out crying a lot, and don't let it bother you. It's just his mother is explaining to him my views on it inherited wealth and… (Laughter)

We also have our directors with us. And they're here in the front row.

I'll introduce them. If they'll stand when introduced, withhold your applause, no matter how extreme the urge to applaud them individually. And when we're finished, then you can go wild.

First of all, Howard Buffett. Steve Burke. Sue Decker. Bill Gates. Sandy Gottesman. Charlotte Guyman. Tom Murphy. Ron Olson. Walter Scott. And Meryl Witmer. And that's our wonderful group. (Applause)

5. Q1 earnings

WARREN BUFFETT: Now we just have two slides to show you now.

The first one is a preliminary… summary figures — for the first quarter.

And you'll notice that insurance underwriting — these are after-tax figures by category — are down somewhat.

The basic underwriting at GEICO is actually improving, but we had some important hailstorms in Texas toward the end of the quarter. We've actually had some since the end of the quarter, too, so there were more cat losses in the first quarter than last year.

Railroad earnings are down significantly, and railroad car loadings throughout the industry, all of the major railroads, were down significantly in the first quarter, and probably will continue to be down, almost certainly will continue to be down, the balance of the year.

We have two companies which we added to the manufacturing, service, and retailing field: Precision Castparts and Duracell, but they were added during the quarter, so their full earnings aren't shown in the figures.

In the other category, we have, and I don't like to get too technical here, and you should read the 10-K — 10-Q — when it comes out next weekend.

But, when we borrow money in other currencies, and the only currency we've done that with is the euro, but we have a fair amount of money that we borrowed in euros, and the nature of accounting is that the change in value of the foreign exchange — change in value each quarter — is actually shown in interest expense.

So if the euro goes up, we have a lot of extra interest expense, they're shown that way. It's not a realized factor, but it moves from quarter to quarter. And if the euro goes down, it offsets interest expense.

It's a technicality, to some extent, because we have lots of assets in Europe and they are expressed in euros when they go up. It does not go through the income account. It goes directly to other comprehensive income. So I just, that figure which looks a little unusual, that's the reason for it.

And we always urge you to pay no attention to the figures below operating earnings. They will bounce around from quarter to quarter, and we make no attempt to manage earnings in any way, to have them be smoother. We could do that very easily, but it'd be ridiculous.

We make investment decisions solely on the basis of what we think the best investment decision is, not on the basis of how it will affect earnings in any quarter or in any year.

And in the first quarter we exchanged - we completed a transaction that was begun over a year ago — whereby we exchanged our Procter and Gamble stock for cash and for Duracell, and that accounts for the large — largely accounts — for the large capital gain in the quarter.

So, those are the figures for the first quarter.

6. Share count and earnings

WARREN BUFFETT: And then, to illustrate what we're sort of all about here, I put up a second slide.

And I started this slide in 1999. The reason being that at the end of 1998, we affected a large merger with Gen Re, and at that point we sort of entered a different era.

After 1998 merger with Gen Re, we had a little over a 1,500,000-some A-equivalent shares out. And our shares — up to that point, we'd increase the outstanding shares by more than 50 percent over the 30-some years preceding that point.

Since that time, as I note here, we've only increased the number of shares, over the next 17 years, we've only increased the shares outstanding by 8.2 percent.

So these figures represent a fairly unchanged share count since that point, whereas the share count had changed quite a bit before.

And, as you'll note, in terms of operations, I've told you that our goal at Berkshire is to increase the normalized earnings, operating earnings, every year.

And I've said sometimes it will — we hope it will only be — it'll turn out to be only a little bit — and sometimes we can get some fairly decent jumps. But that's the goal.

Now, earnings will not increase every year, because there's such a thing as a business cycle, and in times of recession we're going to earn less money, obviously, than in times when things are much better overall.

And on top of that, we're heavily in an insurance business, and earnings there can be quite volatile because of catastrophes.

And this chart shows you what's happened to the operating earnings since that time. Again, pointing out that shares outstanding have gone up very little during that period.

You'll notice in 2001, when we suffered significant insurance losses due to 9/11, we actually were in the red, in terms of operating earnings.

And you'll notice the figures are very irregular, but over time, by adding new subsidiaries, by further developing the businesses we have by bolt-on acquisitions, by the reinvestment of retained earnings, the earnings have moved up, in a very irregular fashion, quite substantially.

I've put in, also, the capital gains we've achieved through investments in derivatives, and they total some $32 billion after-tax, close to fifty billion pretax.

Those are not important in any given year. Those numbers can go all over the place.

The main advantage, from my standpoint, in that $32 billion, is it gives us money to buy other businesses.

What we really want to focus on, what we hope, is that the bigger under operations, five, or ten, or twenty, years from now, grow substantially, partly because retained earnings from operations, partly because our operations improve in their own profitability, partly because they make bolt-on acquisitions, partly because we have gains from securities, which enable us to buy even more businesses.

But we don't manage, as you know, we don't manage to try to get any given number from quarter to quarter. We never make a forecast on earnings. We don't give out earnings guidance. We think it's silly.

We do not have budgets at the parent company level. Most of our subsidiaries have budgets, but they don't submit them, or they're not required to submit them, to headquarters.

We just focus, day after day, year after year, decade after decade, on trying to add earning power, sustainable and growing earning power, to Berkshire.

So that's a quick summary. Now we'll move on to the questions.

I just ask, with the audience, that you limit your question to one question. The multiple questions have a way of sneaking in, occasionally, but — so let's keep them to a single question.

7. "One of the problems of prosperity"

WARREN BUFFETT: We'll start off with the journalist group on my right, and we'll start off with Carol Loomis.

CAROL LOOMIS: Good morning. I'll make my very short little speech about the fact that the journalists and the analysts, too, have given Charlie and Warren no hint of what they're going to ask, so they will be learning for the first time what that's going to be, also.

This question comes from Eli Moises.

"In your 1987 letter to shareholders, you commented on the kind of companies Berkshire likes to buy, those that required only small amounts of capital. You said, quote, 'Because so little capital is required to run these businesses, they can grow, while concurrently making almost all of their earnings available for deployment in new opportunities.'

"Today the company has changed its strategy. It now invests in companies that need tons of capital expenditures, are overregulated, and earn lower returns on equity capital. Why did this happen?"

WARREN BUFFETT: Yeah. Well, it's one of the problems of prosperity.

The ideal business is one that takes no capital, but yet grows, and there are a few businesses like that, and we own some.

But we are not able — we'd love to find one that we could buy for $10 or $20 or $30 billion that was not capital intensive and we may, but it's harder.

And that does — that does hurt us, in terms of compounding earnings growth, because, obviously, if you have a business that grows and gives you a lot of money every year and doesn't take it — it isn't required in its growth — you know, you get a double-barreled effect from the earnings growth that occurs internally without the use of capital, and then you get the capital it produces to go and buy other businesses. And See's Candy was a good example of that. I've used that.

Back when the newspaper business was good, our Buffalo newspaper was, for example, was a good example of that. The Buffalo newspaper was making, at one time, $40 million a year and had no capital requirement, so we could take that whole $40 million and go and do — go buy something else with it.

But capital — increasing capital — acts as an anchor on returns in many ways. And one of the ways is that it drives us into — just in terms of availability — it drives us into businesses that are much more capital intensive.

You just saw a slide, for example, on Berkshire Hathaway Energy, where we just announced, just in the last couple of weeks, we announced a $3.6 billion investment coming up in wind generation. And we pledged overall to have $30 billion in renewables.

Anything that Berkshire Hathaway Energy does, anything that BNSF does, takes lots of money. We get decent returns on capital, but we don't get the extraordinary returns on capital that we've been able to get in some of the businesses we acquire that are not capital intensive.

As I mentioned in the annual report, we have a few businesses that actually earn 100 percent a year on true invested capital. And clearly, that's a different sort of operation than something like Berkshire Hathaway Energy, which may earn 11 or 12 percent on capital — and that's a very decent return — but it's a different sort of animal than the business that's very low capital intensive — intensity.

Charlie?

CHARLIE MUNGER: Well, when our circumstances changed, we changed our minds.

WARREN BUFFETT: Slowly and reluctantly. (Laughs)

CHARLIE MUNGER: In the early days, quite a few times we bought a business that was soon producing 100 percent per annum on what we paid for it and didn't require much reinvestment.

If we'd been able to continue doing that, we would have loved to do it, but when we couldn't, we got to plan B. And plan B is working pretty well. In many ways, I've gotten so I sort of prefer it. How about you, Warren?

WARREN BUFFETT: Yeah, that's true. When something's forced on you, you might as well prefer it. (Laughter)

But, I mean, we knew that was going to happen. And the question is, does it lead you from what looks like a sensational result to a satisfactory result.

And we don't — we're quite happy with a satisfactory result. The alternative would be to go back to working with very tiny sums of money, and that really hasn't gotten a lot of serious discussion between Charlie and me. (Laughs)

8. Precisions Castparts acquisition

WARREN BUFFETT: OK. From the analyst group, Jonathan Brandt.

JONATHAN BRANDT: Hi Warren. Thanks for having me again.

WARREN BUFFETT: Thanks for coming.

JONATHAN BRANDT: My first question is about Precision Castparts.

Besides your confidence in its talented CEO Mark Donegan, what in particular do you like about their business that gave you the confidence to pay historically high multiple?

Are there ways Precision can be even more successful as, essentially, a private company?

For instance, are there long-term investments to support client programs or acquisitions that Precision can make now that they couldn't realistically have done as a publicly traded entity?

WARREN BUFFETT: Yeah, we completed the acquisition of Precision Castparts at the end of January this year. We agreed — we made the deal last August.

And you covered the most important asset in your question. Mark Donegan, who runs Precision Castparts, is an extraordinary manager. I mean we've seen very — and Charlie and I've seen a lot of managers over the years — and I would almost rank Mark as one of a kind.

I mean he is doing extremely important work, in terms of making — primarily making — aircraft parts.

I would say that there's certainly no disadvantages to him to be working as a — and for that company to be a subsidiary of Berkshire and not be a public company.

And I think he would say, and I think Charlie and I would agree with him, that over time, there could be some significant advantages.

For one thing, he can spend 100 percent of his time now on figuring out better things to do with aircraft engines. And it was always his first love to be thinking about that, and he did spend most of his time, but he also had to spend some time, you know, explaining quarterly earnings to analysts and perhaps negotiating bank lines and that sort of thing.

So his time, like all of our managers, can be spent exactly on what makes the most sense to them and their business. Mark does not have to come, ever, to Omaha to put on some show for me, in terms of justifying a billion dollar acquisition or plant investment.

He wastes — doesn't have to waste his time on anything that isn't productive. And running a public company, you do waste your time on quite a bit of stuff that isn't productive.

So I would say we've taken the main asset of Precision Cast and made it — made him in this case — even more valuable to the company.

In terms of acquisitions, Precision's always made a number of them. But, as being part of Berkshire, there's really no limitations on what can be done. And so, there again, his canvas has been broadened, in large, with the acquisition by Berkshire.

I see no downside whatsoever. If he needs capital, I've got an 800 number.

And, you know, he wasn't paying much of a dividend before, but he doesn't have to pay any dividend now.

Precision Cast will do better under Berkshire than it would have independently, although it would have done very, very well independently.

Charlie?

CHARLIE MUNGER: Well, in the early days, we used to make wiseass remarks. And Warren would say we buy a business an idiot can manage, because sooner or later, an idiot will.

And we did buy some businesses like that in the early days, and they were widely available.

Of course we'd prefer to do that, but the world has gotten harder, and we had to learn new and more powerful ways of operating.

A business like Precision Castparts requires a very superior management that's going to stay superior for a long time.

And we gradually have done more and more and more of that, and it's simply amazing how well it works.

I think, to some extent, we've gotten almost as good at picking the superior managers as we were in the old days at picking the no-brainer businesses.

WARREN BUFFETT: Yeah, we would love to find — we won't be able to find them because they're very rare birds — but we would love to find another three or four of a similar type to Precision Castparts, where they, forever, are going to be producing something that — where quality is enormously important, where the customers depend very heavily on them, when there's contracts that extend over many years, and where people don't simply just take the low bid in order to get this gadget of one sort or another.

It's very important that you have somebody there that has enormous skill running the business, and their reputation, among aircraft manufacturers, engine manufacturers, you know, is absolutely unparalleled.

9. "Can't imagine anybody any happier"

WARREN BUFFETT: OK, now we go to the audience, and we go up to section 1. And if you'll give your name and where you're from, I'd appreciate it.

AUDIENCE MEMBER: Hi, good morning. My name is Gaspar. I'm Spanish and I come from London.

I admire you both in many ways, but I would like to know that, when looking backwards, what would you have done differently in life in your search for happiness?

WARREN BUFFETT: Well, I'm 85 and I can't imagine anybody any happier than I am.

So — by accident or whatever, I still — I mean, you know, I'm sitting here eating exactly what I like to eat, doing in life exactly what I love to do, with people I love. So it really doesn't get any better than that and I — (applause)

I did decide, fairly early in life, that my favorite employer was myself. (Laughter)

And, that — I think that presented — I've managed to avoid, really, aggravation of almost any sort.

Really, you know, if you, or those around you that you love, have health problems or something, I mean, that is a real tragedy, and there's not much you can do about it but accept it.

But Charlie and I have, every day, been blessed. I mean, here Charlie is, 92, and he's doing, every day, something that he finds fascinating.

You know he — I think he probably finds what he is doing at 92 as interesting, as fascinating, and as rewarding, as socially productive, you know, as any period you can pick in his life.

And so we've been extraordinarily lucky. We've been, you know, we're lucky it's a partnership. It's more fun doing things as a partnership.

So, I've got no complaints. It would be very churlish of me to have any kind of complaint. I would say, if you're talking about business life, I don't think I would have started with a textile company. (Laughter)

Charlie?

CHARLIE MUNGER: Well, looking back, I don't regret that I didn't make more money, or become better known, or any of those things. I do regret that I didn't wise up as fast as I could have and —

But there's a blessing in that, too. Now that I'm 92, I still have a lot of ignorance left to work on. (Laughter and applause)

10. Reinsurance outlook a factor in Munich Re and Swiss Re sales

WARREN BUFFETT: OK, Becky Quick.

BECKY QUICK: This question comes from Solomon Ackerman, who's in Frankfurt, Germany.

He wants to know why Berkshire has significantly sold down their holdings in Munich Re, which is the world's biggest reinsurance company, based in Germany, while sticking with the reinsurance operations within Berkshire, like Berkshire Hathaway Reinsurance and General Re.

Would you reduce exposure to Berkshire Hathaway Reinsurance and General Re if they were listed companies? And he's hoping that this can bring out some of your insights as to what's happening in the reinsurance business right now.

WARREN BUFFETT: Yeah, we — I said in the annual report that I thought it was very likely that the reinsurance business would not be as good in the next ten years as it has been in the last ten years.

I may be wrong on that, but that's just a judgment based on seeing the competitive dynamics of the reinsurance business now versus 10 or 20 years ago.

Both Munich — we sold our entire holdings, which were substantial — of Munich Re and Swiss Re. We owned about 3 percent of Swiss Re, and we own more than 10 percent of Munich Re, and last year we sold those two holdings.

They're fine companies. They're well-managed companies. I like the people that run them.

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

In part, that's because what's happened to interest rates. A significant portion of what you earn in insurance comes from investment of the float. And both of those companies, and for that matter almost all of the reinsurance industry, is somewhat more restricted in what they can do with their float, because they don't have this huge capital cushion that Berkshire has, and also because they don't have this great amount of unrelated earning power that Berkshire has.

Berkshire has more leeway in what it can do simply because it does have capital that's many times what its competitors have, and it also has earning power coming from a whole variety of unrelated areas — unrelated to insurance.

So it was not a negative judgment, in any way, on those two companies. It was not a negative judgment on their managements. But it was a — at least — a mildly negative judgment on the reinsurance business.

Now, we have the ability at Berkshire to actually rearrange, to a degree — we are certainly affected by industry factors — but we have more flexibility in modifying business models, and we've operated that way, over the years, in insurance generally, and particularly in reinsurance.

So, a Munich, a Swiss, all the major reinsurance companies, except for us, is pretty well tied to a given type of business model.

They don't really have as many options, in terms of where capital gets deployed. They have to continue down the present path.

And I think they'll do fine. But I don't think they will do as fine in the next 10 years as they have in the last 10.

And I don't think if we played the same game as we were playing the last 10, we would do as well, but we do have considerably more flexibility — in terms of how we conduct all of our insurance operations, but particularly in reinsurance — we have an extra string to our bow that the rest of the industry doesn't have.

The amount of capital that's come in to the reinsurance business — you know, it is no fun running a traditional reinsurance company and having money come in — particularly if you're in Europe — and have money come in, and look around you for investment choices and find out that a great many of the things that you were buying a few years ago now have negative yields.

The whole idea of float is it's supposed to be invested at a positive rate — a fairly substantial — positive rate.

And that game has been over for a while, and it looks like it will be, at least, unattractive, if not terrible, for a considerable period in the future.

Charlie?

CHARLIE MUNGER: Yeah. But, you know, there's a lot of new capacity in reinsurance and there's a lot of very heavy competition.

A lot of people from finance have come over into reinsurance, and all the old competitors remained, too. That's different from Precision Castparts, where most of the customers would be totally crazy to hire some other supplier, because Precision Castparts is so much more reliable and so much better.

Of course, we like the place with more competitive advantage. We're learning.

WARREN BUFFETT: The — to put it in terms of Economics 101 — basically, in reinsurance, supply has gone up and demand has not gone up.

And some of the supply is driven by investment managers who would like to establish something offshore where they don't have to pay taxes, and reinsurance is sort of the easiest beard — what you might call beard — behind which to actually engage in money management in a friendly tax jurisdiction.

And you can set up a reinsurance operation with very few people, by taking large chunks of what brokers may offer. It's not the greatest reinsurance in the world, and a couple of the operations that have done that have proven that statement to be right.

But nevertheless, it is a very, very easy way to have a disguised investment operation in a friendly tax jurisdiction. But that becomes supply in the reinsurance field, and supply has gone up relative to demand, and it looks to me like that will continue to be the case. And couple that with the poor returns on float, and it's not as good a business as it was.

11. Rise in auto death rate hurt GEICO

WARREN BUFFETT: Now we'll talk to an insurance man about it, Cliff Gallant.

CLIFF GALLANT: Thank you.

In terms of growth in profitability, GEICO really got whupped by Progressive Direct over the last year. In 2015, Progressive Direct's auto business group grew its policy count by 9.1 percent. GEICO, only 5.4. And in terms of profitability, the combined ratio at Progressive was a 95.1 and GEICO's was a 98.0.

Is this evidence that Progressive's investments in technology, like Snapshot, investments that GEICO has spurned, is it making a difference in a time of difficult loss trends? Why is GEICO suddenly losing to Progressive Direct?

WARREN BUFFETT: Yeah, well, I would say this. Over the — over the last — well, I forget what year it was we passed Progressive and what year it was we passed Allstate, but GEICO's growth rate in the first quarter was not as high as in the past couple first quarters, but it was it was quite satisfactory.

Now the first quarter is, by far, the best quarter for growth. But last year, both frequency — how often people had accidents — and severity — which is the cost per accident; in other words, just how much those accidents cost you — both of those went up quite suddenly and substantially. And Progressive's figures show that they were hit by that less than Allstate and GEICO and some others.

But I don't think you'll see, necessarily, those same trends this year.

It's an interesting thing. Last year, for the first time in I don't know how many years, the number of deaths in auto accidents, per 100 million miles, went up.

Now, if you go back to the mid-1930s, there were almost 15 people killed per 100 million miles driven. It got down to just slightly over one — from 15 — to one.

You had almost as many — you had roughly as many — people killed in auto accidents in the mid-1930s, about 30, 32,000 a year, as we had last year — or the year before — when people drove almost 15 times as many miles.

Cars have gotten far, far, far, far safer.

And it's a good thing, because if we'd had the same rate of deaths from auto accidents as we had in the '30s, relative to miles driven, we would have had over a half a million people die last year from auto accidents, instead of a figure closer to 40,000.

But last year, for the first time, there was more driving, and I think there was more distracted driving. So you really had this uptick in frequency, and more important, in severity.

GEICO has adjusted its rates. As I mentioned, my own prediction would be that the underwriting margins at GEICO will be better this year than last year, although you never know when catastrophes are coming along. March and April have had a lot of cat activity.

I made a bet a long time ago on — a mental one — on the GEICO model versus the Progressive model. And, as I say, they were significantly ahead of us in volume a few years back. Then we passed them and we passed Allstate and, as I put in the annual report, I hope on my 100th birthday that the GEICO people announce to me that they passed State Farm.

But I have to do my share on that, too, by getting to 100. So we'll see what happens on that particular one. (Laughs)

Charlie?

CHARLIE MUNGER: Well, I don't think it's a tragedy that some competitor got a little better ratio from one period. GEICO's quadrupled its market share since we bought all of it.

WARREN BUFFETT: Quintupled.

CHARLIE MUNGER: Yeah, quintupled, all right. (Laughter)

I don't think we should worry about the fact that somebody else had a good quarter.

WARREN BUFFETT: Yeah. (Applause)

I think it's far more sure that GEICO will pass State Farm someday than that I'll make it to 100, I'll put it that way. (Laughs)

12. Amazon has "disrupted plenty of people"

WARREN BUFFETT: OK. We'll go to the shareholder from station 2.

AUDIENCE MEMBER: Greetings to all of you from the Midwest of Europe. I'm Norman Rentrop from Bonn, Germany, a shareholder since 1992.

My question is about the future of salesmanship in our companies.

Warren, you have always demonstrated a heart for direct selling. When we met you in the midst of a tornado warning, in the barbershop, you immediately offered to write insurance for us. (Laughter)

WARREN BUFFETT: That's true. They were all huddled down there in the barbershop. There wasn't going to be any tornadoes, so I told them they give me a dollar, I'd — they can go upstairs and if anything happened to them I'd pay them — I forget — a million dollars, or something of the sort. (Laughter)

AUDIENCE MEMBER: Now we see with the rise of Amazon.com and others a shift from push marketing to pull marketing. From millions of catalogs having been sent out in the past, to now consumers searching on what they are looking for.

What is your take on how this shift from push to pull marketing will affect our companies?

WARREN BUFFETT: Well, Norman, the development you refer to is huge. I mean, really huge.

And it isn't just Amazon, but Amazon is a huge part of it and what they've accomplished, in a fairly short period of time, and continue to accomplish, is remarkable. The number of satisfied customers they've developed and —

We don't make any decision involving even the manufacturing of goods, the retailing, whatever it is, without thinking long and hard about what the world will look like in five or 10 or 20 years with that powerful trend — really hugely powerful trend — that you just described.

So, we're not — we don't look at that as something where we're going to try and beat them at their own game, you know. They're better than we are at that. And so, Charlie and I are not going to out-Bezos Bezos, by a long shot.

But we are going to think about that.

It does not worry us, obviously, with Precision Cast — it doesn't worry us, in terms of the overwhelming majority of our businesses.

But it is a huge economic trend that, 20 years ago, was not on anybody's radar screen, and lately, has been on everybody's radar screen. And many of them have not — and including us, in a few areas — have not figured the way to either participate in it or to counter it.

GEICO's a good example of a company in an industry that had to adjust to change, and some people made the change better than others.

We were slow on the internet. The phone had worked so well for us, you know, this traditional advertising, and the phone had worked so well, you know, there's always a resistance to think about new possibilities.

When we saw what was happening on the internet, we jumped in with both feet and you know, with mobile and whatever. But — but there are — capital — the nature of capitalism is somebody's always trying to figure — if you've got some good business — they're always trying to figure out how to take it away from you and improve on it.

And the effect — I would say just of Amazon, but others that are playing the same game — the effect on industry — the full effect — is far from having been seen.

I mean, it is a big, big force and it will — it already — has disrupted plenty of people and it will disrupt more.

I think Berkshire is quite well situated. For one thing, one big advantage we have is we didn't ever see ourselves as starting out in one industry. I mean, we didn't go into — we went into department stores — but we didn't think of ourselves as department store guys, or we didn't think of ourselves as steel guys, or tire guys, or anything of that sort.

So we've thought of ourselves as having capital to allocate. If you start with a given industry focus and you spend your whole time working on a way to make a better tire, or whatever it may be, I think it's hard to have the flexibility of mind that you have if you just think you have a large — hopefully large — and growing pile of capital, and trying to figure out what is the best — next — best next move that you can make with that capital. And I think we do have a real advantage that way.

But I think — I think the fellow that — I think Amazon's got a real advantage, too, in this intense focus on having, you know, hundreds of millions of, generally, very happy customers getting very quick delivery of something that they want to get promptly, and they want to shop the way they shop.

And if I owned a bunch of shopping malls, or something like that, that would be — I'd be thinking plenty hard about what they might look like 10 or 20 years from now.

Charlie?

CHARLIE MUNGER: Well, I would say that we failed so thoroughly in retailing when we were young that we pretty well avoided the worst troubles when we were old.

I think, net, Berkshire has been helped by the internet. The help at GEICO has been enormous. And it's contributed greatly to the huge increase in market share.

And our biggest retailers are so strong that they're — they'll be among the last people to have troubles from Amazon.

WARREN BUFFETT: I didn't get that dollar from you, Norman, actually that — after I gave you that wonderful advice.

13. Defending Coca-Cola from sugar health worries

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Thank you, Warren. Great to see you today.

Got a lot of questions on this particular topic, and this question is a particularly pointed one.

"Warren, for the last several years at this meeting, you've been asked about the negative health effects of Coca-Cola products, and you've done a masterful job dodging the question, by telling us how much Coke you drink personally. (Laughter)

"Statistically, you may be the exception. According to a peer-reviewed study by Tufts University, soda and sugary drinks may lead to 184,000 deaths among adults every year.

"The study found that sugar-sweetened beverages contributed to 133,000 deaths from diabetes, 45,000 deaths from cardiovascular disease, 6,450 deaths from cancer."

Another shareholder wrote in about Coke, noted that you declined to invest in the cigarette business on ethical grounds, despite once saying, quote, "It was a perfect business because it cost a penny to make, sell it for a dollar, it's addictive, and there's fantastic brand loyalty."

"Again, removing your own beverage consumption from the equation, please explain directly why we Berkshire Hathaway shareholders should be proud to own Coke."

WARREN BUFFETT: Yeah, I think people confuse — (Applause)

— you know, the amount of calories consumed.

I mean, I happen to elect to consume about 700 calories a day from Coca-Cola. So I'm about one-quarter Coca-Cola, roughly. (Laughter)

Not sure which quarter, and I'm not sure we want to pursue the question.

I think if you decide that sugar, generally, is something that the human race shouldn't have — I think the average person consumes something like 150 pounds of dry weight sugar here and 125 pounds — I mean, you know, it —

What's in Coca-Cola, largely, are more of the calories come from is sugar.

I elect to get my 26 or 2700 calories a day from things that make me feel good when I eat them. And that's been my sole test. That wasn't a test that my mother necessarily thought was great, or my grandfather.

But there are over 1.9 billion 8-ounce servings of some Coca-Cola drink. Now they have an enormous range of products, you know. I mean, you have a few that are called Coke, Diet Coke, Coke Zero and that sort of thing, but they have literally thousands of products.

One-point-nine billion. That's — what is that — 693,500,000,000 8-ounce servings a year, except it's a leap year. (Laughter)

That's almost 100 8-ounce servings per capita for 7 billion people in the world every year. And that's been going on since 1886.

And I would find quite spurious the fact that somebody says, if you're eating 3500 or so calories a day, and you're consuming 27-or-8 hundred, and some of the 3500 is Coca-Cola, to lay it — any particular obesity-related illnesses — on the Coca-Cola you drink.

You have the choice of consuming more than you use, I mean. And I make a choice to eat — or get — 700 calories from this, and I like fudge a lot, peanut brittle.

And I am a very, very, very happy guy and I don't know — I think — and I'm serious about this — I think if you are happy every day, you know, it may be hard to measure, but I think you're going to live longer as well. So there may be a compensating factor. (Applause)

And I really wish I'd had a twin, and that twin had eaten broccoli his entire life, and we both consume the same number of calories. I know I would have been happier. And I think the odds are fairly good I would have loved longer.

I think Coca-Cola is a marvelous product, you know. I mean, if you consume 3500 or 4000 calories a day, and live a normal life, in terms of your metabolism, you know, something's going to go wrong with your body at some point.

But if you keep — I think if you balance out the calories so that you don't become obese, I do — I have not seen evidence that convinces me that, you know, I'll make it — it will be more likely I reach 100 if I suddenly switch to water and broccoli.

Incidentally, a friend of mine, Arjay Miller, a remarkable man — born about 100 miles from here, west — eighth child — near Shelby, Nebraska.

He said Shelby's population was 596 and it never changed because every time some girl had a baby a guy had to leave town, it was a very stable. (Laughter)

But Arjay went on to be president of Ford Motor Company, from this farm near Shelby, and he had his 100th birthday on March 4th of this year. So I went out to see Arjay for his birthday on March 4th, and Arjay told me that there were 10,000 men in the United States that had lived to be 100 or greater, and there were 45,000 women that were 100 or greater.

So I came back and I checked that on the internet — I went to the census figures — and sure enough, that is the ratio. There's 10,000 men over 100, roughly, and 45,000 women.

So if you really want to improve your longevity prospects, I mean a guy in my position, you have a sex change. (Laughter)

I mean as a — you're 4 1/2 times more likely to get to be 100.

That sounds like one of those studies that people put out. It's just a matter of facts, folks.

I think I'll have Charlie go first, though, on that one. (Laughter)

Charlie, do you have any comments?

CHARLIE MUNGER: Well —

WARREN BUFFETT: Have some fudge.

CHARLIE MUNGER: I like the peanut brittle better than the Coke. I drink a lot of Diet Coke and — I think the people who ask questions like that one always make one ghastly error that's really inexcusable. They measure the detriment without considering the advantage.

Well, that's really stupid. That's like saying we should give up air travel through airlines because 100 people die a year in air crashes or something. That would be crazy. The benefit is worth the risk.

And if every person has to have about 8 or 10 glasses of water every day to stay alive, and it's pretty cheap and sensible, and it improves life to have a little extra flavor to your water, and a little stimulation, and a little calories, if you want to eat that way, there are huge benefits to humanity in that, and it's worth having some disadvantage.

We ought to have, almost, a law in the editorial — I'm sounding like Donald Trump — (laughter) — where these people shouldn't be allowed to cite the defects without citing the offsetting advantage. It's immature and stupid. (Applause)

14. Renewable energy investments

WARREN BUFFETT: OK. Gregg Warren.

GREGG WARREN: Warren, with both coal fired and natural gas plants continuing to generate around two-thirds of the nation's electricity, and renewables accounting for less than 10 percent, there remains plenty of room for growth.

At this point, Berkshire Energy, which has invested heavily in the segment, is one of the nation's largest producers of both wind and solar power, and yet still only generates around one-third of its overall capacity from renewables.

As you noted earlier, MidAmerican recently committed another $3.6 billion to wind production, which should lift the amount of electricity it generates from wind to 85 percent by 2020.

You've also had the company, overall, pledging to have around 30 billion in renewables longer term.

The recent renewal of both the wind and solar energy tax credits has made this kind of investment more economically viable and should clear the path for future investments.

Eliminating coal-fired plants looks to be the main priority, but natural gas-fired plants are also fossil fuel driven and are exposed to the vagaries of energy prices.

Is the endgame here for Berkshire Energy to get 100 percent of its generation capacity converted over to renewables, and what are the risks and rewards associated with that effort?

After all, the company operates in a highly-regulated industry, where rates are driven by an effort to keep customer costs low, while still providing adequate returns for the utilities.

WARREN BUFFETT: Yeah, well, I think implicit in what you say is that we do — any decision we make — including the one that we just showed on the — during the movie to — on any decision about new generation, changes in generation — has to go through what's usually called the Public Utility Commission, they may have different names in a few states.

But the utility industry is overwhelmingly regulated at the state level, and we cannot make changes that are not approved by the Public Utility Commission.

We've had more problems, for example, in bringing in renewables in our western utility, Pacific Corp, because it's, in effect, regulated by six states — I believe it's six states — and they don't necessarily agree on how the cost and benefits should be divided if we put in a bunch of renewables, and we have to follow their instructions.

Iowa was just been marvelous about encouraging — I mean at every level — I mean the consumer groups, the governor, you name it — they have seen the benefits.

And in Iowa it's literally true that we have one major competitor, called Alliant, and they have not — either been able to — I don't know the reasons — but they have not pursued renewables the way we have, so our rates are considerably lower than theirs.

And, if you look at their budget projections — although they're substantially higher rates than we have now — they may well need a rate increase within a year or so.

And with our latest expansion, we have said that we will not need a rate increase till 2029 at the earliest. That's thirteen years off.

So there've been great benefits if you have a regulation that works with you on that, but it is a determination that is made at the state level.

Now, the federal government has encouraged, in a major way, the development of renewables by this production tax credit, which currently amounts to about 2.3 cents per kilowatt hour.

We would not have the renewable generation that we have if it hadn't been for the fact that that building of those projects is subsidized by the federal government, because the benefits of reducing solar emissions are — or carbon emissions — are worldwide, and therefore it's deemed proper that the citizenry as a whole should participate in subsidizing the cost of reducing those emissions.

And that has encouraged — in fact, it's allowed — things like have happened in Iowa as well.

But the degree to which the renewables replace, primarily coal — although there's plenty of emissions connected with natural gas if you trace it all the way through — will depend on governmental policy.

And I think, so far, I think it's been quite sensible in encouraging — having the cost borne by society as a whole, in terms of reduced tax revenues, and having the benefits, which is less CO_2, into the atmosphere.

They also, broadly — you know, they're not just limited to the people of Iowa when we build that. That's a benefit that accrues to the world.

I think you'll see continued change. It will vary by jurisdiction.

And we would hope — we've got the capital, we've got lots of taxes, federal taxes, paid in our consolidated returns — so we're in a particularly advantageous position to take advantage of massive investments that companies with limited tax appetites couldn't handle.

I think you'll see us be a very big player. But governmental policy is going to be, you know, the major driver.

Charlie?

CHARLIE MUNGER: Yeah, I think we're doing way more than our share of shifting to renewable energy, and we're charging way lower energy prices to our utility customers than other people.

If the whole rest of the world were behaving the way we are, it would be a much better world.

I will say this about the subject, though, and that is that I think that the people who worry about climate change as the major trouble of Earth don't have my view.

I think that we — I like all this shifting to renewables, but I have a different reason. I want to conserve the hydrocarbons, because eventually, I think, we're going to use every drop, humanity, for chemical feedstocks. And so I'm in their camp, but I've got a different reason.

WARREN BUFFETT: One thing you'll find — might find — kind of interesting: Nebraska has not done much with wind power. And maybe three miles from — two miles — from where we're sitting, right across the river, people are buying their electricity cheaper, in Council Bluffs right across the river, than they are in Omaha.

And yet Omaha — Nebraska is entirely a public power state, so there's no stockholders who have to have any earnings, the bonds are issued on a tax-exempt basis, and yet electricity is considerably cheaper right across the river.

And, you know, the wind blowing doesn't just start at the Missouri River. I mean, it comes across Nebraska and that wind could be captured. And, so far, it really hasn't.

And the real irony is that because our electricity is so much cheaper in Iowa, you have these massive server farms of people like Google. It's become a tech haven for these operations that just gobble up electricity. And Iowa has gotten plant after plant after plant and job after job after job, and increased property tax — I mean gotten more property tax revenues — and that's being done — the Google server is probably seven or eight miles from here — and it's located in Iowa because we have cheap wind-generated electricity. And it's creating jobs. It's fascinating.

Nebraska has prided itself on public power. It was originated back, I believe, in the '30s when George Norris was a very powerful senator here and it's been a source of pride. But lately, it's been a source of cost, too.

15. Derivatives still a "danger to the system"

WARREN BUFFETT: OK, shareholders section 3.

AUDIENCE MEMBER: Good morning Mr. Buffett and Mr. Munger. My name's Adam Bergman. I'm with Sterling Capital in Virginia Beach.

In your 2008 shareholder letter, you said, "Derivatives are dangerous… They have made it almost impossible for investors to understand and analyze our largest commercial banks and investment banks."

So my question for you is: how do you analyze and value companies like Bank of America Merrill Lynch and other commercial banks that Berkshire has investments in, relative to their significant derivative exposures? Thanks.

WARREN BUFFETT: Yeah, derivatives do complicate the problem very dramatically.

Now, they are moving away to being collateralized, which helps.

But there's no question that if you asked me to describe the derivative position of the B of A, for example, I would know that they have done a conscientious job and worked hard at properly evaluating.

But the great danger in derivatives is if there's a discontinuity. If there's not discontinuities, you probably don't have much of a problem, assuming they get marked to market, and collateralized, and so on.

But if the system stopped for a while — the system stopped after 9/11 for three or four days. It stopped at the time of World War One. They closed the New York Stock Exchange for many months.

They debated closing the stock exchange, very seriously, the day after October 19, 1987. And it was — there were a lot of people that wanted to close it. And on that Tuesday morning, it looked like it was about to stop, but it continued.

But if you had a — if you have a major cyber, nuclear, chemical, biological, attack on the country — which will certainly happen at some point — if you have a major discontinuity, then you'll have a lot of problems, a lot of problems.

But you will also — when things reopen — you will find there can be enormous gaps in things that you thought were fully protected by collateral, and that sort of thing, or netting arrangements, and that type of thing.

So I regard very large derivative positions as dangerous.

We inherited a modest- sized position at Gen Re and, in a benign market, we lost about $400 million, just in trying to unwind it, with no pressure on us whatsoever.

So I do think it continues to be a danger to the system.

CHARLIE MUNGER: By the way, the accountants blessed that big derivative position as being worth a lot of money. They were only off, what, many hundreds of millions.

WARREN BUFFETT: Yeah, well. Charlie found one position when he was on the audit committee at Salomon. I think it was mismarked by $20 million.

I actually, by happenstance, happen — I do know of one incredibly mismarked position — doesn't affect any of our operations — but it almost staggers the mind to know the way that position is marked. And you can only come to the conclusion that some trader got somehow — influenced whoever did mark it, or marked it himself, heaven forbid, and probably just influenced someone.

Or they didn't know enough. Some of these things get so complicated, they are very hard to evaluate. That's the kind that have the most profit in them, usually, so they were quite enthusiastic about those when we were at Solomon.

They can be extraordinary hard to mark. And, like I say, I know one that's so mismarked it would blow your mind.

And, you know, the auditors, I don't think, are necessarily capable of holding that behavior in check.

It's very interesting, because now there's really four big auditing firms, and obviously, they're auditing companies where there's a derivative position, and they're auditing company A that's on one side of the transaction, and they're auditing company B that's on the other side of the transaction. In some cases, it's the same auditor.

And I will guarantee you that there's plenty of times when the marks on what they're attesting to are significantly different, which would be an interesting exercise to pursue, in terms of checking those numbers out.

Derivatives are still dangerous, in large quantities, and we have — we would not do them, on a collateralized basis, because if there was a discontinuity, I don't know exactly where we would end up, and I'm never going to get us in a position where we could have money demanded of us and not be able to fulfill it with ease, and with me sleeping well.

So we won't engage in it. We've got some in runoff, but so far we've made money and had the use of money for a decade or more, and it's been very attractive for us. But that does not entice me, at all, into doing any derivative transactions that would involve collateral, when collateral is not required.

It's still a potential time bomb in the system.

Anything where discontinuities — and basically that means closing up and stopping trading markets from functioning — anything where discontinuities can exist, can be real poison in markets.

Kuwait, some years ago, went to a very delayed system on settlement of stock purchases, so they didn't have to settle up for six months or thereabouts. And it caused all kinds of problems, because, you know, you've got an IOU from somebody for six months and if you got zillions of those, a lot of trouble can ensue.

So I agree with your general caution. I'm not in the least troubled by our Bank of America investment, nor our Wells Fargo — we added to Wells Fargo — and our Bank of America position, right now, is a preferred stock, but we're very likely to exercise the warrants on that.

On the other hand, there are a great number of banks in the world. If you take the 50 largest banks in the world, we wouldn't even think about probably 45 of them. Wouldn't you say that, Charlie?

CHARLIE MUNGER: Well, we're in the awkward position where I think we'll probably make about $20 billion out of derivatives, and just those few contracts that you and Ajit [Jain] did years ago.

All that said, we're different from the banks. We would really prefer it if those derivatives had been illegal for us to buy. It would have been better for our country.

16. Float still "useful" despite low interest rates

WARREN BUFFETT: Carol?

CAROL LOOMIS: This questions relates to something that Warren briefly said earlier today. The question comes from Lynn Palmer, who is just finishing her freshman year at a Houston, Texas high school.

"My question," she says, "concerns the float generated by Berkshire's insurance companies. In Mr. Buffett's 2015 annual letter, he said that the large amount of float that Berkshire possesses allows the company to significantly increase its investment income.

"But what happens when interest rates decline? If the U.S. were to implement negative interest rates in the same way that the eurozone and Japan have done, how would Berkshire be affected?"

WARREN BUFFETT: Yeah, well some of our float actually exists in Europe, where we have the problem of negative interest rates on very high-grade and short-term and medium — even medium-term bonds — and obviously anything that reduces the value of having money is going to affect Berkshire, because we're always going to have a lot of money.

We — because we have so much capital, and so many sources of earning power, we have the ability, quite properly, to use our float in — to a certain degree — in ways that most insurance companies can't think about.

So we can find things to do, but sometimes we get, you know we — we've got fifty-odd billion of short-term government securities now, and we're going to get another $8.3 billion, in all likelihood, early in June when our Kraft Heinz preferred is called, so we'll be back over 60 billion again very soon.

So we've got 60 billion out, that's out at, say, a quarter of 1 percent. Well, the difference between a quarter of 1 percent and minus a quarter of 1 percent, you know, is not that great. I mean, it's almost as painful to have 60 million out at a quarter of a percent, as to have it out at a negative rate.

Float is not worth as much to insurance companies now as it was 10 years ago or 15 years ago. And that's true at Berkshire. I think it's worth considerably more to us than it is to the typical insurance company, because I think we have a broader range of options as to what to do with it.

But there's no question about it, that having a lot of money around now is not just a problem for insurance companies. It's a problem for retirees. It's a problem for anybody that's stuck with fixed-dollar investments and finds that their income now is a pittance or, you know, in Europe, perhaps a negative rate. And that was not something in their calculation at all 15 years ago.

We love the idea, however, of increasing our float. I mean that money has been very useful to us over time.

It's useful to us today, even under present conditions, and it's likely to be very useful to us in the future. It's shown as a liability, but it's actually a huge asset.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

WARREN BUFFETT: He's now in full swing. (Laughter)

17. We still love BNSF despite falling coal shipments

WARREN BUFFETT: Jonathan?

CHARLIE MUNGER: We can't hear you.

JONATHAN BRANDT: Testing. The railroad industry seems, right now, to be suffering from exposure to some of the weakest parts of the economy, with volume declines of varying magnitudes in coal, oil, sand, and metals. Even intermodal, usually a steady source of growth, has been relatively weak of late.

How much of the weakness is cyclical, how much is secular?

In the last 15 months, the other western railroad's market capitalization is down by 30 — 35 percent — as projections of future growth have come down.

Is your estimate of BNSF's intrinsic value down by a material amount during the same period, or is your view of the value of BNSF's irreplaceable network unaffected by these short-term wiggles?

WARREN BUFFETT: Well, I would — certainly the decline in coal — which is a very important commodity — it's about 20 percent of revenues — that's secular.

Now, there's other factors that may cause the line of decline to jiggle around. We had a very mild winter, and we went into the winter with utilities carrying unusual amounts of coal.

And ironically, part of the reason for that was that our service the year before had been bad and they'd gotten low on coal, so then they compensated by bringing in more than they needed, just to catch up. And because the weather was mild, electricity use was poor in the winter time. And so they continue, at this point, to have considerably more coal on hand than they would like.

So they are not only — they're trying to under order what they will be using, and that has a little effect. But the decline in coal, for sure, is secular. And at 20 percent of revenues, that's a significant factor.

But — and it's true that the market, generally, got very enthused about railroad stocks a year or two ago, so they sold up a lot. And now that people have seen that car loadings are down and earnings are down, in some places, that equity valuations have come down.

We don't — we love the fact we own BNSF. We think we bought it at an attractive price. We'd love to be able to buy a second thing exactly like it at that price. We'd do it in a second. We'd even pay a little bit more, probably.

But we don't mark up, and down, our wholly-owned businesses, based on stock market valuations.

Obviously, stock market valuations are some factor in our thinking, but we are not marking our wholly-owned businesses to market because we know we're going to hold them forever. And we regard BNSF as a very good business to hold forever.

But it will it will lose coal volume and, you know, it may lose in other areas, but it will gain in other areas. It's a terrific and valuable asset, and it will learn a lot of money this year, but it won't earn as much money as it earned last year.

Charlie?

CHARLIE MUNGER: I've got nothing to add.

18. Don't envy people making money from risky behavior

WARREN BUFFETT: OK. Station 4.

AUDIENCE MEMBER: Hi, Warren. Hi, Warren and Charlie. Great to see you. This is Cora and Dan Chen from Taulguard Investments of Los Angeles.

This annual meeting reminds me of the magical world of Hogwarts, of Harry Potter. This arena is our Hogwarts. Warren, you are our Headmaster and Professor Dumbledore. (Laughter)

WARREN BUFFETT: I haven't read Harry Potter, but I'll take it as a compliment. (Laughter)

AUDIENCE MEMBER: Charlie is our Headmaster Snape, direct, and full of integrity.

The magic of long-term, concentrated, value investing is real, yet similar to Harry Potter, the rest of the world doesn't believe we exist.

Your letter to me has changed my life. Your "Secret Millionaire's Club" has changed my children's life. They go to class chatting about investing.

My question is for my children watching at home today and the children in the audience.

How should they look at stocks, when every day in the media they see companies that have never made a dime in their life go IPO?

They're dilutive and they see a lot of very short-term spin. The cycle is getting shorter and shorter.

How should they view stocks, and what's your message for them?

Finally, Cora and I would love to thank you in person and shake your hand personally today. I'll repeat what I said last year: thank you for putting — setting — the seeds for my generation to sit in the shade, and for my children's generation to sit in the shade with the "Secret Millionaire's Club."

I truly walk amongst giants. Thank you.

WARREN BUFFETT: Would you mind repeating the whole thing? (Laughter)

"The Secret Millionaire's Club," we want to give great credit to Andy Heyward on that. I think it has helped — I know it's helped — thousands and thousands of children and Andy — it was Andy's idea — and it grows in strength.

And having young children learn good lessons, in terms of handling money, and making friendships, and just generally behaving as better citizens is a great objective, and Andy makes it easy for them to do. So, on his behalf, I accept your comments.

You don't really have to worry about, you know, what's going on in IPOs, or people making money.

People win lotteries every day, but there's no reason to have that effect you at all. You shouldn't be jealous about it.

I mean, you know, if they want to do mathematically unsound things, and one of them occasionally gets lucky, and they put the one person on television, and the million that contributed to the winnings, with the big slice taken out for the state, you know, don't get on — it's nothing to worry about.

Just, all you have to do is figure out what makes sense. And you don't — you look at buying — when you — when you buy a stock, you get yourself in the mental frame of mind that you're buying a business, and if you don't look at a quote on it for five years, that's fine.

You don't get a quote on your farm every day or every week or every month. You don't get it on your apartment house, if you own one. If you own a McDonald's franchise, you don't get a quote every day.

You know, you want to look at your stocks as businesses, and think about their performance as businesses. Think about what you pay for them, as you would think about buying a business.

And let the rest of the world go its own way. You don't want to get into a stupid game just because it's available.

And I'm going to say a little more about that close to the break. But with that, I'll turn it over to Charlie.

CHARLIE MUNGER: Yeah, well, I think that your children are right to look for people they can trust in dealing with stocks and bonds.

Unfortunately, more than half the time, they will fail, in a conventional answer. So you — they really have to — they have a hard problem. If you just listen to your elders, they'll lie to you and make — spread — a lot of folly.

WARREN BUFFETT: But they really have an easy problem, in the sense that American business, as a whole, is going to do fine over time. So the only way they can —

CHARLIE MUNGER: But not the average client of a stock broker.

WARREN BUFFETT: Well, we'll get to that later. (Laughs)

The stockbroker will do fine. The — (laughter)

CHARLIE MUNGER: Yes, that's true.

WARREN BUFFETT: But, they don't have to do that and we can talk — I'd rather address that just a little later.

But — just — you don't want to worry — you don't want to be — a lot of problems are, as Charlie would say, are caused by envy. You don't want to get envious of somebody who's won the lottery, or bought an IPO that went up. You have to figure out what makes sense and follow your own course.

19. Nevada utility customers shouldn't have to subsidize solar power

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from a shareholder named Lisa Kang Le (PH) in Singapore. And this has to do with NV Energy's issue with solar energy in Nevada.

"Can the chairman help his environmentally conscious shareholders understand why NV Energy has lobbied for new rules in Nevada that make it prohibitive for households to use solar energy? Is there a good reason that we haven't yet heard about?

"And can the chairman or vice chairman share their views on whether there's a need to implement an environmental, social, and governance policy, on Berkshire investments going forward?

"I understand that Berkshire Hathaway typically lets the underlying operating companies and CEOs manage their own policies autonomously, but should Berkshire's board influence better environmental protection policies going forward?"

WARREN BUFFETT: Well, the public utility and the pricing policies and everything in Nevada, as well as other places, but they're determined by a public utility commission. So, there are, I believe, three commissioners that decide what's proper.

The situation in Nevada is that, in terms of rooftop power, was that for the last few years, if you had a solar project on your roof, you could sell back excess power you generated to the grid at a price that was far, far, far above what we, as a utility, could buy it for elsewhere.

So, you could sell it back, we'll say, at roughly 10 cents a kilowatt hour. And about 17,000 — maybe a few more now — about 17,000 people had rooftop installations.

Now they get — there were federal credits involved, but those usually got sold to other people, in terms of tax credits.

So they were being subsidized by the federal government, and that encouraged solar generation, as it's encouraged us to do solar generation and wind generation, as well.

But the people who had these 17,000 rooftop installations were selling back to the grid at 10 cents, roughly, a kilowatt hour, energy we could purchase or produce — either — but purchase elsewhere, too — for 3 1/2 cents, or thereabouts.

So, 99 percent of our consumers were being asked to subsidize the 1 percent that had solar units, by paying them a significantly — triple the market price, basically — of what we could otherwise buy electricity to sell to the 99 percent.

So then it's just a question of whether you wish to have the 99 percent subsidize the 1 percent.

And the public utility commission in Nevada, they had originally let this small amount of rooftop solar generation be allowed as an experiment with this 10 cent, roughly 10 cent, rebate.

And they decided that they did not believe that the 99 percent should be subsidizing the 1 percent.

There may — there's no question — that for solar to be competitive, just like wind, it needs subsidization. Costs are not yet at a level where it becomes competitive with natural gas, for example.

And who pays the subsidy gets to be a real question, if you want to encourage people to use renewables.

And, in general, the federal government has done it through tax subsidies, which means taxpayers, generally, throughout the country subsidize it.

And the public utility commission in Nevada decided that after seeing this experiment, they decided that it was not right for a million — well over a million — customers to be buying electricity at a price that subsidized the 17,000 people, and therefore increase the prices of electricity for the million.

And that question of who subsidizes renewables, and how much, is, you know, going to be a political question for a long time to come.

And I personally think that if society is the one that's benefiting from the lack of — reduction of — greenhouse gases, that society should pick up the tab.

And I don't think that somebody sitting in a house in someplace in Nevada, we'll call it Las Vegas, but it could be other cities because we serve most of Nevada, should be picking up the subsidy for their neighbor, and the public utility commission agrees with that.

I think we have Greg Abel here who — NV Energy is a subsidiary of Mid-American — of Berkshire Hathaway Energy.

Greg, was there anything you want to add? Can we get a spotlight down here? Maybe?

It's not live.

GREG ABEL: I think it's on now.

So, as usual Warren, you summarized it extremely well. When we think of Nevada, it's exactly as you described. I would just add a few things.

One: as you've touched on earlier, we absolutely support renewables. So we start with the fundamental concept that we are for solar. But, as you highlighted, we want to purchase renewable energy at the market rate, not at a heavily subsidized rate that 1 percent of the customers will benefit from and harm the other 99 percent.

And it goes back to being as fundamental as this: if you take, as you touched on, a working family in Nevada who can't afford the roof top unit and you ask him, "Do you want to subsidize your neighbor, that 1 percent?" the answer is clearly no.

At the same time, we're absolutely committed to Nevada utilizing renewable resources, and absolutely proud of what our team's doing. By 2019, we will have eliminated or retired 76 percent of our coal units and be replacing it with solar energy. So we're on a great path there. Thank you. (Applause)

And we're just going to encourage our team. And with the work of the commission, and obviously led by the state, we'll head down a great path. Thank you.

WARREN BUFFETT: Yeah, if the projectionist would put up slide 7, it will give you a view of what the situation is.

This counts all of our all our Berkshire Hathaway Energy operations, and you can see, in a 20-year period we'll have a 57 percent reduction.

You wouldn't want a 100 percent reduction tomorrow. Believe me, the lights would be off all over the country. But it's moving at a fast pace.

But, you do — you want to be sure that you treat fairly the people involved in this, because somebody pays the cost of electric generation.

And I do think that if you're doing something that's to benefit the planet — and it's important that it be done — but that you have the cost be assessed for that, not on a specific person who's having trouble, perhaps, making ends meet in their job.

And obviously, if you've got over a million customers in Nevada, a lot of them are struggling. A lot of them are going fine, too. But they are not the ones, in my view, to subsidize the person who could afford to put the solar unit in.

20. We don't buy or sell based on commodity price predictions

WARREN BUFFETT: OK. Cliff?

CLIFF GALLANT: Over the past year we've learned — perhaps I've learned — that Berkshire's results are more influenced by oil markets than I previously appreciated. Revenues at the railway company and some of Berkshire's manufacturing businesses were negatively impacted. And arguably, low gas prices hurt GEICO's loss ratio.

Yet during this year, Berkshire invested in Phillips 66, Kinder Morgan, and even PCP has revenues associated with the oil and gas industries.

I know Berkshire wouldn't make a bet on a commodity like oil, but is Berkshire making a statement about the long-term outlook for oil?

WARREN BUFFETT: Making a statement about what?

CLIFF GALLANT: Oil.

WARREN BUFFETT: The price? The price of oil?

CLIFF GALLANT: Yes.

WARREN BUFFETT: No. We haven't the faintest idea what the long-term price of oil was and there's always a better system available.

You can buy oil, as you know, for delivery a year from now, or two years from now, or three years from now. We actually did that once, Charlie, didn't we? Some years back.

CHARLIE MUNGER: Cashed it in too soon, too.

WARREN BUFFETT: Yeah. We made money but we could have made a lot more money.

We don't think we can predict commodity prices. We don't hedge cocoa or sugar (inaudible). We do some forward buying of chocolate coatings or something of the sort.

But basically, we are not two fellows who think we can predict the price of soybeans or corn or oil or anything else.

So, anything you have seen in our investment transactions — some of those securities you mentioned there were bought by Todd or Ted, and one was bought by me — but neither they nor I bought those, or if we sell them, sell them, based on commodity price predictions.

We don't know how to do it. And we're thinking about other things when we make those decisions.

Charlie?

CHARLIE MUNGER: I'm even more ignorant than you are.

WARREN BUFFETT: That would be hard to beat. (Laughs)

OK. I think that's the first time I've heard him say that. It has a nice ring to it. (Laughter)

21. Don't expect efficiency in higher education

WARREN BUFFETT: OK, station 5.

AUDIENCE MEMBER: Hi Warren. Hi Charlie.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: I'm Ken Martin. I'm an MBA student from the Tuck School at Dartmouth.

My question is about college tuition and the problem of rising student debt balances.

In the past, prominent philanthropists have founded institutions that are now prominent research universities in our country. Why is this not a bigger part of today's philanthropic debate, the founding of new colleges? Would not new supply in higher education be at least part of the solution to this problem?

WARREN BUFFETT: Charlie, you want to tackle that one? You're more of an expert than I am.

CHARLIE MUNGER: Yeah. I think that if you expect a lot of efficiency — financial efficiency — in American higher education, you're howling at the wind. (Laughter and applause)

WARREN BUFFETT: Well. I think he's also talking about just more philanthropy to deliver there. Am I right?

Want to give him the light back on there?

AUDIENCE MEMBER: Yeah, that's right.

CHARLIE MUNGER: What's the question again?

WARREN BUFFETT: The question about is — maybe — whether more philanthropy ought to be devoted to that relatively because of the cost. But —

CHARLIE MUNGER: Well, I do a lot more than Warren does in this field — (laughs) — and I am frequently disappointed but — (Laughter)

Monopoly has kind of — and bureaucracy — have kind of pernicious effects everywhere, and the universities aren't exempted from it.

But of course, they are the glory of civilization, and if people want to give more to it, why, I'm all for it.

WARREN BUFFETT: Yeah, it — you know, you've got the option of very good state schools and — we spend a lot of money on education in this country.

You know, if you just take — you take kindergarten through twelve, it's interesting. People talk about entitlements in this country. They say it's terrible we have all these entitlements for Social Security and everything.

We have entitlements for the young. We spend $600 billion a year educating 50 million kids in the public schools between kindergarten and twelfth grade, and just think what that is as an entitlement.

Nobody ever seems to bring that up. But it's a huge — and I believe in it, obviously, but — you know, the people in their working ages, generally speaking, I think have an — in a rich society — have an obligation to both the young and the old.

And based on the amount we spend, if we have problems with our school system it's not because we're cheap. No, there are other problems that contribute to it. In terms of the money we put out, we're right up there. (Applause)

But I was the trustee of a college that saw the endowment go from $8 million to over a billion. And I didn't see the tuition come down. And I didn't see the number of students go up.

CHARLIE MUNGER: Nothing went up, except the professors' salaries.

WARREN BUFFETT: Yeah. From 8 million to a billion. I mean — and very, very decent people running the place.

But when you read the figures on endowment of the big schools, you know, and some of them have really got up in the big numbers, the main objective of the people running the endowment is to have the endowment grow larger. And that will be ever thus. That is the way humans operate.

You have any more comments on that, Charlie? You've seen a lot.

CHARLIE MUNGER: I've made all the enemies I can afford at the moment.

WARREN BUFFETT: OK. (Laughter.)

That's never slowed him down in the past. (Laughter)

22. Berkshire will "do fine" if Trump or Clinton wins

WARREN BUFFETT: Andrew.

ANDREW ROSS SORKIN: Thank you, Warren. This from a shareholder who asked to remain anonymous.

"If Donald Trump becomes the president of the United States, and recognizing your public criticism of him and your public support for Hillary Clinton, what specific risks, regulatory, policy, or otherwise, do you foresee for Berkshire Hathaway's portfolio of businesses?

WARREN BUFFETT: That won't be the main problem. (Laughter and applause)

Well. Government, you know, is a very big factor in our business and in all businesses. I mean, there's the very broad policies that affect practically everybody, and sometimes there can be some pretty specific policies.

But, I will predict that if Don — either Donald Trump or Hillary Clinton becomes president — and one of them is likely to be — very likely to be — I think Berkshire will continue to do fine.

Charlie?

CHARLIE MUNGER: I'm afraid to get into this area. (Laughter)

WARREN BUFFETT: Yeah. We've operated under all — I mean, we've operated under price controls. I mean, there —

We've had 52 percent federal taxes applied to our earnings for many years. Even high — I mean, they were higher at other times — but there — you know, we've had regulations come along and, in the end, business in this country has done extraordinarily well for a couple of hundred years, and it was adapted to the society and the society has adapted to business.

This is a remarkably attractive place in which to conduct a business. Imagine, in a world of practically zero interest rates, you know, American business earning terrific returns on tangible cap — equity. I mean, those are the assets that were actually employed in the business. The numbers are staggering.

And, you know, people who have had their money in savings accounts or something like that get destroyed.

But owners of business, if you look at returns on tangible equity, just check them out some time, and they have not suffered even as people who own fixed-interest — fixed-income — instruments have suffered enormously.

And, you know, farm prices are down now. Farmer income has fallen off a lot in the last couple of years.

But business has managed to take care of itself. And for a good reason, because it contributes to, and has been the engine of, our market economy that's delivered output that is staggering by the imagination of anyone that might have existed 100 years ago.

In my lifetime, the GDP per capita, in real terms, of the United States, has gone up six-for-one. Can you imagine a society where in one person's lifetime, overall, people have six times the real output that they had at the beginning.

It's — you know, the system works very well in terms of aggregate output. In terms of distribution of that output, sometimes it can fall very short, in my view. But, it'll keep working. You don't have to worry about that.

Twenty years from now, they'll be far more output per capita in the United States, in real terms, than there is now. In 50 years, it will be far more. It'll — and the quality will get better.

And no presidential candidate or president is going to end that. They can shape it in ways that are good or bad, but they can't end it.

Now Charlie, give something pessimistic here to balance me out.

CHARLIE MUNGER: No, I want to say something optimistic.

I think that the GDP figures greatly understate the real advantage that our system has given our citizens. It underweighs a lot of huge achievements because they don't translate right into money in a certain way that the economists can easily handle.

But the real achievements over the last century, say, are way higher than are indicated by the GDP figures, and the GDP figures are good.

I don't think the future is necessarily going to be quite as a good as the past. But it doesn't have to be.

WARREN BUFFETT: There's no one you'll run into, at least in my experience, that says, "With my same talents, I wish I'd lived 50 years ago instead." Born 50 years earlier.

But a majority of the American public thinks that it's a bad time to be born today compared to when they were born. They think their children will not — they're wrong. I mean, it's — the pace of innovation — just think how different you're living compared to 20 years ago, in terms of what you do with your time.

Now, a lot of people may condemn it, or something of the sort, but you're making free choices that were not available to you 20 years ago and you're making them in a different direction than —

I'm still staying with the landline, but you people are way ahead of me. (Laughs).

23. BNSF CEO doesn't see rail mergers in near future

WARREN BUFFETT: OK. Gregg?

GREGG WARREN: Warren. Late last year we saw Canadian Pacific make a hostile bid for Norfolk Southern, a combination that would have linked Canada's second largest carrier with one of the two largest railroads in the eastern U.S.

This move led to a largely negative reaction from not only Norfolk Southern, but from federal and state lawmakers, shippers, and other railroad operators, even though a formal evaluation process hadn't even begun with the U.S. Surface Transportation Board. Canadian Pacific eventually backed down.

Looking back to 1999, when the Transportation Board blocked a proposed merger between BNSF and Canadian National, the attitude was that any additional mergers amongst railroads would have to be accretive to competition.

What do you think they meant by this? And if one believes that the hookup of one of the two major western railroads with one of the two eastern railroads would not alter the current landscape, where most shippers have just two choices amongst the large railroads operating in the region, and could actually generate efficiencies and cost savings that could be passed along to customers, how does a combination of someone like BNSF with Norfolk Southern or CSX not satisfy their goal?

WARREN BUFFETT: I — I think now there's — and is Matt Rose, is he here? He can probably answer that — some of that — better than I can — certainly. He can answer all of it better than I can.

Yeah. There's Matt. Yeah.

MATT ROSE: Yeah. So, the statement is actually right.

Back in 1999, we had a failed merger with Canadian National. New rules were put in place by our regulator, a little group called the STB, and what they said was that the public litmus test for the next merger would have to be different.

And, at that point in time we didn't really think that a large merger was possible. And so, when Canadian Pacific announced their merger of the Norfolk Southern, when we think about our four constituencies, and those four are our customers, the labor groups, the communities in which we serve, and shareholders, which, our shareholder, of course, is BRK, we didn't see any interest in the final round of these mergers occurring outside of the shareholder community.

And so our position was simply to say, if the rest of the shipping community believes that we ought to see this final round, that's fine, we'll participate, but we don't see it occurring right now.

We do believe that when that final round occurs, there will be great efficiencies made for shippers and communities, but right now we don't see the dynamics in place.

So, what are those dynamics? It will be as the country continues to grow in population from where we are today, 315 million people, to, say, 320, 330, 350, transportation becomes more scarce and the railroads will need to do more. And that's really when we think the next round will occur.

24. Berkshire indifferent to Wells Fargo's investment banking

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Hi, my name is Michael Mozia. I'm from Brooklyn, New York and I'll be starting at Wharton Business School in the fall.

In an interview with Bloomberg Markets recently, Jamie Dimon defended the role banks play in financial markets, saying, "Banks aren't markets. The market is amoral… You're a trade to the market… A bank is a relationship."

But banks, namely investment banks, have struggled as regulators have favored market-based solutions, and many of those relationships investment banks have worked so hard for have proven to be less lucrative, especially compared to the growing fixed costs of supporting them.

As it relates to our marketable securities portfolio, how do you feel about the investment banking component, particularly as Wells moves into that space? Would you feel differently if the cost basis was higher?

And Warren, Charlie, thank you so much for doing this every year.

WARREN BUFFETT: Thank you. Charlie, I didn't totally get that, but does he feel the investment banking firms are being disadvantaged?

CHARLIE MUNGER: Well, he's basically, how do we feel about — Jamie says —

AUDIENCE MEMBER: How do you feel about —?

CHARLIE MUNGER: You can't make as much money as you used to out of relationships, and it's getting tougher and so forth?

WARREN BUFFETT: Yeah. Well, the public policy since 2008-9 has been to, very much, toughen up capital requirements in a variety of ways for banks, but it is specifically been designed to make large banks- very large banks — less profitable relative to smaller banks.

And you do that by increasing capital requirements. You can change the math of banking, and the attractiveness of banking, totally, by capital requirements. Obviously, if you said every bank had to be 100 percent equity, it would be a terrible business. You couldn't possibly earn any money that was significant on capital.

And if you let people operate with 1 percent capital ratios, they can make a lot of money and they will cause the system all kinds of trouble.

So, since 2009, the rules have been tilted against the larger banks by — primarily — through capital requirements. And that just means returns on equity go down, but returns on equity were awfully high prior to that. So it doesn't — it hasn't turned it into a bad business, it's turned it into a less attractive business than earlier.

And that — some of the investment banks operate as bank holdings companies, still, and they've been affected by those capital requirements, too.

I'm not sure I'm getting 100 percent to your question, so I invite you to give me a follow-up, if you like, on that.

AUDIENCE MEMBER: In the marketable securities portfolio, do you feel good about the going-forward prospects of the investment — of the investment banking companies — especially as Wells Fargo moves into that business?

WARREN BUFFETT: Well, Wells Fargo has an investment banking aspect to it that primarily came in through Wachovia. And it's not insignificant.

But our ownership of Wells Fargo, which is very large — it's our largest single marketable security — I'm not counting Kraft Heinz, which is about the same size, because in that situation we're in a control position — it's the largest non-control situation that we have, at Wells Fargo.

And that's by intent. I like it extremely well compared to other securities. Not because it has the most upside, but I feel that, weighted for upside and downside, that it's —

CHARLIE MUNGER: It's not the investment banking that charms you in Wells Fargo. It's the general banking that —

WARREN BUFFETT: Yeah. No. We're not — it isn't that big a deal, and that's not what attracts us.

We think Wells Fargo is a very well run bank. But, we didn't make any decision to buy a single share based on the fact they were going to be more in the investment banking business because of the Wachovia acquisition.

They've got a lot of sources of income. They've got a huge base of very cheap money, but unfortunately, they've got it out at very cheap rates on the other side now. But, spreads will probably work in their advantage eventually. And we think it's a very well run bank.

Investment banking business — Charlie and I are probably a little affected by the experience we had in running one for a short period of time — it's not been something that we invested in significantly.

We, obviously, made a major investment in Goldman Sachs, and we continue to hold shares that came out of the warrants that we received when we made the investment in 2008.

But I think I can't recall us making an investment banking purchase — a marketable security involving an investment bank — for a long time. Can you, Charlie?

CHARLIE MUNGER: No, I think, generally, we fear the genre more than we love it.

25. "Very, very unlikely" activists could break up Berkshire

WARREN BUFFETT: Carol?

CAROL LOOMIS: In the conclusion of the book "Dear Chairman," which you recommend in this year's annual letter — a new book you recommend- the author argues that, quote, "The life's work of great investors is inevitably reabsorbed into the industrial complex with little acknowledgement of their accomplishments."

He then argues that Berkshire Hathaway will eventually be targeted by activist investors if it trades at too sharp a discount to intrinsic value.

Do you agree with this assessment and have you considered installing corporate defenses that might prevent future generations of activists from trying to break up Berkshire Hathaway?

WARREN BUFFETT: Yeah, I used to worry more about that than I do now.

Partly, size is one factor. I think the more important factor would be that Berkshire will always be in a position to repurchase very significant amounts of stock, and as long as it's willing to buy that stock at some price — and it should be — close to intrinsic value, there should not be a large margin, in terms of anybody that might come along and think there'd be a lot money to be made by breaking up.

There would be money lost by breaking it up, in terms of we'd lose — there'd be certain advantages lost.

MidAmerican Energy could not have done what it has done in renewables without Berkshire being the parent. I mean, if it had been split off, it would have been worth — the parts would have been worth — less than the whole. And there are other instance — I could give you significant instances of that in other cases.

So, I don't think there will be a spread that will be enticing to anyone. And beyond that, I think the numbers involved would be staggering, and I think we have a shareholder base that recognizes the advantages of both the Berkshire businesses and its culture and — so I think it's very, very unlikely.

But there have been periods in business history where stocks sold at — where practically all stocks — sold at dramatic discounts from what you might call intrinsic value. And it's interesting that very little activity occurred there.

In the 1974 period, 1973 and '74, you know, there were company — really good companies — one of which was Cap Cities, for example, that Tom Murphy ran, that was selling at a huge discount to what it was worth. But people did not come along. And so, to some extent, when the discounts are huge, money is hard to get.

It's not a huge worry with me. Actually, in my own case, because of the way my stock will get distributed to philanthropies after I die, it's very likely that my estate, for some years, will be, by far, the largest shareholder of Berkshire, in terms of votes, even with this distribution policy that occurs.

So I — it's not something I worry about now. I used to worry about it some, but it's not a factor now.

Charlie?

CHARLIE MUNGER: Well I — I think we have almost no worries at all on this subject, and that most other people have a lot of thoroughly justifiable worry, and I think that helps us. So, I look forward on this subject with optimism.

WARREN BUFFETT: You want to explain how it helps us, Charlie?

CHARLIE MUNGER: Well, if you're being attacked by people you regard as evil and destructive and so on, and you want a strong ally, how many people would you pick in preference to Berkshire?

WARREN BUFFETT: My name is Warren Buffett and I approve of that message. (Laughter)

26. No interest in "pure" leasing businesses

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: Leasing has quietly become an important contributor to Berkshire's earnings with its several leasing units logging about $1 billion in combined annual pre-tax income.

Could you talk about Berkshire's competitive advantages in its varying leasing businesses including containers, cranes, furniture, tank cars, and rail cars?

Are there other leasing businesses you'd be interested in entering, for instance, airplanes or commercial auto fleets? Plane leasing companies, in particular, seem to sell for reasonable prices and are often available.

WARREN BUFFETT: Yeah. Well, we've got a very good truck leasing business in XTRA, and we've got a good, primarily tank car leasing, business at Union Tank Car and Procor. And we expanded by a billion dollars when we bought the GE fleet recently.

Leasing, generally, isn't something that will — we have to bring something to the party.

At XTRA , that's much more than just handing people a trailer and taking a check every month. There's important service advantages brought to that.

But pure leasing — leasing of new cars, which is a huge business — the math is not that attractive for us.

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

And when somebody has, you know, maybe a trillion dollars or so, and they're paying 10 basis points for it, I don't feel very competitive at Berkshire in that situation.

So, pure money-type leasing is not an attractive business for us when we've got other people with a lower cost of funds. I mean, they've got the edge.

And we have got — railcar leasing involves a lot more than just a financial transaction. I mean, we repair — we've got huge activity in the repair field, and those cars require servicing, and the same way in our trailer business.

But you will not see us get in — aircraft leasing doesn't interest me in the least. We've looked at that a lot of times, at various aircraft leasing companies offered to us. And that's a scary business. And some people have done well in it by, in recent years, by using short-term money to finance longer-term assets which have big residual risks, and that just isn't for us.

Charlie?

CHARLIE MUNGER: I think you've said it pretty well. We're well located now but we — I don't agree that we have huge opportunities.

27. "We're not targeting competitors for destruction"

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Good morning Warren and Charlie. I am Vandemere Se from the Philippines. Warren, my wife and I sent original paintings to your office two days ago, we hope you like them.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: Today — sorry — today Berkshire's size ensures that it faces competition from numerous businesses. If you had a silver bullet, which competitor would you take out and why? I'm sorry — and you can't say Donald Trump. (Laughter)

WARREN BUFFETT: Which competitor in which businesses? I mean, you're asking about which —

CHARLIE MUNGER: Which — which competitor would you kill if you could? I don't think — I don't think we have to answer this one.

WARREN BUFFETT: (Laughs) Charlie's a lawyer. (Laughter)

But I've thought about the question. (Laughter)

We have lots of tough competitors. And in many areas, we're a pretty tough competitor ourselves.

And — and the real — what we want our managers to be doing, you know, is thinking every day about how to achieve a stronger competitive position. We call it "widening the moat."

But, we want to turn out better products, we want to keep our costs down to a minimum, you know, we want to be thinking about what our customer's likely to be wanting from us, you know, a month, a year, 10 years from now.

And, generally, if you take care of your customer, the customer takes care of you. But there are cases where there is some force coming along that really is — you may not have the answer for it. And then, you know, you get out of that business.

We had that department store in Baltimore in 1966, and if we'd kept it, we would have gone out of business.

So, recognizing reality is also important. I mean, you do not want to try and fix something that's unfixable.

CHARLIE MUNGER: We're not targeting competitors for destruction. We're just trying to do the best we can everywhere.

WARREN BUFFETT: Spoken like an anti-trust lawyer. (Laughter)

OK. We really hope to be the ones that the other guys want to use the silver bullet on.

28. Sequoia Fund was "overly entranced" by Valeant

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Rom and Raji Terracod from Sugarland, Texas.

He writes, "My wife and I have the vast majority of our net worth invested in Berkshire and in shares of the Sequoia Fund. Mr. Buffett, you have endorsed the Sequoia Fund on more than a few occasions.

"Recently, the Sequoia Fund has been in the news because of its large position in Valeant Pharmaceuticals. Mr. Munger has termed Valeant's business model 'highly immoral.'

"Mr. Buffett, do you agree with Mr. Munger's assessment? Have your views about Sequoia Fund changed? Also, as you know, Sequoia is an admirer and large holder of Berkshire stock. "

WARREN BUFFETT: Yeah, in a sense, I'm the father of Sequoia Fund, in that when I was closing up my partnership at the end of 1969, I was giving back a lot of money to partners, and these people had trusted me, and they wanted to know what they should do with their money.

And we helped out those who wanted to put it in municipal bonds for a few months, Bill Scott and I stayed around and helped those people come up with those. But most of them were equity oriented-type investors.

And we said there were two people that we admired enormously in the investment business, not simply because they were terrific investors, but they were terrific people. And they would be the kind of people that you'd make trustee of your will.

So those two, one of whom is in the room — Sandy Gottesman, our director — and one was Sandy and one was Bill Ruane. They were friends themselves.

So, Sandy took on a number of our clients — a number of our partners — and they became clients, and very happy clients, of his, and I'll bet some of them are still clients, or their children or their grandchildren are, to this day.

Others went with Bill — a lot of them went with both of them, actually — in fact, I would be surprised if the majority who had a lot of money gave some to Sandy and gave some to Bill.

But Bill — we had a lot of people whose total funds were really not of a size that made them economic individual clients. And so, Bill, who would not have otherwise set up a fund, Bill said, "I'll set up a fund."

And they actually had an office in Omaha. John Harding, who used to work for me, became the employer here.

And a number of our ex-partners — my ex-partners — joined Sequoia Fund as a way to find an outstanding investment manager, like I say, both for ability and for integrity, and could deploy small sums with him.

And Bill ran Sequoia until, I think, roughly 2005, when he died, and did a fantastic job.

And even now, if you take the record from inception to now, with the troubles they've had recently, I don't know of a mutual fund in the United States that has a better record. There probably is one, maybe, or two, But it's — it's far better than the S&P, and you won't find many records that go for 30 or 40 years that are better than the S&P.

So Bill did a great job for people. And Bill died in 2005, and the record continued to be good until a year or so ago.

And at that time, they — the management company — the manager, I should say — took an unusually large position in Valeant and, despite the objection of some people on the board, not only maintained that position but actually increased it, after a fair amount of doubt had been expressed by the board about the advisability of doing that.

The record, like I say, to date, still, from when it started, is significantly better than average.

My understanding is that the manager who made the decision on Valeant is no longer running the operation, and that other people have (inaudible) for doing so, and I have every reason to believe that they're — I know that they're very smart, decent people, who are good, probably way better than average analysts, in terms of Wall Street.

So, I think it was a very unfortunate period when the manager got overly entranced with a business model, which, if you — I watched the Senate hearings a couple of days ago when Senator Collins and Senator McCaskill interrogated three people from Valeant, and it was not a pretty picture.

In my view, the business model of Valeant was enormously flawed. It had been touted to us. We had several people who urged us, strongly, to buy Valeant, and wanted us to meet Pearson, and all that sort of thing.

But it illustrated a principle that Pete Kiewit, I think, said many, many years ago. He said if you're looking for a manager, find somebody that's intelligent, energetic, and has integrity. And he said that if they don't have the last, be sure they don't have the first two. If you've got somebody that lacks integrity, you want them to be dumb and lazy.

You know — and if you get an intelligent, energetic guy, or woman, who is pursuing a course of action which, if put on the front page, you know, would make you very unhappy, you can get in a lot of trouble.

It may take a while. But Charlie and I have seen, and we're not remotely perfect at this, I don't mean that, but we've seen patterns. You get — pattern recognition gets very important in evaluating humans and businesses. And, the pattern recognition isn't 100 percent, and none of the patterns exactly repeat themselves, but there're certain things in business and securities markets that we've seen over and over, and that frequently come to a bad end, but frequently look extremely good in the short run.

One, which I talked about last year — I'm not referring to Valeant in this regard — is the chain letter scheme, the disguised chain letter. You're going to see chain letters the rest of your life.

Nobody calls them chain letters because that has a connotation that will scare you off. But they're disguised chain letters. And many of the schemes in Wall Street that are designed to fool people have that particular aspect to it.

And there were patterns at Valeant that I think — certainly if you go and watch those Senate hearings, I think, you'll decide that there were patterns there that really should have been picked up on, and it's been very painful to the people of Sequoia.

And I personally think that the people running Sequoia now are able people, and I'll get into in a second the difficulty in managing money, but first, I'll give Charlie a chance to comment on this.

CHARLIE MUNGER: Well, I totally agree with you that Sequoia, as reconstituted, is a reputable investment fund and that the manager, as reconstituted, is a reputable investment adviser.

I've got quite a few friends and clients that use Ruane, Cunniff, and I've advised them to stay with the place as reconstituted. I believe you've done the same thing, haven't you?

WARREN BUFFETT: Right.

CHARLIE MUNGER: So we trust — we think the whole thing is fixed.

Valeant, of course, was a sewer, and those who created it deserve all the opprobrium that they got. (Applause)

29. Buffett leads in wager against hedge funds

WARREN BUFFETT: In a few minutes we'll break, but I think it almost ties in with this last question.

If we could put slide 3 up.

I promised — some years ago I made a wager — and I promised to report, before the lunch, how the wager was coming out.

And I've been doing that regularly, but it probably seems appropriate, since it's developed this far, to point out a rather obvious lesson, which is what I hoped to drive home, to some degree, by offering to make the wager originally.

Incidentally, when I offered to make the wager, namely that somebody could pick out five hedge funds and I would take the unmanaged S&P index used by Vanguard Fund, and I would bet that over a ten-year period that the unmanaged index would beat these five funds that were all being managed, presumably — they could pick any five funds — that were managed by people who were charging incredible sums to people because of their supposed expertise.

And, fortunately, there's an organization called, or at least you go — if you go to the Internet, if you put in longbets.org — it's a terribly interesting website.

You can have a lot of fun with it because people take the opposite side of various propositions that have a long tail to them and make bets as to the outcome, and then they both give their — each side gives their reasons.

And you can go to that website and you can find bets about, you know, whether — what population will be doing 15 years from now or — all kinds of things.

And our bet became quite famous on there. They — and a fellow I like, who I didn't know before this, Ted Seides, bet that he could pick out five hedge funds — these were funds of funds.

In other words, there was one hedge fund at the top and then that manager picked out who he thought were the best managers underneath, and then bought into these other funds in turn, so that the five funds of funds represent, maybe, 100 or 200 hedge funds underneath.

Now bear in mind that the hedge fund — the fellow making the bet — was picking out funds where the manager on top was getting paid, perhaps, 1/2 percent a year, plus a cut of the profits, for merely picking out who he thought were the best managers underneath, who in turn were getting paid, maybe, 1 1/2 or 2 percent, plus a cut of the funds' profits.

But certainly the guy at the top was incentivized to try and pick out great funds, and at the next level, those people were presumably incentivized, too.

So the result is, after eight years, and several hundred hedge fund managers being involved, is that now the totally unmanaged fund by Vanguard with very, very minimal costs, is now 40-some points ahead of the group of hedge funds.

Now that may sound like a terrible result for the hedge funds, but it's not a terrible result for the hedge fund managers. (Laughs)

These managers — A), you've got this top-level manager that's charging probably 1/2 percent, I don't know that for sure, and down below you've got managers that are probably charging 1 1/2 to 2 percent.

So if you have a couple of percentage points sliced off every year, that is a lot of money.

We have two managers at Berkshire that each manage $9 billion for us. They both ran hedge funds before.

If they had a 2-and-20 arrangement with Berkshire, which is not uncommon in the hedge fund world, they would be getting $180 million each, you know, merely for breathing, annually. (Laughter)

That — I mean that — it's a compensation scheme that is unbelievable to me, and that's one reason I made this bet.

But what I'd like you to do is for a moment imagine that in this room we have the entire — you people own all of America, all the stocks in America are owned by this group. You are the Berkshire 18,000, or whatever it is, that has someone managed to accumulate all the wealth in the country.

And let's assume we just divide it down the middle, and on this side we put half the people — half of all the investment capital in the world — and that capital is what a certain presidential candidate might call "low energy."

In fact, they have no energy at all. They buy half of everything that exists in the investment world, 50 percent, everyone on this side. And so now half of it is owned by these — by these no-energy people.

They don't look at stock prices. They don't turn on business channels. They don't read The Wall Street Journal. They don't do anything. They just — they are a slovenly group that just sits for year after year after year owning half of the country — half of America's business.

Now what's their result going to be? Their result is going to be exactly average, as how America business does, because they own half of all of it. They have no expenses, no nothing.

Now what's going to happen with the other half? The other half are what we call the "hyperactives."

And the hyperactives, their gross result is also going to be half, right? They can't — the whole has to be the sum of the parts here, and this group, by definition, can't change from its half of the ultimate investment results.

This half is going to have the same gross results — you're going to have the same results as the low-energy — no-energy people, and they're also going to have terrific expenses, because they're all going to be moving around, hiring hedge funds, hiring consultants, paying lots of commissions and everything.

And that half, as a group, has to do worse than this half. The people who don't do anything have to do better than the people that are trying to do better. It's that simple.

And I hoped through making this bet to actually create a little example of that, but that offer was open to anybody. And I would make, incidentally, the same offer now except, you know, being around in 10 years to collect gets a little more problematic as we go through life. (Laughs)

But it seems so elementary. But I will guarantee you that no endowment fund, no public pension fund, no extremely rich person, wants to sit in that part of the auditorium.

They just can’t believe that because they have billions of dollars to invest that they can’t go out and hire somebody who will do better than average. I hear from them all the time.

So this group over here, supposedly sophisticated people, generally richer people, hire consultants, and no consultant in the world is going to tell you, just buy an S&P index fund and sit for the next 50 years.

You don’t get to be a consultant that way. And you certainly don’t get an annual fee that way.

So the consultant’s got every motivation in the world to tell you, this year I think we should concentrate more on international stocks, or this year this manager is particularly good on the short side.

And so they come in and they talk for hours, and you pay them a large fee, and they always suggest something other than just sitting on your rear end and participating in American business without cost.

And then those consultants, after they get their fees, they, in turn, recommend to you other people who charge fees which, as you can see over a period of time, cumulatively eat up capital like crazy.

So, I would suggest that what I felt sure — I didn’t feel sure because nothing — you can’t tell for sure about any 10-year period — but it certainly felt very probable or I wouldn’t have stuck my neck out.

It just demonstrates so dramatically — I’ve talked to huge pension funds, and I’ve taken them through the math, and when I leave, they go out and hire a bunch of consultants and pay them a lot of money. And — it — just unbelievable. And the consultants always change the recommendations a little bit from year to year. They can’t change them 100 percent, because then it didn’t look like they knew what they were doing the year before, so they tweak them from year to year.

And they come in and they have lots of charts and PowerPoint presentations, and they recommend people who, in turn, are going to charge them a lot of money. And they say, well, you can only get the best talent by paying 2-and-20, or something of the sort.

And the flow of money from the hyperactive to what I call the helpers is dramatic, while this group over here sits here and absolutely gets the record of American industry.

So I hope you realize that for most — for the population as a whole — American business has done wonderfully, and the net result of hiring professional management, you know, is a huge minus.

And at the bookstore we have a little book called "Where Are the Customer's Yachts?" written by Fred Schwed. I read it when I was about 10-years-old. Been updated a few — well it hasn't been updated, but new editions have been put out a few times — but the basic lessons are there.

That lesson is told in that book from 1940. It's so obvious, and yet all the commercial push is behind telling you that you ought to think about doing something today that's different than you did yesterday.

You don't have to do that. You just have to sit back and let American industry do its job for you.

Charlie, do you have anything to add to my sermon? (Applause)

CHARLIE MUNGER: Well, you're talking to a bunch of people who have solved their problem by buying Berkshire Hathaway. (Laughter)

That worked even better. And there have been a few of these managers, the managers —

WARREN BUFFETT: Sure.

CHARLIE MUNGER: — who've actually succeeded. They are a few in the universities who are really good.

But it's a tiny group of people. It's like looking for a needle in a haystack.

WARREN BUFFETT: Yeah. And when I was given the job of naming two in 1969, I knew — I knew two — I knew a couple of others. Charlie wasn't interested in managing more money then, and my friend Walter Schloss would not scale up well, although he had a fabulous record over 45 years, or thereabouts.

But, you know, that was all I could come up with at that time. And fortunately, you know, I did have a couple. And the people who went with Sequoia Fund have been well-served, if they stayed for the whole period.

But the — the people — there's been far, far, far more money made by Wall — by people in Wall Street — through salesmanship abilities than through investment abilities.

There are a few people out there who are going to have an outstanding investment record. But there are very few of them, and the people you pay to have identify them don't know how to identify them. And — and they do know how to sell you. That's my message.

Afternoon Session - 2016 Meeting

1. Sell commercial insurance on the internet?

WARREN BUFFETT: OK. If you'll take your seats, we'll get underway.

CLIFF GALLANT: Thank you.

Berkshire has an online portal for commercial insurance business. I believe it's CoverYourBusiness.com. Is there an opportunity in commercial lines to go direct akin to what we've seen GEICO do in personal auto insurance?

WARREN BUFFETT: Yeah. Well, the answer to that is we'll find out. We have actually two online arrangements. I'm not sure whether they're both up yet.

One is called — I believe it's called Big. I think we got that domain name, B-I-G, and that will be run by the Applied Underwriters, which is a subsidiary of ours that writes workers comp.

And the other is run by Ajit [Jain]. And then, actually, we do commercial auto, some commercial auto, through GEICO as well, so we will learn soon —

I guess my message about inherited wealth is getting delivered here. (Laughter)

The kid probably wants to put himself up for adoption now. (Laughter)

The — so we will be — we have been a little bit, and we will be experimenting more with various insurance lines.

When you look at what has happened, you know, just take Amazon, you have to — you want to try a lot of things, and it amazed me how fast the inquiries on personal auto migrated from phone to the internet, and, you know, I would've thought that the younger people would do it, but the people like myself would be very slow to do it.

But the adaptation by the American public of internet response has really been pretty incredible and shows no sign of slowing down.

So the answer is, we'll try various things and we'll make some mistakes, and my guess is that 10 and 20 and 30 years from now, it'll be a lot different.

2. Our culture will endure for "many, many decades"

WARREN BUFFETT: Station 8.

AUDIENCE MEMBER: Hi. My name is Matt Clayborn from Columbus, Ohio. And thank you for putting this on for all of us.

My question is: you have said before that your role will be divided into parts for your succession, one of which will be the responsibility of maintaining culture by having [son] Howard [Buffett] as non-executive chairman.

What is the plan for how Berkshire will maintain its culture when Howard no longer fills the role, and what should shareholders watch for to make sure that the culture is being properly maintained decades from now when I am your age?

WARREN BUFFETT: Yeah. Well, that's a question we've obviously given a lot of thought to, and although I hope that Howard is made chairman just for the reason that if a mistake is made in selecting a successor, it's easier to correct it if you have a non-executive chairman. But that's a very, very — I mean, that's a 1-in-100 or 1-maybe-in-500 probability, but there's no sense ignoring it totally.

It's not a key factor. The main — by far, the main factor in keeping Berkshire's culture is that you have a board and you'll have successor board members. You have managers and you'll have successor managers. And you have shareholders that clearly recognize the special nature of the culture, that have embraced the culture. When they sold their businesses to us, they wanted to join that culture.

It's a — it thrusts out people that really aren't in tune with it, and there are very few of them. And it embraces those who enjoy and appreciate it, and I think, to some extent, we don't have a lot of competition on it. So it becomes very identifiable, and it works.

So I think the chances of us going off the rails in terms of culture are really very, very, very slight, regardless of whether there's a non-executive chairman or not. But that's just a small added protection.

So it's — I think that the main problem that Berkshire will have will be size, and I've always — I thought that when I was managing money, when I first started managing money. Size is the enemy of performance to a significant degree.

But I do think that the culture of Berkshire adds significantly to the value of the individual components viewed individually. And I don't see any evidence that there'd be any board member, any managers, or anything that would — could in any way really move away from what we have now for many, many decades. Charlie?

CHARLIE MUNGER: I'm even more optimistic than you are.

WARREN BUFFETT: I've never noticed it. (Laughter)

CHARLIE MUNGER: I really think the culture is going to surprise everybody — how well it lasts — and how well they do. They're going to wonder why they ever made any fuss over us in the first place. It's going to work very well.

WARREN BUFFETT: We've got so many good ingredients in place just in terms of the businesses and people already here, you know, that — at the companies.

CHARLIE MUNGER: That's what I'm saying.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: There's just so much power in place.

WARREN BUFFETT: Another thing that's interesting is how little turnover we get in it, too. So that — the number of managers that have been needed, that we've had to replace in the last ten years, are very few.

You know, without a retirement age, and I tend to bring that up at every meeting to reinforce the idea, the — but without a retirement age and with people working because they love their jobs — and they like the money as well — but their primary motive is that they really like accomplishing what they do in their jobs. And that means that we get long tenure out of our managers.

So the turnover is low, the directors are not here for the money, and so we have great tenure among the directors, and I would argue that's a huge plus. It's going to go on a very long time.

3. Diversity isn't a factor in choosing Berkshire directors

WARREN BUFFETT: Andrew.

ANDREW ROSS SORKIN: Thank you, Warren. The following question comes from Ariz Galdos (PH), and several other shareholders asked similar questions that are a part of this as well. It's a bit of a multipart question.

WARREN BUFFETT: Uh-uh.

ANDREW ROSS SORKIN: "About two dozen men and women work with you, Warren, at our corporate office. I see from last year the quality of the picture has been improved in the annual report, so congratulations on that.

"However, looking at it, there is something that comes to anyone's attention and is the lack of diversity among the staff. A 2015 analysis by Calvert Investments found that Coca-Cola was one of the best companies for workplace diversity while Berkshire Hathaway was one of the worst.

"You've explicitly stated that you do not consider diversity when hiring for leadership roles and board members. Does that need to change? Are we missing any investment opportunities as a result?

"And do you consider diversity, however defined, of company leadership and staff when analyzing the value of a company that you may want to purchase?

WARREN BUFFETT: Well, it's a multiple part question. The answer to the last one is no.

What was the one before it? (Laughter)

ANDREW ROSS SORKIN: "You've explicitly stated you do not consider diversity when hiring for leadership roles and board members. Does that need to change, and are we missing any investment opportunities as a result?"

WARREN BUFFETT: No. We will select board members, and we lay it out. And we've done so for years, and I think we've been much more explicit than most companies.

We are looking for people who are business savvy, shareholder oriented, and have a special interest in Berkshire. And we found people like that. And as a result, I think we've got the best board that we could have. They're not in it — they're clearly not in it for the money.

I get called by consulting firms who have been told to get candidates for directors for other companies, and by the questions they ask, it's clear they've got something other than the three questions we ask, in terms of directors, in mind.

They really want somebody whose name will reflect credit on the institution, which means a big name. You know, and one organization recently, the one that did the blood samples with small pricks, got — they got some very big names on their board. Theranos, I think, or — is that the way you pronounce it, Charlie? Theranos?

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. I mean the names are great, but we're not interested in people that want to be on the board because they want to make 2- or $300,000 a year, you know, for 10 percent of their time. And we're not interested in the ones who — for whom it's a prestige item and who want to go and check boxes or that sort of thing.

So I think we've got — we will continue to apply that test: business savvy, shareholder oriented, and with a strong personal interest in Berkshire.

And every share of Berkshire that our shareholders own, they bought just like everybody else in this room. They haven't gotten them on an option or they haven't — I've been on boards where they've given me stock, you know, and they — I get it for breathing, basically. Half a dozen places that are — maybe three or four that I was on the board of.

We want our shareholders to walk in the shoes — I mean, our directors to walk in the shoes of shareholders. We want them to care a lot about the business, and we want them to be smart enough so that they know enough about business that they know what they should get involved in and what they shouldn't get involved in.

The people in the office — I'm hoping that when we take the Christmas picture again this year, they're exactly the same 25 that were there last year, even though we might have added 30,000 employees elsewhere and maybe 10 billion of sales or something like that.

It's a remarkable group of people, and they — I mean, just take this meeting. Virtually every one of the 25, our CFO, my assistant, whoever, they've been doing job after job connected with making this meeting a success and a pleasant outing for our shareholders. It's a cooperative effort.

The idea that you would have some department called Annual Meeting Department and, you know, you'd have a person in charge of it and she'd — or he — would have an assistant and then they would go to various conferences about holding annual meetings and build up — and then they'd hire consultants to come in and help them on the meeting. We just don't operate that way. It's a place where everybody helps each other, but — (Applause)

Part of the — what makes — part of what makes my — well, my job is extraordinarily easy, but the people around me really make it easy. And part of the reason it's easy is because we don't have any committees. Maybe we have some committee I don't know about, but I've never been invited to any committees, I'll put it that way, at Berkshire.

And we don't — we may have a PowerPoint someplace, I haven't seen it, and I wouldn't know how to use it anyway.

The — we just don't do — we don't have make-work activities. And we might go a to a baseball game together or something like that, but it — I've seen the other kind of operation and I like ours better, I'll put it that way. Charlie?

CHARLIE MUNGER: Well, years ago I did some work for the Roman Catholic Archbishop of Los Angeles, and my senior partner pompously said, you know, you don't need to hire us to do this. There's plenty of good Catholic tax lawyers. And the archbishop looked at him like he was an idiot and said, "Mr. Peeler," he says," last year I had some very serious surgery, and I did not look around for the leading Catholic surgeon." That's the way I feel about board members. (Applause)

4. Buffett's "mixed emotions" on Berkshire buybacks

WARREN BUFFETT: OK. Gregg.

GREGG WARREN: Warren, while —

WARREN BUFFETT: Gregg. (Laughter.)

GREGG WARREN: While Berkshire has authorized a share repurchase program, originally aimed at buying back shares at prices no higher than 10 percent premium to the firm's most recent book value per share, a figure that was subsequently increased to repurchase shares at prices no higher than 20 percent premium to book value, there's been relatively little share repurchase activity during the last four-and-a-half years.

Even as the shares dipped down below the 1.2 times book value threshold during both January and February of this year, if you base it on a buyback price calculated on Berkshire's book value per share at the end of 2015, a number that had not yet been published when the stock did dip that low.

Given your belief that Berkshire's intrinsic value continues to exceed its book value, with the difference continuing to widen over time, are we at a point where it makes sense to consider buying back stock at a higher break point than Berkshire currently has in place, and would you ever consider stepping in and buying back shares if they dip down blow 1.2 times book value per share even if that prior year's figure had not yet been released?

WARREN BUFFETT: Yeah. Gregg, you mentioned that it sold below 1.2, and I don't think that's correct. I keep a pretty close eye on that, and it's come fairly close to 1.2. But I could almost guarantee you that it has not hit 1.2, or we would've done it. And I'd be happy to send you figures on any day that you might feel that it did hit the 1.2.

Clearly in my view, Charlie's view, the board's, the stock is worth significantly more than 1.2, but it should be worth significantly more, or we wouldn't have it at that level.

On the other hand, we did move it up from 1.1 to 1.2 because we had acquired more businesses over time that were — where the differential between our carrying value and the book value — and the intrinsic value really had widened from when we set the 1.1.

I have mixed emotions on the whole thing, in that from strictly a financial standpoint, and from the standpoint of the continuing shareholders, I love the idea of buying it at 1.2, which means I probably would love the idea of buying it a little higher than 1.2.

On the other hand, I don't take — and it's the surest way of making money per share there is. I mean, if you can buy dollar bills for anything less than a dollar, you know, there's no more certain way of making money.

On the other hand, I don't particularly like — enjoy the actual act of buying out people who are my partners at a price that is below — well below what I think the stock is worth.

So — but we will buy stock, almost certainly. We don't make it a 100 percent pledge because there'd be a lot of ramifications to that, but the odds are extremely high that we would buy a lot of stock at 1.2 times or less. But we would do it in a manner where we were not propping the stock at any given level. And if it happens, it will be very good for the stockholders who continue.

It is kind of an interesting situation, though, because if it's true that we will, and are eager even, from a financial standpoint, to buy it at that price, it's really like having a savings account where if you take your money out as a dividend, or as an interest payment on a savings account, you know, you get a dollar.

But if you leave it in, you're almost guaranteed that we'll pay you $1.20. I mean, why would anybody want to take money out of a savings account if they could cash it in, what they left, at 120 percent?

So it's a — it acts as a backstop for ensuring that a no-dividend policy results in greater returns than it would be if we paid out a dollar and people got a dollar. If they leave a dollar in, they're going to get at least $1.20 in my view, at least — it's not a total guarantee, but it's a pretty strong probability.

So would we increase that number? Perhaps. If we run out of ideas, and I don't mean, you know, day by day, but if it really becomes apparent that we can't use capital effectively within the company, in the quantities with which it's being generated, then at some point the threshold might be moved up a little because it could still be attractive to buy it.

And you don't — you know, you don't want — you don't want to keep accumulating so much money that it burns a hole in your pocket. And it's been said, actually, that — you know, that a full wallet is a little like a full bladder, that you may get an urge fairly quickly to pee it away, and we don't want that to happen.

But so far that hasn't happened, and we will — if it ever gets to where we have 100 billion or 120 billion or something like that around, we might have to increase the price.

Anytime you can buy stock in for less than it's worth, it's advantageous to the continuing shareholders, and — but it should be by a demonstrable margin. You can't — intrinsic value can't be that finely calculated that you can figure it out to four decimal places or anything of the sort. Charlie?

CHARLIE MUNGER: Well, you'll notice that elsewhere in corporate America, these buyback plans get a life of their own, and it's gotten quite common to buy back stock at very high prices that really don't do the shareholders any good at all. I don't know why people exactly are doing it. I think it gets to be fashionable.

WARREN BUFFETT: It's fashionable and they get sold on it by advisors.

CHARLIE MUNGER: That's true, too.

WARREN BUFFETT: Yeah. Can you imagine somebody going out and saying, we're going to buy a business and we don't care what the price is? You know, we're going to spend $5 billion this year buying a business, we don't care what the price is.

But that's what companies do when they don't attach some kind of a metric to what they're doing on their buybacks. To say we're going to buy back 5 billion of stock, maybe they don't want to publicize the metric, but certainly they should say, we're going to buy back 5 billion of stock if it's advantageous to buy it back.

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

But I have seen hundreds of buyback notices, and I've sat on boards of directors one after another where they have voted buybacks and basically — and they said they were doing it to prevent dilution or something like that. It's got nothing to do with preventing dilution. I mean, if you're — dilution by itself is a negative and buying back your stock at too high a price is another negative.

So it has to be related to valuation. And as I say, you will not find a lot of press releases about buybacks that say a word about valuation.

CHARLIE MUNGER: The occasion — we're always behaving a lot like what some might call the Episcopal prayer. We prayerfully thank the Lord that we're not like these other religions who are inferior. (Laughs)

I'm afraid there's probably too much of that in Berkshire, but we can't help it. (Laughter.)

5. New Nebraska Furniture Mart store in Dallas doing big business

WARREN BUFFETT: OK. Station 9.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: My name is Shawn Montgomery (PH) from Fort Worth, Texas. The Nebraska Furniture Mart has been open for about a year in Dallas.

WARREN BUFFETT: Right.

AUDIENCE MEMBER: I was just curious how sales have been, how they compare to your other stores, and what you think they'll be in the future. Thank you.

WARREN BUFFETT: Yeah. It's our largest store in volume. But we had a problem there that we had in Kansas City, and we'll probably have every time we open a store, in that we generate so much initial volume that we had a delivery problem. Like I say, it was worse in Kansas City — that was the first one we opened.

So we really had to take our foot off the gas pedal because the last thing in the world we want to do, you know, is make first impressions with delivery problems — accompanied by delivery problems.

So, it's our largest store in volume. The deliveries have gotten far better. They actually are meeting our company standards that we have in Omaha.

But that wasn't the case for some months. And it's hard to go open up — we opened up the largest home furnishing store in the United States, and we did it in an area where we naturally thought we trained the drivers as well as we could and everything.

But delivery with 100-plus units out there in a new operation, you know, taking in carpet and people getting lost and routing being bad and all kind — there was plenty of work to be done. And it's been done.

So I expect that store, which already is the largest store we have, but I think it'll be a billion-dollar annual store before very long. We're getting ready to step on the gas. It's a terrific area.

We have 20-plus auto dealerships there in the Dallas/Fort Worth area. We probably have three or four of them in the area where our Furniture Mart is. They can't build fast enough down there. Toyota's moving there. Lexus.

It's going — it already is a great store, but it's going to be something even far beyond that.

We've opened up about — I think there are about four food places so far. We've got four or five more in the works. And they're doing terrific volumes.

I'm starting to sound like Donald Trump here, you know, tremendous, terrific, you know, fantastic, I've never seen anything like it. (Laughter)

Just wait until next year. I'll come back, I'll really be in shape then.

It's doing well. We couldn't have picked a better area. We have 400 and — have over 400 acres that we were very fortunate in corralling a whole bunch of land, and we're bringing prices and variety like they — nobody's seen. And now we've just got to bring in delivery like nobody's ever seen.

6. Buffett's concerns about weapons of mass destruction

WARREN BUFFETT: OK. Carol.

CAROL LOOMIS: This question comes from Chris Gottscho (PH) of New York.

Mr. Buffett, you have expressed concern about cyber, biological, nuclear, and chemical attacks, but preventing catastrophe is not getting enough attention.

For example, a bill passed the house unanimously to harden the electric grid against the high-altitude nuclear explosion. Not too many bills pass unanimously these days, but then the bill got bottled up in the Senate.

Have you considered funding — wouldn't it be a good idea for you to consider funding a lobbying and educational campaign to promote the public good in this area and counteract industry lobbyists who are often more interested in short-term profits?

WARREN BUFFETT: Yeah. Well, in my view, there is no problem remotely like the problem of what I call C-N-B-C, cyber, nuclear, chemical, and biological attacks, that either by rogue organizations, even possibly individuals, rogue states, I mean, you know, if you think about — you can think about a lot of things. It will happen.

I think we've been both lucky and, frankly, the people have done a very good job in government, because government is the real protection on this, in not having anything since 1945.

We came very, very close during the Cuban Missile Crisis. And I don't know what the odds were, but I do think that if there had been — I can think of many people that if they'd been in place of either [U.S. President John] Kennedy or [USSR Premier Nikita] Khrushchev, we would've had a very different result.

And it's the ultimate problem. As I put in the annual report, it's the only real threat to Berkshire's economic — external threat to Berkshire's economic well-being over time. And I just hope when — it'll happen — I hope when it happens that it's minimized.

But the desire of psychotics and megalomaniacs and religious fanatics and whatever to do harm on others is a lot more when you have 7 billion people on earth than when you had 3 billion or so, which was the case when I was born — less than 3 billion.

And unfortunately, there are means of doing it. You know, if you were a psychotic back far enough, you threw a stone at the guy in the next cave, and you would sort of limit — relationship of damage to psychosis.

But the — and that went along, you know, through bows and arrows and spears and cannons and various things. And in 1945, we unleashed something like the world had never seen, and that is a pop gun compared to what can be done now.

So there are plenty of people that would like to cause us huge damage. And I came to that view when I was in my 20s. And in terms of my philanthropic efforts, I decided that that was one of two issues that I thought should be the main issue, and I got involved with all kinds of things like the Concerned — Union of —

CHARLIE MUNGER: You supported the Pugwash Conference year after year and were exactly all by yourself.

WARREN BUFFETT: Union of Concerned Scientists, and I have given some money to the Nuclear Threat Initiative that was going to create a — sort of a Federal Reserve system to bank uranium that will take away some of the excuse for countries to develop their own highly-enriched uranium.

So — but it's overwhelmingly a governmental problem on what you're dealing, and it should be, and I think it actually has been the top priority for president after president. It's not the thing they can go out and talk about it every day, and they don't want to scare the hell out of everybody, and they also don't want to tip people's hands as to what they're doing.

But being in the insurance business — you don't have to even be in the insurance business — you can — you know that someday somebody will pull off something on a very, very, very big scale that will be harmful.

Maybe it will — the United States is probably the most likely place it happens, but it can happen a lot of other places, and that's the one huge disadvantage to innovation. I mean, people —

CHARLIE MUNGER: Warren, I think he also asked, why don't we, Berkshire, spend a lot more time telling the government what it should be doing and thinking?

WARREN BUFFETT: Well, I've tried telling people. (Laughs)

Nobody disagrees with you on it. They just — it seems sort of hopeless to — I mean, they don't know what to do beyond what they're doing.

And incidentally, they've done a lot of things. I mean, not all gets publicized, but — and I think Kennedy and Khrushchev — I mean, Khrushchev shouldn't have been sending it over to Cuba, but at least he had enough sense when he knew Kennedy meant business to turn the ships around.

But it's — you can't count on there being Kennedys and Khrushchevs all the time in charge of things.

And the mistakes that are — I see the mistakes that are made in business or human behavior where people act so contrary to their own long-range self-interest that — humans are very — you know, they've got a lot of frailties.

You can argue that if Hitler hadn't been so anti-Semitic, you know, he could've kept a lot of scientists that might have gotten him to the atomic bomb before we did, but he was — he drove out the best of the scientific minds and fortunate —

CHARLIE MUNGER: Imagine a guy stupid enough to think the way to improve science is to kick out all the Jews. (Laughter.)

WARREN BUFFETT: It was — the hero of the 20th century may have been Leo Szilard. I mean, Leo Szilard is the guy that got [Albert] Einstein to cosign a letter to [President Franklin] Roosevelt and say, you know, one side or the other is going to get this, and we better get it first, basically. He said it much more eloquently than that. You can go to the internet and look up the letter, but — you know, we've both been good and we've been lucky.

But, if you remember post-9/11, people started getting a few envelopes with anthrax, and they went to, like, the National Enquirer and Tom Brokaw and Tom Daschle — I can't remember.

I mean, who knows what — when you're — when you've got a mind that's going to send anthrax to people, you know, how that decision making is made is just totally beyond comprehension. And that person did not end up doing a lot of damage, but the capability for damage is absolutely incredible.

I don't know how Berkshire does anything about — I don't know how to do it philanthropically. If I knew how to do — reduce the probabilities of the C-N-B-C-type mass attack, if I knew how to reduce the probability by 5 percent, all my money would go to that, no question about that, maybe 1 percent.

CHARLIE MUNGER: But hasn't it been true we haven't been very good at getting the government to follow any of our advice?

WARREN BUFFETT: Yeah. But this one's important. (Laughter.)

CHARLIE MUNGER: Yeah, well —

WARREN BUFFETT: Yeah. Nobody argues with you about it. They just sort of throw up their hands. And some people work for a while on it and just get discouraged and quit.

I was involved — I forget the exact name of it, but their idea was — a bunch of nuclear scientists — this is long ago, but their idea was to affect elections in small states, the theory being that government was the main instrument and you would have the maximum impact. And just one after another, you know, people took it up and got discouraged.

I don't — I don't think it's because we — we've had the wrong leaders. I think our leaders have been good on this.

I think that any candidate — well, I do not worry about the fact that either [Hillary] Clinton or [Donald] Trump would regard that as the paramount problem of their presidency.

But I just don't know — the offense can be ahead of the defense, and that's — you can win the game 99.99 percent of the time, but eventually anything that has any probability of happening, you know, will happen.

I wish I could give you a better answer. Charlie, have you got any —

CHARLIE MUNGER: I have no hope of giving a better answer.

WARREN BUFFETT: That's what they all say to me. Yeah.

7. Lubrizol's lubricant additives business

WARREN BUFFETT: Jonathan.

JONATHAN BRANDT: The Lubrizol lubricant additives business is one of your six largest noninsurance units, but there's been relatively little disclosure about its performance since it was acquired nearly five years ago.

Can you please update us on how the core business has done and how the competitive landscape and end markets have evolved since it was acquired?

I know the core business is not a growth business, but has the increase in miles driven helped their top line at all?

Could you also talk about the performance of one or two of their more important bolt-on acquisitions, whether it be Chemtool, the pipeline flow-improver company, Warwick, Weatherford, or Lipotec?

WARREN BUFFETT: Yeah. The additive business — there's four companies in it, basically — and it's a no-growth, but very good, business, and we're the leader.

So it has performed almost exactly as you would anticipate since purchase. And other specialty companies have — some of which have — have growth possibilities, but they're small.

So Lubrizol overall, on an operational basis, has been very much as we anticipated, or you would've anticipated, if you looked at the prospectus at the time we bought it.

They made one large acquisition which is — was a big mistake, and that was in the oil field specialty chemical area, and was made just about the time that — or even a little after — that oil took a nosedive.

So we've had a — we've had some decent acquisitions there, but the biggest acquisition should not have been made.

It is — we still got the fundamental earning power of the additives business and everything. That has not disappointed us in any way. It's a very well-run operation that way, but it's not a growth operation.

Charlie?

CHARLIE MUNGER: Nothing to add.

8. "We like to look at micro factors"

WARREN BUFFETT: OK. Station 10.

AUDIENCE MEMBER: Hello. Hello, Mr. Buffett and Mr. Munger, thank you so much for your insights, teaching, and being great role models. My name is Eric Silberger, a violinist based in New York City.

My question for both of you is related to psychological biases. Through Berkshire Hathaway's operations, you get a very good read on macroeconomic factors. Yet, Berkshire does not make investment decisions based upon macroeconomic factors.

How do you control the effect of information, such as knowing macroeconomic factors, or the anchoring effect of knowing stock prices, because after a while it's hard not to once you've analyzed them before?

And how does that influence your rational decision making, whether you should ignore it, or whether you should try to use it in a positive way?

WARREN BUFFETT: Charlie and I are certainly — we read a lot, so we — and we're interested in economic matters, and political matters, for that matter. And so we — we know a lot, or are familiar a lot, I should say, with almost all the macroeconomic factors.

That doesn't mean we know where they're going to lead. We don't know where zero interest rates are going to lead. But we do know what's going on, if we don't know what — what is likely to —

CHARLIE MUNGER: Warren, there's a confusion here.

WARREN BUFFETT: Oh.

CHARLIE MUNGER: It says microeconomic factors.

WARREN BUFFETT: Oh, micro.

CHARLIE MUNGER: We pay a lot of attention to those.

WARREN BUFFETT: Oh, yeah. I'm sorry.

CHARLIE MUNGER: If you talk about macro, we don't know any more than anybody else.

WARREN BUFFETT: He summed it up.

In terms of the businesses we buy, and we — when we buy stocks, we look at it as buying businesses, so they're very similar decisions — we try to know all, or as many as we can know, of the microeconomic factors.

We — I like looking at the details of a business whether we buy it or not. I mean, I just find it interesting to study the species, and — and that's the way you do study it. So I — I don't think there's any lack of interest in those factors or denying the importance of them. So am I getting his question or not, Charlie?

CHARLIE MUNGER: Well, there hardly could be anything more important than the microeconomics. That is business. Business and microeconomics is sort of the same term.

AUDIENCE MEMBER: I guess —

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

AUDIENCE MEMBER: The anchoring effect, I mean, how do you deal with that as well?

CHARLIE MUNGER: Well, we're not anchored to what we're ignoring.

AUDIENCE MEMBER: I see. (Laughter)

WARREN BUFFETT: But we — Charlie and I are the kind that literally find it interesting in every business — we like to look at micro factors.

If we buy — when we buy a See's Candy in 1972, you know, there may have been 140 shops or something. We'll look at the — we'll look at numbers on each one, and we'll watch them over time, and we'll see how third-year shops behave in the second year — we really like understanding businesses.

It's just — it's interesting to us. And some of the information is very useful, and some of it may look like it's not helpful, but who knows when some little fact stored in the back of your mind pops up and really does make a difference.

So, we're fortunate in that we're doing what we love doing. I mean, we love doing this like other people like watching baseball games, and which I like to do, too.

But they — just the very act, every pitch is interesting, and every movement, you know, and whether the guy's — you know, a double steal is interesting, or whatever it may be, and so that's what our activity is really devoted to, and we talk about that sort of thing.

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

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

CHARLIE MUNGER: Absolutely.

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

CHARLIE MUNGER: Otherwise, you should just keep quiet. It would do wonders for our politics if everybody followed my system. (Laughter and applause)

9. I'd "much rather make money for Berkshire than for myself"

WARREN BUFFETT: OK, Becky.

BECKY QUICK: Warren, just a quick request. Would you please stop using C-N-B-C as an acronym for mass destruction? (Laughter.)

WARREN BUFFETT: But if I use N-B-C-C, then I've got a problem with [NBCUniversal CEO] Steve [Burke].

BECKY QUICK: This question comes from Matt Bandy in Dallas, Texas.

He's asking about Seritage Growth Properties. He says, "In December, 2015, you filed a personal 13-G evidencing a roughly 8 percent ownership position in the real estate investment trust Seritage Growth Properties, which to my knowledge is not paralleled as a Berkshire investment.

"Alternatively, in September, 2015, Warren filed a personal 13-G evidencing ownership in Phillips 66, which is paralleled as a Berkshire investment.

"My question is, how do you decide when making a personal investment for your own account versus an investment for Berkshire? I understand market cap and ownership sizing are the likely factors, but does it still not behoove him to invest for the shareholder's benefit in a company like Seritage that might have significant upside, and where are you putting your personal money to work?"

WARREN BUFFETT: Right. I do not own a share, or never have owned, a share of Phillips 66, so I'm not sure where that person — what he's referring to.

It may be that there's some way when the form is filled out that — that because I'm CEO of Berkshire that on some line it imputes ownership to me or something. The answer is I've never owned a share of Phillips.

And Seritage is a real estate investment trust that had a total market value of under $2 billion when I bought it. And my situation is that I have about 1 percent of my net worth outside of Berkshire and 99 percent in it, and I can't be doing things that Berkshire does.

So a Seritage, with a $2 billion market cap, is not really something that is of a Berkshire size. Plus we've never owned a real estate investment trust to my knowledge, or my memory, in Berkshire at all. I mean, it's just not a — so, I could buy that and not have any worry about a conflict with Berkshire.

As a practical matter, you know, my best ideas are — I hope they're my best ideas —are off-limits for me because they go to Berkshire, if they're sizable enough to have a significance to Berkshire.

We will not be making investments — unless it's something very odd — we will not be making investments in companies with a total market cap of a couple billion while we're our present size.

But — so, every now and then I see something that's subsize for Berkshire that I'll put my — that 1 percent of my net worth in, and the rest of the stuff is off-limits, basically, unless Berkshire's all done buying something or — I mean, I own some wells that I bought a long, long time ago, and Berkshire was not in — was not interested. I mean, we bought enough or something at the time, or maybe we didn't have money for investment.

But I try to stay away from anything that could conflict with Berkshire.

And if I'd been buying Phillips, when Berkshire was buying Phillips, or immediately — or prior — or subsequently, there could be a case where it'd be OK when — we might have hit some limit.

But the answer is I didn't buy any, and I've never owned any. Charlie?

CHARLIE MUNGER: Well, part of being in a position like that we occupy, is you really don't want conflict of interest or even the appearance of it. And it's been 50 or 60 years, when have we embarrassed Berkshire by some of our side-gunning?

Both of us have practically nothing of significance, in the total picture, outside of Berkshire. I've got some Costco stock, because I'm director of Costco. Berkshire's got some Costco stock.

There are two or three little overlaps like that, but basically Berkshire shareholders have more to worry about than some conflict that Warren and I are going to give it. We're not going to do it.

WARREN BUFFETT: It may sound a little crazy, and it's only because I can afford to say this, but I would much rather make money for Berkshire than for myself.

I mean, it isn't going to make any difference to me anyway. I've got all the money I could possibly need, and way more, and on balance, my personality — everything's more wound up in how Berkshire does than I am myself, because I'm going to give it all away.

So, I know my end result is zero, and I don't want Berkshire's end result to be zero. So I'm on Berkshire's side. (Laughs)

10. Berkshire's cash flow outlook

WARREN BUFFETT: Cliff. (Applause.)

CLIFF GALLANT: One of the great financial characteristics of Berkshire today is its awesome cash flow.

While its simple earnings-less-capex formula yields an annual free cash flow calculation of, I figure, of around 10 to 12 billion, in reality it seems to be much higher, closer to 20 billion, and I think, in part, due to changes in the deferred tax asset year-to-year.

What is the outlook for free cash flow, and can investors continue to expect similar dynamics going forward?

WARREN BUFFETT: Yeah. There's a lot of deferred tax that's attributable to unrealized appreciation in securities. I don't have the figure, but let's just assume that's 60 billion of unrealized appreciation in securities. Well, then there would be 21 billion of deferred tax.

That isn't really cash that's available. It's just an absence of cash that's going to be paid out until we sell the securities.

Some arises through bonus depreciation. The railroad will have depreciation for tax purposes that's a fair amount higher than for book purposes.

But overall, I think of, primarily, the cash flow of Berkshire as a practical matter relating to our net income plus our increase in float, assuming we have an increase.

And over the years, float has added $80-billion-plus to make available for investment beyond what our earnings have allowed for, and that's the huge element.

We're going to spend more than our depreciation in our businesses, primarily, number one, because of the — well, the railroad and Berkshire Hathaway Energy are two entities that will spend quite a bit more than depreciation, in all likelihood, for a long, long, long, long time.

And the other businesses, unless we get into inflationary conditions, it won't be a huge swing one way or the other.

So, our earnings, the 17 — not counting investment, not counting capital gains — but our earnings, which were — whatever they were, you know, around 17 billion — plus our change in float is the net new available cash. But, of course, we can always sell securities and create additional cash. We can borrow money and create additional cash.

But it's not a very complicated economic equation at Berkshire. People didn't — for a long time, they didn't appreciate the value of float. We kept explaining it to them, and I think they probably do now.

The big thing, the goal, what Charlie and I think about, we want to add, every year, something to the normalized — you know, the normalized earning power per share of the company.

And we think we can do it because we should be able to do it. We have retained earnings to work with every year to get that job done.

Sometimes it doesn't look like we've accomplished much, and we haven't accomplished much.

And other years, we — something big happens, and we don't know ahead of time which year is going to be which. Charlie?

CHARLIE MUNGER: Well, there are very few companies that have ever been similarly advantaged.

In the whole history of Berkshire Hathaway, we've lived in a torrent of money, and we were constantly deploying it, and disbursed assets, and we were wising up as we went along. That's a pretty good system.

WARREN BUFFETT: It's a —

CHARLIE MUNGER: We're not going to change it.

WARREN BUFFETT: No. And it's allowed for a lot of mistakes. I mean, that's the interesting thing.

American business has been good enough that you don't have to be — you don't have to really be smart to get a decent result. And if you can bring a little bit of intellect, you know, then you should get a pretty good result.

CHARLIE MUNGER: What you've got to do is be aversive to the standard stupidities. You just keep those out. You don't have to be smart.

WARREN BUFFETT: Thank God.

CHARLIE MUNGER: Thank God, right.

11. We've "avoided the self-destructive behavior"

WARREN BUFFETT: OK. Section 11.

AUDIENCE MEMBER: Hey, Warren and Charlie. Thank you so much for your generosity and sharing your life's accumulation of knowledge and financial capital to the progress of humanity. Thank you for that.

And Berkshire managers, thank you for building important companies and stewarding our financial futures. Thank you, guys.

This is Bruce Wang from MICROJIG, traveling west from Orlando, Florida.

Last year, you kindly shared with me the importance of getting the best reputation you can and behaving well. This year I'd like to ask and preface with, Bill Gates wrote, "Warren's gift is being able to think ahead of the crowd. It requires more than taking his aphorisms to the heart to accomplish that, although Warren is full of aphorisms well worth taking to heart."

And he also added that, "I've never met anyone who thought in business in such a clear way."

Warren, what elusive, yet obvious to you, truth has allowed you to think ahead of the crowd and build a clear mental framework to produce a historically significant institution powerhouse brand?

And, Charlie, same to you, what obvious truth presents itself so clearly to you, but many would fervently disagree with you upon?

WARREN BUFFETT: I think I got the question, and I — you know, I owe a great deal to Ben Graham in terms of learning about investing.

And I learned a — I owe a great deal to Charlie, in terms of learning a lot about business.

And then I've also been around — I mean, I spent a lifetime, you know, looking at businesses and why some work and why some don't work.

You know, as Yogi Berra said, you can see a lot just by observing. And that's pretty much what Charlie and I have been doing for a long time.

And you do — I mentioned pattern recognition earlier — you know, there's — you — and I would say it's important to recognize what you can't do. So we have — we may have tried the department store business and a few things, but we've — we've generally tried to only swing at things in the strike zone, and our particular strike zone. And it really hasn't been much more complicated than that.

You do not need — you don't need the IQ in the investment business that you need in certain activities in life. But you do have — you do have to have emotional control.

I mean, we see very smart people do very stupid things, and it's fascinating how humans do that. Just take the people that get very rich and then leverage themselves up in some way that they lose everything.

I mean, they are risking something that's important to them for something that isn't important to them.

Well, you can say, you could figure that one out in first grade, but people do it time after time.

And you see that constantly, self-destructive behavior of one way or another. I think we've probably — and it doesn't take a genius to do it, but I think we've sort of avoided the self-destructive behavior.

Charlie?

CHARLIE MUNGER: Well, there's just a few simple tricks that work — work well, and particularly if you've got a temperament that has a combination of patience and opportunism in it.

And I think that's largely inherited, although I suppose it can be learned to some extent.

Then I think there's another factor that accounts for the fact that Berkshire has done as well as it has, is that we're really trying to behave well.

And I had a great-grandfather. When he died, the preacher gave the talk, and he said none envied this man's success, so fairly won and wisely used. That's a very simple idea, but it's exactly what Berkshire's trying to do.

There are a lot of people who make a lot of money and everybody hates them, and they don't admire the way they earned the money.

And I'm not particularly admirable of making money running gambling casinos. And, you know, we don't own any. And we've turned down businesses, including a big tobacco business.

So, I don't think Berkshire would work as well if we were just terribly shrewd, but didn't have a little bit of what the preacher said about my grandfather, Ingham.

We want to have people think of us as having won fairly and used wisely.

It works. (Applause.)

WARREN BUFFETT: And we were very, very lucky to be born when we were and where we were. And I mean, we — you could've dropped us at some other place in time or some other part of the world, and things would've turned out —

CHARLIE MUNGER: And think of how lucky you were to have your Uncle Fred. Warren had an uncle who was one of the finest men I ever knew. I used to work for him, too. You know, a lot of people have terrible relatives. (Laughter.)

WARREN BUFFETT: That's not an unimportant point. Just yesterday, we had a meeting of all my cousins and a whole bunch that we just get together at the annual meeting time. There are probably 40 of us or 50 of us there.

And they were pulling out some old pictures, and four — I had four aunts, they are all in these pictures — and every one of them — you know, I mean, you were so lucky to have one like that, and I had four. I mean, they just were — in every way they reinforced a lot of things that needed some reinforcement in my case.

CHARLIE MUNGER: I wish you'd had a couple more. (Laughter.)

WARREN BUFFETT: But —

CHARLIE MUNGER: We'd be doing even better.

WARREN BUFFETT: But, he mentioned my Uncle Fred, but my Aunt Katie worked in the store, too. My Aunt Alice worked in the store, and they just — you just couldn't have been around better people. I think Charlie would agree with that.

CHARLIE MUNGER: Yeah. Well, we were very lucky.

WARREN BUFFETT: Yeah. My grandfather was a little tough, however. Tell them what my grandfather used to do when he paid you on Saturday, Charlie.

CHARLIE MUNGER: Well, that was very interesting. Warren's a Democrat, but he came from different antecedents. I worked for his grandfather, Ernest, and he was earnest. (Laughs)

And when they passed Social Security, which he disapproved of because he thought it reduced self-reliance — and he paid me $2 for 10 hours work, there was no minimum wage in those days — on Saturday, and it was a hard ten hours.

At the end of the ten hours, I came in and he made me give him two pennies, which was my contribution to Social Security. (Laughter)

And he gave me two $1 bills and a long lecture about the evils of Democrats, and the welfare state, and a lack of self-reliance, and it went on and on and on and on.

So, I had the right antecedents, too. I had Ernest Buffett telling me what to do.

WARREN BUFFETT: OK. Enough family history.

CHARLIE MUNGER: I haven't overstated that, have I?

WARREN BUFFETT: No, you haven't overstated it at all. (Laughs)

CHARLIE MUNGER: You can't believe what people — and he thought he was doing his duty by the world to do that.

WARREN BUFFETT: But we were lucky then. The people we were around when we were young, we were very lucky.

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

WARREN BUFFETT: Andrew.

ANDREW ROSS SORKIN: "Warren and Charlie, you're famous for making a deal over a day or two with nothing more than a handshake. You pride yourself on the small overhead of doing the diligence mostly yourself.

Other successful acquisitive companies use teams of internal people, outside bankers, consultants, and lawyers to due diligence, often over many months to assess deals.

Speed may be a competitive advantage. You've done some amazing deals. But does your diligence process also put us at greater risk? And if you're ever gone, how would you recommend Berkshire change how we approach dealmaking?

WARREN BUFFETT: Yeah. I get that question fairly often, sometimes — often from lawyers.

In fact, our own — we talked to Munger Tolles, the law firm, and that was one of the questions I got, why we didn't do more due diligence, which we would have paid them by the hour for.

The — (Laughter)

It's interesting. We've made plenty of mistakes in acquisitions. Plenty. And we made mistakes in not making acquisitions, but the mistakes are always about making an improper assessment of the economic conditions in the future of the industry of the company.

They're not a bad lease. They're not a specific labor contract. They're not a questionable patent. They're not the things that are on the checklist, you know, for every acquisition by every major corporation in America. Those are not the things that count.

What counts is whether you're wrong about — whether you've really got a fix on the basic economics and how the industry's likely to develop, or whether Amazon's likely to kill them, you know, in a few years, or that sort of thing.

We have not found a due diligence list that gets at what we think are the real risks when we buy a business. And like I say, we've made — we've certainly made at least — oh, at least a half a dozen mistakes and probably a lot more if you get into mistakes of omission.

But none of those would have been cured by a lot more due diligence. They might have been cured by us being a little smarter.

It isn't — it just isn't the things that are on the checklist that really count. Assessing whether a manager, who I'm going to hand a billion dollars to, for his business, and he is going to hand me a stock certificate, assessing whether he's going to behave differently in the future in running that business than he has in the past when he owned it, that's incredibly important, but there's no checklist in the world that's going to answer that.

So, if we thought there were items of due diligence — and incidentally, there are a few that get covered. I mean, you want to make sure that they don't have twice as many shares out as you're buying or something of the sort.

But they're — if we thought there were things that we were missing that were of importance in assessing the future economic prospects of the business, you know, we would, by all means, drill down on those.

But the question of — you know, when we bought See's, it probably had 150 leases. You know, when we — when we buy Precision Castparts, they have 170 plants, you know, there's going to be pollution problems at some place.

Those are — that is not what determines whether a $32 billion acquisition is going to look good five years from now, or ten years from now.

We try to focus on those things. And I do think it probably facilitates things with, at least, certain people that our method of operation does cut down —

You get into squabbles on small things. I've seen deals fall apart because people start arguing about some unimportant point, and their egos get involved, and, you know, they draw lines in the sand and all of that.

I think we gain a lot. When we start to make a deal, it usually gets done. Charlie.

CHARLIE MUNGER: Well, if you stop to think about it, business quality usually counts on something more than whether you cross the T in some old lease or something.

And the human quality of the management who are going to stay are very important. And how are you going to check that as — by due diligence, you know?

And I think — I don't know anybody who's had a generally better record than Berkshire in judging business quality and the human quality of the people.

We're going to lead the business after it's acquired, and I don't think it would've improved at all by using some different method. So I think the answer is that for us, at least, we're doing it the way we should.

WARREN BUFFETT: Negotiations that drag out have a tendency — they're more likely to blow up for some reason. I mean, people — they can get obstinate about very small points, and it's silly to be obstinate, but people get silly sometimes.

I like to keep things moving. I like to show a certain amount of trust in the other person, because usually trust comes back to you.

But the — you know, the truth is there's some bad apples out there, and spotting them is not going to come from looking at documents.

You really have to size up whether that person who's getting a lot of cash from you is going — how they're going to behave in the future, because we're counting on them.

And that assessment is as important as anything involved — you know, we know all the figures and everything going in, and we know what we'll pay, and so we don't want things to get gummed up in negotiations.

And I'm perfectly willing to lose small points here and then on a deal. If I have the deal on the right terms, I don't believe in — in making a — and Tom Murphy taught me this — I mean, you know, you just don't try and win every point. It's a terrible mistake.

You make a decent deal, and if you find something that bends a little different someway, that's OK.

If you think it's bad faith and gives an indication of the character of the person you're dealing with, then you got another problem, and you're lucky if you find that out early. Charlie, any more?

CHARLIE MUNGER: How many people who, in this room, are happily married, carefully checked their spouse's birth certificate and so on? (Laughter)

My guess is that our methods are not so uncommon as they appear.

WARREN BUFFETT: Yeah. I'll think about that. (Applause.)

13. "We don't pay any attention to titles"

WARREN BUFFETT: OK, Gregg.

GREGG WARREN: Warren, the announcement earlier this month, that Ajit Jain would be taking over responsibility for all of Berkshire's reinsurance efforts once Tad Montross retires from General Re, has raised some questions about not only the change in leadership structure but succession planning.

Given the state of the reinsurance market, it makes sense to have Ajit overseeing both businesses, especially if the pricing environment expected to be difficult for another ten years, and there are duplicative efforts that can be streamlined.

Given this move and the change in responsibilities we've seen at several of Berkshire's subsidiaries the last few years, I was just wondering if you could just give us some color on how succession planning is handled at the subsidiary level, and any insight you could give us into what led you to finally decide to have Ajit oversee both of Berkshire's reinsurance arms, and whether or not it will change the amount of work you'll be doing on the specialty side of the business, would be greatly appreciated.

WARREN BUFFETT: Yeah. Well, Tad Montross, after 39 years, has done an absolutely sensational job for Berkshire. You know, originally — (applause)

Gen Re was a problem child for a while, as you know. Some brought on by itself and some external. But the — and Tad is — I mean, he's sensational, and I tried several times, maybe successfully in terms of months but not in terms of years, to get him to stay on longer.

As you say, it makes sense to have the reinsurance operation under Ajit. Ajit's ability to handle more and more things in insurance — he oversees a company called GUARD, which most of you have never heard it, and we bought it a few years ago, and it's doing terrifically. It's based in Wilkes-Barre, Pennsylvania.

It's doing a great job with small business policies, primarily workers' comp, around the country. And it's flourished, you know, being put under Ajit.

He started the specialty operation a couple years ago, and under Peter [Eastwood], that is going gangbusters.

And I have found — and this is interesting, but it's true — I have found with really able people, they can handle so much.

I mean, they almost — well, just take Carrie Sova, that put this meeting together.

You know, if you have some preconceived notion that an annual meeting that's going to have 40,000 people therefore needs, you know, to spend millions of dollars with all kinds of organizational planning and meetings and meetings and meetings, but really able people — my assistant, Debbie Bosanek, she can do anything.

So there's just no limit to what talented people can accomplish. And if I had something else in insurance tomorrow that needed doing, I'd probably call Ajit on that, too.

So it has no — you know, in terms of my succession, that's something — we'll have a board meeting on Monday, but we'll talk about it as we always do at every meeting and — you know, when — we haven't — our thoughts are as one on that, and everybody knows why it makes the most sense.

But five years from now, something different could make sense. That's one reason for not announcing any names. I mean, who knows what happens in terms of the time when it happens or what happens to the person involved? Maybe their situation changes.

So it's not a — there are no tea leaves to read in the fact that Ajit is supervising Gen Re from this point forward. Charlie?

CHARLIE MUNGER: Well, and there's an obverse side of that. Not only can the able people usually do a lot more, but the unable people by and large you can't fix. So —

WARREN BUFFETT: That is for sure.

CHARLIE MUNGER: I think you're forced to use our system if you have your wits about you.

WARREN BUFFETT: And we don't feel the need to follow any kind of organizational common view as to, you know, you do this and you have — only so many people can report to you or any of this sort of thing.

Berkshire — every decision that comes up, you know, we just try and figure out the most logical thing to do at that time. But we don't have some grand design in mind of, you know, like an army organizational chart or something of the sort, and we never will.

CHARLIE MUNGER: Warren and I once reached a decision we wouldn't pay more than X dollars for something, and the man who was subordinate to both of us who was working on it just said, you guys are out of your minds. This is really stupid. This is a quality operation, you ought to pay up for it. We just looked at one another, and did it his way.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: We don't pay any attention to titles or —

WARREN BUFFETT: He was right, too.

CHARLIE MUNGER: He was right, yeah, of course. (Laughs)

WARREN BUFFETT: OK. I'm sorry. Have you got —?

CHARLIE MUNGER: If a charwoman gave us a good idea, we'd accept it cheerfully.

WARREN BUFFETT: Actually, one time the woman that does clean my office came in, and I think she'd been kind of wondering what I did, you know, based on — and I'd see her frequently, and her name was Ruby.

And finally one day she decided to really get to the heart of the matter, and she said, "Mr. Buffett, do you ever get any good horses?" Apparently thought this is where I was really making my money, was at the track, but — (Laughter)

14. "The rating agencies are wrong" on Berkshire

WARREN BUFFETT: OK. Station 1.

AUDIENCE MEMBER: Hello, Mr. Buffett —

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: — Mr. Munger. Nirav Patel. Haverhill, Massachusetts. Thank you for taking my question.

With Berkshire Hathaway being so well managed, why doesn't it have a highest credit bond rating?

CHARLIE MUNGER: Let me take that one.

WARREN BUFFETT: OK.

CHARLIE MUNGER: The rating agencies are wrong — (laughter and applause)

— and set in their ways.

WARREN BUFFETT: And we don't fit their model very well.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. I mean, we don't look like anything, exactly, they see otherwise. But —

CHARLIE MUNGER: But that's the answer.

WARREN BUFFETT: Yeah. And we — (Laughter)

I'll say this, though. What I do, when they come in the door, I always say, "Let's talk quadruple-A." I believe in starting the negotiation from that standpoint. I never get any place.

15. 3G's cost cutting hasn't hurt Kraft Heinz

WARREN BUFFETT: OK. Carol.

CAROL LOOMIS: Questions continuing to come in about the financing and working relationship that Berkshire formed with 3G a couple of years ago, and this is one of those questions:

"While 3G has been very successful in cutting costs and increasing margins at Kraft Heinz, the company has seen volumes and revenues decline.

As a long-term investor, how do you judge when a management is cutting muscle as well as fat? Can a business increase revenues while cutting costs?"

And I forgot to say, this came from Rick Smith at New York City.

WARREN BUFFETT: Well, the answer is, yes, that sometimes you can cut costs that are a mistake to cut, and you can — and sometimes you can keep costs that are a mistake to keep.

Tom Murphy had the best approach. I mean, he never hired a person that he didn't need, and therefore, they never had layoffs.

And you might say that at headquarters at Berkshire, we follow a similar approach. You would never — we just don't — we don't take on anybody.

Now, I think it is totally crazy when companies are in — now, if you're in a cyclical business, you may have to cut a workforce because there aren't as many carloads of freight moving, or something like that, so you cut back on crane crews and all that — but the idea that you give up your staff, whatever it may be, economists or something like that, because business has slowed down — if you didn't need them — if you don't need them now, you didn't need them in the first place, you know.

I mean, the people that are there just because somebody started a department, and they hired more people, and so on, I would argue that — since we've forgotten to insult this group so far — I would suggest that happens in investor relations departments, perhaps, or something of the sort.

You know, you get people — you get a department going and they're always going to want to expand.

The ideal method is not to do it in the first place. But there are all kinds of American companies that are loaded with people that aren't really doing anything or are doing the wrong thing. And if you cut that out, it should not really have any significant effect on volume.

On the other hand, if you cut out the wrong things, you could have a big effect. I mean, it can be done in a dumb way or a smart way.

My impression, with everything I've seen, and I've seen a fair amount so far, is that 3G, in terms of the cost cuts that they have made, have been extremely intelligent about it, and have not done things that will cut volume.

It is true that in the packaged goods industry, volume trends for everybody — whether they're fat or lean in their operation — volume trends are not good. And the test will be over time — you know, three, five years — are the operations which have had their costs cut, do they do poor, in terms of volume, than the ones, that in my judgment, look very fat? So far I see no evidence of that whatsoever.

I do think at Kraft Heinz, for example, we've got certain lines that will decline in volume. I think we've got certain lines that will increase. But I think overall, the packaged goods industry is not going to go anyplace in terms of physical volume, and it may decline just a bit.

I can't — I've never — I've never seen anybody run anything more sensibly than 3G has, in terms of taking over operations where costs were unnecessarily high, and getting those costs under control in a hurry.

And the volume question, we'll look at as we go along. But believe me, I look at those figures every month, and I look at everybody else's figures every month, and I try to — I'm always looking for any signs of underperformance because of any decisions made, and I've seen none. Charlie?

CHARLIE MUNGER: Yeah. And sometimes when you reduce volume, it's very intelligent, because you're losing money on the volume you're discarding.

It's quite common for a business, not only to have more employees than it needs, but sometimes it has two or three customers that it would be better off without. And so it's hard to judge from outside whether things are good or bad just because volume is going up or down a little.

Generally speaking, I think the leanly-staffed companies do better at everything than the ones that are overstaffed. I think overstaffing is like getting to weigh 400 pounds when you're a normal person. It's not a plus.

WARREN BUFFETT: Yeah. Sloppy thinking in one area probably indicates there may well be sloppy thinking elsewhere.

And I have been a director of 19 public corporations, and I've seen some very sloppy operations, and I've seen a few really outstanding business operators. And there's a huge, huge difference.

If you have a wonderful business, you can get away with being sloppy. We could be wasting a billion dollars a year at Berkshire, you know, 650 million after tax, that'd be 4 percent of earnings, and maybe you wouldn't notice it. But —

CHARLIE MUNGER: I would.

WARREN BUFFETT: — it grows. (Laughter)

Charlie would notice it, so I —

But it's the really prosperous companies that — you know, some — well, the classic case I think were the tobacco companies many years ago. I mean, they, you know, they went off into this thing and that thing and — and it was practically play money because it was so easy to make, and it didn't require, you know — it didn't require good management, and they took advantage of that fact. You can read about some of that in "Barbarians at the Gate."

16. We paid less for Van Tuyl than it appears

WARREN BUFFETT: OK. Jonathan.

JONATHAN BRANDT: Berkshire paid 4.1 billion for Van Tuyl's auto retailing business and consolidated its earnings for nearly ten months last year.

Given prevailing acquisition multiples in the industry, and margins, and the record level of retail auto sales, it seems that the acquisition should have contributed more to Berkshire's bottom line in 2015 than it seemed to, although it's hard to tell for sure since its results were lumped in with those of the German motorcycle apparel acquisition, which was only owned for a part of the year, also.

I understand the deductive — tax-deductible intangibles reduce the effective purchase price of Van Tuyl, but I still wonder whether there were any one-time charges or whether profits from insurance and finance operations could have been reported somewhere other than in the retail segment?

WARREN BUFFETT: Yeah.

JONATHAN BRANDT: I imagine Berkshire is earning a better return on the acquisition than is so far apparent, but I wonder if you could explain the difference between the likely economics of the deal and what I infer from the annual report figures.

WARREN BUFFETT: Yeah. Well, you're right about it. It is better than it looks.

For one thing, we got a billion dollars of securities, roughly, with the 4.1, and those securities we're basically carrying at a quarter of a percent. But that billion is available to us, and that came with the deal.

There's some very significant acquisition accounting charges that will continue for a couple of years, and that I'm happy to have taken that way.

The economics of Van Tuyl, I would say, have worked out almost exactly as — if you had me, a year ago, lay out a projection — I don't do it — but if I had, it would look very much like things have turned out.

And Jeff Rachor, who runs that operation, really fits the Berkshire mold. I mean, we've got a first-class CEO there.

But take a billion off the purchase price just for openers, and then there are some amortization charges of items that are allowable that make you correctly see a fairly low figure against what it appears the acquisition price was. So far, it's exactly on schedule, and the schedule was perfectly satisfactory.

OK. Station 2.

We haven't — incidentally — we haven't had much luck, so far, in acquiring other auto dealerships based on the same metrics that we bought Van Tuyl. And I think to a small degree, that's because people think we paid more for Van Tuyl than we did.

They're not seeing certain factors in it, so they think we paid X, and therefore they're entitled to X, and we didn't pay X, so we haven't made — we've bought very little so far. I hope that changes in the future.

But we're not going to change — we're not going to change our metrics, in terms of how we value auto dealerships.

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

WARREN BUFFETT: OK. Station 2.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. I'm John Gorry from Iowa City, Iowa.

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

Do you choose a high valuation because the discount rate is low, or on the other hand, do you choose a low valuation because the cash flow is likely to be poor?

WARREN BUFFETT: Well, going from — which we haven't done in this country, yet — but going from zero to minus-a-half is really no different than going from 4 to 3 and a half.

It has a different feel to it, obviously, if you have to pay a half a point to somebody. But if you have your yield — or your base rate — reduced by a half a point, it's of some significance, but it isn't dramatic.

What's dramatic is interest rates being where they are, generally. I mean, whether they're zero, plus a quarter, minus a quarter, plus a half, minus a half, we are dealing with a situation of, essentially, very close to zero interest rates, and we have been for a long time and longer than I would've anticipated.

The nature of it is that you'll pay more for a business when interest rates are zero than if they were, like, 15 percent when [former Federal Reserve Chairman Paul] Volcker was around, and you can take that up and down the line.

I mean, we don't get too exact about it, because it isn't that exact a science, but very cheap money makes me pay a little more for businesses than when money was at what we previously thought was normal rates. And very tight money would cause me to pay somewhat less.

I mean, you know, the — we had a rule for 2600 years that — Aesop lived around 600 BC, but he didn't happen to know it was BC, but, you know, you can't know everything — and it was that a bird in a hand is worth two in the bush. But a bird in the hand now is worth about nine-tenths of a bird in the bush in Europe, you know, because it depends on how far out the bush, but it keeps getting a little less as you go on. So these are very unusual times that way.

And if you ask me whether I paid a little more for Precision Castparts because interest rates were around zero, than if they'd been 6 percent, the answer is yes.

I try not to pay too much more, but it has an effect. And if interest rates continue at this rate for a long time, if people ever really start thinking something close to this is normal, that will have an enormous effect on asset values.

It already has some effect. Charlie?

CHARLIE MUNGER: Yeah, but I don't think anybody really knows much about negative interest rates. We never had them before.

And we've never had periods of stasis like — except for the Great Depression — we didn't have things like happened in Japan: great modern nation playing all the monetary tricks, Keynesian tricks, stimulus tricks, and mired in stasis for 25 years.

And none of the great economists who have studied this stuff, and taught it to our children, understand it, either. So we just do the best we can.

WARREN BUFFETT: And they still don't understand it.

CHARLIE MUNGER: No. Our advantage is that we know we don't understand it.

WARREN BUFFETT: It's interesting, though. I mean, we are — you know, it's — it makes for an interesting movie.

And it does modestly affect what we pay for businesses. Whether — I don't think anybody expected it to last this long, do you Charlie, personally?

CHARLIE MUNGER: I don't think — if you're not confused, you haven't thought about it correctly.

WARREN BUFFETT: Yeah. I thought about it correctly, then. (Laughs)

18. No comment on GEICO-IBM cooperation

WARREN BUFFETT: Becky.

BECKY QUICK: Warren, in the past you've talked about GEICO working with IBM's Watson.

WARREN BUFFETT: Yeah.

BECKY QUICK: And this shareholder, Guillermo Bermudez, writes in and wants to know, "Would IBM be able to offer insurance industry competitors of GEICO the solutions developed with GEICO help and expense?

"I would think that there would be confidentiality provisions to protect GEICO, because in as much as GEICO educates IBM as to insurance issues, GEICO could be at jeopardy of competitors gaining or equaling its advantage if they purchase solutions jointly developed by GEICO and IBM."

WARREN BUFFETT: Yeah. I would say the answer to that is that both parties have thought about that matter, very intensively and extensively, and neither would be in a position to talk about it.

I don't like to not answer any questions, but there's some things that it doesn't pay to answer. Am I right, Charlie?

CHARLIE MUNGER: Yes, of course you're right. (Laughter)

WARREN BUFFETT: I like that.

19. American Express faces tough competition

WARREN BUFFETT: Cliff.

CLIFF GALLANT: You've long stressed the importance of taking a long-term view when investing. Over the decades, your substantial returns in American Express seem to support your point.

Now, you've talked in the past about the ability of American Express to reinvent itself over time, but today it seems to be a company that doesn't have alternative businesses and its brand doesn't seem to have the same cachet as it once did.

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

WARREN BUFFETT: Well, we reassess our reasons for owning all investments on almost a continuous basis.

And both Charlie and I do that, and we're usually in a general range of agreement, but sometimes we are a fair distance apart, perhaps.

There's no question that payments are an area of intense interest to a lot of very smart people, who have got a lot of resources, and —

CHARLIE MUNGER: And rapid change.

WARREN BUFFETT: Yeah. And rapid change, and it will change.

And I personally feel OK about American Express. We — and I'm happy to own it. I think — but their position — and it has been under attack for decades, more intensively later — lately — and it will continue to be under attack.

I mean, it's too big a business, and it's too interesting a business, and it could be too attractive a business, for people to ignore it.

And it plays to the talents of some very smart people. I mean, it's a natural, that a great many organizations that are really quite able, think about it. And it's big. So —

CHARLIE MUNGER: A lot of great businesses aren't quite so great as they used to be.

The packaged good business, the Procter & Gambles and so forth of the world — General Mills — they're all weaker than they used to be at their peak and —

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

CHARLIE MUNGER: Oh, my God. When I think of the power of General Motors when I was young, and what happened — they wiped out all the shareholders — I would no more have predicted that.

When I was young, General Motors loomed over the economy like a colossus. It looked totally invincible. Torrents of cash. Torrents of everything.

WARREN BUFFETT: Trying to hold down market share.

CHARLIE MUNGER: Yes, because they — yeah, they were afraid they'd be too monopolistic.

And so the world changes, and we can't change — make a portfolio change — every time something is a little less advantaged than it used to be.

WARREN BUFFETT: But you have to be —

CHARLIE MUNGER: Alert.

WARREN BUFFETT: — you have to be thinking all the time and alert to whether there's been something that really changes the game in a big way. And that's not only true for American Express, that's true for other things we own, including things we own 100 percent of.

And we'll be wrong sometimes. We'll be late sometimes, we'll be wrong sometimes. But we'll be right sometimes, too. But it's not that we're not cognizant of threats.

Assessing the probabilities of those threats being a minor problem, or a major problem, or a life-threatening problem, you know, it's a tough game, but that's what makes our job interesting.

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

20. We like steak but aren't interested in owning cattle

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Hi, Mr. Buffett.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: Hi, Mr. Munger. I'm from Flagstaff, Arizona. My name is Nick Kelly. My family runs some cattle ranches down in Arizona, and that's kind of what my question pertains to.

I'm curious on your thoughts as it relates to the expanding global population and investing in cattle and if you think it's wise. Thank you.

WARREN BUFFETT: Charlie?

CHARLIE MUNGER: I think it's one of the worst businesses I can imagine for somebody like us. (Laughter)

WARREN BUFFETT: There's nothing personal about this.

CHARLIE MUNGER: Yeah. Not only is it a bad business, but we have no aptitude for it.

WARREN BUFFETT: Some people have done well in it, Charlie.

CHARLIE MUNGER: Well, I — yeah. They have one good year every 20 years or something.

AUDIENCE MEMBER: I know you guys like steak.

WARREN BUFFETT: Very much.

CHARLIE MUNGER: But not owning cattle. (Laughs)

WARREN BUFFETT: You know, it — actually, I know a few people that have done reasonably well in cattle, but they usually own banks on the side or something, so — (Laughter)

But I wish you the best at it. (Laughter)

And I'm in Kiewit Plaza, if want to send anything along. (Laughs)

CHARLIE MUNGER: Somebody has to occupy the tough niches in the economy.

We need you. (Laughter)

AUDIENCE MEMBER: Thank you.

WARREN BUFFETT: Thank you.

CHARLIE MUNGER: Yeah. (Applause)

21. Don't reward profits in compensation plans

WARREN BUFFETT: Andrew.

ANDREW ROSS SORKIN: Warren and Charlie — well, the first part is for Charlie; second part is for Warren.

"Charlie, you clearly understand the power of incentives. How do you apply this at Berkshire when designing compensation formula?

"Without naming names or dollar amounts, please illustrate for us with examples — of a couple of examples — of how Berkshire's operating managers get paid for performance in different industries."

The second part is for Warren, which is, "You once said you'd write about how we should compensate the next Berkshire CEO. Can you describe exactly how we should do it now?"

CHARLIE MUNGER: I'll let Warren worry about the next CEO.

But the — when it comes to assess — our incentive systems are different and what they try and adapt to is the reality of each situation.

And the basic rule on incentives is you get what you reward for. So, if you have a dumb incentive system, you get dumb outcomes.

And one of our really interesting incentive systems is at GEICO, and I'll let Warren explain it to you, because we don't have a normal profits-type incentive for the people at GEICO.

Warren, tell them, because it's really interesting.

WARREN BUFFETT: Yeah. Well at GEICO, we have two variables, and they apply to well over 20,000 people. I think you have to be there a year, but beyond that point, anybody that's been there a year or more — and I could be wrong on the exact period — is subject — and knows — understands — that these two variables will determine bonus compensation. And as you go up the ladder, it has a multiplier effect.

It's still the same two variables, but it gets to be larger and larger, in terms of bonus compensation as a percentage of your base, but it's always significant. It's always significant.

And those two variables are very simple. I care about growing the business, and I care about growing it with a profitable business. So we have a grid, which consists of growth and policies in force on one axis — not gross in dollars, because that's reflected by average premiums, which are outside their control — but growth in policies in force.

And then on the other grid, we have the profitability of seasoned business. It costs a lot of money to put business on the books. I mean, we spend a lot of money on advertising and all of that.

So the first year, any business we put on the books is going to reduce profits significantly. And I don't want people to be worried about the profit if it's going — that comes — that might be impaired by growing the business fast.

So, profit of seasoned business, growth of policies in force. Very simple. We've used it since 1995. We put a tiny little tweak or two in for new businesses or something, but it's overwhelmingly a simple system.

Everybody understands it. In February, or so, it's a big day when the two variables are announced and people figure out how they come out on it.

And it totally aligns the goals of the organization, in terms of compensation, with the goals of the owner.

And that's a simple one. The interesting thing about —

CHARLIE MUNGER: It's simple, but other people might reward something like just profits, and so the people don't take on new business, they should take it on, because it hurts profits.

So you've got to think these things through, and, of course, Warren's good at that, and so is [GEICO CEO] Tony Nicely.

WARREN BUFFETT: Yeah. And just thinking about — you know, I mean, very — somebody comes in and says, well, if you reward profits — you don't want to award profits, alone. It'd be the dumbest thing you could do.

You just quit advertising, and, you know, start shrinking the business a little. That's a — and like I said, that — people there know that the very top person is getting paid based on those same two variables. So that they — they don't think that the guys at the top have got a cushy deal compared to them, and all of that. It's just a very logical system.

The interesting thing — and I'll get to your second thing in a — second question — in a minute, but the interesting thing is that if we brought in a compensation consultant, they would start coming up with plans that would be designed for all of Berkshire, and get us all pulling together, you know —

CHARLIE MUNGER: Maybe an undertaking parlor.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: God knows where they'd get the plan.

WARREN BUFFETT: The — you know, the idea of having a — sort of — a coordinated arrangement for incentive compensation across 70 or 80 businesses, or whatever, is just totally nuts.

And yet, I would almost guarantee you that if we brought in somebody, they would be thinking in terms of some master plan, and little subplans, and all this kind of thing, and explain it with all kinds of objectives.

We try to figure out what makes sense in each business we're in. There's some businesses where the top person is enormously important, or some businesses where the business itself dominates the nature — the result.

We try to design plans that make sense. In certain cases — I asked one fellow that came to work for us — or that was selling me his business — the day I met him he came to the office, and he had a business he wanted to sell, but he also wanted to keep running it. And I made a deal with him on it.

And then I said, you know, tell me what the compensation plan should be. And he said, well, he said, I thought you told me that. (Laughs)

I said no. I said, I don't want a guy working for me that has a plan that he thinks doesn't make sense, or that he's unhappy with, or chewing at him, or he's complaining to his wife about it, whatever it may be.

You tell me what makes sense. And he told me what made sense, and it made sense, and we've been using it ever since. Never changed a word.

We have so many different kinds of businesses. Some of them are very tough businesses. Some of them are very easy businesses. Some of them are capital intensive. Some of them don't take capital.

I mean, you just go up and down the line, and to think that you'll have a simple formula that can be sort of stamped out for the whole place, and then with some overall stuff for corporate results on top of it, you'd be wasting a lot of money, and you'd be misdirecting incentives.

So we think it through one at a time, and it seems to work out pretty well.

In terms of the person that succeeds me, it's true, I have sent a memo to the — in fact, I sent two memos to the board — with some thoughts on that. Maybe I'll send a third one.

But I don't think it would be wise to disclose exactly what's in those letters. But it's the same principle as I've just gotten through describing.

CHARLIE MUNGER: And he wanted more bad examples.

A lot of the bad examples of incentives come from banking and investment banking. And if you reward somebody with some share of the profits, and the profits are being reported using accounting practices that cause the profit to exist on paper that are not really happening in terms of underlying economics, then people are doing the wrong thing, and it's endangering the bank and hurting the country and everything else.

And that was a major part of the cause of the great financial crisis: it's that the banks were reporting a lot of income they weren't making, and the investment banks were, too.

The accounting allowed, for a long time, a lender to use his bad — as his bad debt provision — his previous historical loss rate. So an idiot could make a lot of money by just making way-gamier loans at high interest, and accruing a lot of interest, and saying, "I'm not going to lose any more money on these, because I didn't lose money on different loans in the past."

That was insane for the accountants to allow that. And — literally insane. That's not too strong a word.

And yet nobody's ashamed of it. I've never met an accountant that's ashamed of it.

WARREN BUFFETT: The other — another thing that — possibility is when you get the very greedy chief executive who wants an enormous payoff for himself, and to justify it, designs a pyramid, so that a whole bunch of other people down the line get overpaid in some relation — or get paid — in relation to something they have no control over, just so it doesn't look like he's all by himself, in terms of that fantastic payoff he's arranged for himself.

There's a lot of misbehavior.

And, you know, we saw it — you saw it in pricing of stock options. I mean, people that — you know, I literally would hear conversations in a board room where they hoped they were issuing the options, you know, at a terribly low price.

Well, if you've got people interested in having options issued at a terribly low price, they may occasionally do something that might cause that. And it certainly — what could be dumber than a company looking for a way to issue shares at the lowest price?

Compensation isn't as complicated as the world would like to make it, but that's — if you were a consultant, you would want to make people think it's very complicated, and that only you could solve this terrible problem for them that they couldn't solve.

CHARLIE MUNGER: We want it simple and right, and we don't want it to reward what we don't want.

If you have — those of you with children — just imagine how your household would work if you constantly rewarded every child for bad behavior.

The house would be ungovernable in short order.

22. BNSF's capital expenditures

WARREN BUFFETT: OK. Gregg.

GREGG WARREN: During the past several years, Burlington Northern has spent more than just about every railroad on capital expenditures.

While the company reduced its capex budget from $5.7 billion during 2015, to $4.3 billion this year, it stills represents around 20 percent of annual revenue, which we believe is at least a bare minimum for most railroads to continue to invest indefinitely.

Other than maintenance capex, which is likely to account for around 60 percent of that total, what do you believe are the most likely additional investment opportunities for BNSF, realizing that the secular decline in coal, which has accelerated of late, and the complicated nature of crude oil shipments, where BNSF has already invested heavily the past few years, are likely to push it more towards other parts of the business?

WARREN BUFFETT: As I mentioned in the annual report, in the case of all railroads, merely spending their depreciation expense will not keep them in the same place.

So depreciation is an inadequate measure of the actual steady state of capital expenditure needs of a railroad, even in these fairly noninflationary ways.

And that's an important consideration in buying the business. We knew that going in, and it's been reinforced since.

We spent a lot of money in 2015 because we had a lot of problems to correct. That was when we spent the 5.7 billion.

I would say that the true maintenance capex, if you're looking at 4.3 billion, is higher than 60 percent of that number, when you really evaluate keeping the railroad in competitive shape to do just the same volume as it would be doing the year before.

There is an additional expense at BNSF that is not reflected in the figures. There — we also have a lot of intangible expenses at some other businesses that aren't real expenses. I mean, overall, I think that Berkshire's figures actually are on the conservative side, in relation to real economic earnings. But that's not true at any railroad.

We've also had something called "positive train control," which amounts to a lot of money for the industry. I think we may be a little further along than most of them in paying for that, but that's 2 or $300 million a year and maybe — I don't know whether it'd be close to 2 billion, or something like that, in aggregate.

So it is a very capital-intensive business. We run — at the BNSF — we run far more gross, in revenue ton miles, than any other railroad in North America. And that has obviously some — is a factor on capital expenditures.

But I would say that it's very likely that we will spend more than depreciation — unfortunately, quite a bit more than depreciation — to stay in the same place for a long, long time, as will other railroads.

And that is — that's a negative in the picture. We will always be looking for ways to use capital expenditure money to develop additional business, and we get that opportunity regularly. It's just a question of the size of it.

And, you know, we did a lot of that in the Bakken, and we got benefits from it. We're not getting benefits as much as we thought we would at this point when the price of oil was falling off. But that was a very sensible capital expenditure. And I hope we get the opportunity to do more.

What's happening in coal, with the decline, I mean, that doesn't really have anything to do with our overall capital expenditure budget except we won't be spending a whole lot of money to expand in that arena.

Does that answer your question OK?

GREGG WARREN: I was just thinking maybe with intermodal as well, if that's, you know, a longer-term opportunity to invest more heavily there.

WARREN BUFFETT: Well, we're always open to it. But we would want — you know, you have to see a fair amount of revenue coming from —

We had a proposition, very recently, which we worked on for many, many years, in terms of making the port at Long Beach considerably more efficient. And we spent a lot of money on that, and spent a lot of time, and we would've spent a lot more money — a whole lot more money — if it'd been approved.

Recently a court came out with a decision that was negative on it, and whether that kills the chance to do that or we look someplace else, you know, we'll have to look at the situation.

CHARLIE MUNGER: Our competitors there pretend to be environmentalists. (Laughs)

It's a common practice now.

WARREN BUFFETT: Yeah. In any event, we wouldn't — we thought we had something that made a lot of sense, for both the area and for the transportation system of the country, and — but there are —

CHARLIE MUNGER: We are trying to do the right thing, and so far we've lost.

WARREN BUFFETT: But we're still willing to spend a lot of money —

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: — if we can find things that make the railroad more efficient, or make it larger, I mean, either way.

23. U.S. benefits overall from low oil prices

WARREN BUFFETT: OK. Section 4.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Marcus Douglas. I'm an investment advisor from Houston, Texas.

Where I'm from, there are a lot of people losing their jobs, mostly due to the sharp decline of crude oil prices. My question pertains to the overall state of the union, more so than my dear city.

Keeping in mind that crude oil is primarily bought and sold in American dollars, do either of you believe the major fluctuations in the supply of crude oil influence the future monetary policy decisions?

WARREN BUFFETT: Well, that's yours, Charlie.

CHARLIE MUNGER: Well, my answer would be, not much.

WARREN BUFFETT: Yeah, it's an important industry, obviously. And the decline in the price of oil has had a lot of effects, very good for the consumer, millions and — well, hundreds and millions of consumers — and very bad for certain of the businesses, like the one we bought in Lubrizol, and some others, to a degree.

You know — net, it should be good for the United States, overall, to have low prices for oil. We're a net oil importer. I mean, just like it's good for the United States to have low prices for bananas. We're a banana importer.

Anything we net buy is a plus when prices fall, but oil is big enough, and extends into so many areas, that it also hurts, plenty, when the price of oil falls, and it particularly hurts capital values.

So the value — the consumer gets the benefit when he or she goes to the filling station, you know, every two or three weeks, or something like that, and it comes in relatively small increments.

The capital value contraction, which is huge, if you project out lower-price oil for a while, you know, hits immediately. I mean, an oil field that was worth X may be worth half X, or a third of X, or no X, overnight.

And so, there's certain big factors — well, in terms of our chemical operation, people just stop ordering.

So you have this big impact on capital values immediately, and you have the benefits move in over time. But net, the United States is better off, and Saudi Arabia is worse off, when prices of oil are lower.

Oil is a big part of the economy, but our economy has continued to make progress, overall, during the oil price decline.

But obviously, different regions suffer disproportionately, just like they boomed — you know, they got a real boom in — during the period when it was at $100, and when trucking came in big time. Charlie?

CHARLIE MUNGER: Well, I think that that will do it for this subject.

24. No need to sweep cash from subsidiaries

WARREN BUFFETT: OK. Carol.

CAROL LOOMIS: The question is from Larry Levowitz (PH) of Boston.

"The year-end balance sheet for our manufacturing, service, and retailing operations shows total current assets of 28.6 billion, of which cash and equivalents are 6.8 billion.

"Meanwhile, total current liabilities are 12.7 billion, implying net working capital of 15.9 billion.

"It has become increasingly common for companies like Apple and Dell to finance their business via their suppliers, in some cases with negative working capital.

"Why is it necessary for these Berkshire businesses to have so much working capital, particularly so much cash?

"More generally, how do you think about efficiently managing the working capital of a business segment so large, sprawling, and decentralized as this one?"

WARREN BUFFETT: Yeah. Well, we have excess cash every place at Berkshire, so we don't — at present, it really doesn't make any difference whether we have it at certain subsidiaries or other subsidiaries.

So we do not — we have excess cash. As I pointed out in the past, we'll never go below 20 billion in cash, and we'll actually stay comfortably above it, but — allowing for the preferred that's going to — of Kraft Heinz — we'll be, again, over 60 billion of consolidated cash.

We don't really worry much about what pocket it's in. It's not making anything, anyway, at these levels.

Now, if rates move higher, we've actually got the mechanics in process to do sweep accounts and that sort of thing, which — so I would pay no attention to the particular cash that's being held in that category there.

The cash in Berkshire Hathaway Energy, the cash in the railroad, we have independent levels, that we don't guarantee their debt, and they run with ample cash, and we would not look at sweeping that down to a minimum.

But if you talk about 40 or 50 of our miscellaneous subsidiaries, we will go to a sweep account when rates gets where it really makes any difference to do it.

But right now, when you're getting zero, it doesn't make much difference where you get zero. So I think the fellow's overanalyzed it a little bit, but I understand why he did it.

CHARLIE MUNGER: Warren, one of these ideas is, why don't we imitate some of these other people, and pay our suppliers a lot more slowly, so we have more working capital?

WARREN BUFFETT: Yeah. Well, that's a big thing in business now. And last year, Walmart, for example, went to almost all of their suppliers, as I understand it, and certainly the companies that we supply, and they basically had a list of half a dozen things that they wanted present suppliers to agree to, and one of those things was more-extended terms.

And each of our companies made their own decisions, but my guess is they got more extended terms from most of their suppliers, maybe a very high percentage of their suppliers, and they may have gone from — I don't remember the exact request, whether they went from 30 to 60 days, or what it was — but they got a meaningful extension.

So, you will — you know, in a couple years or a year, takes time to implement, you'll see higher payables, relative to sales, at Walmart than you saw a year or two ago.

And, you know, they are under a lot of pressure competing with Amazon and others, and that's one of the ways they expressed it.

And I've seen it done other places, and it's conceivable that one of our subsidiaries might deem it wise to do it, but I don't think they will. I mean, I think that the pressure for cash at Berkshire is not that high, and I think that the pressure for — or the desire for — great relations with suppliers is — would probably overcome, in most of our managers' minds, any desire to start extending terms.

CHARLIE MUNGER: Yeah. I think it's hard to do that, brutally, when you're rich and your supplier isn't, and think that your supplier is going to love you.

And so I think there's something to be said for leaning over backward to have a win-win relationship with both suppliers and customers, always. (Applause)

WARREN BUFFETT: It's never been pushed at Berkshire, that's for sure.

You can argue we got a pretty good thing going in float anyway, so — (Laughs)

CHARLIE MUNGER: Yeah, and we don't need it. Let somebody else set the record on that one.

25. "We don't need to inflate the figures"

WARREN BUFFETT: OK. Jonny?

JONATHAN BRANDT: Most American corporations separate out supposedly one-time restructuring costs, whereas Berkshire doesn't. Berkshire's reported operating earnings are, therefore, in my opinion, of higher quality.

Have you ever calculated how much higher operating earnings, on average, would be if Berkshire separated out plant closing costs, product line exits, severance pay, and similar items?

Is it a material number? Or does Berkshire not incur much in the way of these types of costs typically because most of your acquisitions are stand-alones?

CHARLIE MUNGER: Let me take that one.

That's a question like asking, why don't you kill your mother to get the insurance money? (Laughter)

We don't do it. We're not interested in manipulating those numbers, and we haven't had a restructuring charge ever, and I don't think we're about to start. (Applause)

WARREN BUFFETT: Yeah. I would say this, too, Johnny.

We don't do that. The numbers would not be huge. You know, there could be a year, I suppose, when they might be, for some reason, but they are more conservatively stated than most companies, and I think they're of higher quality.

But I've pointed out, also, that I think that our depreciation expense at the railroad, which is standard and which all of the other railroads use, is inadequate as a measure of true operating earnings, but that's —

CHARLIE MUNGER: And you're talking about — we like to advertise our defects.

WARREN BUFFETT: Not all of them. (Laughs)

There's no question that we — I think we will have more amortization of certain intangibles in our — which reduce earnings and reported earnings, but which, in reality, are not expenses — we'll have more of that than some companies.

And I've pointed that out. I haven't — I never want to report one of these things where I have the whole adjusted earnings set out and say, this is what you're supposed to pay attention to, because every one of those I've seen virtually results in some inflation of figures.

Things are good enough at Berkshire. We don't need to inflate the figures.

26. Berkshire Hathaway's credit default swaps

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: This is Martin, calling from Germany. I'm a fixed-income manager.

We launched, with (inaudible), a fund and —

WARREN BUFFETT: You have my — you have my sympathy.

AUDIENCE MEMBER: Yeah, yeah. The volume is about 600, 650 million. We are 4.1 percent ahead this year.

Obviously my question is about fixed income. If I look in your annual report, it's about the volume of 25 billion. And if I add, let's say, the CDS, you were selling the CDS, it is by the volume of 7 or 8 billion.

So my concrete question is, the premium on your CDS is about 31 percent — 31 basis points — at the end of the year, so mark-to-market, it is probably at the high teens or 20s.

So would you consider to unwind this position? Are you allowed to do it and the (inaudible) say no? But probably you can make exactly the contrary trade on it. That means you are buying protection.

Is that a philosophy which you stand behind? Could you do that from the (inaudible) point of view, when the premiums are extremely low, which is at the case that the spreads are, as I said, between 15 and 20 basis points? Can you give —?

WARREN BUFFETT: Charlie, that sounds like it was designed for you. (Laughs)

I think he was referring to — we have one position left over from six or seven years ago, or thereabouts, that involves us selling protection on zero coupon municipal bonds with a nominal value — maturity value, which is — since there's zero coupons, is far off, and not present value, at all. I think 7.7 billion or something like that.

And we're just sitting with that position because we like the position. And the gentleman mentions that our CDS — our CDS is — that's an insurance premium against our debt that people buy.

A, there's a fair amount of activity in it from time to time, and I think that's partially caused by the fact that we neither collateralize that municipal contract that he refers to, but we don't collateralize, with minor exceptions, the equity puts that are still out there.

So the counterparties have to buy — I believe this is the case — I think the counterparties have to buy protection on Berkshire's credit through CDSs.

Now, the people they buy it from, their credit probably isn't as good as Berkshire's, so I mean I think they're — but it's probably an internal rule at some of these firms that are on the other side of the contract, and so — but that really doesn't make any difference to us.

Back in 2008 and '9, our CDS prices went up to a crazy level, and I even commented here at the annual meeting that I would love to be selling them myself, except I wasn't allowed to.

But what goes on in a CDS market really isn't of any particular interest to us, and it's too bad for the other guys. They didn't get collateral from us and we wouldn't have given it to them. And so they have to buy these things that, like I say, from our standpoint, they're wasting their money, but they probably have internal rules that make them.

I think I've addressed your question, but — Charlie, do you think I've addressed his question?

CHARLIE MUNGER: Well, the truth of the matter is that we don't pay much attention to trying to get an extra two basis points by being gamey on our short-term things. And that credit default position is a weird, historical accident, and we don't pay much attention to it, either. It'll go away in due course.

WARREN BUFFETT: Yeah. All of our contracts are just going to expire. We're not — now, we do a few operational contracts in our energy company. I've mentioned a couple places where they — for their own reasons and sometimes because the utility commissions want them to — they do certain things, but it's peanuts.

And the positions that I instituted six or seven years ago are basically all in a runoff position, and the first big runoffs will be in 2018, in a couple years.

CHARLIE MUNGER: We're basically not in — we don't fool around with our own credit defaults.

WARREN BUFFETT: No, no, never, no. But I would've liked to have sold them in 2008. (Laughs)

They actually got up — people were paying —

CHARLIE MUNGER: I know, it was crazy.

WARREN BUFFETT: — 500 basis points, 5 percent, in terms of betting that Berkshire would go broke, which was totally crazy, but I couldn't take advantage of it. I wanted to, though.

27. A fantastic manager makes a huge difference

WARREN BUFFETT: Becky.

BECKY QUICK: This question comes from Tom Hinsley, a long-time shareholder from Houston, Texas, who says, "Over the years, you've been effusive in your praise of Ajit Jain and his contributions to Berkshire.

"In the 2009 chairman's letter you wrote, 'If Charlie, Ajit, and I are ever sinking in a boat, and you can only save one of us, swim to Ajit.'

My question is, what if we don't get to Ajit in time? Please comment on the impact on National Indemnity and Berkshire, and whether or not there's another Ajit in the house."

WARREN BUFFETT: There's not another Ajit in the house.

I didn't hear the part immediately before it when you were — but there is not another Ajit on the house.

BECKY QUICK: The impact on National Indemnity — I guess the impact on the insurance companies, as a result —

WARREN BUFFETT: If we lost him?

BECKY QUICK: Yeah.

WARREN BUFFETT: It would be very significant. And that would be true of some other managers of some other subsidiaries.

But it's quite dramatic with Ajit's operation, because, literally, there were a few years when we had, like, 25 or so — or 30 — people where that operation — it was an unusual period to be in — but where it's earning potential, under Ajit, was fantastic. That probably won't happen to that degree again. I wish it would.

But he's done a tremendous amount for Berkshire. But I can, you know, you can start with [GEICO CEO] Tony [Nicely] — you go to all — there have been a lot of managers that have created billions and billions of dollars of value for Berkshire. I mean, and maybe you can get into the tens of billions, you know.

It's — having a fantastic manager that has a large business — potential business — available to them, and who makes the most of it, you know, it's huge over time. You don't see it necessarily in a week or a month or anything of the sort.

But when you're building capital value, I mean, think of the value of [CEO] Jeff Bezos to Amazon. It wouldn't have happened without him, you know, and you're looking at huge values.

And I could name other situations. You know, the value of Tom Murphy and Dan Burke was the difference between zero and what they ended up with. I mean, they built that thing from a bankrupt UHF station in Albany.

It wasn't that they were — they didn't invent television or anything of the sort, they just managed it so well.

So, really outstanding managers, they're invaluable, and we want to —

Charlie and I can't do it ourselves, but we want to align ourselves with them and then, you know, have them feel about Berkshire the way we feel about it.

And if we do that, we have an enormous asset, and we do have, in Ajit and a number of the other managers. Charlie?

CHARLIE MUNGER: Yes, and Ajit has a longer shelf life than we do. (Laughter)

He'd be particularly missed.

WARREN BUFFETT: Well, let's not give up here, Charlie. (Laughter)

I reject such defeatism. (Laughs)

28. Paying a little money now to have a lot of money later

WARREN BUFFETT: Cliff.

CLIFF GALLANT: Thank you.

Low-to-negative interest rates is something that's been discussed a few times today, and you've mentioned its implications for a return on float.

I was wondering, how should shareholders value the 25 percent of the float that's been created by retrocessional reinsurance, where the business is booked at an underwriting loss, and at times, has adversely developed?

WARREN BUFFETT: Yeah. Cliff brings up, some of our business, in the insurance business, we take with either the probability of some underwriting loss, in order to get to use the money for a very long period of time. And it would look, under today's interest rates, like we can't do much with that.

There's two answers to that. We don't think it will — for the duration of the kind of contracts we have — we don't expect these rates, but we could be wrong.

But the second one, also, is that we do think that occasionally we will get chances, even in periods of low interest rates, to do things that are — will produce quite a bit — very reasonable returns.

And so we do not — we are not measuring it against, you know, double-A corporates, or anything of the sort. We're measuring it in the potential utility, to us with our really pretty unusual flexibility, in respect to the deployment of funds, and this long period when we'll have an opportunity, perhaps, to come up with one or two things that — where we can deploy money at a rate that may be quite a bit higher than other people. Assume now the money can be deployed. Charlie?

CHARLIE MUNGER: Yeah, we're willing to pay a little money now to have just a certainty of having a lot of money available in case something really attractive comes up in a difficult time.

WARREN BUFFETT: Yeah. It's an option cost.

CHARLIE MUNGER: It's an option cost, right.

WARREN BUFFETT: And that option came in handy in 2008 and '9, for example.

CHARLIE MUNGER: Did it ever.

29. No nationwide bubble in residential real estate now

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Hi, Charlie and Warren. My name is Mindy Jensen, and I'm from Longmont, Colorado. I work for the largest real estate investing social network online, called BiggerPockets.com.

We're seeing investors starting to get concerned that the real estate market is a bit frothy, similar to the run-up of 2005, '6, and '7, that led to the crash in 2008.

Warren, in 2012, you told Becky Quick that if you had a way to easily manage them, you'd buy 100,000 houses and rent them out. How do you feel about the real estate market today?

WARREN BUFFETT: It's not as attractive as it was in 2012. (Laughs)

The — you know, we're not particularly better at predicting real estate markets than we are stock markets, or interest rate markets, but there's certainly — and it's driven to some extent by these low interest rates — but there's certainly properties that are being sold at very, very low cap rates that strike me as having more potential for loss than gain.

But again, if you can borrow money for very, very little, and you think you're getting into some very safe asset, 100 basis points or 150 basis points higher, there's a great temptation to do it.

I think it's a mistake to do that, but, you know, I could be wrong.

I don't see a nationwide bubble in residential real estate now, at all. I think, you know, I think in a place like Omaha or, you know — most of the country — you are not paying bubble prices for residential real estate.

But it's quite different than it was in 2012. And I don't think the next time around the problem is going to be a real estate bubble. I think that it certainly was the cause, in a very large part, of what happened in 2008 and '9, but I don't — I don't think it'll be a replica of that. Charlie?

CHARLIE MUNGER: Nothing to add.

30. Praise for portfolio managers Ted Weschler and Todd Combs

WARREN BUFFETT: OK. Andrew.

ANDREW ROSS SORKIN: Warren, Todd and Ted now have been at Berkshire for several years.

What have been their biggest hits, and failures, specifically?

And what have they learned from Charlie and Warren, and what are the biggest differences between you and them?

WARREN BUFFETT: Well, I'll answer the last part, the easiest.

I am trying to think of very big deals that we can do something in, in investments, or in business, preferably just in operating businesses.

I mean, they still are — their primary job is working on — each has a $9 billion portfolio, and one of them has, I don't know, perhaps seven or eight positions, and the other one has maybe thirteen or fourteen, but they have a very similar approach to investing.

They've both been enormously helpful in doing several things, including important things, that — for which they don't get paid a dime, and which they're just as happy working on as — working on the things — as they are when they're working on things that do pay off for them financially.

They've got — they're perfect cultural fits for Berkshire. They're smart at what they do. And, you know, they're a big addition to Berkshire. Charlie?

CHARLIE MUNGER: Again, I've got nothing to add.

WARREN BUFFETT: Did I cover the whole thing, Andrew, or was there one —a part I missed there?

ANDREW ROSS SORKIN: Biggest hits and failures. I think they specifically wanted to know, in terms of investments, and trying to understand the way you think perhaps — I think the question was more — I think — the implication was, the way they think and the way you think, are there differences?

WARREN BUFFETT: Yeah. They're — I would say they're — they have a bigger universe to work with, because they can look at ideas in which they can put 500 million, and I'm looking — I'm trying to think of ways to put, you know, sums into billions.

But — and they probably — well, they certainly — have more extensive knowledge of certain industries and activities in business that have developed in the last ten or fifteen years. They'd be smarter on that than I am.

But their approach to investing, I mean, they're looking for businesses that they understand and that are going to — and through the stocks of those businesses — that they can buy at a sensible price and that they think will be earning significantly more money five or ten years from now.

So it's very similar to what I'm thinking about, except I'd probably add another zero to it.

CHARLIE MUNGER: And we don't want to talk about specific hits and failures.

WARREN BUFFETT: No.

OK. Gregg.

Yeah, we will never get into disclosing — I mean, we file reports every 90 days that show what Berkshire does in marketable securities, but we don't identify — I may identify whether it's mine or theirs, but we don't get into identifying what they do individually.

31. We moved money to pay for Precision Castparts

GREGG WARREN: Looking at Berkshire's finance and financial products segment, there was a fairly significant increase in the amount of cash carried on the group's books last year.

After holding steady between 2 and 2-and-a-half billion dollars during 2012 to 2014, the amount of cash held at the segments spiked up to 5.4 billion at the end of the third quarter of last year, and $7.1 billion at the end of 2015.

This incidentally coincided with your acquisition of GE's railcar leasing unit, as well as the acquisition of several railcar repair maintenance facilities.

Sales and profitability were fairly solid last year, but don't really seem to account for the magnitude of the change in cash. And investments, debt, and other liabilities do not look to have changed significantly enough to count for the difference, perhaps accounting for about $1 billion of the increase.

Just wondering where the additional $3.5 billion in cash came from, and whether or not the elevated level of cash at the end of last year is excess to the business, or a new required level of cash for the operation?

WARREN BUFFETT: Yeah. Well, I can — I can't tell where it came from — you think I would, 3-and-a-half billion — but I can tell you why we were funneling money into the parent company and the finance company.

That money was basically dedicated to making the 22 billion portion of the Precision Castparts purchase that was accounted for by cash. We borrowed — we actually borrowed 12 billion — but 10 billion was what was — of the borrowing — was there.

And we pushed money from various sources, depending on who owned what and that sort of thing, we pushed money into those two entities, and eventually into the parent company, to take care of the 22 billion that was coming due, turned out to be at the end of January, when the Precision Castparts closed. There's really no significance to it other than that.

32. IBM is "coping with a considerable change"

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett and Mr. Munger. My name is Jeffrey Ustep (PH) from Cranford, New Jersey.

I just have a simple question for you. How would you explain IBM's moat?

WARREN BUFFETT: I'm not sure that's a simple question. (Laughs)

CHARLIE MUNGER: No, I don't either.

WARREN BUFFETT: Well, it has certain strengths and certain weaknesses. And I don't think we want to get into giving an investment analysis of any of the portfolio companies that we own.

I would — I think I probably better leave it there. Charlie?

CHARLIE MUNGER: Yeah. It's obviously coping with a considerable change in the computing world, and it's attempting something that's big and interesting, and God knows whether it's going to work modestly or very well.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I don't think Warren knows either.

WARREN BUFFETT: No. We'll find out whether the strengths are strengths. But —

CHARLIE MUNGER: But it’s a field that a lot of intelligent people are trying to get big in.

33. Where Buffett and Munger get their sense of humor

WARREN BUFFETT: OK. We’re going to go to Section 8, and then we will adjourn for 15 minutes, prior to the formal meeting of the company.

Station 8.

AUDIENCE MEMBER: Hello, everybody. Good afternoon. My name is Cristian Campos. I’m from New York City. I’m a senior accounting major at Baruch College, part of the City University of New York.

And, Mr. Buffett, in your annual shareholder letters, and during interviews, and even today, your sense of humor always shines through. Where does your sense of humor come from? Please tell us. Thank you. (Laughter)

WARREN BUFFETT: That’s just the way I see the world. It’s a very interesting and, at times, very humorous place. And actually, I think Charlie has a better sense of humor than I have, so I’ll let him answer where he got his. (Laughter)

CHARLIE MUNGER: I think if you see the world accurately, it’s bound to be humorous, because it’s ridiculous. (Laughter and applause)

WARREN BUFFETT: Well, I think that’s a good note to close on.

34. Shareholder Q&A concludes

WARREN BUFFETT: We will reconvene in 15 minutes for the formal part of the meeting.

We have one proxy item to act on, and — so I hope that those of you who are interested in learning more about, actually, the insurance aspects of climate change, will stick around, and we’ll have a discussion on that. And I’ll see you at 3:45. Thank you.

35. Berkshire’s formal annual meeting begins

WARREN BUFFETT: OK. If everybody will please settle down, we’ll proceed with the meeting.

The meeting will now come to order.

I’m Warren Buffett, chairman of the board of directors of the company. I welcome you to this 2016 annual meeting of shareholders.

This morning, I introduced the Berkshire Hathaway directors that are present.

Also with us today are partners in the firm of Deloitte & Touche, our auditors. They're available to respond to appropriate questions you might have concerning their firm's audit of the accounts of Berkshire.

Sharon Heck is secretary of Berkshire Hathaway, and she will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting. She will certify the count of votes cast in the election for directors, and the motion to be voted upon at this meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding — turned off the lights on me — entitled to vote and represented at the meeting?

SHARON HECK: Yes, I do.

As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 2nd, 2016, the record date for this meeting, there were 807,242 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 1,254,393,030 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to one ten-thousandth of one vote on motions considered at the meeting.

Of that number, 575,608 Class A shares and 772,724,950 Class B shares are represented at this meeting by proxies returned through Thursday evening, April 28th.

WARREN BUFFETT: Thank you. That number represents a quorum, and we will therefore directly proceed with the meeting.

The first order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

MARC HAMBURG: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. We will vote on the motion by voice vote. All those in favor say, "Aye."

Opposed? The motion is carried.

36. Election of Berkshire directors

WARREN BUFFETT: The next item of business is to elect directors.

If a shareholder is present who did not send in a proxy or wishes to withdraw a proxy previously sent in, you may vote in person on the election of directors and other matters to be considered at this meeting. Please identify yourself to one of the meeting officials in the aisle so that you can receive a ballot.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ron Olson, Walter Scott, and Meryl Witmer be elected as directors.

WARREN BUFFETT: Is there a second?

MARC HAMBURG: I second the motion.

WARREN BUFFETT: It has been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors.

Are there any other nominations or any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballot on the election of directors and deliver their ballot to one of the meeting officials in the aisles.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxy holders, in response to proxies that were received through last Thursday evening, cast not less than 643,789 votes for each nominee. That number far exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick.

Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer have been elected as directors.

37. Shareholder proposal on climate change risks

WARREN BUFFETT: The next item of business is a motion put forth by the Nebraska Peace Foundation.

The motion is set forth in the proxy statement, and will the projectionist please put up number 9? Here we are.

The motion requested our insurance business issue a report describing their response to the risks posed by climate change, including specific initiatives and goals relating to each risk issue identified.

The directors have recommended that the shareholders vote against the proposal.

I will now recognize — and I think it'll be up in area one — I will now recognize Dr. James Hansen to present the motion.

But I believe, maybe, the gentleman from the Nebraska Peace Foundation may be introducing it, and then he may introduce Dr. Hansen.

To allow all interested shareholders to present their views, I ask the initial speaker to limit his remarks to five minutes, and then those — the microphone in zone one is available for those wishing to speak for or against the motion, subsequently — zone one is the only microphone station in operation.

For the benefit of those present, I ask that each speaker for or against the motion limit themselves, with the exception of the initial speaker, to two minutes, and confine your remarks solely to the motion. And the motion should be left up on the — let's see, is that up there or not? Yeah, OK, the motion shall be left up there.

In a sense, incidentally, it asks us to present a report about the risk to the insurance division by climate change, and I did address this subject in the annual report. That would be a report, and it was a report that was concurred in by Ajit Jain, who is our number one expert on insurance risks. So that does represent the view of our insurance division, and myself, as the chief risk officer.

But the subject now is open and we welcome the initial speaker's comments.

And if you're just going to introduce Dr. Hansen — I can't see who's who up there — then I presume that he will have the five minutes and then subsequent speakers will have two minutes. So go to it, you're on.

MARK VASINA: Thank you. My name is Mark Vasina. I'm the treasurer of the Nebraska Peace Foundation, the owner of one A share of Berkshire Hathaway.

We are the sponsor of the shareholder resolution which Mr. Buffett has described. In so doing, making the recommendation to develop a risk analysis and report on it, we're following the lead of the Bank of England, which last September published a comprehensive report on climate change risks facing the insurance industry, and recommended that its regulated companies conduct reviews of the risks and make this available.

The Bank of England regulates the UK insurance industry, which is the third-largest global insurance market. I'll turn the rest of my time over to world-renowned climate scientist Dr. James Hansen.

DR JAMES HANSEN: Thank you for this opportunity.

I want to make a suggestion that I hope you will ponder.

Some aspects of climate have become clear. Humans are changing the atmosphere, and we can measure how this is changing earth's energy balance. More energy is coming in than going out.

So the ocean is warming, ice sheets are melting, and sea level is beginning to rise.

We are now close to a point of handing young people a situation that will be out of control, with ice sheet disintegration and multimeter sea level rise during the lifetime of today's young people, which would mean loss of coastal cities and economic devastation.

Sea level rise would be irreversible on any time scale of interest to humanity. The other irreversible effect of rapid climate change would be extinction of a substantial fraction of the species on Earth.

The bottom line is that we cannot burn all fossil fuels, and the economic law of gravity is that as long as fossil fuels appear to be the cheapest energy, we will keep burning them.

So my request, given the respect and the trust the public has in you, is that you reflect upon the possibility of a public statement in favor of a revenue-neutral, gradually-rising carbon fee.

A carbon fee is needed to make the price of fossil fuels honest, to include the costs to humanity of their air pollution, water pollution, and climate change.

A rising carbon fee is needed to spur effective investments by the private sector in clean energies and energy efficiency.

Most important, it will steadily phase down fossil fuel use. I'm not asking you to endorse a carbon fee on the spot, but I hope that you will reflect upon it and perhaps provide a clear statement in your next report.

It could be your greatest legacy. It could affect everything, even the course of our future climate. T

Thanks.

WARREN BUFFETT: Thank you, Dr. Hansen.

I might say that we — (Applause)

— although we may differ on some specifics, and I don't know — I am no expert on this subject whatsoever — I don't think you and I have any difference in the fact that it's important that climate change — you know, since it's something where there is a point of no return — if we are on the course that you think is certain and I think is probable, that it's a terribly important subject.

But the motion that was put forth was relating to the insurance aspects of it, and we have discussed — believe me, we have thought and discussed insurance aspects, and I've, in effect, given a report in the — which was asked for by this — within the annual report.

So it is really not — the issue before the shareholders is not how I feel about whether climate change is real, or whether a carbon tax is appropriate, it's whether it poses a risk to our insurance business.

And I recognize the Bank of England — read that report — but we respectfully disagree with them in terms of — not in terms of the importance of climate change — but in terms of the risk to our insurance business.

We don't — we are not forced — we don't write policies for a long period of time. We're not forced to write a policy on anything, so we are — our judgment is made as propositions are presented to us, usually as to whether, for one year, we are willing to accept a given risk for a given price.

And that — obviously, climate is enormously important in our activities, hurricanes being the most important, probably, although we also get involved in earthquakes — but that is what the proposal is about, and that — and we've given a response to that, and it does not mean that we differ on the importance of climate change to the human race.

So with that, I would be delighted to hear from the various seconders.

JIM JONES: Hello. My name is Jim Jones. I'm the executive director of the Katie School of Insurance at Illinois State University.

I would like to express my concerns, based on three hidden risks associated with climate change.

The first relates to stranded assets of insurers investing in fossil fuels. The second is a more insidious risk related to climate change. This risk is associated with the long-term liabilities associated with property, life, and health lines of business.

And I realize that a number of intelligent people and experts don't see a long-term liability, but they're missing one important part, is that primary insurers are not able to withdraw or reprice books — entire books of business.

Following Hurricanes Katrina, Rita, and Wilma, new hurricane models were developed in Florida, and they attempted to get the recommended rate approvals for that. They were not allowed to, and so many insurers began to withdraw from that market.

Ten years later, that — about 40 percent of the underperforming business is still on the books of those insurers, and this could play out in several other states that are exposed to climate risk.

For a reinsurer, the value of reinsurance with their customers is a long-term business.

The reason why this is so important is because, according to my count, 156 of your reinsurance customers have filed climate change disclosures, and these customers are looking for long-term interest being protected by their reinsurer.

And if not, there's a potential for a relationship default risk that could occur if they perceived your reinsurance as just being one-year contracts that can be repriced or withdrawn.

And you enter into that world of the expanding market competition of alternative reinsurance, which just last year was $72 billion, and earlier this quarter, we set a record of $2.2 billion in cap bonds.

WARREN BUFFETT: Thank you. The — I would point out that we have not been asked, ever, to my knowledge, to write long-term contracts. Our primary insurers know that we look at it one year at a time, and we will not write business that we think has a major negative probability. They don't expect us to.

It's way less a relational business than in the past. It's much more a transactional business.

But it — we will not write — if we lose a customer because they want us to do something stupid, we lose the customer, and there is not a — in our business — I'm not speaking for other reinsurers, but in our business, and I believe with most other reinsurers, they are not going to do something that they think is terribly disadvantageous to them just to maintain a relationship. That's not really a relationship. It'd be a subsidy.

So I do — that does not strike me, frankly, as a factor at all of any negative consequence at Berkshire.

We — in terms of what happened after Katrina — rates went up, and actually it — the hurricane experience in Florida has been better than any period since before 1850 that we have any records on.

That's been a surprise to us, incidentally. But we have not written business — catastrophe business — in Florida during that period, because we didn't think the rates were adequate. They were adequate, we just were wrong about it.

So the — and incidentally, that does not — the fact that we walked away from cat business in Florida that we thought was mispriced — does not hurt us in the business.

It's really a — it's much more of a transactional business in the — there may have been a time when relationships were very big in reinsurance, but with so many entrants in it, it is very much a transactional business. And no one expects you to do something that's very stupid.

You know, if they do, it's the wrong kind of a relationship. But glad to hear the next speaker.

JANE KLEEB: Hello, Mr. Buffett. My name is Jane Kleeb. I run a group called Bold Nebraska, which was part of an unlikely alliance who beat Keystone XL, to protect the aquifer in our state as well as property rights.

And I met you several years at Senator Nelson's home, and I had pulled you aside and asked how could we get health care reform passed?

And you told me two things: You said, the polling numbers matter, and that we have to keep on applying public pressure.

And we feel the same way about climate change and climate action. The most recent Yale study said that even 47 percent of conservatives believe in climate change and want to start seeing corporate and government action.

And your response to this resolution struck me, because one of the sentences said that if you live in a low-lying area, you should probably move.

Well, we work with Native brothers and sisters who live in coastal communities, and one of those tribes is now the first United States climate refugees.

They didn't have the option to move. They were forced to move.

And so we're turning to you and we're turning to ourselves to continue to apply public pressure and hope that both you and Charlie stand with us.

And maybe it's not this year, and maybe it's not the year after, but we really look forward to you doing full climate risk analysis, as well as divesting from all the fossil fuels that you own.

And lastly, it takes both small and mighty, as well as big and powerful, to solve this problem of climate change. So you blocking small solar in Nevada is the wrong road to go down. Thank you. (Scattered applause)

WARREN BUFFETT: I think you'll have a reasonable time to move, but I would say, if you're making a 50-year investment in low-lying properties, it's probably a mistake.

I actually said you may — as a homeowner in a low-lying area — you may wish to consider moving.

And I would say that if you expect to be there for ten years or so, I don't think I would consider moving. But if I thought I was making a 100-year investment, I don't think I would make it.

I think it gets to the question — we have a shareholder proposal that says, what are the risks to the insurance division from climate change?

We're not denying climate change is an incredibly important subject. We're not denying its existence.

But it will not hurt our insurance business, and it's immaterial compared to other things that could affect our insurance business. And, you know, that is the issue before the meeting. But I'll be glad to hear from the next speaker.

AUDIENCE MEMBER: Good afternoon, Mr. Buffett. My name is Kay Harn (PH). I've been a shareholder for more than a decade, basically my investing life.

Today someone said that you think ahead of the crowd. With regards to this resolution, you're saying that the Berkshire insurance business will just raise rates the next time the policy is renewed, and that makes sense. But you agree that climate change poses a major problem for our planet.

I would say that climate change poses a major problem for the stability of our global financial markets, if the political action continues at its current pace with regards to this issue.

I personally agree with Dr. Hansen, that a carbon fee is the solution to address this issue. I'm wondering if you can tell us what you think the solution to address this issue is, and whether you think the Berkshire businesses, more broadly than just insurance, will be impacted by this issue in the next decade or two.

WARREN BUFFETT: Yeah. I would doubt if it's affected in the next decade or two.

But I won't argue with you at all that it's likely, not certain, that — unless various techniques are designed for reducing — well, for sequestration, different things of that sort — that plenty of people will be working on — or unless the emissions greenhouse — gas emissions — are reduced significantly — that it's a terribly important problem for civilization.

And there have been other — I mean, there's certainly going to be some very smart people working on ways to change the balance in some way, either through less being released in the atmosphere or by various techniques that might diminish the impact, but no one here will deny that it's important.

I don't think it will impact — I don't think it will impact, in a serious way, the climate — or insurance, for that matter — in the next decade or two.

But, as I pointed out in the report, if you're dealing with something where there's a point of — where you pass a point of no return, the time to do something isn't when we get ten minutes away from the point of no return.

So there are policies, which we've subscribed to very strongly, in terms of renewables and that sort of thing, but I think there's also possibilities that within the scientific community, there will be solutions that are beyond my limited knowledge of physics to conjure up myself, but there are a whole lot of people out there that are a lot smarter.

And I think that a basic problem on the reduction — if those things don't come to pass — is the fact that it's a planetary problem, and it requires cooperation by very important countries, and I think President Obama has made a good start in working with leaders of other countries. But it can't be solved by the United States alone, as you know better than I.

I'd be glad to hear from the next speaker.

AUDIENCE MEMBER: Hello. My name is Nancy Meyer (PH), and I've been a shareholder for 15 years with my husband.

We have great faith in Berkshire Hathaway. That's why we invested. So I'm just here to say that, as a shareholder, I'd like to ask my fellow shareholders to consider the economic costs of climate change and urge Berkshire Hathaway to adopt this resolution to show leadership in the insurance industry. Thank you.

WARREN BUFFETT: Thank you. I appreciate the fact you've been a shareholder, but I do think for reasons that — I don't really think that the resolution — I think the resolution is, in a sense, inapplicable to our insurance business.

I mean, insurance — global climate is not a risk to our insurance business. It may be a risk to the planet over time, but that's a different thing.

I mean, you can — we can adopt all kinds of resolutions about saying that, obviously, nuclear proliferation is a threat to the planet, and you can say, well then, it's a threat to Berkshire.

But in terms of being Berkshire-specific, you know, you can read the resolution and, like I say, our answer, with Ajit Jain, probably the smartest person I know in insurance, and I have 99 percent of my net worth in Berkshire that's all destined to go to philanthropic institutions, and I'm not eager to see that disappear, and I do regard myself as the chief risk officer of Berkshire, and I worry about things that can hurt Berkshire, and I do not see it in our insurance division, in relation to climate change. But, thank you.

RICHARD MILLER: Good afternoon, Mr. Buffett. I am Richard Miller, in the Creighton Theology Department, here in Omaha. And I study and teach climate change and its social effects.

I just wanted to make you aware that Berkshire is operating within a larger economy, and that the most important climate analysis — economic analysis — from Nicholas Stern, indicates that on our current path, by the end of this century, 30 percent loss in global GDP is possible.

The other issue is, when we talk about doing something about climate change, doing something means to avoid major sea level rise, we need to reduce emissions globally, starting today, 7 percent per year.

The only time we've ever reduced emissions, over a ten-year period, in a growing economy, was in the 1990s in England, and we reduced them 1 percent per year.

So we're talking about a completely different thing than President Obama's gradual move.

And we need to do something — no, we need to do massive transformation — immediately. And with your large global holdings, you are a world significant figure on this, not just about this particular shareholder resolution. Thank you for your time.

WARREN BUFFETT: Thank you.

Is that the — complete the speakers?

AUDIENCE MEMBER: Say that again?

WARREN BUFFETT: Are you the final speaker?

AUDIENCE MEMBER: Yes, I think those are all the speakers.

WARREN BUFFETT: OK. Well, thank you. Charlie, do you have anything you want to say?

CHARLIE MUNGER: Well, yes.

We're in Omaha, which is considerably above sea level. We have no big economic interest in this subject in our insurance companies. We don't write much of that catastrophic insurance we used to write many years ago.

So we're asked, as a corporation, to take a public stance on very complicated issues. We've got crime in the cities. We've got 100 — we've got 1,000 — complicated issues that are very material to our civilization.

And if we spend our time in the meeting taking public stands on all of them, I think it would be quite counterproductive.

And I don't like the fact that the people that constantly present this issue never discuss any solution, except reducing consumption of fossil fuels.

So there are geo-engineering possibilities that nobody's willing to talk about, and I think that's asinine, so put me down as not welcoming. (Applause)

WARREN BUFFETT: We don't want to have a political rally.

The motion is now ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the motion and deliver their ballot to one of the meeting officials in the aisles.

Ms. Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready.

The ballot of the proxy holders, in response to proxies that were received through last Thursday evening, cast 69,114 votes for the motion and 531,724 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares properly cast on the matter, as well as all votes outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Ms. Amick. The proposal fails.

38. Adjournment

WARREN BUFFETT: Does anyone have any questions for our audit firm before we adjourn? If not, I recognize Mr. Scott to place a motion before the meeting.

WALTER SCOTT: I move this meeting be adjourned.

WARREN BUFFETT: Mr. Olson?

RON OLSON: And I second it.

WARREN BUFFETT: Motion to adjourn has been made and seconded. We will vote by voice. Is there any discussion? If not, all in favor say, “Aye.”

All opposed say, “No.”

Morning Session - 2017 Meeting

1. Welcome and introductions

WARREN BUFFETT: Thank you, and good morning.

That's Charlie. I'm Warren. (Laughter)

You can tell us apart because he can hear and I can see. That's why we — (laughter) — work together so well. We each have our specialty.

I'd like to welcome you to — we've got a lot of out-of-towners here, and I'd like to welcome you to Omaha. It's a terrific — (Applause)

Thank you.

It's a terrific city. And Charlie's lived in California now for about 70 years, but he's still got a lot of Omaha in him.

Both of us were born within two miles of this building that you're in. And Charlie — as he mentioned [in the pre-meeting movie] in his description of his amorous triumphs in high school — Charlie graduated from Central High, which is about one mile from here. It's a public school.

And my dad, my first wife, my three children and two of my grandchildren have all graduated from the same school.

In fact, my grandchildren say they've had the same teachers that my dad — (Laughter)

The — but it's a great city. I hope you get to see a lot of it while you're here.

And in just a minute we will start a question period — hopefully a question and answer period that will last till about noon, and then we'll take a break for an hour or so. We'll reconvene at one. And then we'll go — continue with the question and answer period till 3:30.

And then we'll break for 15 minutes or so. And then we'll convene the annual meeting of Berkshire, which I — we have three propositions that people wish to speak on, so that could last perhaps as long as an hour.

Before we start, I'd like to make a couple of introductions, the first being Carrie Sova, who's been with us about seven years. And can we have a light on Carrie? I think she — Carrie, are you there? (Applause)

Carrie. Stand up, Carrie, come on. (Laughter and applause)

Carrie puts on this whole program. She came to us about seven years ago and a few years ago I said, "Why don't you just put on the annual meeting for me?" And she handles it all. And she has two young children.

And she has dozens and dozens and dozens of exhibitors that she works with and, as you can imagine, with all of what we put on and all of the numbers of you that come, the hotels and the airlines and the rental cars and everything, she does it as if, you know, she could do that and be juggling three balls at the same time.

She's amazing, and I want to thank her for putting on this program for us. And — (Applause)

I also would like to welcome and have you welcome our directors.

They will be voted on later, so I'll do this alphabetically. They're here in the front row. And if we could just have the spotlight drop on them as they're introduced.

And alphabetically, is Howard Buffett, Steve Burke, Sue Decker, Bill Gates, Sandy Gottesman, Charlotte Guyman, we have Charlie Munger next to me, Tom Murphy, Ron Olson, Walter Scott, and Meryl Witmer. Yeah. (Applause)

One more introduction I'm going to make, but I'll save that for just a minute.

2. First quarter earnings

WARREN BUFFETT: And our earnings report was put out yesterday.

The — as we regularly explain, the realized investment gains or losses in any period really mean nothing. I mean, they —

We could take a lot of gains if we wanted to. We could take a lot of losses if we wanted to. But we don't really think about the timing of what we do at all, except in relation to the intrinsic value of what we're buying or selling. We are not —

We do not make earnings forecasts. And we have — on March 31st, we have over $90 billion of net unrealized gains. So if we wanted to report almost any number you can think of and count capital gains as part of the earnings, we could do it.

So in the first quarter — and I would say that we have a very, very, very slight preference this year, if everything else were equal — well, it's true in any year, but it's a little more so this year — we would rather take losses than gains, because of the tax effect if two securities were equally valued.

And there’s probably just one touch more of emphasis on that this year, because we are taxed on gains at 35 percent, which means we also get the benefit — the tax benefit — at 35 percent of any losses we take.

And I would say that there’s some chance of that rate being lower, meaning that losses would have less tax value to us after this year than they would have this — after this year than this year.

That is not a big deal, but it would be a very slight preference. And it may get to be more of a factor in deferring any gains, and perhaps accelerating any losses, as the year gets closer to December 31st, assuming — and I’m making no predictions about it — but assuming that there were to be a tax act that had the effect of reducing the earnings.

So in the first quarter, insurance underwriting was the swing factor. And the — there’s a lot more about this in our 10-Q, which you can look up on the internet.

And you really, if you’re seriously interested in evaluating our earnings or our businesses, you should go to the 10-Q, because the summary report, as we point out every quarter, does not really get to a number of the main points of valuation.

I would just mention two factors in connection with the insurance situation, which I love.

In the first four months — not the first three months — but the first four months, GEICO’s had a net gain of 700,000 policy holders, and that’s the highest number I can remember.

There may have been a figure larger than that somewhere in the past. I did not go back and look at them all. But last year I believe that figure was like 300,000.

And this has been a wonderful period for us at GEICO, because several of our major competitors have decided — and they publicly stated this — in fact one of them just reiterated it the other day — although they’ve now changed their policy — but they intentionally cut back on new business because new business carries with it a significant loss in the first year. There’s just costs of acquiring new business.

Plus the loss ratio, strangely enough, on first-year business tends to run almost 10 points higher than on renewal business. And so not only do you have acquisition costs, but you actually have a higher loss ratio.

So when you write a lot of new business, you’re going to lose money on that portion of the business that year.

And we wrote a lot of new business, and at least two of our competitors announced that they were lightening up for a while on new business, because they did not want to pay the penalty of the first-year loss.

And, of course, that's made to order for us, so we just put our foot to the floor and tried to write as much business — good business — as we can. And there are costs to that.

A second factor — well, it was not a factor in the P&L — but an important event in the first quarter is that we increased our float.

And on the slide, I believe it shows that year-over-year, 16 billion. Fourteen billion of that came in the first quarter of this year, so we had a $14 billion increase in float.

And for some years I've been telling you it's going to be hard to increase the float at all, and I still will tell you the same thing.

But it's nice to have $14 billion or more, which is one reason, if you look at our 10-Q, you will see that our cash and cash equivalents, including Treasury bills, now has come to well over 90 billion.

So I think I feel very good about the first quarter, even though our operating earnings were down a little bit.

One quarter means nothing. I mean, over time, what really counts is whether we're building the value of the businesses that we own.

And I'm always interested in the current figures, but I'm always dreaming about the future figures.

3. Tribute to Vanguard's Jack Bogle

WARREN BUFFETT: There's one more person I would like to introduce to you today, and I'm quite sure he's here. I haven't seen him, but I understood he was coming. There's a — I believe that he's made it today. And that is Jack Bogle, who I talked about in the annual report.

Jack Bogle has probably done more for the American investor than any man in the country. (Applause)

And Jack, would you stand up? There he is. (Applause)

Jack Bogle, many years ago, he wasn't the only one that was talking about an index fund, but he — it wouldn't have happened without him.

I mean, Paul Samuelson talked about it. Ben Graham even talked about it.

But the truth is, it was not in the interest of invest — of the investment industry of Wall Street. It was not in their interest, actually, to have the development of an index fund — the index fund — because it brought down fees dramatically.

And, as we've talked about some in the reports, and other people have commented, index funds, overall, have delivered for shareholders a result that has been better than Wall Street professionals as a whole.

And part of the reason for that is that they've brought down the costs very significantly.

So when Jack started, very few people — certainly Wall Street did not applaud him, and he was the subject of some derision and a lot of attacks.

And now we're talking trillions when we get into index funds, and we're talking a few basis points when we talk about investment fees, in the case of index funds, but still hundreds of basis points when we talk about fees elsewhere.

And I estimate that Jack, at a minimum, has saved — left in the pockets of investors, without hurting them overall in terms of performance at all — gross performance — he's put tens and tens and tens of billions into their pockets. And those numbers are going to be hundreds and hundreds of billions over time.

So, it's Jack's 88th birthday on Monday, so I just say happy birthday, Jack, and thank you on behalf of American investors. (Applause)

And Jack, I've got great news for you.

You're going to be 88 on Monday, and in only two years you'll be eligible for an executive position at Berkshire. (Laughter)

Hang in there, buddy. (Laughter)

4. Q&A begins

WARREN BUFFETT: OK. We've got a panel of expert journalists on this side, and expert analysts on that side, and expert shareholders in the middle. And we're going to rotate, starting with the analysts. And some who are here I have a — here we go. And we will — we'll do this through the afternoon.

After we — if we get through 54 questions, which would be six for each journalist, six for each analyst, and 18 more for the audience, then we will go strictly to the audience.

I don't think I've got any information as to what the situation is on overflow rooms. But we'll go to at least one of them.

But let's start off with Carol Loomis of Fortune Magazine, the longest serving employee in the history of Time Inc., I believe, with 60 years. And Carol, go to it. (Applause)

5. Loomis asks for Berkshire-related questions

CAROL LOOMIS: Thank you. Thanks from all of us journalists up here.

I know that there are many, many people out there who have sent us questions that aren't going to get answered. And I just want to say that it's very hard to get a question answered.

The one thing I could suggest is that you follow Warren's thought in the annual report, that he wants everybody to go away from this meeting more educated about Berkshire than they were when they came.

And one way you can do that is keep your questions quite directly Berkshire-related or relating to the annual letter. Even then it will be hard to get your question answered.

The three of us only have 18 questions in total, but I encourage you to think in the Berkshire-related direction when you're submitting a question next year.

6. Wells Fargo didn't act quickly enough to stop bad behavior

CAROL LOOMIS: Now, my first question. It's about Wells Fargo, which is Berkshire's largest equity holding — 28 billion at the end of the year. And this question comes from a shareholder who did not wish to be identified.

"In the wake of the sales practices scandal that last year engulfed Wells Fargo, the company's independent directors commissioned an investigation and hired a large law firm to assist in carrying it out.

"The findings of the investigation, which were harsh, have been released in what is called the Wells Fargo Sales Practices Reports." You can find it on the internet.

"It concludes that a major part of the company's problem was that, and I quote, 'Wells Fargo's decentralized corporate structure gave too much autonomy to the community banks' senior leadership,' end of quote.

"Mr. Buffett, how do you satisfy yourself that Berkshire isn't subject to the same risk, with its highly decentralized structure and the very substantial autonomy given to senior leadership of the operating companies?"

WARREN BUFFETT: Yeah, it's true that we at Berkshire probably operate on as — we certainly operate on a more decentralized plan than any company of remotely our size.

And we count very heavily on principles of behavior rather than loads of rules.

It’s one reason at every annual meeting you see that Salomon description. And it’s why I write very few communiqués to our managers, but I send them one once every two years and it basically says that we’ve got all the money we need. We’d like to have more, but we’re — it’s not a necessity.

But we don’t have one ounce of reputation more than we need, and that our reputation at Berkshire is in their hands.

And Charlie and I believe that if you establish the right sort of culture, and that culture, to some extent, self-selects who you obtain as directors and as managers, that you will get better results that way in terms of behavior than if you have a thousand-page guidebook.

You’re going to have problems regardless. We have 367,000, I believe, employees. Now, if you have a town with 367,000 households, which is about what the Omaha metropolitan area is, people are doing something wrong as we talk here today. There’s no question about it.

And the real question is whether the managers at — [audio drops out] — are in a better — are worrying and thinking about finding and correcting any bad behavior, and whether, if they fail in that, whether the message gets to Omaha, and whether we do something about it.

At Wells Fargo, you know, there were three very significant mistakes, but there was one that dwarfs all of the others.

You’re going to have incentive systems at any business — almost any business. There’s nothing wrong with incentive systems, but you’ve got to be very careful what you incentivize. And you can’t incentivize bad behavior. And if so, you better have a system for recognizing it.

Clearly, at Wells Fargo, there was an incentive system built around the idea of cross-selling and number of services per customer. And the company, in every quarterly investor presentation, highlighted how many services per customer. So, it was the focus of the organization — a major focus.

And undoubtedly, people got paid and graded and promoted based on that number — at least partly based on that number.

Well, it turned out that that was incentivizing the wrong kind of behavior.

We’ve made similar mistakes. I mean any company’s going to make some mistakes in designing a system.

But it’s a mistake. And you’re going to find out about it at some point. And I’ll get to how we find out about it.

But the biggest mistake was that — and I don't know — obviously don't know all the facts as to how the information got passed up the line at Wells Fargo.

But at some point, if there's a major problem, the CEO will get wind of it. And that is — at that moment, that's the key to everything, because the CEO has to act.

That Salomon situation that you saw happened because of — on April, I think, 28th, the CEO of Salomon, the president of Salomon, the general counsel of Salomon, sat in a room and they had described to them, by a fellow named John Meriwether, some bad practice, terrible practice, that was being conducted by a fellow named Paul Mozer, who worked for them.

And Paul Mozer was flimflamming the United States Treasury, which is a very dumb thing to do. And he was doing it partly out of spite, because he didn't like the Treasury and they didn't like him. So he put in phony bids for U.S. Treasurys and all of that.

So on April 28th, roughly, the CEO and all these people knew that they had something that had gone very wrong, and they had to report it to the Federal Reserve Board in New York — the Federal Reserve Bank of New York.

And the CEO, John Gutfreund, said he would do it, and then he didn't do it. And he undoubtedly put it off just because it was an unpleasant thing to do.

And then on May 15th, another Treasury auction was held, and Paul Mozer put in a bunch of phony bids again.

And at this point, it's all over, because the top management had known ahead of time, and now a guy that was a pyromaniac had gone out and lit another fire. And he lit it after they'd been warned that he was a pyromaniac, essentially.

And it all went downhill from there. It had to stop when the CEO learns about it.

And then they made a third mistake, actually, but again, it pales in comparison to the second mistake.

They made a third mistake when they totally underestimated the impact of what they had done once it became uncovered, because they — there was a penalty of 185 million. And in the banking business, people get fined billions and billions of dollars for mortgage practices and all kinds of things.

The total fines against the big banks, I don't know whether the total's 30 or 40 or a billion or whatever the number may be.

So, they measured the seriousness of the problem by the dimensions of the fine. And they thought $185 million fine signaled a less offensive practice than something involved 2 billion, and they were totally wrong on that.

But the main problem was they didn't act when they learned about it. It was bad enough having a bad system, but they didn't act.

At Berkshire, we have — the main source of information for me about anything that's being done wrong at a subsidiary is the hotline. Now, we got 4,000 or so hotline reports — or that come — we get communications on the hotline — perhaps 4,000 times a year.

And most of them are frivolous. You know, the guy next to me has bad breath or something like that. I mean it's — (laughter) — but there are a few serious ones, and the head of our internal audit, Becki Amick, looks at all those. People — a lot of them come in anonymous, probably most of them.

And some of them, she refers back to the companies, probably most of them. And — but anything that looks serious, you know, I will hear about, and that has led to action — well, put it, more than once.

And we've spent real money investigating some of those. We put special investigators, sometimes, on them. And, like I say, it has uncovered certain practices that we would not at all condone at the parent company.

I think it's a good system. I don't think it's perfect. I don't know what — I'm sure they've got an internal audit at Wells Fargo, and I'm sure they've got a hotline.

And I don't know the facts, but I would just have to bet that a lot of communications came in on that, and I don't know what their system was for getting them to the right person. And I don't know who did what at any given time.

But that was — it was a huge, huge, huge error if they were getting — and I'm sure they were — getting some communications and they ignored them, or they just sent them back down to somebody down below.

Charlie? You've followed it. What are your thoughts on it?

CHARLIE MUNGER: Well, put me down as skeptical when some law firm thinks they know how to fix something like this.

If you're in a business where you have a whole a lot of people under incentives very likely to cause a lot of misbehavior, of course you need a big compliance department.

Every big wirehouse stock brokerage firm has a huge compliance department. And if we had one, we would have a big compliance department too, wouldn't we, Warren?

WARREN BUFFETT: Absolutely.

CHARLIE MUNGER: Absolutely, but doesn't mean that everybody should try and solve their problems with more and more compliance.

I think we've had less trouble over the years by being more careful in whom we pick to have power and having a culture of trust. I think we have less trouble, not more.

WARREN BUFFETT: But we will have trouble from time to time.

CHARLIE MUNGER: Yes, of course. We'll be blindsided someday.

WARREN BUFFETT: Charlie says an ounce of prevention — he said when Ben Franklin, who he worships, said, "An ounce of prevention is worth a pound of cure," he understated it. An ounce of prevention is worth more than a pound of cure.

And I would say a pound of cure, promptly applied, is worth a ton of cure that's delayed. It — problems don't go away.

John Gutfreund said that problem, originally, was — he called it a traffic ticket. He told the troops there at Salomon it was a traffic ticket. You know, and it almost brought down a business.

Some other CEO, that they described the problem that he'd encountered as a foot fault. You know, and it resulted in incredible damage to the institution.

And so you've got to act promptly. And frankly, I don't know any better system than hotlines and anonymous letters to me. I get anonymous letters. And I've gotten three or four of them probably in the last six or seven years that have resulted in major changes.

And very, very occasionally they're signed. Almost always they're anonymous, but it wouldn't make any difference, because there were — will be no retribution against anybody, obviously, if they call our attention to something that's going wrong.

But I will tell you, as we sit here, somebody is doing — quite a few people — are probably doing something wrong at Berkshire, and usually, it's very limited. I mean maybe stealing small amounts of money or something like that.

But when it gets to some sales practice like was taking place at Wells Fargo, you can see the kind of damage it would do.

7. Driverless vehicles would hurt BNSF and GEICO

WARREN BUFFETT: We will now shift over to the analysts and Jonny Brandt.

JONATHAN BRANDT: Hi, Warren. Hi, Charlie. Thanks for having me.

You've addressed the risk of driverless cars to GEICO's business. But it strikes me that driverless trucks could narrow the cost advantage of railroads, even if the number of crew members in a locomotive eventually declines from two to zero.

Is autonomous technology more of an opportunity or more of a threat for the Burlington Northern?

WARREN BUFFETT: Oh, I would say that driverless trucks are a lot more of a threat than an opportunity — (laughs) — to the Burlington Northern.

And I would say that if driverless cars became pervasive, it would only be because they were safer. And that would mean that the overall economic cost of auto-related losses had gone down, and that would drive down the premium income of GEICO.

So, I would say both of those — and autonomous vehicles — widespread — would hurt us if they went — if they spread to trucks, and they would hurt our auto insurance business.

I think my personal view is that they will certainly come. I think they may be a long way off, but that will depend. It'll probably, frankly, depend on experience in the first early months of the introduction in other than test situations.

And if they make the world safer, it's going to be a very good thing, but it won't be a good thing for auto insurers.

And similarly, if they learn how to move trucks more safely, there's a — tends to be driver shortages in the truck business now — it obviously improves their position vis-à-vis the railroads.

Charlie?

CHARLIE MUNGER: Well, I think that's perfectly clear. (Laughter)

WARREN BUFFETT: Finally, approval. All these years. (Laughter)

8. Buying See's Candies from someone who preferred "girls and grapes"

WARREN BUFFETT: OK. Station 1. The shareholder.

AUDIENCE MEMBER: Hi, Warren and Charlie. My name is Bryan Martin and I'm from Springfield, Illinois.

In the HBO documentary, "Becoming Warren Buffett," you had a great analogy comparing investing to hitting a baseball and knowing your sweet spot.

Ted Williams knew his sweet spot was a pitch right down the middle. When both of you look at potential investments, what attributes make a company a pitch in your sweet spot that you'll take a swing at and invest in?

WARREN BUFFETT: Well, I'm not sure I can define it in exactly the terms you would like, but the — we sort of know it when we see it.

And it would tend to be a business that, for one reason or another, we can look out five, or 10, or 20 years and decide that the competitive advantage that it had at the present would last over that period.

And it would have a trusted manager that would not only fit into the Berkshire culture, but that was eager to join the Berkshire culture. And then it would be a matter of price.

But the main — you know, when we buy a business, essentially, we're laying out a lot of money now based on what we think that business will deliver over time. And the higher the certainty with which we make that prediction, the better off — the better we feel about it.

You can go back to the first — it wasn't the first outstanding business we bought, but it was kind of a watershed event — which was a relatively small company, See's Candy.

And the question when we looked at See's Candy in 1972 was, would people still want to be both eating and giving away that candy in preference to other candies?

And it wouldn't be a question of people buying candy for the low bid. And we had a manager we liked very much. And we bought a business that was — paid $25 million for it, net of cash, and it was earning about 4 million pretax then. And we must be getting close to $2 billion or something like that, pretax, that was taken out of it.

But it was only because we felt that people would not be buying, necessarily, a lower-price candy.

I mean it does not work very well if you go to your wife or your girlfriend on Valentine's Day — I hope they're the same person — (laughter) — and say, you know, "Here's a box of candy, honey. I took the low bid." You know, it doesn't — it loses a little as you go through that speech.

And we made a judgment about See's Candy that it would be special and — probably not in the year 2017 — but we certainly thought it would be special in 1982 and 1992. And fortunately, we were right on it. And we're looking for more See's Candies, only a lot bigger.

Charlie?

CHARLIE MUNGER: Yeah, well, but it's also true that we were young and ignorant then. And —

WARREN BUFFETT: Now we're old and ignorant. Yeah. (Laughter)

CHARLIE MUNGER: And yes, that's true, too.

And the truth of the matter is that it would have been very wise to buy See's Candy at a slightly higher price. You know if they'd asked it, we wouldn't have done it, so we've gotten a lot of credit for being smarter than we were.

WARREN BUFFETT: Yeah, and to be more accurate, if it had been 5 million more, I wouldn't have bought it. Charlie would have been willing to buy it, so, yeah.

Fortunately, that we didn't get to the point where we had to make that decision that way. But he would've pushed forward when I probably would've faded.

It's a good thing that a guy came around — actually the seller was the — well, he's the grandson of Mrs. See, wasn't he, Charlie? He was Larry See's son. Am I correct? Or Larry See's brother.

But he was not interested in the business. And he was interested in — more interested in girls and grapes, actually. And he almost changed his mind. Well, he did change his mind about selling.

And I wasn't there, but Rick Guerin told me that Charlie went in and gave a — an hour talk on the merits of girls and grapes over having a candy company. (Laughter)

This is true, folks. And the fellow sold to us, so that — (laughter) — I pull Charlie out in emergencies like that. He's — (Laughter)

CHARLIE MUNGER: We were very lucky that, early, the habit of buying horrible businesses because they were really cheap. It gave us a lot of experience trying to fix unfixable businesses as they headed downward toward doom.

And that early experience was so horrible, fixing the unfixable, that we were very good at avoiding it, thereafter. So, I would argue that our early stupidity helped us.

WARREN BUFFETT: Yeah, yeah. We learned we could not make a silk purse out of a sow's ear.

CHARLIE MUNGER: No, we learned —

WARREN BUFFETT: So, we went out looking for silk after that.

CHARLIE MUNGER: But you have to try it for a long time and fail and have rub — have your nose rubbed in it to really understand it.

9. “There are going to be marauders” at the moat

WARREN BUFFETT: OK, Becky? Becky Quick.

BECKY QUICK: This question comes from a shareholder named Mark Blakley in Tulsa, Oklahoma, who says, “There has been more news than usual in some of Berkshire’s core stock holdings.

“Wells Fargo in the incentive and new account scandal, American Express losing the Costco relationship and playing catch-up in the premium card space, United Airlines and customer service issues, Coca-Cola and slowing soda consumption.

“How much time is spent reviewing Berkshire’s stock holdings? And is it safe to assume, if Berkshire continues to hold these stocks, that the thesis remains intact?”

WARREN BUFFETT: Well, we spend a lot of time think — those are very large holdings. If you add up American Express, Coca-Cola, and Wells Fargo, I mean, you’re getting up, you know, well into the high tens of billions of dollars. And those are businesses we like very much. There’re different characteristics.

In the case of — you mentioned United Airlines, we actually are the largest holder of all four of the — we’re the largest holder of the four largest airlines. And that is much more of an industry thought.

But all businesses have problems. And some of them have some very big plusses.

I personally — you mentioned American Express. If you read American Express’s first quarter report and talk about their Platinum Card, the Platinum Card is doing very well.

The gains around the world. You know, I think there were 17 percent or something like that in billings in the U.K. and 15 percent is original currency — or the local currency — Japan, Mexico, and very good in the United States.

There’s competition in all these businesses. If we thought — we did not buy American Express or Wells Fargo or United Airlines, Coca-Cola, with the idea that they would never have problems or never have competition.

What we did buy — why we did buy them — is we thought they had very, very strong hands. And we liked the financial policies in the cases of many of them. We liked their position.

We've bought a lot of businesses. And we do look to see where we think they have durable competitive advantage.

And we recognize that if you've got a very good business, you're going to have plenty of competitors that are going to try and take it away from you. And then you make a judgment as to the ability of your particular company and product and management to ward off competitors.

They won't go away, but the — we think — I'm not going to get into specific names on it — but those companies generally are very well-positioned.

I've likened essentially — if you've got a wonderful business, even if it was a small one like See's Candy, you basically have an economic castle. And in capitalism, people are going to try and take away that castle from you.

So, you want a moat around it, protecting it in various ways that can protect it. And then you want a knight in the castle that's pretty darn good at warding off marauders. But there are going to be marauders. And they'll never go away.

And if you look at — I think Coca-Cola was 1886. American Express was 18 — I don't know — '51 or '52 — starting out with an express business.

Wells Fargo was — I don't know what year they were started. Incidentally, I — American Express was started by [Henry] Wells and [William] Fargo as well.

So these companies had lots of challenges. And they'll have more challenges. And the companies we own have had challenges.

Our insurance business has had challenges. But, you know, we started with National Indemnity's $8 million purchase in 1968. And fortunately, we've had people like Tony Nicely at GEICO. And we've had Ajit Jain, who's added tens of billions of value.

And we've got some smaller companies that you probably don't even know about, but really have done a terrific job for us.

So there'll always be competition in insurance, but there'll always be things to do that a really intelligent management with a decent distribution system, various things going for him, can do to ward off the marauders.

So I — there was a specific question, "How much time is spent reviewing the holdings?" I would say that I do it every day. I'm sure Charlie does it every day.

Charlie?

CHARLIE MUNGER: Well, I don't think I had anything to add to that, either. (Laughter)

WARREN BUFFETT: We'll cut his salary if he doesn't participate here. (Laughter)

10. "We think we'll do well" with AIG reinsurance deal

WARREN BUFFETT: OK, Jay Gelb.

JAY GELB: This question is on Berkshire's retroactive reinsurance deal with AIG, which was the largest ever of its kind.

Based on AIG's track record of reserve deficiencies and the opportunity for Berkshire to invest the float, what is your level of confidence that this contract covering up to $20 billion of AIG's reserves in return for $10 billion of premiums will ultimately be profitable for Berkshire?

WARREN BUFFETT: Well, at the time we do every deal, I think it's smart. And then sometimes — (laughs) — I find out otherwise as we go along.

The deal, that Jay knows, but might be unfamiliar to many people, is that AIG transferred to us the liability for 80 percent of 25 billion — excess — of 25 billion.

In other words, they had to pay the first 25 billion. And then on the next 25 billion, we had to pay 80 percent of what they paid up to a limit of 20 billion, 80 percent of 25. And we got paid $10.2 billion for that.

And we had — and this applies to their losses in many classes of business written — or earned — before December 31st, 2015.

So Ajit Jain, who has made a lot more money for Berkshire than I — for you — than I have, but he evaluates that sort of transaction.

We talk about it a fair amount ourselves. I just find it interesting. I particularly find the 10.2 billion that they're going to give us interesting.

And the — we come to the conclusion that we think we'll do well by getting 10.2 billion today with a maximum payout of 20 billion over some — I mean, between now and judgment day — on this large piece of business.

AIG had very good reasons for doing this, because their reserves had been under criticism. And this essentially — probably — and should have, I think — put to bed the question of whether they were underreserved on that business. And we get the 10.2 billion.

And the question is how fast we pay out the money and how much money we pay out. And Ajit does 99 percent of the thinking on that. And I do one percent. And we project out what we think will happen.

And we know whatever our projection is, that it will be wrong, but we try to be conservative.

And we've done a fair amount of these deals. This is the largest. The second largest was a creature that was formed out of Lloyd's of London some years ago.

And we've been wrong on one transaction that involved something over a billion of premium. I mean clearly wrong.

And there are a couple of others that may or may not work out depending on what you assume we have earned on the funds. But they're OK.

But they probably didn't come out as well as we thought they would, though. But overall, we've done OK on this.

It's less OK when we're sitting around with 90-plus billion of cash. So the incremental 10.2 billion we took in in the first quarter is earning us peanuts at the moment. And peanuts is not what fits into the formula for making this an attractive deal.

So we have — we do have to assume we'll find uses of the money, but the money will be with us quite a while. And I think our calculations are on the conservative side. They are not the identical calculations that AIG makes. I mean, we come up with our own estimate of payouts and all of that.

And I think it — actually, I think it was quite a good transaction from AIG's standpoint. Because they did take 20 billion of potential losses off for 10.2 billion.

And I think they satisfied the investing community that they were quite unlikely to have adverse development in the period prior to 2015 that was not accounted for by this transaction.

Charlie?

CHARLIE MUNGER: Well, I think it's intrinsically a dangerous kind of activity. And — but that's one of its attractions. I don't think there are any two people in the world that are better at this kind of transaction than Ajit and Warren.

And nobody else has had the experience we've had. Just get me in a lot more of those businesses and I'll accept a little extra worry.

WARREN BUFFETT: There's one thing I should mention, too, that we actually were the only insurance operation in the world that would write that sort of a contract and that — where it would be satisfactory to the other party.

I mean, when somebody hands you $10.2 billion and says, "I'm counting on you to pay 20 billion back, even if it's 50 years from now, on the last dollar," there are very few people that they'd want to hand 10.2 billion to. And there —

So it's a — there's limited people on the other side. I mean, there's not that many people remotely that have that kind of size deal. But —

CHARLIE MUNGER: "Very few" is a good expression. He means "one." (Laughter)

WARREN BUFFETT: Yeah.

11. "A life properly lived is just learn, learn, learn"

WARREN BUFFETT: OK. We'll go to station 2.

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger. My name's Grant Gibson (PH). I'm from Denver, Colorado, and this is my fifth consecutive year here. So thank you for having us.

WARREN BUFFETT: Thanks for coming.

AUDIENCE MEMBER: Appreciate it. With all due respect, Mr. Buffett, this question is for Mr. Munger. (Laughter)

In your career of thousands of negotiations and business dealings, could you describe for the crowd which one sticks out in your mind as your favorite or is otherwise noteworthy?

CHARLIE MUNGER: Well, I don't think I've got a favorite. But the one that probably did us the most good as a learning experience was See's Candy.

It's just the power of the brand, the unending flow of ever-increasing money with no work. (Laughter)

AUDIENCE MEMBER: Sounds nice. (Laughter)

CHARLIE MUNGER: It was. And I'm not sure we would have bought the Coca-Cola if we hadn't bought the See's.

I think that a life properly lived is just learn, learn, learn all the time. And I think Berkshire's gained enormously from these investment decisions by learning through a long, long period.

Every time you appoint a new person that's never had big capital allocation experience, it's like rolling the dice. And I think we're way better off having done it so long. And —

But the decisions blend, and the one feature that comes through is the continuous learning. If we had not kept learning, you wouldn't even be here.

You'd be alive probably, but not here. (Laughter)

WARREN BUFFETT: There's nothing like the pain of being in a lousy business — (laughs) — to make you appreciate a good one.

CHARLIE MUNGER: Well, there's nothing like getting into a really good one that's a very pleasant experience and it's a learning experience.

I have a friend who says, "The first rule of fishing is to fish where the fish are. And the second rule of fishing is to never forget the first rule." (Laughter)

And we've gotten good at fishing where the fish are.

WARREN BUFFETT: Yeah, that's only metaphorically.

CHARLIE MUNGER: There're too many other —

WARREN BUFFETT: I went to fish with Charlie one time. He didn't get —

CHARLIE MUNGER: There are too many other boats in the damn water. (Laughter)

But the fish are still there.

WARREN BUFFETT: Yeah, we bought a department store in Baltimore in 1966. And there's really nothing like being in an experience of trying to decide whether you're going to put a new store in a area that hasn't really developed yet enough to support it, but your competitor may move there first.

And then you have the decision of whether to jump in. And if you jump in, that kind of spoils it. Now you've got two stores where even one store isn't quite justified.

How to play those games — those business games — is — you learn a lot by trying. And what you really learn is which ones to avoid.

I mean, it — you just stay out of a bunch of terrible businesses, you're off to a very great start, as far as — because we've tried them all.

CHARLIE MUNGER: But you can really learn, because the experience is a lot like eating cuttle (PH) burgers. And it really gets your attention. (Laughter)

WARREN BUFFETT: Well, we won't expand on that. (Laughter)

12. Making mistakes with IBM, Google, and Amazon

WARREN BUFFETT: Andrew Ross Sorkin.

ANDREW ROSS SORKIN: Good morning, Warren.

This question comes from a long-time shareholder who I should tell you accosted me last night in the lobby of the Hilton Hotel with this question.

"Warren, for years, you stayed away from technology companies, saying they were too hard to predict and didn't have moats. Then you seemed to change your view about technology when you invested in IBM, and again when you recently invested in Apple.

"But then on Friday you said IBM had not met your expectations and sold a third of our stake.

"Do you view IBM and Apple differently? And what have you learned about investing in technology companies?"

WARREN BUFFETT: Well, I do view them differently. But, you know, obviously, when I bought the IBM — started buying it six years ago — I thought it would do better in the six years that have elapsed than it has.

And Apple — I regard them as being in quite different businesses. I think Apple is much more of a consumer products business, in terms of the — in terms of sort of analyzing moats around it, and consumer behavior, and all that sort of thing.

It's obviously a product with all kinds of tech built into it. But in terms of laying out what their prospective customers will do in the future, as opposed to, say, IBM's customers, it's a different sort of analysis.

That doesn't mean it's correct. And we'll find out over time. But they are two different types of decisions.

And I was wrong on the first one, and we'll find out whether I'm right or wrong on the second. But I do not regard them as apples and apples, and I don't quite regard them as apples and oranges, but they're — it's somewhat in between on that.

Charlie?

CHARLIE MUNGER: Well, we avoided the tech stocks, because we felt we had no advantage there and other people did. And I think that's a good idea not to play where the other people are better.

But, you know, if you ask me, in retrospect, what was our worst mistake in the tech field, I think we were smart enough to figure out Google. Those ads worked so much better in the early days than anything else.

So I would say that we failed you there. And we were smart enough to do it and didn't do it. We do that all the time, too.

WARREN BUFFETT: Yeah. We were their customer very early on with GEICO, for example. And we saw — I don't — these figures are way out of date, but I — as I remember, you know, we were paying them 10 or 11 dollars a click or something like that.

And any time you're paying somebody 10 or 11 bucks every time somebody just punches a little thing where you've got no cost at all, you know, that's a good business, unless somebody's going to take it away from you.

And so we were close up, seeing the impact of that.

And incidentally, if any of you don't have anything to do in your hotel rooms tonight, just keep punching Progressive or something. And — (Laughter)

Don't really do that. (Laughter)

The thought just happened to cross my mind. The — (Laughter)

But, you know, that is — and you've never seen a business — almost never seen a business — like it, where —

And I think for LASIK surgery and things like that, I think the figures were, you know, 60 or 70 bucks a click with no incremental — no cost.

So — and I knew the guys. I mean, they actually designed their prospectus. They came to see me. And they — a little bit after the original one, when they went public, a little bit after Berkshire even. And so I had plenty of ways to ask questions or anything of the sort, educate myself. But I blew it — (laughs) — and —

CHARLIE MUNGER: We blew Walmart, too. When it was a total cinch, we were smart enough to figure that out and we didn't.

WARREN BUFFETT: Yeah, figuring out — execution is what counts. So — (Laughs)

Anyway, we'll — and I could be making two mistakes on IBM. I mean, the — you know, they're — they —

It's harder to predict, in my view, the winners in various items, or how much price competition will enter in to something like cloud services and all of that.

I will — I made a statement the other day, which it's really remarkable, and I was — I asked Charlie whether he could think of a situation like it — where one person has built an extraordinary economic machine in two really pretty different industries, you know, almost simultaneously, as has happened —

CHARLIE MUNGER: From a standing start at zero.

WARREN BUFFETT: From a standing start at zero, with other — with competitors with lots of capital and everything else.

To do it in retailing and to do it with the cloud, like Jeff Bezos has done, I mean, I —

People like the Mellons invested in a lot of different industries and all of that. But he has been, in effect, the CEO, simultaneously, of two businesses starting from scratch that if — you know, Andy Grove used to use — at Intel — used to say, you know, "Think about if you had a silver bullet and you could shoot it at — and get rid of one of your competitors, who would it be?"

Well, I think that both in the cloud and in retail, there are a lot of people that would aim that silver bullet at Jeff.

And he's done — it's a different sort of game — but he's, you know, at The Washington Post, he's played that hand as well as anybody I think possibly could.

So it's a remarkable business achievement, where he's been involved, actually, in the execution, not just bankrolling it, of two businesses that are probably as feared by their competitors, almost, as any you can find.

It's — Charlie, you got further thoughts?

CHARLIE MUNGER: Well, we're sort of like the Mellons, old-fashioned people who done all right. And Jeff Bezos is a different species. (Laughter)

WARREN BUFFETT: And we missed it entirely, incidentally. We never owned a share of Amazon. (Laughs)

13. Buffett defends investing in competitive airline industry

WARREN BUFFETT: OK, Gregg Warren.

GREGG WARREN: Warren, my question relates to some recent stock purchases as well.

Unlike the railroads, which benefit from colossal barriers to entry due to their established, practically impossible to replicate, networks of rail and rights of way, the airline industry seems to have few, if any advantages.

Even with the consolidation we've seen during the past 15 years, the barriers to entry are few and the exit barriers are high.

The industry also suffers from low switching cost and intense pricing competition, and is heavily exposed to fuel costs, with rising fuel prices being difficult to pass on, and declining fuel prices leading to more price competition.

Compare this with rail customers who have few choices and thus wield limiting buying power, and where fuel charges allow the industry to mitigate fuel price fluctuations.

While you've noted several times since the airline stock purchases were announced that the two industries are quite different and that comparisons should not be made to Berkshire's move into railroads a decade ago, could you walk us through what convinced you that the airlines were different enough this time around for Berkshire to invest close to $10 billion in the four major airlines?

Because it would seem to me that UPS, which you have a small stake in, and FedEx, both of which have wider economic moats built on more identifiable and durable competitive advantages, would be a better option for long-term investors.

WARREN BUFFETT: Yeah, the decision in respect to airlines had no connection with our being involved in the railroad business.

I mean, you can classify them, you know, maybe in — as transportation businesses or something. But it had no connection, had no more connection than the fact we own GEICO or, you know, any other business.

You couldn't pick a tougher industry, you know, ever since Orville [Wright] went up and I said, you know, that if anybody'd really been thinking about investors, they should have had Wilbur [Wright] shoot him down and save everybody a lot of money for a hundred years.

You can go to the internet and type in "airlines" and "bankrupt," and you'll see that something like a hundred airlines — in that general range, you know, gone bankrupt in the last few decades.

And actually, Charlie and I were directors for some time of USAir. And people write about how we had a terrible experience in USAir. It was the — one of the dumbest things I'd ever done. And there's a lot of —

CHARLIE MUNGER: You made a fair amount of money out of it, too.

WARREN BUFFETT: Yeah, and we made a lot of money out of it. (Laughs)

CHARLIE MUNGER: It was undeserved.

WARREN BUFFETT: But we made a lot of money out of it, because there was one little brief period when people got all enthused about USAir. And after we left as directors and after we sold our position, USAir managed to go bankrupt twice in the subsequent period.

I mean, you've named all of the — not all of them — but you've named a number of factors that just make for terrible economics.

And I will tell you that if capacity — you know, it's a fiercely competitive industry. The question is whether it's a suicidally competitive industry, which it used to be.

I mean, when you get virtually every one of the major carriers, and dozens and dozens and dozens of minor carriers going bankrupt, you know, it ought to come upon you, finally, that maybe you're in the wrong industry.

It has been operating for some time now at 80 percent or better of capacity — being available seat miles — and you can see what deliveries are going to be and that sort of thing.

So if you make — I think it's fair to say that they will operate at higher degrees of capacity over the next five or 10 years than the historical rates, which caused all of them to go broke.

Now the question is whether, even when they're doing it in the 80s, they will do suicidal things in terms of pricing, remains to be seen.

They actually, at present, are earning quite high returns on invested capital. I think higher than either FedEx or UPS, if you actually check that out.

But that doesn't mean — tomorrow morning, you know, if you're running one of those airlines and the other guy cuts his prices, you cut your prices, and as you say, there's more flexibility when fuel goes down to bring down prices than there is to raise prices when prices go up.

So the industry, you know — it is no cinch that the industry will have some more pricing sensibility in the next 10 years than they had in the last hundred years. But the conditions have improved for that.

They've got more labor stability than they had before, because they're basically all going to — they've been through bankruptcy.

And they're all going to sort of have an industry pattern bargaining, it looks to me like. They're going to have a shortage of pilots to some degree. But it's not like buying See's Candy.

Charlie?

CHARLIE MUNGER: No, but the investment world has gotten tougher with more competition, more affluence, and more absolute obsession with finance throughout the whole country. And we picked up a lot of low-hanging fruit in the old days, where it was very, very easy. And we had huge margins of safety.

Now we operate with a less advantageous general climate. And maybe we have small statistical advantages, where in the old days it was like shooting fish in a barrel.

But that's all right. It's OK if it gets a little harder after you get filthy rich. (Laughter)

WARREN BUFFETT: Yeah. Charlie's more philosophical than I am on that point. (Laughter)

CHARLIE MUNGER: Well, I can't bring back the low-hanging fruit, Warren. You're just going to have to keep reaching for the higher branches.

WARREN BUFFETT: Gregg, the — I don't — I think the odds are very high that there are more revenue passenger miles five years from now or 10 years from now.

If the airlines — if the airline companies are only worth, five or 10 years from now, what they're worth now, in terms of equity, we'll get a pretty reasonable rate of return, because they're going to buy in a lot of stock at fairly low multiples.

So if the company's worth the same amount at the end of the year and there's fewer shares of stock outstanding, over time we make decent money. And all four of the major airlines are buying in stock at a —

CHARLIE MUNGER: You've got to remember that the railroads were a terrible business for decades and decades and decades and then they got good.

WARREN BUFFETT: Yeah, it — we like — I like the position. Obviously, by buying all four, it means that it's very hard to distinguish who will do the — at least in my mind — it's hard to distinguish who will do the best.

I do think the odds are quite high that, if you take revenue passenger miles flown five or 10 years from now, it will be a higher number. And that will be —

There'll be low-cost people who come in. And, you know, the Spirits of the world and JetBlues, whatever it may be. But the — my guess is that all four of the companies we have will have higher revenues. The question is what their operating ratio is.

They will have fewer shares outstanding by a significant margin. So even if they're worth just what they're worth today, we could make a fair amount of money. But it is no cinch, by a long shot.

14. Coca-Cola and Buffett get "Black Planet Award"

WARREN BUFFETT: OK, station 3.

AUDIENCE MEMBER: Good morning, everybody. My name is Savilla Aliance (PH). I'm from Germany. And I'm member of board of Ethecon Foundation Ethics and Economy.

I'm very happy that I can put my question here. And maybe you are not as happy as I am to listen to it.

WARREN BUFFETT: (Laughs) Well, we'll try to stay happy. Thank you for coming. (Laughter)

AUDIENCE MEMBER: Thank you. Mr. Buffett, a few years ago, I saw a movie in which you proclaimed that the print on the dollar bill — "In God We Trust" — does not really express your philosophy. In your opinion, only cash counts. And your credo is, "in the dollar I trust." You obviously thought —

WARREN BUFFETT: I don't think I've ever said that actually. But —

AUDIENCE MEMBER: Well, I can show you the movie. (Laughs) That will prove.

WARREN BUFFETT: Oh, well, I — send me a clip. I —

AUDIENCE MEMBER: Well, maybe it was just joking. But always behind a joke there is also a truth. So — well, you laughed heartily at that moment.

You, as one of the most richest men in — of all times on this Earth, are you not a good-humored, friendly, elderly gentleman?

Whatever motivated those who designed the dollar notes, they certainly wanted to say that there is something higher than the value of this printed paper.

Regrettably, you have shown many times in your life that you see this differently. You have accumulated billions of dollars — (applause) — showed extraordinary cleverness and skill, and you knew — you knew better to pick up than many others who, like you, used the rules which are inherent to capitalism for their own intentions.

But have you ever given a thought to what troubles and sacrifices, slavery and destruction of Mother Earth, and even diseases and deaths stick to the dollar bills which you gather so eagerly? (Booing)

Let’s take Coca-Cola. (Booing)

Ethecon Foundation Ethics and Economy from Germany has awarded the Black Planet Award to the members of the board of directors as well as to the large shareholders, Warren Buffett and Allen — and Herbert Allen —because you are co-responsible for all of what makes these group make so much money, isn’t it?

Among other things, Coca-Cola deprives people —

WARREN BUFFETT: Well, I —

AUDIENCE MEMBER: — of their drinking water —

WARREN BUFFETT: — at some point, yeah, I —

AUDIENCE MEMBER: — in drought-prone areas of the world.

WARREN BUFFETT: Well, are you asking a question?

AUDIENCE MEMBER: And many (inaudible) contaminate the groundwater in these areas.

WARREN BUFFETT: I don’t want to interrupt you, but are you — (applause) — making a speech or asking a question?

AUDIENCE MEMBER: Well, I put my question right now.

WARREN BUFFETT: OK, good.

AUDIENCE MEMBER: Will you give up your Coca-Cola shares if the destruction of the environment, the monopolization of the right to healthy drinking water, and the shameless exploitation of the workers continue?

CHARLIE MUNGER: Well, that’s more of a speech than a question.

WARREN BUFFETT: Yeah. (Applause)

I don’t think that quote you had earlier — I have — I’ve said once or twice that it should say “In the Federal Reserve We Trust” because they print the money. And if they print too much of it, it could decline in value.

But I’ve never — to my knowledge, I’ve never said anything like you originally said.

And I would say this. I think I’ve been eating things I like to eat all my life. And Coca-Cola — this Coca-Cola’s 12 ounces, I drink about five a day. (Laughter) It has about 1.2 ounces of sugar in it.

And if you look at what people — different people — get their sugar and calories from, they get them from all kinds of things. I happen to believe that I like to get 1.2 ounces with this. And it's enjoyable.

Since 1886, people have found it pleasant. And I would say that if you pick every meal in terms of what somebody in some recent publication has told you is the very best for you, I offer you that. I say, "Go to it."

But if you told me that I would live one year longer. And I don't even think that — that I would live one year longer if I'd eaten nothing but broccoli and asparagus and everything my Aunt Alice wanted me to eat all my life or I could eat everything I enjoyed eating, including chocolate sundaes, and Coca-Cola, and steak, and hash browns, you know, I would rather eat what — in a way I enjoy for my whole life than — and — than, you know eat some other way and live another year. (Applause)

And I do think that choice should be mine, you know? If somebody decides sugar is harmful, you know, there — maybe you'd encourage the government to ban sugar. But sugar in Coca-Cola is not different than eating sugar, you know, put on my Grape-Nuts in the morning or whatever else I'm having.

So I think Coca-Cola's been a very, very positive factor in America for — and the world — for a long, long time. And you can look at a list of achievements of the company. (Applause)

And I really don't want anybody telling me I can't drink it.

Charlie?

CHARLIE MUNGER: Well, I've solved my Coca-Cola problem by drinking Diet Coke. And I swill the stuff like other people swill I don't know what. And I've been doing it for just as long as you've been taking all those Coca-Colas that — I've had breakfast with Warren when he has Coca-Colas and nuts. (Laughter)

WARREN BUFFETT: And pretty damn good too. (Laughter)

CHARLIE MUNGER: If you keep doing that, Warren, you may not make a hundred.

WARREN BUFFETT: Well — (laughter) — I think there's something in longevity to feeling happy about your life, too. It's not —

CHARLIE MUNGER: Absolutely. (Applause)

15. Intrinsic value projections depend on interest rates

WARREN BUFFETT: OK, Carol?

CAROL LOOMIS: This question is from Franz Tramberger (PH) of Austria. And it concerns intrinsic value, which is neither — Warren may rather — he may amend this, my definition here, but — which is neither a company's accounting value nor its stock market value, but is rather its estimated real value.

So the question is, "At what rate has Berkshire compounded intrinsic value over the last 10 years? And at what rate, including your explanation for it please, do you think intrinsic value can be compounded over the next 10 years?"

WARREN BUFFETT: Yeah. Intrinsic value, you know, can only be calculated — or gains — you know, in retrospect.

But the intrinsic value pure definition would be the cash to be generated between now and Judgment Day, discounted at an interest rate that seems appropriate at the time. And that's varied enormously over a 30 or 40-year period.

If you pick out 10 years, and you're back to May of 2007, you know, we had some unpleasant things coming up. But we've — I would say that we've probably compounded it at about 10 percent.

And I think that's going to be tough to achieve, in fact almost impossible to achieve, if we continued in this interest rate environment.

That's the number one — if you asked me to give the answer to the question, if I could only pick one statistic to ask you about the future before I gave the answer, I would not ask you about GDP growth. I would not ask you about who was going to be president.

I would — a million things — I would ask you what the interest rate is going to be over the next 20 years on average, the 10-year or whatever you wanted to do.

And if you assume our present interest rate structure is likely to be the average over 10 or 20 years, then I would say it'd be very difficult to get to 10 percent.

On the other hand, if I were to pick with a whole range of probabilities on interest rates, I would say that that rate might be — it might be somewhat aspirational. And it might well — it might be doable.

And if you would say, "Well, we can't continue these interest rates for a long time," I would ask you to look at Japan, you know, where 25 years ago, we couldn't see how their interest rates could be sustained. And we're still looking at the same thing.

So I do not think it's easy to predict the course of interest rates at all. And unfortunately, predicting that is embedded in giving a good answer to you.

I would say the chances of getting a terrible result in Berkshire are probably as low as about anything you can find. Chance of getting a sensational result are also about as low as anything you can find. So if I — I would — I —

My best guess would be in the 10 percent range, but that assumes somewhat higher interest rates — not dramatically higher — but somewhat higher interest rates in the next 10 or 20 years than we've experienced in the last seven years.

Charlie?

CHARLIE MUNGER: Well, there's no question about the fact that the future, with our present size is, in terms of percentages of rates of return, is going to be less glorious than our past. And we keep saying that. And now we're proving it. (Laughter)

WARREN BUFFETT: Do you want to end on that note, Charlie? Or would you care to — (Laughter)

CHARLIE MUNGER: Well, I do think Warren's right about one thing. I think we have a collection of businesses that on average has better investment values than, say, the S&P average. So I don't think you shareholders have a terrible problem.

WARREN BUFFETT: And I would say we probably — well, I'm certain — we have — we do have more of a shareholder orientation than the S&P 500 as a whole. I mean, for — you know, the —

This company has a culture where decisions are made for — as an owner, as a private owner would make them. And frankly, that's a luxury we have that many companies don't have. I mean, they're under pressures today, sometimes, to do things.

One of the questions I ask the CEO of every public company that I meet is, "What would you be doing differently if you owned it all yourself?" And the answer, you know, is usually this, that, and a couple of other things.

If you would ask us, the answer is, you know, we're doing exactly what we would do if we owned them all — all the stock ourselves. And I think that's a small plus over time.

Anything further, Charlie? (Applause)

CHARLIE MUNGER: I think we have one other advantage. A lot of other people are trying to be brilliant. And we're just trying to stay rational. And — (laughter and applause) — it's a big advantage. Trying to be brilliant is dangerous, particularly when you're gambling.

16. Who benefits from corporate tax cut varies by industry

WARREN BUFFETT: OK, Jonathan?

JONATHAN BRANDT: If corporate tax rates are reduced meaningfully, Berkshire will enjoy a one-time boost to book value because of its sizable deferred tax liability, and its go-forward earnings should be higher, too, at least in theory.

How much of the reduced tax rate will be passed along to Berkshire's customers through, for instance, lower electricity rates or lower railroad shipping rates? And how much will go to Berkshire shareholders?

WARREN BUFFETT: Yeah, the question is, in the case of our utility businesses, all benefit of lower tax rates goes to customers. And it should be, because we are allowed a return on equity — in general — I mean, I'm simplifying a little bit. But the —

We're allowed a return on equity that's computed on an after-tax basis. And the utility commissions would, if taxes were raised, would presumably give us higher rates to compensate for that.

And if taxes are lowered, they would say, "You're not entitled to make more money just because tax rates — on equity — because tax rates have been lowered." So forget about the utility portion of the deferred taxes.

The deferred taxes that are applicable to our unrealized gains in securities, we would get all the benefit of. Because I mentioned we had 90 billion-plus of unrealized gains. And if the rates were changed on those in either direction, our owners, dollar for dollar, will participate in that.

And then you get into the other businesses. You mentioned the railroad, but it can be all of our other businesses.

To some extent, if tax rates are lowered, to different degrees in different industries, depending on the number of players, the competitive conditions, some of it may — some if it almost certainly gets competed away. And some of it would likely not be competed away.

And that's — you know, economists can argue about that a lot. But I've seen it in action in a lot of cases.

You got a big decline in rates, for example, in the U.K. And we've had them over my lifetime. We had 52 percent corporate rates. You know, we've had a lot of different numbers.

So I have seen how behavior — economic behavior — works. And I would say that it's certain that some of any lower rate would be competed away. And it's virtually certain that some would enure to the benefit of the shareholders. And it's very industry and company specific in how that plays out.

Charlie?

Well, we — dollar for dollar, I mean, there's 90 or 95 billion, if the rate were to drop 10 percent, that 9 1/2 billion is — by 10 percentage points — that 9 1/2 billion's real.

On the other hand, if it goes up as it did — went up from 28 to 35 percent, they can take it away from us, too.

CHARLIE MUNGER: Well, I think it's true that we're peculiar in one way. If things go to hell in a handbasket and then get better later, we're likely to do better than most others.

And we don't wish for that. And we don't want our company to have to suffer through it. And we fear what might happen if the country went through the ringer like that.

But if that real adversity comes, we're likely to do better in the end. We're good at navigating through that kind of stuff.

WARREN BUFFETT: Yeah, and occasionally, there will be —

CHARLIE MUNGER: A lot — in fact, we're quite good at it. (Laughter)

WARREN BUFFETT: There will be occasional hiccups in the American economy. Doesn't have much to do with who's president or anything like that. Those people may get blamed or given credit for different things.

But it's just — it is the nature of market systems to occasionally go haywire in one direction or another. And it's been ever thus, you know, and it'll be ever thus.

It's not — it does not have a — there's not a — it's not a — on a regular sine wave-type picture or anything of the sort. But it's certain to happen from time to time.

And we will probably have a fair amount of money and credit at that time. And we certainly —

We're not affected. When the rest of the world is fearful, we know America's going to come out fine. And we will not have a trouble — any trouble — psychologically, acting at all.

And then the question is how much do we have in the way of resources? We'll also never put the company in any kind of risk just because we see a lot of opportunities. We'll grab all the ones we can that we can handle. And not lose a day of sleep.

(Someone shouts in the audience)

I didn't quite get that. But —

17. Why Buffett sold his used Cadillac for a profit

WARREN BUFFETT: In any event, we will now go to station 4. And if the person yelling — are we up there in station — are you on station 4?

AUDIENCE MEMBER: Yes, Dr. Bruce Hertz from Glenview, Illinois. I wanted to thank you for allowing me to attend. I feel both honored and blessed.

My question for Mr. Buffett is, you've always advised us to purchase equities that appreciate in value. Yet a few years ago you sold your used Cadillac at a tremendous profit. (Laughter)

How can you justify selling a depreciating asset for a significant profit? Thank you.

WARREN BUFFETT: Yeah, well — (laughter) — actually I gave it to Girls Inc. And they sold it. And it was kind of an interesting — (Applause)

A very nice guy bought it for a hundred and some thousand dollars. And I did not — and Girls Inc. got the money. And he got in the — he came later, actually, with his family.

And he drove it away without any plates. He was driving back to New York. And he got picked up by the police — (laughter) — in Illinois. And he said, "Well" — he started giving this explanation about how he'd given this money to Girls Inc. and was driving the car back. And he had this nice looking family with him.

And the cops were quite skeptical. But fortunately, I'd signed the dashboard for him as part of the deal when he — and so they looked at that. And then they just said, "Well, did he give you any stock tips?" And they let him go. (Laughter)

I can't recall ever selling a used car at a profit. But we — I don't think I've sold any personal possession. Well, I've got a house for sale.

CHARLIE MUNGER: You don't have any personal possessions. (Laughter)

WARREN BUFFETT: Yeah. No, I — anything you see with a figure attached like that —

CHARLIE MUNGER: You're a fatter version of Mahatmas Gandhi — (laughter) — Mahatma Gandhi.

WARREN BUFFETT: The guy was a very nice guy that bought it. And, you know, his check cleared. So we were fine. (Laughter)

18. Why Buffett wants his wife to own an index fund after he dies

WARREN BUFFETT: Becky?

BECKY QUICK: I'd like to ask a question that can serve as a follow-up to the question that Carol had asked. And Charlie, in that response, said that he thinks that Berkshire's businesses on the whole will do better than the S&P 500.

Clark Cameron (PH) from Birmingham, Alabama, who owns 281 shares of Berkshire B, writes in and asks, "Why have you advised your wife to invest in index funds after your death rather than Berkshire Hathaway? I believe Munger has counseled his offspring to quote, 'Not be so dumb as to sell.'"

WARREN BUFFETT: Yeah. (Laughter)

She won't be selling any Berkshire to buy the index funds. All of my Berkshire, every single share, will go to philanthropy.

So the — I don't even regard myself as owning Berkshire, you know, basically — (applause) — it's committed.

And so far, about 40 percent has already been distributed.

So the question is, somebody who is not an investment professional will be, I hope, reasonably elderly by the time that the estate gets settled.

And what is the best investment, meaning one that there would be less worry of any kind connected with and less people coming around and saying, "Why don't you sell this and do something else?" and all those things. She's going to have more money than she needs.

And the big thing, then, you want is money not to be a problem. And there will be no way that if she holds the S&P — or virtually no way, absent something happening with weapons of mass destruction — but virtually no way that she won't — she'll have all the money that she possibly can use.

She'll have a little liquid money so that if stocks are down tremendously at some point, there's — they close the stock exchange for a while, anything like that — she'll still feel that she's got plenty of money.

And the object is not to maximize. It doesn't make any difference whether the amount she gets doubles or triples or anything of the sort. The important thing is that she never worries about money the rest of her life.

And I had an Aunt Katie here in Omaha, who Charlie knew well, and worked for her husband, as did I. And she worked very hard all her life. And had lived in a house she'd paid, I think, I don't know, $8,000 for at 45th and Hickory all her life.

And because she was in Berkshire, she ended up — she lived to 97 — she ended up with, you know, a few hundred million. (Laughter)

And she would write me a letter every four or five months. And she said, “Dear Warren, you know, I hate to bother you. But am I going to run out of money?”

And — (laughter) — I would write her back. And I’d say, “Dear Katie, it’s a good question because, if you live 986 years, you’re going to run out of money.” And — (laughter) — then about four or five months later, she’d write me the same letter again.

And I have seen there’s no way in the world, if you’ve got plenty of money, that it should become a minus in your life. And there will be people, if you’ve got a lot of money, that come around with various suggestions for you, sometimes well-meaning, sometimes not so well-meaning.

So if you’ve got something as certain to deliver — you know, it was all in Berkshire, they’d say, “Well, if Warren was alive today, you know, he would be telling you to do this.” I just don’t want anybody to go through that.

And the S&P will be a — I think actually what I’m suggesting is what — a very high percentage of people should do something like that. And I don’t think they will have as — I think there’s a chance they won’t have as much peace of mind if they own one stock.

And they’ve got neighbors and friends and relatives that are trying to do some — like I say, sometimes well-intentioned, sometimes otherwise, to do something else. And so I think it’s a policy that’ll get a good result and is likely to stick.

Charlie?

CHARLIE MUNGER: Well, as Becky said, the Mungers are different. I want them to hold the Berkshire.

WARREN BUFFETT: Well, I want to hold the Berkshire, too. (Laughter)

CHARLIE MUNGER: No, but I mean I don’t like the — I recognize the logic of the fact that that S&P algorithm is very hard to beat. You know, diversified portfolio of big companies. It’s all but impossible for most people. But, you know, it’s — I’m just more comfortable with the Berkshire.

WARREN BUFFETT: Well, it’s the family business.

CHARLIE MUNGER: Yeah.

WARREN BUFFETT: Yeah. But it — I've just — I've seen too many people as they get older, particularly, being susceptible and just having to listen to the arguments of people coming along.

CHARLIE MUNGER: Well, if you're going to protect your heirs from the stupidity of others, you may have some good system. But I'm not much interested in that subject.

WARREN BUFFETT: OK. (Laughter)

19. Berkshire probably would have put $15B into failed Unilever deal

WARREN BUFFETT: OK. Jay?

JAY GELB: Berkshire reportedly partnered with 3G and Kraft Heinz's attempt to acquire Unilever for $143 billion.

How much was Berkshire willing to invest in this deal? And does this mean Berkshire's next large acquisition is likely to be in partnership with 3G?

WARREN BUFFETT: Yeah, well, Kraft, I — you'd have to distinguish between two situations. Kraft Heinz was a widely-owned company in which we and 3G act as a control group and have a little over 50 percent of the stock.

But as originally contemplated — no certainty that this exactly is what would have happened — we would have invested an additional 15 billion and 3G would have invested an additional 15 billion if a friendly agreement could have been reached.

So if the deal had been made, if the independent directors of Kraft Heinz had approved the transaction, the likely — well, then the likelihood is that we would have invested 15 billion. But it would've required the approval of the independent directors as well.

Now Kraft Heinz, in going forward with making that offer, wanted to be sure that there would be enough equity capital, in addition to the debt that would be incurred, to make the deal. And so, informally, we had basically committed the 15 billion.

It only was approved on the basis that it be a friendly deal with Unilever. And initially, we thought they would be at least possibly interested in such a deal.

And when we found out otherwise, we withdrew the offer. So it would have been 15 billion of additional money, in all probability.

20. Speculation is inevitable in China and the U.S.

WARREN BUFFETT: OK, station 5?

AUDIENCE MEMBER: Dear Honorable Mr. Buffett and Mr. Munger, I'm Tian Du Hua (PH) from China. My company (Inaudible) Holdings is spreading value investing philosophy in Asia.

My business partner Ken Chi (PH), Cho Quy Ying (PH), and I are committed to awake 100 million Chinese people to return to rational way of investing.

The hardest thing in this world is to change people's values or belief system. And we should like to awake investors to change from speculate in the market to investing in the market. It's not changing the speculator's values or belief system.

May I ask you, Mr. Buffett, can you kindly advise us what we should do to spread your value investing philosophy? Or is there any word of encouragement? Thank you.

WARREN BUFFETT: Yeah, the — when — in any system — Keynes wrote about this in 1936 — I think it was, in "The General Theory," or '35. I think it's Chapter 12. It's — great chapter on investing.

And he talked about investment and speculation and the propensity of people to speculate and the dangers of it.

And worded eloquently, there's always the possibility of, I mean, there's always some speculation, obviously, and there's always some value investors and all that sort of thing in the market. But there's —

When speculation gets rampant, and when you're getting what I guess Charlie would call "social proof" — that it's worked recently — people can get very excited about speculating in markets. And we will have it from time to time in this market.

There's nothing more agonizing than to see your neighbor who you think has an IQ about 30 points below you getting richer than you are by buying stocks. And whether it's internet stocks or whatever. And it — and people succumb to it. And they'll succumb in this economy just as elsewhere.

There's also a point which gets to your question. I would say that early on in the development of markets — there is probably a — there's some tendency for them, I think, to be more speculative than markets that have been around for a couple hundred years because the — it has a — invest —

Markets have a casino characteristic that has a lot of appeal to people, particularly when they see, like I say, people getting rich around them. And those that haven't been through cycles before are probably a little more prone to speculate than people who have experienced the outcome of wild speculation.

So I — you know, basically in this country, Ben Graham was, in the book I read in 1949, was preaching investment. And that book continues to sell very well.

But if the market gets hot, new issues are doing well and people on leverage are doing well, a lot of people will be attracted to, not only speculation, but what I would call gambling. And I'm afraid that that will be true in the United States.

And I think that China, being a newer market, essentially, in which there's widespread participation, is likely to have some pretty extreme experiences in that respect. We will have some in this country, too.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that. (Laughter)

The Chinese will have more trouble. They're very bright people. They have a lot of action and, sure they're going to be more speculative.

And it's a dumb idea. And to the extent you're working on it, why, you're on the side of the angels. But lots of luck. (Laughter)

WARREN BUFFETT: Well, it will offer the investor more opportunities actually — (laughs) — if they can keep their wits about them — if you have wild speculation. I mean, we —

Charlie just mentioned earlier, you know, that if we get into periods that are very tough, Berkshire certainly will do reasonably well because it won't — we won't be — we won't get fearful. And fear spreads like you cannot believe until you've seen a few examples of it.

At the start of September 2008, you had 35 million people with their money in money market funds with $3 1/2 trillion in them. And none of them were afraid that that dollar wasn't going to be a dollar when they went to cash in their money market fund.

And three weeks later, they were all terrified, and 175 billion flowed out in three days. And so the way the public can react is really extreme in markets. And that actually offers opportunities for investors.

You'll never — people like action and they like to gamble. And if they think there's easy money to be made, a lot of them, you'll get a rush to it. And for a while it will be self-fulfilling and create new converts until the day of reckoning comes. They'll —

Just keep preaching investing, and if the market swings around a lot, you'll keep adding a few people here and there to a group that recognizes that markets are there to be taken advantage of, rather than to instruct you as to what is going on. OK. Andrew?

Anything more on that, Charlie?

CHARLIE MUNGER: We've done a lot of preaching, Warren, without much effect.

WARREN BUFFETT: Right. And that's probably good, from our standpoint.

21. We don't do anything differently due to tax law changes

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: Thank you, Warren. This question comes from Ryan Prince (PH).

"President Donald Trump and his advisors have talked about proposing a substantial investment tax credit to provide incentives for long-term corporate fixed capital investment.

"In BNSF, Berkshire owns a sprawling infrastructure portfolio requiring regular routine maintenance investment of substantial scale.

"What impact would an investment tax credit have on BNSF's capital investment decision-making, from a return on investment capital perspective, as well as in terms of timing?

"And just as importantly, given the current economy and employment picture, would such a tax credit amount to a subsidization of otherwise mandatory maintenance capital investment or a proper incentive to stimulate investment?"

WARREN BUFFETT: Yeah, well, it would all depend on how it was worded — you know, because — we've had investment tax credits in this country, and we've had bonus depreciation. It's another form of it. We — and we do get extra first-year depreciation. That does not enter into our calculation very much.

You know, in fact — certainly at the Berkshire level, I've never instructed anybody to do anything different because of investment tax credits or accelerated depreciation. There may be some calculations done down at the operating company level.

It's certainly true in something like wind projects and solar projects. They are dependent on the tax law, currently. There may come a time when they aren't, but they wouldn't have been done without some subsidization through the tax law.

But I would say, if you change the depreciation schedules and, you know, double depreciation — triple depreciation, for — that — we're going to do what we need to do at the railroad to make it safer and more efficient if we just had ordinary depreciation.

And I doubt if there'd be any dramatic differences. Obviously, if you were going to, say, buy a bunch of planes and the law was going to change on December 31st, and the math made it better to wait till January 1st or do it this December 31st, you make that kind of calculation.

But I can't recall, in all the years, that I've ever sent out anything to our managers saying, "Let's do this because the tax law is being changed or might be changed," or something of the sort.

As I mentioned earlier, it changes just a little bit if you think there's going to be a change in capital gains rates at a given time. Obviously if it's going to — the rate's going to be lowered, you would take losses ahead of time and defer gains, maybe, a little.

And that's why it's useful, actually, if the tax committees in the Senate and the House are working on something, it might be useful if the chairmans would say that, "If we do make any changes, we're likely to use this effective date," or something of the sort. And I think they've done that a few times in the past.

We are not, the big tax-driven item — is — in wind and solar. And that is a specific policy, because the government has decided they want to move people — or society has decided — they want to move people toward those forms of electric generation. And the market system wouldn't do it.

And there may come a time when the market system will do it all by itself.

We won't make big changes. And it's so speculative anyway, in terms of even what the law would be.

But beyond that, if it becomes less speculative as the law and it really looks like something is going through, it doesn't change us big time at all.

Charlie?

CHARLIE MUNGER: Nothing to add. We're not going to change anything at the Berkshire — at the railroad — for some little tax jiggle.

WARREN BUFFETT: Yeah, if we need a bridge repaired, we're going to repair the bridge, you know. And if need — we need a lot of track maintenance all the time and that sort of thing. And it just, I don't think [BNSF's] Matt [Rose] and I have ever had a talk about it since we've owned the railroad, but —

22. Coal shipment revenues will drop for BNSF

WARREN BUFFETT: Gregg?

GREGG WARREN: Warren, my question also relates to Burlington Northern.

Despite the current administration's belief that they can bring the coal industry back, market forces continue to lead to the industry's demise.

While 90 percent of U.S. coal consumption is driven by electricity generation, natural gas has been both cheaper and cleaner burning, and renewable electricity generation has remade parts of the market as wind and solar have gained scale and become cheaper alternatives.

This has created problems for Burlington Northern, with coal shipments accounting for just 18 percent of volume and revenue for the railroad last year, down from an average of 24 percent for both measures the previous 10 years.

While some of this was due to large buildup of coal supplies the past couple of winters, which finally seem to be working their way out, what are your expectations for the contribution coal can make to BNSF longer term?

And I know that the railroad currently handles some export shipments going through Canada's Pacific Coast ports, but will there be enough growth there to offset domestic demand? Or will BNSF need to rely more heavily on segments like intermodal to offset lost coal volumes?

WARREN BUFFETT: Yeah, the answer is coal's — coal is going to go down over time. I don't think there's much question about that.

The specifics of any given year relate very importantly to the price of natural gas. I mean, right now there are — there —

Demand is somewhat up — fair amount up — from last year because natural gas is at 3.15 or 3.20, and the utilities can produce electricity, in many cases, quite a bit cheaper with coal than with natural gas. Whereas, with a $2, it would all be — it would be natural gas.

But over time, coal is — in my mind — is essentially certain to decline as a percentage of the revenue of the railroad.

The speed at which it does, you know, it — you don't build — create generation plants overnight. And so it —

You can't predict the rate. And if natural gas is cheap enough, it's going to be a — you'll see a big conversion back to natural gas.

So coal is a — coal is going to go down, as a percentage of revenues, significantly.

You know, certainly over 10 years it'll be quite significant, and who knows exactly, year by year. We are looking for other sources of growth than coal. If you're tied to coal, you got problems.

Charlie?

CHARLIE MUNGER: Well — you go out over the extremely long term, I think that all hydrocarbons will be used, including all the coal.

So I think that, in the end, these hydrocarbons are a huge resource for humanity, and I don't think we've got any good substitute.

And I've never minded saving them for the next generation. I don't like using them up very fast. So, I'm often on a road on my own on this one.

And people think that all this hydrocarbons are going to be stranded and the whole world's going to change. I think we're going to use every drop of the hydrocarbon sooner or later. We'll use them as chemical feed stocks. It's —

I regard all these things as very hard to predict. And I'm not at all sure that — I would eventually expect natural gas to be pretty short in supply.

WARREN BUFFETT: A change in storage would make a big difference.

We will produce, within a few years, as much electricity in Iowa — or virtually as much — electricity in Iowa from wind as our customers use. But the wind only blows about 35 percent of the time or something like that. And sometimes it blows too hard.

But the storage, you know, having it 24 hours a day, seven days a week, is a real problem, even if we've got the capability of producing, like I say, a self-sufficient amount, essentially, in Iowa before very long.

Coal — our shipments of coal are up fairly substantially this year on the BNSF. But they were very low last year, and as you said, stockpiles grew and have come down somewhat. They're still on the high side.

But in my mind — Charlie's got a longer-term outlook on this — in my mind, we're going to be shipping a whole lot less coal 10 or 20 years from now than we are now.

On the other hand, I think there's some decent prospects in other long hauls.

I mean, it's a pretty cheap way to move bulk commodities long distance. Rail is. And I think it's a good business, but the coal aspect of it's going to diminish.

23. Big change: You don't need money to run America's biggest companies

WARREN BUFFETT: OK. Station 6.

AUDIENCE MEMBER: Good morning. It's Marcus Burns from Sydney, Australia.

My question, Mr. Buffett, is, you used to buy capital-light, cash-generative businesses, but now buy lower-growth, capital-consumptive businesses.

I realize Berkshire generates a lot of cash flow, but would shareholders have been better off if you had continued to invest in capital-light companies?

WARREN BUFFETT: Well, we'd love to find them. I mean, there's no question that buying a high-return-on-assets, very light-capital-intensive business that's going to grow beats the hell out of buying something that requires a lot of capital to grow.

And this varies from day to day, but I believe — and I don't think it's sufficiently appreciated. I believe that probably the five largest American companies by market cap — and some days we're in that group and some days we aren't — let's assume we're not in that group on a given day — they have a market value of over $2 1/2 trillion, and that 2 1/2 trillion is a big number.

I don't know whether the aggregate market cap of the U.S. market is, but that's probably getting up close to 10 percent of the whole market cap of the United States. And if you take those five companies, essentially, you could run them with no equity capital at all. None.

That is a very different world than when Andrew Carnegie was building a steel mill and then using the earnings to build another steel mill and getting very rich in the process, or Rockefeller was building refineries and buying tank cars and everything.

Generally speaking, over — for a very long time in our capitalism, growing and earning large amounts of money required considerable reinvestment of capital and large amounts of equity capital, the railroads being a good example.

That world has really changed, and I don't think people quite appreciate the difference.

You literally don't need any money to run the five companies that are worth collectively more than $2 1/2 trillion, and who have outpaced any number of those names that were familiar, if you looked at the Fortune 500 list 30 or 40 years ago, you know, whether it was Exxon or General Motors or you name it.

So we would love — I mean, there's no question that a business that doesn't take any capital and grows and has, you know, almost infinite returns on required equity capital, is the ideal business.

And we own a couple of businesses — a few businesses — that earn extraordinary returns on capital, but they don't grow.

We still love them, but if they had — if they were in fields that would grow, believe me, we wouldn't — you know, they would be number one on our list.

We aren’t seeing those that we can buy and that we understand well.

But you are absolutely right that that’s a far, far, far better way of laying out money than what we’re able to do when buying capital-intensive businesses.

Charlie?

CHARLIE MUNGER: Yeah. The chemical companies of America, at one time, were wonderful investments.

Dow and DuPont sold at 20-some times earnings, and they kept building more and more complicated plants and hiring more Ph.D. chemists, and it looked like they owned the world.

Now, most chemical products are sort of commoditized and it’s a tough business being a big chemical producer. And in comes all these other people like Apple and Google and they’re just on top of the world.

I think the questioner’s basically right that the world has changed a lot, and that the people who have made the right decisions in getting into these new businesses that are so different from the old ones have done very well.

WARREN BUFFETT: Yeah, Andrew Mellon would be absolutely baffled by looking at the high-cap companies now. I mean, the idea that you could create hundreds of billions of value essentially without assets — without tangible assets —

CHARLIE MUNGER: Fast.

WARREN BUFFETT: Fast, yeah. But that is the world. I mean, there is —

When Google can sell you something that — where GEICO was paying 11 bucks or something every time somebody clicked something — that is a lot different than spending years finding the right site and developing, you know, iron mines to supply the steel plants and, you know, railroads to haul the iron to where the steel is produced and distribution points, and all that sort of thing.

Our world was built — you know, when we first looked at it, our U.S. — our capitalist system, basically, was built on tangible assets, and reinvestment, and all that sort of thing, and a lot of innovation and invention to go with it.

But this is so much better, if you happen to be good at it, to essentially be able to build hundreds of billions of market value without really needing any capital.

That is a different world than existed in the past. And I think, listen, I think it's a world that is likely to continue. I mean, the trend is, I don't think the trend in that direction is over by a long shot.

CHARLIE MUNGER: A lot of the people who are chasing that sort of thing very hard now in the venture capital field are losing a lot of money. It's a wonderful field, but not everybody's going to win big in it. A few are going to win big in it.

24. Benefits of Berkshire's "management by abdication"

WARREN BUFFETT: OK. Carol?

CAROL LOOMIS: This question is from a shareholder in California, in the Silicon Valley area, who didn't want his name mentioned because he said he wasn't looking for publicity, but whose picture makes him appear to be a millennial.

"Every Berkshire shareholder knows about the stock market value of Berkshire, but my question is about the value of Berkshire to the world.

"For instance, the value of Apple to the world has been iPhones. The value of GEICO is cost-effective auto insurance. The value of 3G," and I will tell you that there are some shareholders who would be arguing about it here, but "the value of 3G is improved operations."

"But about Berkshire, I just don't know. In managing Berkshire's subsidiaries, as Mr. Munger once famously said, you practice 'delegation just short of abdication.' So, hands-on management can't be the answer.

"That means the majority of Berkshire's subsidiaries would do just as well if they were to stay independent companies. So that's my question. What is the value of Berkshire to the world?"

WARREN BUFFETT: Yeah, well, the — I would say the question about — I'm with him to the point where he says that our — which he accurately describes as "delegation to the point of abdication."

But I would argue that that abdication, actually, in many cases, will enable those businesses to be run better than they would if they were part of the S&P 500 and the target, perhaps, of activists or somebody that wants to get some kind of a jiggle in the short term.

So I think that our abdication actually has some very positive value on the companies. But that, you know, you'd have to look at it company by company.

We've got probably 50 managers in attendance here. And naturally, they're not going to say anything, probably, on television or anything where they knock a certain thing.

But get them off in a private corner and just ask them whether they think their business can be run better with a "management by abdication" from Berkshire, but with also all the capital strengths of Berkshire, that when any project that makes sense can be funded in a moment without worrying whether the banks are still lending, like in 2008, you know, or whether Wall Street will applaud it or something of that sort.

So I think our very — our hands-off style, actually, I think can add significant value in many companies, but we do have managers here you could ask about that.

We certainly don't add to value by calling them up and saying that we've developed a better system, you know, for turning out additives at Lubrizol, or running GEICO better than Tony Nicely can run it or anything of the sort.

But we do take a — we have a very objective view about capital allocation.

We can free managers up. I would say that we might very well free up at least 20 percent of the time of a CEO in the normal public — who would have — otherwise have a public company — just in terms of meeting with analysts, and the calls, and dealing with banks, and all kinds of things that, essentially, we relieve them of so that they can spend all of their time figuring out the best way to run their business.

So I think we bring something to the party, even if it — even if we're just sitting there with our feet up on the desk.

Charlie?

CHARLIE MUNGER: Yeah. We're trying to be a good example for the world. I don't think we'd be having these big shareholders meetings if there weren't a little bit of teaching ethos in Berkshire.

And I've watched it closely for a long time. I'd argue that that's what we're trying to do, is set a proper example. Stay sane. Be honest. Yeah. (Applause)

So I'm proud of Berkshire, and I don't worry too much if we sell Coca-Cola. (Laughter)

WARREN BUFFETT: We — I would say, you know, GEICO is an extraordinarily well-run company and it would be extraordinarily well-run if it were public.

But it has gone from 2-and-a-fraction percent of the auto insurance market to 12 percent.

And part of the reason, a small part — the real key is GEICO and Tony Nicely — but part of the reason is that when other — at least two of our competitors — and big competitors — said that they would not meet their profit objectives if they didn't lighten up their interest in new business, eight or 10 months ago, I think our business decision to step on the gas is a better business decision.

But I think that GEICO, as a public company, would have more trouble making that decision than they do when they're part of GEICO [Berkshire].

Because we are thinking about nothing but where GEICO's going to be in five or 10 years, and if that requires having new— we want new business cost to penalize our earnings in the short-term.

And other people have different pressures. I'm not arguing about how the —how they behave, because they have a different constituency than GEICO has with Berkshire and what Berkshire has with its shareholders, in turn.

And I think in that case, our system's superior. But it's not because we work harder. Charlie and I don't do hardly anything. (Laughter)

25. Structured settlements interest rate

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: Could you please talk about your periodic payment annuity business? The weighted average interest rate on these contracts is 4.1 percent, which doesn't sound particularly attractive given the current interest rate environment.

Is the duration of these liabilities long enough to make that an attractive cost of funds? Or were these contracts executed primarily when rates were higher?

WARREN BUFFETT: Well, those contracts — these are what are called structured settlements, primarily.

And when somebody young has a terrible auto accident or whatever it may be — perhaps urged by the court, urged by family members who really do have the interest of the injured party at heart, or — they may convert what could be a large sum settlement, probably against the insurance company — you know, maybe a million dollars, maybe $2 million — into periodic payments for the rest of the life of the injured party.

And we issue those for other insurance companies.

In fact, sometimes the court directs that Berkshire — or hints strongly — that Berkshire should be the one to issue those, because you're talking about somebody's life 30 or 40 or 50 years from now.

And the court, or the lawyer, or the family, they want to be very, very sure that whoever makes that promise is going to be around to keep it. And Berkshire has a preferred position in that.

We look — to get to your question, Jonny — we look for taking the longer maturity situations. We always have.

And we have to make assumptions about mortality, and we have to make — and then we have to decide at what interest rate we'll do it.

The 4.1 is a mix of a lot of contracts over a lot of years, obviously. We write maybe 30 million of these, 20 to 30 million a week, looking for the long maturities.

And so, if you take an average of 15 years, or something of the sort, that's how we come up with that sort of a figure. We adjust them to interest rates at all times.

And when doing that, we're making an assumption that we're going to earn more money that — than is inherent in the cost of these structured settlements. It's a business we've — I think we've got six or seven billion up now. And we'll keep doing them.

And incidentally, probably a significant percentage of the six or seven billion, we're not yet paying anything on. Somebody else may have the earlier payments. And they're certainly weighted far out. So it's a business that we'll be in 10 or 20 years from now.

We've got some natural advantage, because people trust us more than any other company to make those payments. And the test is whether we earn, over time, a return above that which we're paying to the injured party.

And that's a bet we're willing to make. But if interest rates continued at present levels for a long time — we would, assuming we kept the money in fixed-income instruments — we would — we'd have some loss in that.

We've got an allowance in there for the expenses, incidentally, because we do make monthly payments to these people, eventually.

And we have to keep track of whether they're still alive or not. Because you cannot count on the relatives of somebody that's deceased when a check is coming in every month to notify you promptly that the person has become deceased. But it's — it'll —

That number will go up over time. If interest rates stay where they are, that 4.1 will come down a little bit as we add new business.

26. USG investment not "great," but not a "disaster"

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Thank you, Mr. Buffett and Mr. Munger, for all you've done and the opportunity to learn even more from your approach to investing and life.

My name's Harry Hong, and I'm a respirologist from Vancouver, British Columbia.

The question involves, back in 2001, you made an initial investment in USG, shortly before the company declared bankruptcy due to the mounting asbestos liability.

You held those shares through the bankruptcy process, even though standard wisdom says that the equity in Chapter 11 is usually worthless. Can you explain why USG's equity was a safe investment?

WARREN BUFFETT: Well, I don't really remember all the details then.

CHARLIE MUNGER: It was very cheap. (Laughter) Very cheap. (Laughter)

WARREN BUFFETT: Yeah, but I would say this. USG, we own — I'm not sure what percent, but it's very significant percentage. I don't know what —

CHARLIE MUNGER: Twenty percent, or something.

WARREN BUFFETT: Probably 30 percent or something like that. But USG, overall, has just been disappointing because the gypsum business has been disappointing.

And I think — I may be wrong — I think they went bankrupt twice, first from asbestos going back and then, subsequently, because they just had too much debt. So it has not been a brilliant investment.

Now if gypsum prices were at levels that they were in some years in the past, it would have worked out a lot better.

CHARLIE MUNGER: But it hasn't been terrible.

WARREN BUFFETT: No, it hasn't been terrible, but it — gypsum took — has taken a real dive several times, and there has been too much gypsum capacity.

And then when it comes back, the managements have been — not necessarily at USG, but including USG perhaps — they've gotten more optimistic about future demand than they should have. And it —

And they like — going back historically a way — they like to build new plants. And it's a business where the supply has been significantly — potential supply — has been significantly greater than demand in a lot of years. I mean, it —

You've seen housing starts in — since 2008 and 2009 — not come back anywhere near as much as people anticipated. So gypsum prices have moved up but not dramatically.

So just put that one down as not one of our great ideas. Not one of my great ideas. Charlie wasn't involved in that. It's no disaster, though.

CHARLIE MUNGER: No it isn't. It's —

27. "Terrific" insurance operations are even better with Ajit Jain

WARREN BUFFETT: Becky?

BECKY QUICK (off microphone): This question — this question —

WARREN BUFFETT: Oh.

BECKY QUICK: Hello? Oh, there we go.

WARREN BUFFETT: OK.

BECKY QUICK: This question comes from Axel Meyersiek in Germany who writes, "If Ajit Jain were to retire, God forbid, be promoted, what would be the impact on the insurance operations, both with regards to underwriting profit as well as the development of float?"

WARREN BUFFETT: Well, nobody will — could possibly replace Ajit. I mean, it just — you can't come close.

But we have a terrific operation in insurance. We really do, outside of Ajit, and it's terrific-squared with Ajit.

There are things only he can do. But there are a lot of things that are institutionalized, a lot of things in our insurance business, where we've got extraordinarily able management, too.

So Ajit, for example, bought a company that nobody here has heard of, probably, called Guard Insurance a few years ago, based in worker's comp, primarily. It's based in — improbably — in Wilkes-Barre, Pennsylvania.

And it's expanding like crazy in Wilkes-Barre. And it — it's been a gem. And Ajit oversees it, but we've got a terrific person running it.

And we bought Medical Protective some years ago. Tim Kenesey runs that. Ajit oversees it, but Tim Kenesey can run a terrific insurance company, with or without Ajit. But he's smart enough to realize that, if you got somebody like Ajit that's willing to oversee it to a degree, that's great.

But Tim is a great insurance manager all by himself, and Medical Protective has been a wonderful business for us. Most people don't know we own it. The company goes back into the 19th century, actually.

We've got a lot of good operations. If you look at that section of the annual report called "Other" — insurance company, I mean that is — in aggregate, that is a wonderful insurance company. There's very few like it. GEICO is a terrific company.

So, Ajit has made more money for Berkshire than I have, probably. But we've still got what I would consider the world's best property-casualty insurance operation, even without him. And with him, you know, it — nobody, I don't think anybody comes close.

Charlie?

CHARLIE MUNGER: Well, a few years ago, California made a little change in its workmen's compensation law, and Ajit saw instantly that it would cause the underwriting results to change drastically.

And he went from a tiny percent of the market, (inaudible) 10 percent of the market, which is big, and he just grasped a couple billion dollars, at least, out of the air, like it was snapping his fingers. And when it got tough, he pulled back.

We don't have a lot of people like Ajit. It's hard to just snap your fingers and grab a couple billion dollars out of the air. (Laughter)

WARREN BUFFETT: Well, we've — actually, the California Workers' Comp (inaudible), Guard has moved into that. I — we have got a lot of terrific insurance managers. I mean, I don't know of a better collection any place. And Ajit has found some of those.

I've gotten lucky a few times. I mean, Tom Nerney at U.S. Liability, that goes back, what, 15, 16 years. He has a terrific operation. It's not huge, but it is so well-managed.

And people don't even know we own these things. But if you look at that last line — and now we've added Peter Eastwood with Berkshire Hathaway Specialty. And these are really good businesses, I got to tell you. (Laughs)

When you can produce underwriting prowess, and on top of that just hand more float — we don't have many businesses like that. Those are great businesses.

We've got a hundred — you know, whatever it is — a hundred billion-plus of money that we get to earn on, while at the same time, overall, you know, on balance, we're likely to make some additional money for holding it.

And if you can get somebody to hand you $104 billion and pay you to hold it while you get to invest and get the proceeds, it's a good business.

Now, most people don't do well at it. And, you know, the problem is that what I just described tempts lots of people to get into it.

And recently, people have gotten into it, really, just for the investment management. It's a way to earn money offshore. And we don't do that, but it can be done for small companies with investment managers.

So there's a lot of competition in it. But we have some fundamental advantages, plus we have — in certain areas — plus we have absolutely terrific managers to maximize those advantages. And we're going to make the most of it.

28. Promo for Kraft Heinz Philadelphia Cream Cheese product

WARREN BUFFETT: I've just been handed something Kraft Heinz came out with. They just came out with it commercially a couple days — a few days ago, maybe a few weeks ago. At the directors' meeting they had this. I had three of these.

I'm sure that there's a member or two of the audience that may not approve of it, but they — (laughter) — I got to tell you folks, it's good.

It's a cheesecake arrangement with topping and Philadelphia Cream Cheese (Inaudible), so you create your own cheesecake.

And I thought that I can eat it while Charlie's talking. And — (laughter) — you'll be able to get it at the halftime. It's selling very well.

And I think, just so you don't feel too guilty, I think it's 170 calories for this cherry one. Like I say, I had three of these here. I don't mind having five- or 600 calories for dessert, you know. (Laughter)

I'll let somebody else eat the broccoli and I'll have the dessert. (Laughter)

So we'll be eating this, but you, too, at halftime — I think they brought 8- or 9,000 of these. I'll be disappointed if we don't run out. Actually, I'll be disappointed in you, not them. (Laughter)

29. Subsidiary managers aren't competing for Buffett's job

WARREN BUFFETT: OK. Jay?

JAY GELB: This question is on the topic of succession planning.

Warren, there seem to be fewer mentions, by name, of top-performing Berkshire managers in this year's annual letter. Does this mean you're changing your message regarding the succession plan for Berkshire's next CEO?

WARREN BUFFETT: Well, the answer to that's no. And I didn't realize there were fewer mentions by name.

I write that thing out and send it to Carol [Loomis], and she tells me, "Go back to work." (Laughs)

I don't actually think that much about how many personally get named.

I would say this. And this is absolutely true. We have never had more good managers — now, it's because we've got more good companies — but we have never had more good managers than we have now, so I — but it has nothing to do with succession.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that. We don't seem to have a whole lot of 20-year-olds. (Laughter)

WARREN BUFFETT: Certainly not at the front table. (Laughter)

No, we've got an extraordinary group of good managers, which is why we can manage by abdication.

It wouldn't work if we had a whole bunch of people who were — had come with the idea of getting my job. I mean, if we had 50 people out there, all of who wanted to be running Berkshire Hathaway, it would not work very well. And —

But they have the jobs they want in life. Tony Nicely loves running GEICO. You know, it — then you go down the line. They have jobs they love.

And that's a lot better, in my view, than having a whole bunch of them out there that are kind of doing their job there kind of hoping the guys competing with them will fail so that, when I'm not around, that they'll get the nod.

It's a much different system than exists at most American corporations.

Charlie, got anything?

30. Berkshire's buying advantage: "There just isn't anyone else"

WARREN BUFFETT: Well, we'll go to Station 8.

AUDIENCE MEMBER: Hi, Warren and Charlie. My name's Vicky Wei. I'm an M.B.A. student from the Wharton School of Business.

This is my first time to be in the first — in the annual meeting. I'm really excited about it. Thanks for having us here. My —

WARREN BUFFETT: Thanks for coming.

AUDIENCE MEMBER: My question is, where do you want to go fishing for the next three to five years? Which sectors are you most bullish on, and which sectors are you most bearish on? Thank you.

WARREN BUFFETT: Yeah. Charlie and I do not really discuss sectors much. Nor do we let the macro environment or thoughts about it enter into our decisions.

We're really opportunistic. And we — we, obviously, are looking at all kinds of businesses all the time. I mean, it's a hobby with us, almost — probably more with me than Charlie.

But we're hoping we get a call, and we've got a bunch of filters.

And I would say this is true of both of us. We probably know in the first five minutes or less whether something is likely to — or has a reasonable chance of happening.

And it's just going to go through there, and it's going to — first question is, "Can we really ever know enough about this to come to a decision?" You know, and that knocks out a whole bunch of things.

And there's a few. And then if it makes it through there, there's a pretty good — reasonable chance we're going to — we may do something. But it's not sector specific. It —

We do love the companies, obviously, with the moats around the product long — where consumer behavior can be, perhaps, predicted further out. But I would say it's getting harder to — for us, anyway — to anticipate consumer behavior than we might've thought 20 or 30 years ago. I think that it's just a tougher game now.

But we'll measure it and we'll look at it in terms of returns on present capital, returns on prospective capital. We may have — we can —

A lot of people give you some signals as to what kind of people they are, even in talking in the first five minutes, and whether you're likely to actually have a satisfactory arrangement with them over time. So a lot of things go on fast, but it —

We know the kind of sectors we kind of like to — or the type of business we'd kind of like to end up in. But we don't really say, "We're going to go after companies in this field, or that field, or another field."

Charlie, you want to?

CHARLIE MUNGER: Yeah. Some of our subsidiaries do little bolt-on acquisitions that make sense, and that's going on all the time. And, of course we like it when —

But I would say the general field of buying whole companies, it's gotten very competitive. There's a huge industry of doing these leveraged buyouts. That's what I still call them.

The people who do them think that's a — kind of a bad marker, so they say they do private equity. You know, it's like (inaudible) a janitor call himself the chief of engineering or something. (Laughter) And —

But at any rate, the people who do the leveraged buyouts, they can finance practically anything in about a week or so through shadow banking. And they can pay very high prices and get very good terms and so on.

So, it's very, very hard to buy businesses. And we've done well, because there's a certain small group of people that don't want to sell to private equity. And they love the business so much that they don't want it just dressed up for resale.

WARREN BUFFETT: We had a guy some years ago, came to see me, and he was 61 at the time. And he said, "Look, I've got a fine business. I got all the money I can possibly need." But he said, "There's only one thing that worries me when I drive to work."

Actually, there's more than one guy's told me that that's used the same term.

He said, "There's only one thing that bothers me when I go to work. You know, if something happens to me today, my wife's left.

"You know, I've seen these cases where executives in the company try to buy them out cheap or they sell to a competitor and all the people —"

He says, "I don't want to leave her with the business. I want to decide where it goes, but I want to keep running it, and I love it."

And he said, "I thought about selling it to a competitor, but if I sell it to a competitor, you know, their CFO's going to become the CFO of the new company, and there, you know, on down the line.

"And all these people who helped me build the business, you know, they're — a lot of them are going to get dumped. And I'll walk away with a ton of money, and some of them will lose their job." He said, "I don't want to do that."

And he says, "I can sell it to a leveraged buyout firm, who would prefer to call themselves private equity, but they're going to leverage it to the hilt and they're going to resell it. And they're going to dress it up some, but in the end, it's not going to be in the same place. I don't know where it's going to go."

He said, "I don't want to do that." So he said, "It isn't because you're so special." He says, "There just isn't anyone else." (Laughter)

And if you're ever proposing to a potential spouse, don't use that line, you know. (Laughter)

But that's what he told me. I took it well, and we made a deal.

So, logically, unless somebody had that attitude, we should lose in this market. I mean, you can borrow so much money so cheap. And we're looking at the money as pretty much all equity capital.

And we are not competitive with somebody that's going to have a very significant portion of the purchase price carried in debt, maybe averaging, you know, 4 percent or something.

CHARLIE MUNGER: And he won't take the losses if it goes down. He gets part of the profit if it goes up.

WARREN BUFFETT: Yeah, his calculus is just so different than ours. And he's got the money to make the deal.

So, if all you care about is getting the highest price for your business, you know, we are not a good call.

And we will get some calls in any event. And we can offer something that — wouldn't call it unique, but it's unusual.

The person that sold us that business and a couple of others that have — actually it's almost, word for word, the same thing they say. They are all happy with the sale they made, very happy.

And, you know, they are — they have lots and lots and lots of money, and they're doing what they love doing, which is still running the business. And they know that they made a decision that will leave their family and the people who work with them all their lives in the best possible position.

And that's — in their equation, they have done what's best. But that is not the equation of many people, and it certainly isn't the equation of somebody who buys and borrows every dime they can with the idea of reselling it after they, you know, maybe dress up the accounting and do some other things.

And — but there — when the disparity gets so wide between what a heavily debt-financed purchase will bring as against an equity-type purchase, it gets to be tougher. There's just no question about it. And it'll stay that way.

CHARLIE MUNGER: But it's been tough for a long time, and we've bought some good businesses.

WARREN BUFFETT: Yeah. Yeah.

31. "If the board hires a compensation consultant after I go, I will come back"

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: Warren. This comes from a shareholder who I think is here, who asked to remain anonymous.

Writes: "Three years ago, you were asked at the meeting about how you thought we should compensate your successor. You said it was a good question, and you would address it in the next annual letter. We've been patiently waiting. (Laughter)

"Can you tell us now, at least philosophically, how you've been thinking about the way the company should compensate your successor, so we don't have to worry when the pay consultants arrive on the scene?"

WARREN BUFFETT: Yeah. Well, that — unfortunately, at my age I don't have to worry about things I say — said three years ago, but this guy, obviously much younger, remembers. (Laughter)

I'm not — well, I'll accept his word that I said that. But the — there's a couple possibilities, actually.

I don't want to get into details on them, but you may have — and I, actually, would hope that we would have somebody, A) who's already very rich — which they should be if they've been working a long time and have got that kind of ability — that's very rich, and really is not motivated by whether they have 10 times as much money that they and the families can need or a hundred times as much.

And they might even wish to perhaps set an example by engaging for something far lower than actually what you could say their true market value is. And that could or could not happen, but I think it'd be terrific if it did. But I can't blame anybody for wanting their market value.

And then — if they didn't elect to go in that direction, I would say that you — would probably pay them a very modest amount and then have an option which increased in value by — or increased in striking price — annually.

Nobody does this, hardly. The Washington — Graham Holdings has done it, The Washington Post Company did a little bit — but would increase because it's assuming that there were substantial retained earnings every year.

Because why should somebody retain a bunch of earnings and then claim they've actually improved the value, simply because they withheld the money from shareholders?

So it's very easy to design that, and in private companies people do design it in that way. They just don't want to do it in public companies, because they get more money the other way.

But they might have a very substantial one that could be exercised, but where the shareholder's — the shares had to be held for a couple years after retirement, so that they really got the result over time that the majority of the stockholders would be able to get, and not be able to pick their spots, as to when they exercised and sold a lot of stock.

It's — it would — it's not hard to design. And it really depends who you're dealing with, in terms of actually how much they care about money and having money beyond what they can possibly use.

And most people do have an interest in that, and I don't blame them.

But I don't know. What do you think, Charlie?

CHARLIE MUNGER: Well, I — one thing I think is that I have avoided, all my life, the compensation consultants. To me it's a — I hardly can find the words to express my contempt. (Laughter)

WARREN BUFFETT: I will say this. If the board hires a compensation consultant after I go, I will come back. (Laughter)

CHARLIE MUNGER: Mad. Mad.

So I think there's a lot of mumbo jumbo in this field, and I don't see it going away.

WARREN BUFFETT: Oh, it isn't going to go away. No, it's going to get worse. It — I mean, the — if you look at, I mean, the way compensation gets handled, I mean, it — you know, everybody looks at everybody else's proxy statement and says, "We can't possibly hire a guy that hasn't been — "

CHARLIE MUNGER: It's ridiculous.

WARREN BUFFETT: —so on. And the human relations department, you know, who work for the CEO, come in and suggest a consultant.

What consultant is ever going to get another assignment if he says, "You should pay your CEO below the — down in the fourth quartile because you're getting a fourth quartile result?" It —

I mean, it just, you know — it isn't that the people are evil or anything. It's just the nature of the situation just — it produces a result that is not consistent with how representatives of the owners should behave.

CHARLIE MUNGER: It's even worse than that. Capitalism is the golden goose that we all live on. And if people generally get so they have contempt for it because they don't like the pay arrangements in the system, your capitalism may not last as well. And that's like killing the golden goose.

So I think the existing system has a lot wrong with it.

WARREN BUFFETT: I think there is something coming in pretty soon — I may be wrong about this — where companies are going to have to put in their proxy statement the CEO's pay to the average pay, or something like that. That isn't going to change anything. I mean —

CHARLIE MUNGER: It won't change a thing.

WARREN BUFFETT: It won't change a thing. And, you know, it'll cost us virtually —

CHARLIE MUNGER: By the way, it won't get any headlines, either. It'll be tucked away.

WARREN BUFFETT: It'll cost us a lot of money, with 367,000 people employed around the world. And, I mean, we'll hope to get something that makes it somewhat simpler so we can use estimates or something of the sort.

But to get the median income or mean income or whatever, however the rules may read, you know, and —

CHARLIE MUNGER: That's what consultants are for, Warren. (Laughter)

WARREN BUFFETT: It — it's, you know, it is human nature that produces this. And, you know, the most —I write in this letter to the managers every two years, I said, "The only excuse I won't take on something is that everybody else is doing it."

But of course, "everybody else is doing it," is exactly the rationale for why people did not want to count the costs of stock options as a cost — I mean, it was ridiculous.

All these CEOs went to Washington and they got the Senate, I think, to vote 88 to 9 to say that stock options aren't a cost. And then a few years later, you know, it became so obvious that they finally put it in so it was a cost. You know, it reminded me of Galileo or something, I mean, all these guys.

CHARLIE MUNGER: Worse. It was way worse. The pope behaved better to Galileo in the —and he was —

WARREN BUFFETT: Well, anyway, it's — it — I would hope, you know, like I say, somebody — well — and it doesn't even have to be, I'm not talking about the current successor or anybody else.

I mean, successors down the line are probably going to have gotten very wealthy by the time they're running Berkshire. And the incremental value of wealth gets very close to zero at some point. And there is a chance to use it as a different sort of model.

But I don't have any problem, if it's — a system is devised that recognizes retained earnings. Nobody wanted — I've never heard anybody talk about it, you know, in the 20 boards I've been on.

You know, if you and I were partners in a business, you know, and we kept retaining earnings in the business and I kept having the value to buy a portion of you out at a constant price, you'd say, "This is idiocy."

But of course that's the way all option systems are designed, and it's better to be — for the CEO and for the consultants. And of course, usually if there's — there's some correlation between what CEOs are paid and what boards are paid.

If CEOs were getting paid at the rate that they got paid 50 years ago, adapted to present dollars, director pay would be lower. So it's — you know, it's got all these built-in things that, to some extent, sort of kindle the —

CHARLIE MUNGER: No Berkshire director is in it for the money.

WARREN BUFFETT: Well, they are if they own a lot of stock. And they bought it in the market just like the —

CHARLIE MUNGER: Yeah, it's —

WARREN BUFFETT: — shareholder did.

CHARLIE MUNGER: It's a very old-fashioned system.

WARREN BUFFETT: I looked at one company the other day, and seven of the directors had never bought a share of stock with their own money. Now they'd been given stock, but not one of them — I mean, I shouldn't say not one — seven of the directors had never actually bought a share of stock.

And there they are, you know, making decisions on who should be CEO and how they should be paid and all that sort of thing. But, you know, they never felt like shelling out a dollar themselves. Now they'd been given a lot of stock.

And it's, you know, we're dealing with human nature here, folks. (Laughs) And that — what you want is to have a system that works well in spite of how human nature's going to drive it.

And we've done awfully well in this country in that respect. I mean, American business has — overall has done very well for the Americans generally. But not every aspect of it is exactly what you want to teach your kids.

32. BNSF is a "good" business, but probably won't grow much

WARREN BUFFETT: OK. Gregg?

GREGG WARREN: Warren.

WARREN BUFFETT: Yeah.

GREGG WARREN: Between 2010 and 2015, intermodal rail traffic enjoyed double-digit rates of revenue growth as shorter-haul freight converted from truck to rail.

During the past year or so, though, cheaper diesel prices and more readily available truckload capacity have made trucking more competitive, leading to a decline in intermodal rail traffic.

While carload growth is expected to be solid longer term, helping to offset weakness in other segments like coal, what impact do you expect the widening of the Panama Canal, which was completed last year, to have on the West Coast port shipments that BNSF has traditionally carried through to exchange points for the Eastern U.S. railroads, as shippers elect to have goods unloaded at ports in the Gulf of Mexico or up the Eastern seaboard?

And while loss of volumes is never a good thing, could there be a small trade-off here as the bottleneck in Chicago, where most East-West cargo is handed off, eases a bit over time, if some of the current traffic gets rerouted?

WARREN BUFFETT: Well, you know — I — Chicago has got lots of problems, and it's going to continue for a while. I mean, that requires a good solution.

When you think of how the railroads developed, I mean, they — Chicago was the center and, you know, they laid the rails — and there were a whole bunch of different railroads — you know, a hundred years ago. And the city grows up around them and everything. So Chicago is a — can be a huge problem.

But getting to intermodal, I think intermodal will do very well. But you are correct that car loadings actually hit a peak in 2006, so here we are 11 years later.

And the investment of the five big Class I railroads — four of the biggest — if you look at their investment beyond depreciation, it's tens and tens of billions of dollars, and we're carrying less freight before, in aggregate, than we were in 2006. And coal will continue to decrease.

It's a good business, and it has big advantages over truck in many respects. Truck gets much more of a free ride in terms of the fact that their right of way, which is the highway system, is subsidized to a much greater degree beyond the gas tax — you know, we — than the railroad industry.

But it has not been a growth business, in physical volume, to any great degree. I think it's unlikely to be. I think it's likely to be a good business. I think we've got a great territory.

I like the West better than the East, and as you mention, you know, there will be some intermodal traffic that gets diverted to Eastern ports perhaps or so on.

Overall, I —we've got a terrific system in that respect. And we will do well.

It would be more fun if we had something where you could expect aggregate car loadings to increase two or three or four percent a year, but I don't think that's going to happen.

I do think our fundamental position is terrific, however. I think we'll earn decent returns on capital. But that's — I think that's the limit of it.

Charlie?

CHARLIE MUNGER: Nothing to add.

33. Berkshire's next CEO needs a "money mind"

WARREN BUFFETT: OK. Station 9.

AUDIENCE MEMBER: I'm from — Shankar Anant from Gurnee, Illinois. Thank you for doing everything you do for us. I have a question.

The two of you have largely avoided capital allocation mistakes by bouncing ideas off of one another.

Will this continue long into Berkshire's future? And I'd like to — I'm interested in both at headquarters and at subsidiaries.

CHARLIE MUNGER: It can't continue very long.

WARREN BUFFETT: I — (Laughter)

Don't get defeatist, Charlie. (Laughter)

Any successor that's put in at Berkshire, capital allocation abilities, and proven capital allocation abilities, are certain to be uppermost in board's minds or in, in the current case — in terms of my recommendation, Charlie's recommendation, for what happens after we're not around.

Capital allocation is incredibly important at Berkshire. Right now we have 280 or -90 billion, whatever it may be, of shareholders' equity. If you take the next decade alone, you know, nobody can make accurate predictions on this.

But in the next 10 years, if you just take — and depreciation right now is another seven billion a year, something on that order.

The next manager in the decade is going to have to allocate, maybe, 400 billion or something like that, maybe more. And it's more than already has been put in.

So 10 years from now, Berkshire will be an aggregation of businesses where more money has been put in in that decade than everything that took place ahead of time. So you need a very sensible capital allocator in the job of being CEO of Berkshire. And we will have one.

It would be a terrible mistake to have someone in this job where, really, capital allocation might be — might even be their main talent. It probably should be very close to their main talent.

And of course, we have an advantage at Berkshire, in that we do know how important that is and there is that focus on it.

And in a great many companies, people get to the top through ability, and sales sometimes, if they come from the legal side, something like that — all different sides — and they then have the capital allocation, sort of, in their hands.

Now, they may not establish strategic thinking divisions. And they may listen to investment bankers and everything, but they better be able to do it themselves.

And if they've come from a different background or haven't done it, it's a little bit, as I put in one of my letters, I think — it's like getting to Carnegie Hall playing the violin, and then you walk out on the stage and they hand you a piano.

I mean, it is something that — Berkshire would not do well if somebody was put in who had a lot of skills in other areas but really did not have an ability to capital allocation.

I've talked about it as being something I call a "money mind." I mean, people can have 120 IQs or 140 IQs or whatever it may be, very similar scoring abilities in terms of intelligence tests. And some of them have minds that are good at one kind of thing and some of them another.

I've known very bright people that do not have money minds, and they can make very unintelligent decisions. They can do all kinds of other things that most mortals can't do. But it just doesn't, it isn't the way their wiring works.

And I've known other people that really would not do that brilliantly. They do fine, but on an SAT test or something like that. But they've never made a dumb money decision in their life. And Charlie, I'm sure, has seen the same thing.

So we do want somebody — and hopefully they've got a lot of talents — but we certainly do not want somebody that — if they lack a money mind.

Charlie?

CHARLIE MUNGER: Well, there's also the option of buying in stock, which — so, it isn't like it's some hopeless problem. One way or another, something intelligent will be done.

WARREN BUFFETT: And a money mind will recognize when it makes sense to buy in stock and doesn't. You know, and —

In fact, it's a pretty good test for some people, in terms of managements, how they think about something like buying in stock, because it's not a very complicated equation if you sort of think straight about that sort of a subject.

But some people think that way and some don't, and they're probably miles better at something else. But they say some very silly things when you get to something that seems so clear as whether, say, buying in stock makes sense.

Anything further, Charlie?

CHARLIE MUNGER: No.

34. Most financial advisors don't deserve their fees

WARREN BUFFETT: OK, Carol?

CAROL LOOMIS: This question comes from Steve Haverstroll (PH) of Connecticut.

“Warren, you have made it very clear in your annual letter that you think the hedge fund compensation scheme of ‘2 and 20’ generally does not work well for the fund’s investors.

“And in the past, you have questioned whether investors should pay, quote, ‘financial helpers,’ unquote, as much as they can. But financial helpers can create tremendous value for those they help.

“Take Charlie Munger, for instance. In nearly every annual letter and on the movie this morning, you describe how valuable Charlie’s advice and counsel has been to you and, in turn, to the incredible rise in Berkshire’s value over time.

“Given that, would you be willing to pay the industry standard, quote ‘financial helper’ fee of one percent on assets to Charlie? Or would you perhaps even consider ‘2 and 20’ for him? What is your judgment about this matter?”

WARREN BUFFETT: Yeah. (Laughter)

Well, I’ve said in the annual report that I’ve known maybe a dozen people in my life — and I said there are undoubtedly hundreds or maybe thousands out there.

But I’ve said that I’ve known, personally, a dozen where I would have predicted or did predict — in a fair number of those 12 cases — I did predict that the person involved would do better than average in investing over a long period of time.

And obviously, Charlie is one of those people. So would I pay him? Sure. But would I take financial advisors as a group and pay them one percent with the idea that they would deliver results to me that were better than the S&P 500 by one percent, and thereby leave me breaking even against what I could have done on my own? You know, there’s very few.

So it’s just not a good question to ask whether, you know, I’d pay Charlie one percent. That’s like asking, you know, whether I’d have paid Babe Ruth, you know, 100,000 or whatever it was to come over from the Red Sox to the Yankees. I mean, sure I would have, but there weren’t very many people I would have paid 100,000 to in 1919, or whatever it was, to come over to the Yankees.

And so, the — it’s a fascinating situation, because the problem isn’t that the advisors are going to do so terrible. It’s just that you have an option available that doesn’t cost you anything that is going to do better than they are, in aggregate.

And it — it’s an interesting question. I mean, if you hire an obstetrician, assuming you need one, they’re going to do a better job of delivering the baby than, you know, if the spouse comes in to do it, or if they just pick somebody up off the street.

And if you go to a dentist, if you hire a plumber, in all of the professions, there is value added by the professionals as a group, compared to doing it yourself or just randomly picking laymen.

In the investment world, it isn't true. I mean, they, the active group, the people that are professionals, in aggregate, are not, cannot do better than the aggregate of the people who just sit tight.

And if you say, "Well, in the active group there's some person that's terrific," I will agree with you. But the passive people can't all pick that person. And they wouldn't — they don't know how to identify them. So I —

CHARLIE MUNGER: It's even worse than that. The (inaudible) — the expert who's really good, when he gets more and more money in, he suffers just terrible performance problems.

WARREN BUFFETT: Yeah. Yeah.

CHARLIE MUNGER: And so you'll find the person who has a long career at "2 and 20," and if you analyze it, net, all the people who've lost money because some of the early people have had a good record but more money coming in later and they lose it.

So, the investing world is just, it's a morass of wrong incentives, crazy reporting, and I'd say a fair amount of delusion.

WARREN BUFFETT: Yeah, if you asked me whether I — those 12 people I picked would do better than the S&P working with a hundred billion dollars, I would answer that probably none of them would. I mean, they — that would not be their prospective performance.

They're not, but when I was talking of them, I — you know, or referencing them — and when they actually worked in practice, they dealt, generally, with pretty moderate sums. And as the sums grew, their relative advantage diminished.

It — I mean, it's so obvious from history. The example I used in the report — I mean, the guy who made the bet with me, and incidentally all kinds of people didn't make the bet with me because they knew better than to make the bet with me.

You know, there were hundreds, at least a couple hundred underlying hedge funds. These guys were incented to do well. The fund of fund manager was incented to pick the best ones he could pick. The guy who made the bet with me was incented to pick the best fund of funds.

You know, and tons of money, and just in with those five funds, a lot of money went to pay managers for what was subnormal performance over a long period of time. And it can't be anything but that.

And it's an interesting — you know, it's an interesting profession when you have tens of thousands, or hundreds of thousands of people, who are compensated based on selling something that, in aggregate, can't be true: superior performance. So —

But it'll continue, and the best salespeople will tend to attract the most money. And because it's such a big game, people will make huge sums of money, you know, far beyond what they're going to make in medicine or you name it. I mean, you know, repairing the country's infrastructure, I think.

I mean, the big money — huge money — is in selling people the idea that you can do something magical for them.

And if you have — if you even have a billion-dollar fund, you know, and get two percent of it — for terrible performance, you make — that's $20 million.

In any other field, you know, it would just blow your mind. But people get so used to it, you know, in the Wall — in the field of investment that it just sort of passes along. And $10 billion, I mean, $200 million fees?

We've got two guys in the office, you know, that are managing $11 billion. Well, no they're not. I'm sorry. Yeah, they're managing 20 billion, you know, between the two of them, 21 billion maybe.

And, you know, we pay them a million dollars a year, plus the amount by which they beat the S&P. They have to actually do something to get contingent compensation, which is much more reasonable than the 20 percent.

But how many hedge fund managers in the last 40 years have said, "I only want to get paid if I do something for you?" You know, "Unless I actually deliver something beyond what you can get yourself, you know, I don't want to get paid." It just doesn't happen.

And, you know, it get back — it's get back — it gets back to that line that I've used, but when I asked a guy, you know, "How can you, in good conscience, charge '2 and 20?'" And he said, "Because I can't get 3 and 30." You know — (Laughter)

Any more, Charlie? Or have we used up our —

CHARLIE MUNGER: I think you've beaten up on them enough.

WARREN BUFFETT: Yeah, well. (Laughter)

35. "I love the fact we bought Precision Castparts"

WARREN BUFFETT: Jonathan.

JONATHAN BRANDT: Precision Castparts represents the second largest acquisition Berkshire has ever made. There wasn't much qualitative or quantitative information about it in the 2016 annual.

Would you be willing to update us here with how it is doing currently, what excites you about its prospects, and what worries you most about it?

I'm also curious if there were any meaningful purchase price adjustments beyond intangible amortization that negatively impacted Precision's earnings in 2016, as was the case with Van Tuyl in 2015?

And finally, are there any opportunities in sight for bolt-on acquisitions?

WARREN BUFFETT: Yeah, we've actually made acquisitions, and we will make more that fit there, because we've got an extraordinary manager. And we've got a terrific position in the aircraft field.

So there will be sensible — there will be the chance for sensible acquisitions. And we've already made two, anyway. And we will make more over time. The — it's —

The amortization of intangibles is the only big purchase price adjustment. That's something over $400 million a year, nondeductible. In my mind, that's 400-and-some million of earnings.

I do not regard the economic goodwill of Precision Castparts being diminished at that rate annually. That is a — and, you know, I've explained that in some degree. The —

As a very long-term business, you can worry about 3-D printing. I don't think you have to worry about aircrafts being manufactured. But aircraft deliveries can be substantially altered in relation to any given backlog in most cases.

So the deliveries can be fairly volatile, but I don't think the long-term demand is anything I worry about.

And the question is, whether anybody can do it better or cheaper, or like I say, whether 3-D printing at least takes away part of the field in some respects.

But overall, I would tell you I feel very good about Precision Castparts. It is a very long-term business. I mean, we have contracts that run for a very long time, and like I say, the initiation of a new plane may be delayed or something of the sort.

But if you take a look at the engine that's in the other adjoining room here and in our exhibition hall, you would, if you were putting that engine together for the 20 or 25-year life or whatever it may have, carrying hundreds of people, you would care very much about your supplier.

And you'd care not only in the quality, you know — which would be, absolutely you'd care — of the work being done. But you also, if you were an engine manufacturer or an aircraft manufacturer further down the line, you would care very much about the reliability of delivery on something.

Because you do not want a plane that — or an engine — that's 99 percent complete while somebody's dealing with a problem of faulty parts or anything else that would delay delivery.

So, the reliability is incredibly important. And I don't think anybody has a reputation better than Mark Donegan for — and the company — for delivery.

So I love the fact we bought Precision Castparts.

Charlie?

CHARLIE MUNGER: Yeah, well, what's interesting about them, too, is that it's a very good business purchased at a fair price under — but this is no screaming bargain like the old days.

WARREN BUFFETT: No.

CHARLIE MUNGER: For quality businesses, you pay up now a lot more than we used to.

WARREN BUFFETT: Yeah, that's absolutely true, and we — you don't get a bargain price.

The 400-plus million incidentally, you know, goes on for quite a while, too.

And we'll explain it in the report just like — just as we'll explain that the depreciation charge at a railroad would not be adequate. I mean, it's the way accounting works.

36. A "really stupid" accounting rule change

WARREN BUFFETT: And starting — I don't even want to tell you about this one — but starting the first of next year, accounting is going to become sort of a nightmare in terms of Berkshire and other companies because they're going to have us mark our equities to market just like we were a Wall Street trading firm or something.

And those changes in the value of Coca-Cola, or American Express, or everything, are going to run through the income account every quarter. In fact, they run through it every day in this theory, so that it really will get confusing.

Now, it's our job to explain things so that you aren't confused when we report GAAP earnings, but GAAP earnings, as reported, will become even more meaningless, if looking only at the bottom line, than they are now, and —

CHARLIE MUNGER: That was not necessarily a good idea.

WARREN BUFFETT: No, I think it's a terrible idea, but we'll deal with it. And we'll — and, I mean, it's my job to explain to what extent GAAP accounting is useful to you in evaluating Berkshire, and the times when it actually distorts things.

Accounting isn't supposed to — it's not supposed to describe value.

On the other hand, it's a terribly useful tool, if understood, in order to estimate value if you're analyzing businesses. And so, you know, certainly, you can't blame the auditing profession for doing what they think is their job, which is not to present value. Although, by using these market values —

CHARLIE MUNGER: But you can blame the audit —

WARREN BUFFETT: What's that?

CHARLIE MUNGER: You can blame the audit profession for that one.

WARREN BUFFETT: OK, well.

CHARLIE MUNGER: That was really stupid. (Laughter)

WARREN BUFFETT: Well, I agree with that actually. (Laughter)

But we will do our best to give you — we're always going to give you the audited figures.

And then we're going to explain their shortcomings in either direction and how they — how what you should use and what you probably should ignore in looking at those numbers and using them to come to a judgment as to the value of your holdings.

And I'll explain it to you the same way I would explain it to my sisters or anybody else that — you know, we want you to understand what you own. And we try to cover the details that are really important in that respect.

I mean, there's a million things you can talk about that are just of minor importance when you're talking about a $400 billion market value.

But they're the things that, if Charlie and I were talking about the company, that they'd be the figures or the interpretations or anything that we would regard as important in sort of coming to an estimate of the value of the business. But it's going to be —

You can't knock the media. I mean, they've only got a few paragraphs to describe the earnings at Berkshire every quarter. But if they simply look at bottom line numbers, what can be silly this year will become absolutely ludicrous next year because of the new rule that comes into effect for 2018.

37. Munger: China's stock market is cheaper than U.S.

WARREN BUFFETT: OK. Station 10.

AUDIENCE MEMBER: Hello Warren. This is a question from China.

VOICE: (Inaudible)

WARREN BUFFETT: Pardon me?

AUDIENCE MEMBER: I am Jeff Chan (PH), a pension fund manager from China, Shanghai. My question is quite simple.

What is the probability of duplicating your great investment track record in China's stock market the next decades or two in terms of a (inaudible)? That's all.

And I thank my friends from (FOREIGN LANGUAGE) Fund Management House for guiding me in writing this question. Thank you.

WARREN BUFFETT: Charlie, you're the expert on China. (Laughter)

CHARLIE MUNGER: It's like determining the order of precedency between a louse and a flea. Yeah.

I do think that the Chinese stock market is cheaper than the American market. And I do think China has a bright future. And I also think that there'll be growing pains, of course. And —

But —

WARREN BUFFETT: Well —

CHARLIE MUNGER: We have this opportunistic way of going through life. We don't have any particular rules about which market we're in or anything like that.

WARREN BUFFETT: Well, Charlie's delivered a headline anyway, now: "Munger Predicts China Market Will Outperform U.S." (Laughter)

Afternoon Session - 2017 Meeting

1. Berkshire and 3G's different approaches to job cuts

WARREN BUFFETT: Panel all here? OK. We're back for action. And we'll go right to Becky.

BECKY QUICK: All right. This question comes from Anne Newman (PH). She says that she's a shareholder of the Class B stock.

And her question is, "The primary investment strategy of 3G Capital is extreme cost-cutting after the purchase of a company. This typically includes the elimination of thousands of jobs.

"With the current U.S. president focusing on retention of U.S. jobs, will Berkshire Hathaway still consider future investments with 3G Capital if those investments result in the purchase of U.S. companies and the elimination of more U.S. jobs?"

WARREN BUFFETT: Now, the, essentially, 3G management — and I've watched them up very close at Kraft Heinz — is — basically, they don't — they believe in having a company as productive as possible.

And, of course, the gains in this world, for the people in this room, and people in Omaha, and people throughout America, have come through gains in productivity.

If there had been no change in productivity, we would be living the same life as people lived in 1776.

Now, the people — the 3G people — do it very fast. And they're very good at making a business productive with fewer people than operated before.

But that — they've been, you know, we've been doing that in every industry, whether it's steel, or cars, or you name it. And that's why we live as well as we do.

We prefer at Berkshire — I wrote about this a year ago — we prefer to buy companies that are already run efficiently because, frankly, we don't enjoy the process at all of getting more productive. I mean, it's not pleasant.

But it is what has enabled the country to progress. And nobody has figured out a way to double people's consumption per capita without, in some way, improving productivity per capita.

It's a good question in the — whether it's smart overall if you think you're going to suffer politically because political consequences do hit businesses. So I don't know that I can answer the question categorically.

But I can tell you that they not only focus on productivity and do it in a very intelligent way, but they also focus, to a terrific degree, on product improvement, innovation, and all of the other things that you want a management to focus on.

And I hope that, at the lunchtime, if you had the Kraft Heinz cheesecake, you'll agree with me that product improvement and innovation there is a — is just as much a part of the 3G playbook as productivity. I don't —

Personally, we have been through the process of buying into a textile business that employed a couple thousand people and went out of business over a period of time, or a department store, a business that was headed for oblivion.

And it is just not as much fun to be in a business that cuts jobs rather than one that adds jobs.

So, Charlie and I would probably forego, personally, having Berkshire directly buy businesses where the main benefits were come — would come from increasing productivity by actually having fewer workers.

But I think it's pro-social to think in terms of improving productivity. And I think that people at 3G do a very good job at that.

Charlie?

CHARLIE MUNGER: Well, I agree. I don't see anything wrong with increasing productivity. On the other hand, there's a lot of counterproductive publicity to doing it. Just because you're right doesn't mean you should always do it.

WARREN BUFFETT: Yeah. I'd agree with that.

2. Pressure to deploy Berkshire's cash grows as it nears $100B

WARREN BUFFETT: Jay?

JAY GELB: Berkshire's cash and Treasury bill holdings are approaching $100 billion.

Warren, a year ago, you said Berkshire might increase its minimum valuation for share buybacks above 1.2 times book value if this occurred. What are your latest thoughts on raising the share repurchase threshold?

WARREN BUFFETT: Yeah, the — when the time comes — and it could come reasonably soon, even while I'm around — but [if] we really don't think we can get the money out in a reasonable period of time into things we like, we have to reexamine then what we do with those funds that we don't think can be deployed well.

And at that time, we'd make a decision. And it might include both, but it could be repurchases. It could be dividends.

There are different inferences that people draw from a dividend policy than from a repurchase policy that, in terms of expectations that you won't cut a dividend and that sort of thing. So you have to factor that all in.

But if we really — if we felt that we had cash that was unlikely to be used — excess cash — in a reasonable period of time, and we thought repurchases at a price that was still attractive to continuing shareholders was feasible in a substantial sum, that could make a lot of sense.

At the moment, we're still optimistic enough about deploying the capital that we wouldn't be inclined to move to a price much closer where there's only a narrow spread between an intrinsic value and the repurchase price. But at a point, the burden of proof is definitely on us.

I mean, that — I — the last thing we like to do is own something at a hundred times earnings where the earnings can't grow.

I mean, we're — as you point out, we've got almost a hundred billion — it's $90-plus billion invested in a business, we'll call it a business, where we're paying almost a hundred times earnings. And it's kind of a lousy business.

CHARLIE MUNGER: It's more after after-tax earnings.

WARREN BUFFETT: Yeah. So, it — you know, we don't like that. And we shouldn't use your money that way for a long period of time. And, then, the question is, you know, are we going to be able to deploy it?

And I would say that history is on our side, but it'd be more fun if the phone would ring instead of just relying on history books.

And, you know, I am sure that sometime in the next 10 years — and it could be next week or it could be nine years from now — there will be markets in which we can do intelligent things on a big scale.

But it would be no fun if that happens to be nine years off. And I don't think it will be, but just based on how humans behave and how governments behave and how the world behaves.

But like I say, at a point, the burden of proof really shifts to us, big-time. And there's no way I can come back here three years from now and tell you that we hold 150 billion or so in cash or more, and we think we're doing something brilliant by doing it.

Charlie?

CHARLIE MUNGER: Well, I agree with you. The answer is maybe. (Laughter)

WARREN BUFFETT: He does have a tendency to elaborate. (Laughter)

3. CBT and animal rights

WARREN BUFFETT: Station 11.

AUDIENCE MEMBER: Thank you, Mr. Buffett and Mr. Munger. I am Anil Daron (PH) from Short Hills, New Jersey and New Delhi, India.

This is my 18th time to this wonderful event, and profoundly thank you for your extraordinary wisdom, generosity, and time.

As I'm involved with sustainable investments that also do not directly harm animals, I would appreciate your perspective, if any, on the practices of your CTB subsidiary, which is somewhat involved in pig, poultry, and egg production.

Somewhat indirectly related, as you share your concern on nuclear war extensively at the last annual meeting, I would love to pick your brain on Albert Schweitzer's Nobel Peace Prize acceptance speech, shortly after the first nuclear bombs were detonated, that compassion can attain its full breadth and depth if it is not limited to humans only. Thank you.

WARREN BUFFETT: Well, that's a pretty broad question. I would say on your first point, we have a subsidiary, CTB, run by Vic Mancinelli. And I sit down with him once a year. And he's a terrific manager. He's one of our very best. You don't hear much about him.

And they do make the equipment for poultry growers. And I would — I can't answer your question specifically, but I would be glad to have you get in contact with Vic directly because I know that what — question you raised is a — it's a major factor in what they do.

I mean, they do care about how the equipment is used, in terms of poultry and egg production. And, as you know, a number of the largest purchasers and the largest producers are also in the same camp. But I can't tell you enough about it directly that I can give you a specific answer.

But I can certainly put you in touch with Vic. And I think you would find him extremely well-informed and doing some very good things in the area that you're talking about.

In terms of the nuclear weapon question, I'm very pessimistic on weapons of mass destruction, generally. Although, I don't think that nuclear, probably, is quite as likely as either biological — primarily, biological — and maybe cyber. I don't know that much about cyber.

But I do think that's the number one problem with mankind. But I don't think I can say anything particularly constructive on it now.

Charlie?

CHARLIE MUNGER: Well, I don't think we mind killing chickens. (Laughter)

And I do think we're against nuclear war, so — (Laughter)

WARREN BUFFETT: Yeah. (Applause)

We are not actually a poultry producer, but we do — they use our equipment. And that equipment has been changed substantially in the last 10 or 15 years.

But, again, I'm not that good on the specifics that I can give them to you. But I can certainly you put you in touch with Vic.

4. Giving Weschler and Combs more to manage wouldn't help them

WARREN BUFFETT: Andrew ?

ANDREW ROSS SORKIN: Warren. Since Todd [Combs] and Ted [Weschler] joined Berkshire, the market cap of the company has doubled, and cash on hand is now nearly a hundred billion dollars.

It doesn't look like Todd and Ted have been allocated new capital on the same relative basis. Why?

WARREN BUFFETT: Well, actually, I would say they have been.

I think we started out with two billion. That could be wrong, but my memory was two billion with Todd when he came with us. And so, there have been substantial additions.

And, of course, their own capital has grown just because — say, in a sense, they retain their own earnings.

So yeah, they are managing a proportion of Berkshire's capital — also measured by marketable securities — I think they're managing a proportion that's pretty similar, maybe even a little higher than when each one of them entered. And Ted entered a year or two after Todd.

You know, they — I think they would agree that it's tougher to run 10 billion than it is to run one or two billion. I mean, your expectable returns go down as you get into larger sums.

But the decision to bring them on has been terrific. I mean, they have — they've done a good job of managing marketable securities. They made more money than I would've made with that same, what is now 20 billion, but originally was two billion.

And they've been a terrific help in a variety of ways beyond just money management. So that decision, I'll — you know — that's been a very, very good decision.

And they are — they're smart. They have money minds. They are good, specifically, at investment management. But they're absolutely first-class human beings. And they really fit at Berkshire. So, that was —

Charlie gets credit for Todd. He met Charlie first. And I'll claim credit for Ted. And I think we both feel very good about the decisions.

Charlie?

CHARLIE MUNGER: Well, I think the shareholders are very lucky to have them because they both think like shareholders.

WARREN BUFFETT: Totally.

CHARLIE MUNGER: After all, it came up that way. And that is not the normal way headquarters employees think. It's a pretense that everybody takes on, but the reality is different.

And these people really, deeply think like shareholders. And they're young, and smart, and constructive. So we're all very lucky to have them around.

WARREN BUFFETT: Yeah. Their mindset is a hundred percent, "What can I do for Berkshire," not, "What can Berkshire do for me?" And, believe me, you can spot that over time with people.

And on top of that, you know, they're very talented.

But, you know, it's hard to find people young, ambitious, very smart, that don't put themselves first. And I would — every experience we've had, they did not put themselves first. They put Berkshire first.

And believe me, I can spot it when people are extreme in one direction or another. Maybe I'm not so good around the middle, but you've got —

You couldn't have two better people in those positions.

But — and you say, "Well, why don't you give them another 30 billion each or something?" I don't think that would improve their lives or their performance.

They may be handling more as they go along, but the truth is, I've got more assigned to me than I can handle at the present time, as proven by the fact that we've got this 90 billion-plus around.

I think there are reasonable prospects for using it. But if you told me I had to put it to work today, I would not like the prospect.

Charlie, anything?

CHARLIE MUNGER: Well, I certainly agree with that. It's a lot harder now than it was at times in the past.

5. Private transactions not needed now for Class A shares

WARREN BUFFETT: Gregg?

GREGG WARREN: Warren, plans for your ownership stake, which is heavily concentrated in Class A shares, are fairly well known, with the bulk of the stock going to the Bill and Melinda Gates Foundation and four different family charities over time.

Your annual pledges to these different charities involve the conversion of Class A shares, which hold significantly greater voting rights than the Class B shares.

As such, the voting control held by your estate will diminish over time, with a whole layer of super-voting shares being eliminated in the process.

While the voting influence of Class B shareholders are expected to increase over time, it will not be large enough to have a big influence on Berkshire's affairs.

With that in mind, and recognizing the great importance on having Berkshire buy back and retire Class A shares in the long run, I was just wondering if the firm has compiled a pipeline of potential future sellers from the ranks of the company's existing shareholders.

Given the limited amount of liquidity for the shares, privately negotiated transactions with these sellers, like the one you negotiated in December of 2012, would end up being in the best interest of both parties.

WARREN BUFFETT: Well, again, it would depend on the price of Berkshire.

So, in terms of what I give away annually, you know, it's — the last two years, it's been about 2.8 billion per year. That can be — you know that's one day's trading in Apple.

I mean, the amount I'm giving away is, in terms of Berkshire's market cap, I mean, you know, you're down to seven-tenths of one percent of the market cap. So, it's not a big market factor, and it really wouldn't be that illiquid.

So, I know a few big holders that, you know, might have 8- or 10,000 shares of A. But the market can handle it now.

When we bought that block of — I think it was 12,000 shares of A, I mean, we bought it because we thought it increased the intrinsic business value of Berkshire by a significant amount. And we paid the seller what the market was at the time.

And, you know, we're open to that up to 120 percent. And who knows? If it came along at a time and it was 124 percent or something, it was a very large block and the directors decided that that was OK, it still was a significant discount, we might very well buy it.

But in terms of the orderly flow of the market or anything like that, there will be no problems just as there haven't been, you know, when I've given away — I do it every July — when I've given away the last two years.

Some of the foundations may keep it for a while. But they have to spend what I give them. And they may build up a position in B for, you know, a fairly significant dollar amount. But they're going to sell it.

And it is true that for a period after I die, there'll be a lot of votes still in the estate and later in a trust.

But, you know, that will get reduced over time. I see no problem with our capitalization over time.

You know, I like the idea of a fair number of votes being concentrated with people that believe in the culture strongly and, you know, would be thinking about whether they'd get a 20 percent jump in the stock if somebody came along with some particular plan.

But, eventually, that's going to get diminished. It continues to get diminished. And I think, in terms of — you know, there's a very good market in Berkshire shares.

And if we can buy them at a discount from intrinsic business value and somebody offers some sum — a big piece — and it may be at a hundred — stock may be selling at 122 percent, 124 percent, you know, I would pick up the phone and call the directors and see if they didn't want to make a change.

And we did it once before. And if it made sense, I'm sure they'd say yes. And if it didn't make sense, I'm sure they'd say no. So, I don't think we have any problem in terms of blocks of stock or anything.

I don't think people that own it have a problem selling it. And I don't think we have a problem in terms of evaluating the desirability of repurchasing it.

Charlie?

CHARLIE MUNGER: Nothing to add.

6. Deciding whether to exercise Bank of America warrant

WARREN BUFFETT: OK. Station 1.

AUDIENCE MEMBER: Hello. My name is Erin Byer. And I was born and raised in Pasadena, California, and I currently live in New York City.

It's been a dream of mine to come here today. I've been a proud BH shareholder for almost 20 years.

I asked my dad for stock for Christmas when I was 15. And I kept thinking at the opportunity to ask you a question today that I should make it one that would change my life.

Well, that question is, do you know any eligible bachelors living in the New York City area? (Laughter and applause)

WARREN BUFFETT: Well, you certainly have the approach toward life that Charlie and I would. (Laughs)

AUDIENCE MEMBER: But the question that might make my Monday, back in the office: back in 2011, you purchased Bank of America preferred stock with a warrant. You had the opportunity, at a later date, to exercise and convert those into common shares.

When you're looking at evaluating that decision to exercise that position, which would increase all of our Berkshire holdings — or the value of the Berkshire holdings — what are you going to consider when you're looking at that?

WARREN BUFFETT: Well, it's almost — well, if the price of the stock is above seven dollars a share, which seems quite likely, whether we were going to keep it or not, it would still make sense for us to exercise the warrant shortly before it expired, because it would be a valuable warrant, but it's only a valuable warrant if it's converted — or if exercised — and exchanged into common. And that warrant does expire.

So, as I put in the annual report, our income from the investment would increase if the Bank of America ever got to where it was paying 11 cents quarterly.

We get 300 million off the — a year — off the preferred. And for us to use the preferred as payment in the exercise of the warrant, we would need to — we would want to feel we were getting more than 300 million a year by — and that would take 11 cents quarterly.

They may or may not get to where they pay that amount before the warrant expires in 1921 — or 2021.

If we — if it does get to there, we'll exercise the warrant. And then, instead of owning the five billion of preferred and the warrant, we'll have 700-plus million shares of common.

Then that becomes a separate decision. Do we want to keep the 700 million shares of common?

I — if it were to happen today, I would definitely want to keep the stock. Now, who knows what other alternatives may be available in 2021 or —

But as of today, if our warrant were expiring tomorrow, we would use the preferred to buy 700 million-plus shares of common. And we would keep the common.

If they get to 11 cents quarterly dividend, we'll convert it. And we'll very likely keep the common.

And if we get to 2021, if the common's above seven dollars, which I would certainly anticipate, we will exercise.

So that's all I can tell you on that. But I certainly wish you success on your other objective. (Laughter)

And I think, probably, the fellow will be using very good judgment, too.

OK. Charlie?

CHARLIE MUNGER: Well, I think it's a very wise thing for a woman that owns Berkshire stock and is a good looking woman to put her picture up like that. (Laughter and applause)

WARREN BUFFETT: It does give me a thought, though. We might actually start selling ads in the annual report. And — (Laughter)

OK. That — incidentally, that BofA purchase, it literally was true that I was sitting in the bathtub when I got the idea of checking with the BofA, whether they'd be interested in that preferred.

But I've spent a lot of time in the bathtub since, and nothing's come to me. So — (Laughter)

Clearly, I either need a new bathtub or we got to get in a different kind of market.

7. Defending 3G's job cuts

WARREN BUFFETT: Carol?

CAROL LOOMIS: This is a question from George Benaroya. And it adds a layer to the discussion about 3G a little bit ago.

He says, "I am a very happy, long-term shareholder. But this is a concern I have regarding Berkshire Hathaway's Kraft Heinz investment.

"This investment has done well in economic terms. The carrying value is 15 billion, and the market value was 28 billion in 2016.

"But the DNA of 3G is quite different from ours. We do not make money by buying companies and firing people. 3G fired 2,500 employees at Kraft Heinz. That is what private equity firms do, but we are not a private equity firm.

"Our values have worked for us for over four — 50 years. There is a risk that as 3G continues to deviate from our principles, they will, eventually, harm both our value and our values. How do we prevent that from happening?"

WARREN BUFFETT: Well, that's interesting. I mentioned earlier that it was very gradual. But it would've been, probably, a better decision. We fired 2,000 people over time — and some retired and left and all of that — but at the textile operation [Berkshire Hathaway]. You know, it didn't work.

And at Hochschild Kohn, the successor — we fortunately sold it to somebody else — but eventually, they closed up the department stores because department stores, at least that particular one and a good many, actually, including our competitors in Baltimore, could not make it work.

Walmart came along with something — and, now, Amazon's coming along with something — that changed the way people thought they knew. You —

We mentioned our poultry with CTB, which is a lot of different farm equipment.

The farm equipment, often, that CTB develops, the idea is that it's more productive than what already is out there, which means fewer people are employed on farms.

We had 80 percent of the American public — population, working population — working on farms a couple of hundred years ago.

And if nobody had come up with things to make it more productive — farming — we'd have 80 percent of people working on farms now to feed our populace. And it means that we'd be living in a far, far more primitive way.

So there — you know — if you look at the auto industry, it gets more productive. If you look at any industry, they're trying to get more productive. Walmart was more productive than department stores, and —

That will continue in America. And it better continue or we won't live in — or our kids won't live any better than we do.

Our kids will live better than we do, because America does get more productive as it goes along. And people do come up with better ways of doing things. The —

When Kraft Heinz finds that they can do whatever amount of business — $27 billion worth of business or something — and they can do it with fewer people, they're doing what American business has done for a couple hundred years and why we live so well. But they do it very fast.

They're more than fair, in terms of severance pay and all of that sort of thing. But they don't want to have two people doing the job that one can do.

And I, frankly, don't like going through that, having faced that.

I faced that down at Dempster in Beatrice, Nebraska. And it really needed change. But the change is painful for a lot of people. And I just would rather spend my days not doing that sort of thing, having had one or two experiences.

But I think that it's absolutely essential to America that we become more productive because that is the only way we have more consumption per capita, is to have more productivity per capita.

Charlie?

CHARLIE MUNGER: Well, I — you're absolutely right. We don't want to go back to subsistence farming. I had a week of that when I was young on a western Nebraska farm. And I hated it. (Laughter)

And I don't miss the elevator operators who used to sit there all day in the elevator, run the little crank, you know.

So, on the other hand, it — as you say it's terribly unpleasant for the people that have to go through it and why would we want to get into a — the business of doing that over and over ourselves?

We did it in the past when we had to, when the businesses were dying.

I don't see any moral fault in 3G at all, but I do see that there's some political reaction that doesn't do anybody any good.

WARREN BUFFETT: Milton Friedman, I think it was, used to talk about the time — probably apocryphal — he would talk about the huge construction project in some communist country.

And they had thousands and thousands and thousands of workers out there with shovels digging away on this major project.

And, then, they had a few of these big, earth-moving machines behind — which were idle — and which could've done the work in one-twentieth of the time of the workers.

So the economists suggested to the local party worker or whoever it was that, you know, why in the world didn't they use these machines to get the job done in one-tenth or one-twentieth the time instead of having all these workers out there with shovels?

And the guy replied, "Well, yeah. But that would put the workers out of work." And Friedman said, "Well, then, why don't you give them spoons to do it instead," you know? (Laughter)

8. Berkshire's $20B cash cushion is an "absolute minimum"

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: I understand that Berkshire is much more liquid than is ideal right now with a 113 billion of consolidated cash and bonds versus policyholder float of 1-0 — 105 billion. But I have trouble calculating how much incremental buying power Berkshire has at any point in time.

You've talked about having a minimum of 20 billion in cash on a consolidated basis.

But for regulatory, risk control, or liquidity purposes, is there some minimum amount of float beyond the 20 billion that has to be in cash bonds or, say, preferred stocks?

Or can all but 20 billion be put into either common stocks or invested into wholly-owned businesses if you found attractive opportunities?

WARREN BUFFETT: Yeah.

JONATHAN BRANDT: What does the balance sheet look like if you were fully invested? And where does additional debt fit into the equation, if at all?

WARREN BUFFETT: Yeah. The — I wouldn't conflate the cash and the bonds. I mean, when we talk about 20 billion in cash, we can own no bond beyond that. Twenty billion would be the absolute minimum. As a practical matter, I never —

Since I've set 20 billion as a minimum, I'm not going to operate with 21 billion any more than I'm going to see a highway, a truck sign that says maximum load 30,000 pounds or something and, then, drive 29,800 across it. So, we won't come that close.

But the answer is that, A, we could use — we're not inclined to use debt. Obviously, if we found something that really lit the — lit our fire — we might use some more debt, although that'd be a — it's unlikely under today's circumstances. But we can —

Twenty billion's an absolutely minimum. You can say that because I say 20 billion's an absolute minimum, it probably wouldn't be below 24 or 25.

And we could do a very large deal if we thought it was sufficiently attractive. I mean, we have not put our foot to the floor on anything for really a very long time. But if we saw something really attractive —

We spent 16 billion back when we were much smaller in a period of two or three weeks — probably three weeks maybe — in the fall of 2008. And we never got to a point where it was any problem for me sleeping at night. And now, we, obviously, have a lot more money to put out.

So, if a good — Charlie, at what point, if I called you, would you say, "I think that's a little bit big for us today?"

CHARLIE MUNGER: I would say about $150 billion.

WARREN BUFFETT: Well, in that case, I'll call you. (Laughter)

Don't — I'm a little more conservative on that than, actually, Charlie. But we both would do a very, very big deal if we —

CHARLIE MUNGER: We don't have to agree perfectly.

WARREN BUFFETT: Yeah. It'd have to be —

But, if we find a really big deal that makes compelling sense —

CHARLIE MUNGER: Now, you're talking.

WARREN BUFFETT: — we're going to do it. (Laughter)

9. Very unlikely Jorge Paulo Lemann would succeed Buffett as CEO

WARREN BUFFETT: OK. Station 2.

AUDIENCE MEMBER: Hello, Mr. Buffett, Mr. Munger.

My name is Felipe Kioni (PH). I'm 19 years old from Brazil.

And your partnership with Jorge Paulo Lemann and his associates at 3G has been very successful, taking into account great outcome of transactions such as the Kraft Heinz merger.

Even though you and Jorge Paulo have different investment methods, would you and Charlie consider him to be your — a member of your board, or even your successor?

WARREN BUFFETT: I don't think that will happen, but I — but then, I think it would complicate things, in terms of the board membership.

But we love the idea of being their partner. And I don't think — I think there's a good chance that we will do more, and perhaps even bigger, things together.

But the — we're probably unlikely to be doing much change in the board, certainly in the next few years.

And there will be a successor, and the successor could very well be while I'm alive.

But that will be — there's a very high probability that will be from somebody that's been in our company for some time. I mean, the world could change in very strange ways, you know. But that's a very, very high probability.

Charlie?

CHARLIE MUNGER: All I can say is that my back hurts when I come to these functions because I want to indicate to the — my fellow shareholders — that they probably got seven more good years to get out of Warren. (Laughter and applause)

WARREN BUFFETT: Charlie's inspiring me. I got to tell you that.

But we've been very, very lucky in life. And so far, our luck seems to be holding.

10. Online competition hasn't yet affected Berkshire retailers

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from Drew Estes in Atlanta, Georgia.

And he asks, "Is Fruit of the Loom experiencing difficulties related to the distribution channel shift towards online and the troubles in the brick and mortar retail world? If so, do you believe the difficulties are short term in nature?"

And, then, Drew goes on to add, "I'm hoping millennials haven't bucked the underwear trend, too." (Laughter)

WARREN BUFFETT: Yeah. Well, he may know more about that than I do. (Laughter)

The answer is essentially no, so far. But anybody that doesn't think that online isn't changing retail in a big way, and that anybody who thinks they're totally insulated from it is correct —

I mean, the world is changing big time. And like I say, at Fruit of the Loom, I don't — it really hasn't changed. And at our furniture operation, which is setting a record so far again this year for the shareholder's weekend. You know, I mentioned it in the report, but I think we did $45 million in one week.

And our furniture operations — it's hard to see any effect from online, outside of our own online operations. It had really good same-store gains.

You can take, you know, whether it's the Nebraska Furniture Mart, but RC Willey, whether it's in Sacramento, or Reno, or Boise, or Salt Lake City, or Jordan's, which, in Boston, has done very well on a same-store basis.

So, we don't really see it, but there were a lot of things we didn't see 10 years ago that then materialized.

One thing you may find interesting is that the Furniture Mart here in Omaha, which is an extraordinary operation — the online has grown very substantially.

And I may be wrong on this, but I think it's getting up to — I'd like to check this with the Blumkins before I say it, but I think it's getting pretty close to 10 percent or so of volume. But it's a very significant percentage of those people still go and pick the product up at the Furniture Mart.

So apparently, they — it's the time spent entering the store or maybe at check-out lines or whatever it may be. I'm surprised that it gets to be that percentage.

But the one thing about it is we keep looking at the figures and trying to figure out what they're telling us.

So far, I would not say that it's affected Fruit of the Loom in a significant manner. I would not say it's affected the furniture operation in a significant manner. But I have no illusions that 10 years is going to look — from now — is going to look anything like today.

If you think about it, you know, if you go back a hundred years to the great department stores, what did they offer? They offered incredible selection.

You know, if you had a big department store in Omaha, you had the thousand bridal dresses. And if you lived in a small town around, the local guy had two or something of the sort.

So the department store was the big, exciting experience of variety and decent prices and convenient transportation, because people took the street cars to get there.

And, then, along came the shopping center. And they took what was vertical before. And they made it horizontal. And they changed it into multiple ownerships.

But they still kept incredible variety, and assortments, and convenience of going to one place, and accessible transportation because, now, the car was the method. And now you go to — and, you know, and then, we went for the discount stores and all of that.

But now you've got the internet. And you've got the ultimate, in terms of assortments. And you've got people that are coming in at low prices. And the transportation is taken care of entirely, so the evolution that has taken place —

The department store is online now, basically, except much expanded in assortment, much more convenient, and lower prices.

So the world has evolved, and it's going to keep evolving. But the speed has increased dramatically.

And what'll happen with — the brands are going to be tested in a variety of ways that — and they have to make decisions as to whether they try to do an online themselves, or work through an Amazon, or whether they try to hang onto the old methods of distribution while embracing new ones.

There's a lot of questions in retail and in branding that are very interesting to watch. And you'll get some surprises in the next 10 years, I can promise you that.

Charlie?

CHARLIE MUNGER: It's — it would be certainly — be unpleasant if we were in the department store business. Just think of what we avoided, Warren.

WARREN BUFFETT: Yeah, we got very lucky, actually, because we were in the department store business, and our business was so lousy that we recognized it. If it had been a little bit better, we would've hung on.

And we owe a tremendous gratitude to Sandy Gottesman, our director who's here in the front row, because he got us out of the business when Charlie and I, and Sandy, were partners in that.

And something we paid six dollars a share for, I think it's worth about $100,000 a share now, because we got out of the business.

And if it had been a somewhat better business, you know, it might be worth 10 or $12 a share now. So, sometimes you get lucky.

We don't miss it either, do we, Charlie? Hochschild Kohn.

CHARLIE MUNGER: No. We don't miss it.

11. Book value a "whole lot less" relevant to Berkshire

WARREN BUFFETT: Jay.

JAY GELB: This question is on Berkshire's intrinsic value. A substantial portion of the company's value is driven by operating businesses rather than the performance of the securities portfolio.

Also, the values of previously acquired businesses are not marked up to their economic value, including GEICO, MidAmerican, and Burlington Northern.

Based on these factors, is book value per share still a relevant metric for valuing Berkshire?

WARREN BUFFETT: Well, it's got some relevance, but it's got a whole lot less relevance than it used to. And that's why — I don't want to drop the book value per share factor, but the market value tends to have more significance as the decades roll along.

It's a starting point. And clearly, our securities aren't worth more than we're carrying for — carrying them for — at that time. And, on the other hand, we've got the kind of businesses you've mentioned.

But we've got some small businesses that are worth 10 times or so, you know, what would — could carry it for. We've also got some clunkers, too.

But I think the best method, of course, is just to calculate intrinsic business value. But it can't be precise.

We know — we think the probability's exceptionally high that 120 percent understates it. Although, if it was all in securities, you know, 120 percent would be too high.

But as the businesses have evolved, as we built in unrecognized value at the operating businesses — unrecognized for accounting purposes — I think it still has some use as being kind of the base figure we use.

If it were a private company and 10 of us here owned it, instead we'd just sit down annually and calculate the businesses one by one and use that as a base value.

But that gets pretty subjective when you've got as many as we do. And so, I think the easiest thing is to use the standards we're using now, recognizing the limitations in them.

Charlie?

CHARLIE MUNGER: Yeah. I think the equities in the insurance company offsetting shareholders equity in the company are really not worth the full market value because they're locked away in a high-tax system.

And so I, basically, like it when our marketable securities go down and our own businesses go up.

WARREN BUFFETT: Yeah, we're working to that end. We've been working that way for 30 years now or something like that.

CHARLIE MUNGER: We've done a pretty good job, too.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: We have a lot of — we've replaced a lot of marketable securities with unmarketable securities that are worth a lot more.

WARREN BUFFETT: Yeah. And it's actually a more enjoyable way to operate, too, beyond that, but —

CHARLIE MUNGER: Yeah. We know a lot of people we wouldn't otherwise —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — be with. Good people.

12. I don't know tech, but I know consumer behavior

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Hello.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: My name is Michael Monahan (PH). And I'm from Long Island, New York.

I don't know if this question qualifies as investment advice. So I have a short, different question if you don't want answer this one. (Laughter)

Unlike the last shareholder from zone 3, this will not be a stump speech, nor a protest.

One of your most well-known pieces of investment advice is to buy what you know. Additionally, you said earlier, one of the main criteria for buying is if you could ever understand the business.

Ever since I came to my first meeting in 2011, you were not known for being a tech guy. You have said smart phones are too smart for you, you don’t have a computer at your desk, and you’ve only tweeted nine times in the last four years. (Laughter)

WARREN BUFFETT: It was either that or going to a monastery. (Laughter)

AUDIENCE MEMBER: Despite this, you’ve recently been investing, looking, and talking more about tech companies.

My question to you and also to Charlie to comment is, what you turned you from the Oracle of Omaha to the Tech Maven of Omaha?

WARREN BUFFETT: (Laughs) Well, I don’t think I would — I don’t think I’ve talked that much about tech companies.

But the truth is, we made a large investment in IB — I made a large investment in IBM, and — which has not turned out that well. We haven’t lost money. But in terms of the bull market we’ve been in, it’s been a significant laggard.

And, then, fairly recently, we took a large position in Apple, which I do regard as more a consumer goods company, in terms of certain economic characteristics. Although, that —

You know, it has a huge tech component in terms of what that product can do, or what other people might come along to do, to leapfrog it in some way.

But I’ve — I think I’ll end up being — no guarantees — but I think I’ll end up being 1- for-2 instead of 0- for-2. But we’ll find out.

Charlie?

I make no pretense whatsoever of being on the intellectual level of some 15-year-old that’s got an interest in tech. I think I may know — have some insights into consumer behavior.

I, certainly, can get a lot of information on consumer behavior and, then try to draw inferences about what that means about what consumer behavior is likely to be in the future. But we will find with —

The one — the other thing I’ll guarantee is I’ll make some mistakes on marketable securities, and I’ve made them in other areas than tech. So it — you’ll not bat a thousand, you know, no matter what industries you stick — you try to stick by.

I know insurance pretty well. But I think we probably lost money on an insurance stock, perhaps, you know, once or twice over the years. So it — you don't bat a thousand.

But I have gained no real knowledge about tech in the last — well, since I was born, actually. (Laughter)

Charlie?

CHARLIE MUNGER: I think it's a very good sign that you bought the Apple. It shows either one of two things. Either it is you've gone crazy or you're learning. (Laughter)

I prefer the learning explanation.

WARREN BUFFETT: Well, so do I, actually. (Laughter)

13. Artificial intelligence impact is hard to predict

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: Hi, Warren. This one's a fun one. Thomas Kimay (PH) is here. He's a 27-year-old shareholder from Kentfield, California.

And I should preface this question by saying that he was here 17 years ago at 10 years old, asked you a question from the audience asking you if the internet might hurt some of Berkshire's investments.

At the time, you said you wanted to see how things would play out. He's now updated the question. (Buffett laughs)

"What do you think about the implications of artificial intelligence on Berkshire's businesses, beyond autonomous driving and GEICO, which you've talked about already? In your conversations with Bill Gates, have you thought through which other businesses will be most impacted?

"And do you think Berkshire's current businesses will have a significantly — will have significantly more or less employees a decade from now as a function of artificial intelligence?"

WARREN BUFFETT: Well, I —

ANDREW ROSS SORKIN: I mixed a couple questions together.

WARREN BUFFETT: Yeah. I certainly have no special insights on artificial intelligence, but I will bet a lot of things happen in that field in the next couple of decades, and probably a shorter timeframe.

They should lead, I would certainly think — but again, I don't bring much to this party. But I would certainly think they would result in significantly less employment in certain areas. But that's good for society.

And it may not be good for a given business, but let's take it to the extreme. Let's assume one person could push a button and, essentially, through various machines and robotics, all kinds of things, turn out all of the output we have in this country.

So, everybody's — there's just as much output as we have. It's all being done by, you know, instead of 150-some million people being employed, one person.

You know, is the world better off or not? Well, certainly we'd work a lot less hours a week — of work per week and so on.

I mean, it would be a good thing, but it would require enormous transformation in how people relate to each other, what they expect of government, you know, all kinds of things. And, of course, as a practical matter, more than one person would keep working.

But pushing the idea that way is one of the — you'd certainly think that's one of the consequences of making great progress in artificial intelligence.

And that's enormously prosocial, eventually. It's enormously disruptive in other ways. And it can have huge problems, in terms of a democracy and how it reacts to that.

It's similar to the problem we have in trade where trade is beneficial to society, but the people that see the benefits day by day of a — of trade — don't see a price at Walmart on socks or whatever they're importing, that says, you know, "you're buying — you're paying X, but you would pay X-plus-so-many-cents if you bought this domestically."

So they're getting these small benefits and invisible benefits. And the guy that gets hurt by it, who's the roadkill of free trade, feels it very specifically. And that translates into politics.

And so, you can — it gets very uncertain as to how the world would adjust, in my view, to great increases in productivity.

And without knowing a thing about it, I would think that artificial intelligence would have that hugely beneficial social effect, but a very unpredictable political effect if it came in fast, which I think it could.

Charlie?

CHARLIE MUNGER: Well, you're painting a very funny world where everybody's engaged in trade. And the trade is, I give you golf lessons and you dye my hair. And that would be a world kind of like the royal family of Kuwait or something.

And I don't think it would be good for America to have everything produced by one person and the rest of us just engaged in leisure.

WARREN BUFFETT: How about if we just got twice as productive?

CHARLIE MUNGER: What?

WARREN BUFFETT: How about if we got twice as productive in a short period of time, so that 75 million people could do what 150 million people are doing now?

CHARLIE MUNGER: I think you'd be amazed how quickly people would react to that.

WARREN BUFFETT: In what way?

CHARLIE MUNGER: Favorably.

WARREN BUFFETT: I —

CHARLIE MUNGER: That's what happened during the period when there — I'm sure everybody remembers with such affection — back in the Eisenhower years, five percent a year or something — people loved it.

Nobody complained that they were getting air conditioning and they didn't have it before. Nobody wanted to go back to stinking, sweating nights in the South and —

WARREN BUFFETT: Well, if you cut everybody's hours in half, it's one thing. But if you fire half the people and the other people keep working, I just think it gets very unpredictable. I mean, I think we saw some of that in this election because I think that —

CHARLIE MUNGER: Well, we've adjusted to an enormous amount of it. It just came along a few percent per year.

WARREN BUFFETT: Well, and the question, then, is —

CHARLIE MUNGER: Don't think you have to worry — I don't think you have to worry about coming out at 25 percent a year. You know, I think you have to worry about it — you're going to get less than two percent a year. That's what's worrisome.

WARREN BUFFETT: OK. We'll move on. But it will be, you know, it's an absolutely fascinating subject to see what happens with this. But it's very, very hard to predict.

If — in some way, you know, we've got 36,000 people, say, employed at GEICO, you know.

And if you could do the same — perform all the same functions, virtually all the same functions even, and do it with five- or 10,000 people, and it came on quickly, and the same thing was happening in a great many other areas, you know, I don't think we've ever experienced anything quite like that.

And maybe we won't experience anything like it in the future. I don't know that much about AI, but —

CHARLIE MUNGER: I don't think you have to worry about that.

WARREN BUFFETT: Well, that's because I'm 86. (Laughter)

CHARLIE MUNGER: It's not going to come that quickly.

14. We have a "huge appetite" for both wind and solar projects

WARREN BUFFETT: OK. Gregg.

GREGG WARREN: Warren, during the past five years, Berkshire Energy's investments in solar and wind generation have been about equal, with around 4.7 billion dedicated to capital projects in each segment.

Based on the company's end-of-year capital spending forecast for 2017 through 2019, investments in wind generation were expected to be more than seven times greater than investments in solar generation the next three years, with just over $4.5 billion going into wind generation.

Just wondering how much of that future spending is tied to PacifiCorp's recently announced $3.5 billion expansion plan, which is heavily weighted towards improving and expanding the subsidiary's existing wind fleet, and whether the economics for wind are that much better than solar given that MidAmerican has also been spending heavily on wind investments?

Or is this disparity between the two segments being driven more by genuine capacity needs, which would imply that you have much more solar capacity than you need?

WARREN BUFFETT: Yeah. It is — we don't look at it as having more solar capacity than we need or anything like —

It's really a question of what comes along. I mean, and these — the projects, they're internally generated, they're externally offered to us, and we've got a big appetite for wind or solar. We have seen — you know — just based on those figures, we've seen more wind lately.

But we have no bias toward either one. I mean, if we saw five billion of attractive solar projects we could do and didn't happen to see any wind during that period, it wouldn't slow us down from doing the five billion or vice versa.

So we are — we have an appetite, a huge appetite, for projects in either area. We're particularly well situated, as I think I've explained or talked about in the past, because we pay lots of taxes.

And therefore, solar and wind projects all involve a tax aspect to them. And we can handle those much better than many other — certainly, electric utilities.

Most electric utilities really, A, don't have that much money left over after dividends and these — frequently, the taxes aren't that significant.

At Berkshire, we pay lots of taxes, and we've got lots of money. So it's really just a question of doing the math on the deals as they come along.

We've been very fortunate in Iowa, in finding lots of projects that made sense. And as a result, we've had a — we've got a much lower price for electricity than our main competitor in the state. We've got a lower price than in any states that touch us.

We've told the people of Iowa we won't — they won't have a price increase for many, many, many years — guaranteed that. So this worked out extremely well.

But if somebody walks in with a solar project tomorrow and it takes a billion dollars or it takes three billion dollars, we're ready to do it. There's no specific —

And the more, the better. There's no specific preference between the two. Obviously, it depends where you are in the country.

I mean, Iowa's terrific for wind. And, obviously, California's terrific for sun. And there are geographical advantages to one or the other. But from our standpoint, we can do them anyplace. And we will do them anyplace.

15. I "underestimated the brilliance" of Jeff Bezos at Amazon

WARREN BUFFETT: OK. Station 4.

AUDIENCE MEMBER: Hi. My name is Joey (PH). And I'm an MBA candidate at Wharton. Thank you for having us.

Amazon has been hugely disruptive, due to the brilliance of Jeff Bezos, whom Charlie earlier called the business mind of our generation.

What is your current outlook and — on Amazon? And why hasn't Berkshire bought in?

WARREN BUFFETT: Well, because I was too dumb to realize what was going to happen — (laughs) — even though I admired Jeff. I've admired him for a long, long time and watched what he was doing.

But I did not think that he could succeed on the scale he has. And I certainly didn't — I didn't even think about the possibility of doing anything with Amazon Web Services or the cloud.

So if you'd asked me the chances that, while he was building up the retail operation, that he would also be doing something that was disrupting the tech industry, you know, that would've been a very, very long shot for me. And I've underestimated — I've really underestimated the brilliance of the execution.

I mean, it's one thing to dream about doing this stuff online, but it takes a lot of ability. And, you know, you can read his 1997 annual report. And he laid out a roadmap. And he's done it, and done it in spades.

And if you haven't seen his interview on Charlie Rose three or four months ago — CharlieRose.com — go to it and listen to it because you'll learn a lot. At least, I did. So, I just plain —

It always looked expensive. And I really never thought that he would be where he is today. I thought he would do — I thought he was really brilliant. But I did not think he would be where he is today when I looked at it three, five, eight, 12 years ago — whenever it may have been.

Charlie, how did you miss it? (Laughter)

CHARLIE MUNGER: It was easy. (Buffett laughs)

What was done there was very difficult, and it was not at all obvious that it was all going to work as well as it did.

I don't feel any regret about missing out on the achievements of Amazon. But other things were easier. And I think we screwed up a little.

WARREN BUFFETT: No. We won't pursue that line. (Laughs)

CHARLIE MUNGER: Well, I meant Google.

WARREN BUFFETT: Well, we missed a lot of things.

CHARLIE MUNGER: Yes.

WARREN BUFFETT: We missed a lot of things.

CHARLIE MUNGER: And we'll keep doing it.

WARREN BUFFETT: Yeah. (Laughter) And we'll have a two —

CHARLIE MUNGER: Luckily, we don't miss everything, Warren. That's our secret. We don't miss them all. (Laughter)

WARREN BUFFETT: OK. We better move on, I think. (Applause)

He may start getting specific.

16. "If I died tonight, I think the stock would go up tomorrow."

WARREN BUFFETT: Carol?

CAROL LOOMIS: The creator of this question, Jim Keifer (PH) of Atlanta, has even higher expectations for Warren's longevity than Charlie does.

"Mr. Buffett, we all hope you win the record as mankind's oldest living person. But at some point, you and/or Charlie will go, and Berkshire stock may then come under selling pressure.

"My question is, if Berkshire stock falls to a price where share repurchase is attractive, can we count on the board and top management to repurchase shares?

"I ask this question both because of past comments you have made about not wanting to take advantage of shareholders and because some of the passages in the owner's manual lead me to believe this might be an instance when the board does not choose to repurchase shares.

"Can you clarify what course of action we might expect about repurchases in the circumstances I have outlined?"

WARREN BUFFETT: Yeah. Well, as far as I'm concerned, they're not taking advantage of shareholders if they buy the stock when it's undervalued. That's the only way they should buy it. And they should —

But in doing so — there were a few cases back when Charlie and I were much younger — where there were very aggressive repurchases — or the equivalent of repurchases — by people. And the repurchases, incidentally, made a lot more sense than they do now.

But they were done by people who either — for various techniques — tried to depress the shares. And if you're trying to encourage your partners to sell out at a depressed price by various techniques, including misinformation — but there's other techniques — you know, I think that's reprehensible. But our board wouldn't be doing that.

I'll take exception to the first part of it, but I'll still answer the second. I think the stock is more likely to go up. If I died tonight, I think the stock would go up tomorrow. And there'd be speculation about break ups and all that sort of thing.

So, it would be a good Wall Street story that, you know, this guy that's obstructed breaking up something that — where some of the parts might sell for more than the whole.

They wouldn't necessarily be — probably be worth less than the whole — but might sell for — temporarily — for more than the whole. And it would happen. So I would bet in that direction.

But if, for some reason, it went down to a level that's attractive, I don't think the board is doing anything in the least that's reprehensible by buying in the stock at that point. No false information, no nothing. It should —

And their buying means that the seller would get a somewhat better price — if there are a lot of sellers — they'd get a mildly better price than if they weren't buying. And the continuing stockholders would benefit.

So I think that — I think it's obvious what they would do. And I would think it's obvious that it's pro-shareholder to do it. And I think they would engage in pro-shareholder acts as far as the eye can see. I mean, we've got that sort of board.

Charlie?

CHARLIE MUNGER: Well, I think you or I might suddenly get very stupid very quickly, but I don't think our board is going to have that problem. (Laughter)

WARREN BUFFETT: Well, I want to think about that one. (Laughter)

17. We try to explain material accounting issues to shareholders

WARREN BUFFETT: OK. Jonathan.

JONATHAN BRANDT: Warren, in the past, you've enjoyed discussing accounting for options grants.

So I'm curious, what's your view of the new accounting standard which mandates that companies report lower tax provisions, based on so-called excess tax benefits enjoyed when share-based compensation ends up being more profitable for the grantees than when it's initially modeled?

These so-called benefits — excess benefits — used to go through the shareholder's equity line on the balance sheet. Which accounting method makes more sense to you, the old method or the new?

WARREN BUFFETT: Jonny, I think you know a lot more about it than I do. So, if I were asked to answer that question, I'd probably call you up and say, "What should I say?" (Laughter)

It's not a factor that will enter into Berkshire, so I really have not — I mean, I've heard just a little bit about that accounting standard. But I really don't know anything about it.

Charlie?

CHARLIE MUNGER: It's not a big deal, Warren.

WARREN BUFFETT: Yeah. Well, I know that. (Laughter)

Yeah. We — there are few things in accounting we really disagree with and whether they might be material to somebody trying to evaluate Berkshire. And, you know, that primarily gets into amortization of intangibles.

It will certainly — it certainly gets into realized capital gains and that sort of thing. And we will go to great lengths to try to tell our partners, basically, not all of whom, you know, are accounting experts or anything.

And we will try to make clear to them, at least, what our view is. You know, the same way as if I had a family business and I was talking to my sisters or something about it.

But unless it's material, we'll probably stay away from trying to opine on any new accounting standards. If it's material to Berkshire, we'll go to great lengths to, at least, give our view.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with that.

WARREN BUFFETT: OK —

CHARLIE MUNGER: That is, that what he's talking about is not very material to Berkshire.

WARREN BUFFETT: No. It isn't. And it really won't be. You know, and —

CHARLIE MUNGER: No.

WARREN BUFFETT: Some of these others are, though, and we will bring those up as they come up. The — yeah.

We are reporting 400-and-some million dollars less in our earnings than if Precision Castparts had remained a public company.

Well, is Precision Castparts — I mean, are the earnings less real? Is the cash less real? Is anything — because it's moved, the ownership? I don't think so.

And I want to convey that belief to shareholders. And they can debate whether it's right or wrong. But I think it's a mistake not to comment if — and just assume that the owners understand that because it, you know, it's a fairly arcane point. And so, we point it out. But we also point out if we think depreciation is inadequate.

As for valuation purposes, the depreciation is inadequate at a very capital-intensive business like BNSF, which we, I must say, still love anyway.

Charlie, any more?

CHARLIE MUNGER: No.

18. "Valuation … is not reducible to any formula"

WARREN BUFFETT: OK. Section 5.

AUDIENCE MEMBER: Thank you, and good afternoon. I'm Adam Bergman with Sterling Capital in Virginia Beach, Virginia.

Earlier today, Mr. Munger commented on the valuation of China versus the U.S. market.

My question for you is, are market cap to GDP and cyclically adjusted P/E still valid ways to consider market valuation? And how do those influence Berkshire's investment decisions? Thank you.

WARREN BUFFETT: Charlie, I think — well, I expect that I guess Charlie's overall valued in China.

I would say that both of the standards you mention are not paramount at all in our valuation of securities. It's harder —

People are always looking for a formula. And there is an ultimate formula, but the trouble is you don't know what to stick in for the variables. But the —

And, you know, that's the value of anything, being the present value of all the cash it's ever going to distribute. But the P/E ratios — I mean, every number has some degree of meaning, means more sometimes than others.

Valuation of a business is — it's not reducible to any formula where you can actually put in the variables perfectly.

And both of the things that you mentioned get — themselves, get bandied around a lot.

It's not that they're unimportant. But sometimes they're — they can be very important. Sometimes they can be almost totally unimportant. It's just not quite as simple as having one or two formulas and, then, saying the market is undervalued or overvalued or a company is undervalued or overvalued.

The most important thing is future interest rates. And, you know, and people frequently plug in the current interest rate saying that's the best they can do. After all, it does reflect a market's judgment.

And, you know, the 30-year bond should tell you what people who are willing to put out money for 30 years and have no risk of dollar gain or dollar loss at the end of the 30-year period.

But what better figure can you come up with? I'm not sure I can come up with a better figure. But that doesn't mean I want use the current figure, either. So, I would say that —

I think Charlie's answer will be that he does not come up with China versus the U.S. market based on what you've mentioned as yardsticks. But, no, Charlie, you tell them.

CHARLIE MUNGER: All I meant was that — I said before that the first rule of fishing is to fish where the fish are — is that a good fisherman can find more fish in China if your — if fish is the stock market. That's all I meant.

WARREN BUFFETT: Yeah. One — I'm going to go back to one —

CHARLIE MUNGER: It's a happier hunting ground.

19. Lessons from running a "lousy business"

WARREN BUFFETT: This doesn't really directly relate. Just going — I want to go back to one question that was mentioned earlier.

I really think if you want to be a good evaluator of businesses — an investor — you really ought to figure out a way, without too much personal damage, to run a lousy business for a while.

I think you learn a whole lot more about business by actually struggling with a terrible business for a couple of years than you run by — than you learn by getting into a very good one where the business itself is so good that you can't mess it up.

I don't know what — I don't know whether Charlie has a view on that or not. But it's certainly — it's — it was a big part of our learning experience. And I think a bigger part, in a sense, than running — being involved — with good businesses was actually being involved in some bad businesses and just seeing —

CHARLIE MUNGER: How awful it was.

WARREN BUFFETT: — how awful it is, and how little you can do about it, and how IQ does not solve the problem, and a whole bunch of things.

It's a useful experience. But I wouldn't advise too much of it. Would you think so, Charlie? Or —

CHARLIE MUNGER: It was very useful to us. There's nothing like personal, painful experience if you want to learn. And we certainly had our share of it.

20. Weapons of mass destruction pose biggest risk to Berkshire

WARREN BUFFETT: OK. Becky.

BECKY QUICK: This question comes from Tom Spanfelner (PH). And he'd like to be called Tom Span from Pennsylvania.

He says, "In life, business, and investing, strategies often work until they don't work. Other than a massive insurance loss, any thoughts on what could cause the Berkshire enterprise to not work?"

WARREN BUFFETT: I think the only —

CHARLIE MUNGER: Good question.

WARREN BUFFETT: Yeah. Well, if there were some change, if we got some infection — outside agent of some sort that changed the culture in some major way, an invasion of different thought.

But as a practical matter, I don't think anything — you know, and it's the things you can't think of — but I can't think of anything that can harm Berkshire in a material, permanent way except weapons of mass destruction. But I don't regard that as a low probability.

It would take a recession, a depression, a panic, you know, hurricanes, earthquakes. They all would have some effect. And in some cases, it might even be that we would do better because of them.

But if there were a successful — as measured by the aggressor — nuclear, chemical, biological, or cyber-attack on the United States — and there are plenty of people that would like to pull that off or organizations and maybe even a few countries — it could disrupt society to such an extent that it would harm us.

But I think — with the variety of earning streams, with the asset positions, with the general philosophy at play — the culture — I think that we would be close to the last one affected.

But if somebody figures out how to kill millions of Americans and totally disrupt society, then, you know, then all bets are off.

Charlie?

CHARLIE MUNGER: Well, I agree. It would take something really extreme.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And just take the question like — British Petroleum took a huge loss with one oil well blowing.

And Berkshire has all these independent subsidiaries. And they really are independent. And the parent company is not (inaudible) if there's one horrible accident somewhere.

We would tend to pay, of course, maybe more than our legal liability, but we are not — one accident in one subsidiary that caused a big lot of damage, we're better protected than most companies.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: In every way, Berkshire is structured to handle stresses.

WARREN BUFFETT: It's the kind of thing we think about all the time. We've thought about it ever since we started. But I really don't know any company that can take more general adversity or even some specific adversities.

But if you get into the "what could happen with weapons of mass destruction?" that is something we can't predict about. But if that ever happens, there'll be more to worry about than the price of Berkshire.

21. Buffett confident about growth for property-casualty business

WARREN BUFFETT: Jay?

JAY GELB: Berkshire Hathaway Specialty Insurance generated $1.3 billion of premium volume in 2016. This business is on the smaller end of commercial property-casualty insurers in terms of scale, although its volume did grow 40 percent last year.

In a highly competitive commercial P&C environment, what gives you confidence that Berkshire Hathaway Specialty is destined to become one of the world's leading commercial P&C insurers, as you said in this year's annual letter?

WARREN BUFFETT: Yeah. I think it will be. And I think how fast it grows depends very — it does depend very much on the market.

I mean, we're, you know, we are not interested in trying to be a price-cutter in a market where the prices already aren't that attractive.

But we have built the scale, worldwide. And a lot of this has just been added in, you know, recent months and just over the past year. We have —

We will grow a lot. But if the market should turn hard for any reason, we would grow a lot faster. But we are destined, at Berkshire Hathaway Specialty, to be one of the leading PC firms in the world, just as we were destined to have — when Ajit [Jain] came in, even though we had nothing — we were destined to become a very important reinsurer throughout the world and, in certain ways, almost the only reinsurer for certain types of risks in the world.

And we've got the people. We've got the capital. We've got the reputation. There is no stronger company in the insurance world — and there won't be — than the Berkshire Hathaway insurers. We've got the talent there.

So it will grow. It may grow slowly some years. It may have big jumps just like the reinsurance operation did many years ago. But it's a very important addition to Berkshire that brought that on. I wish — just wish we could've started a little earlier.

But we had to have to right people. And they came to us. And, as you say, we wrote whatever it was, a billion-three or a billion-four last year, and we'll write more this year. But we won't write as much as if we were in a hard market.

22. "My God, we're still learning"

WARREN BUFFETT: Station 6?

AUDIENCE MEMBER: Good afternoon. My name Sally Burns. I'm from Australia. But I currently reside in Austin, Texas.

My question, Mr. Buffett, I have heard that Mr. Munger says your greatest talent is that you're a learning machine, that you never stop updating your views.

What are the most interesting things you've learned over the last few years?

WARREN BUFFETT: Well, it is fun to learn. I would say Charlie is much more of a learning machine than I am. I'm a specialized one, and he's a much — he does as well as I do in my specialty. And, then, he's got a much more general absorption rate than I have about what's going on in the world.

But, you know, it's a world that gets more fascinating all the time. And a lot of fun can occur when you learn you were wrong on something. It — you know, that's when you really learn that the old ideas really weren't so correct. And you have to adapt to new ones. And that, of course, is difficult.

I don't know that I would pick out — well, I think, actually, what's going on, you know, in America is terribly, terribly interesting, you know, and politically, all kinds of things. But just the way the world's unfolding, it's moving fast.

I do enjoy trying, you know, to figure out not only what's going to happen, but what's even happening now. But I don't think I've got any special insights that would be useful to you. But maybe Charlie does.

CHARLIE MUNGER: Well, I think buying the Apple stock is a good sign in Warren. (Laughter)

And he did run around Omaha and ask if he could take his grandchildren's tablets away. (Buffett laughs)

And he did market research.

And I do think we keep learning. And more important, we keep — we don't unlearn the old tricks. And that is really important.

You look at the people who try and solve their problems by printing money and lying and so forth.

Take Puerto Rico. Who would've guessed that a territory of the United States would be in bankruptcy? Well, I would've predicted it because they behave like idiots. (Laughter) And so —

WARREN BUFFETT: And we did not buy any Puerto Rico bonds. (Laughs)

CHARLIE MUNGER: No. And if you go to Europe — you go to Europe, you should look at the government bond portfolios we're required to hold in Europe. There's not only no Greek bonds, they're the bonds of nobody but Germany.

Everywhere you look in Berkshire, somebody is being sensible. And that is a great pleasure. And if you combine that with being very opportunistic so that when something comes along like a panic, why, it's a nice — it's like playing with two hands instead of one on a game that requires two hands.

It helps to have a fair-sized repertoire.

And, Warren, we've learned so damn much. There are all kinds of things we've done over the last 10 years we would not have done 20 years ago.

WARREN BUFFETT: Yeah. That's true, although if you take — it's interesting. I've mentioned this before. But one of the best books on investment was written, I think, in 1958. I think I read it around 1960, by Phil Fisher, called Common Stocks and Uncommon Profits. And he told —

CHARLIE MUNGER: All the countries went — companies went to hell eventually.

WARREN BUFFETT: But it talked about the importance, I mean, or the usefulness of, what do you call, the "scuttlebutt method." And, you know, that was something I didn't learn from [Benjamin] Graham.

But every now and then, it's turned out to be very useful. Now, it doesn't solve everything. And, I mean, there's a whole lot of more —

CHARLIE MUNGER: I saw you do it with American Express in the Salad Oil scandal.

WARREN BUFFETT: Yeah, yeah.

CHARLIE MUNGER: You're still doing at Apple, you know, decades later.

WARREN BUFFETT: Yeah. It — in certain cases, you actually can learn a lot just by asking a lot of questions. And I give Phil Fisher credit. That book goes back a lot of years.

But as Charlie said, some of the companies he picked as winners forever did sort of peter out on him.

But the basic idea, that you can learn a lot of things just by asking in some cases — I mean, I used to —

I mean, if I got interested in the coal industry — just say to pick one out of the air — you know, when I was much younger, more energetic, if I went and talked to the heads of 10 coal companies and I asked each one of them — way later into the conversation, after they got feeling very — they felt like talking.

And I would just, you know, I'd just say, "If you had to go away for 10 years on a desert island and you had to put all of your family's money into one of your competitors, which one would it be and why?"

And then, you know, and then I'd ask them if they had to sell short one of their competitors for 10 years, all their family money, why?

And they — everybody loves talking about their competitors. And if you do that with 10 different companies, you'll probably have a better fix on the economics of the coal industry than any one of those individuals has.

I mean, the — it — there's ways of getting at things. And sometimes they're useful. Sometimes, they're not. But sometimes, they can be very useful.

And, you know, the idea of just learning more all the time about —

I'm more specialized in that by far than Charlie. I mean, he wants to learn about everything. And I just want to learn about something that'll help Berkshire.

But — (laughs) — it's a very, you know, it's a very useful attitude toward — have toward — the world.

And, of course, I don't know who said it. But somebody said the problem is not in getting the new ideas but shedding the old ones. And there's a lot of truth to that.

CHARLIE MUNGER: We would never have bought ISCAR if it had come along 10 years earlier. We would never have bought Precision Castparts if it had come along 10 years earlier. We are learning. And, my God, we're still learning.

23. "We're getting too much medicine"

WARREN BUFFETT: OK. Andrew?

ANDREW ROSS SORKIN: Hi. Warren, this is my final question.

In 2012, you were quoted as saying, "I think the health care problem in — is the number one problem of America and of American business. We have not dealt with that yet."

Do you believe that the current administration's plan to repeal and replace ACA will ultimately benefit the economy and Berkshire or not?

WARREN BUFFETT: Yeah. Well, I'll answer — I'll give you two answers here, the first one being that if you go back to 1960 or thereabouts, corporate taxes were about four percent of GDP. I mean, they bounced around some.

And, now, they're about two percent of GDP. And at that time, health care was five percent of GDP. And now, it's about 17 percent of GDP.

So when American business talks about taxes strangling our competitiveness or that sort of thing, they're talking about something that, as a percentage of GDP, has gone down from four to two while medical costs, which are borne to a great extent by business, have gone from five to 17 percent.

So medical costs are the tapeworm of economic — American economic competitiveness, I mean, if you're really talking about it.

And that — and business knows that. They don't feel they can do much about it, but it is not —

The tax system is not crippling Berkshire competitiveness around the world or anything of the sort. Our health costs have gone up incredibly and will go up a lot more. And if you look at the rest of the world, there were a half a dozen countries that were around our five percent if you go back to the early years.

And while we're at 17, now, they're at 10 or 11. So they have gained a five or six point advantage — the world — even in these countries with fairly high medical costs.

CHARLIE MUNGER: And that's with socialized medicine.

WARREN BUFFETT: Yeah. So it's a huge — whatever I said then goes and is accentuated now. And that isn't a problem —

I mean, that is a problem this society is having trouble with and is going to have more trouble with, and — regardless of which party's in power or anything of the sort. It almost transcends that.

In terms of the new act that was passed a couple days ago versus the Obama administration act, it's a very interesting thing.

All I can tell you is the net effect of that act on one person is that my taxes — my federal income taxes — would've gone down 17 percent last year, if the act — if what was proposed went into effect.

So, it is a huge tax cut for guys like me. And you'll have to figure out the effects of the rest of the act.

But the one thing I can tell you is if it goes through the White House — put in, I mean, it — anybody with $250,000 a year of adjusted gross income and a lot of investment income is going to have a huge tax cut. And when there's a tax cut, either the deficit goes up or they get the taxes from somebody else.

So, as it stands now, it is — that is the one predictable effect, if it should pass, as it — and it — the Senate will do something different and hold a conference. And who knows what happens? But that is in the law that was passed a couple days ago.

Charlie?

CHARLIE MUNGER: Well, I certainly agree with you about the medical care. What I don't like about the medical care is that a lot of — we're getting too much medicine.

There's too much chemotherapy on people that are all but dead, and all kinds of crazy things go on in Medicare and in other parts of the health system.

And every — there are so many vested interests that it's very hard to change.

But I don't think any rational person looking objectively from the outside of the American system of medical care — we all love all the new life-saving stuff, and the new chemotherapies, and the new drugs, and all that.

But, my God, the system is crazy. And the cost is just going wild. And it does put our manufacturers at a big disadvantage with other people where the government is paying the medical bills. And so, I agree with Warren totally.

WARREN BUFFETT: If you had to bet, 10 years from now, we'll be higher or lower than 17 percent of GDP?

CHARLIE MUNGER: Well, if present trends continue, it'll get more and more. There are huge vested interests in having this thing continue the way it is. And they're very vocal and active. And the rest of us are indifferent. So, naturally, we get a terrible result.

And I would say that on this issue, both parties hate each other so much that neither one of them can think rationally. And I don't think that helps, either.

WARREN BUFFETT: It's — (Applause)

It is kind of interesting that, you know, with — the federal government spends — or raises, we'll say — 3 1/2 trillion or something like that — I mean, the degree of concern everybody has about that — although that's stayed fairly steady in the 18 percent or so of GDP plus or minus a couple points — but three trillion-plus is spent on health care.

And everybody wants the best. And it's perfectly understandable. But it's a very, very — it's a big number compared to the whole federal budget. I mean, there's some overlap and all of that. But it's —

If you talk about world competitiveness of American industry, it's the biggest single variable where we keep getting more and more out of whack with the rest of the world.

And it's very tough for political parties to attack it. Yet, it's, you know, it — basically, it's a political subject.

CHARLIE MUNGER: A lot of it is deeply immoral. If you have a group of hospital people and doctors that are feasting like a bunch of jackals on the carcass of some dying person, it's not a pretty sight.

WARREN BUFFETT: Tell them about that group out — (applause) — in California that —

CHARLIE MUNGER: Oh yes.

WARREN BUFFET: Perfect — this is —

CHARLIE MUNGER: This is Redding. This is one of my favorite stories. There are a bunch of very ambitious cardiologist and heart surgeons in Redding.

And they got the thought that, really, what a heart was was a "widowmaker." So everybody — every patient that came in, they said, "You've got a widowmaker in your chest. And we know how to fix it." And so they recommended heart surgery for everybody.

And, of course, they developed a huge volume of heart surgery. And they got very wonderful results because nobody comes through heart surgery better than the man who doesn't need it at all. (Laughter)

And they made so much money that the hospital chain, which was Tenet, brought all its other hospitals — why can't you be more like Redding? And this is a true story. And it went on and on and on.

And finally, there was some beloved Catholic priest. And they said, "You've got a widowmaker in your chest." And he didn't believe them. And he blew the whistle.

WARREN BUFFETT: He was a priest. You could see why he didn't believe them. (Laughter)

CHARLIE MUNGER: At any rate — well, when you get a routine, you just keep using it, you know. A heart is a widowmaker. It's a widowmaker.

Later, I met one of the doctors who threw these people out of the medical profession. And I said to him, "In the end, did they think they were doing anything wrong?"

He said, "No, Charlie. They thought that what they were doing was good for people." That is why it's so hard to fix these things. The self — the delusion that comes into people as they make money and get more successful by doing God-awful things should never be underestimated. And it's — there's a lot — (Applause)

A lot of that goes on. And you're (inaudible) such gross craziness. And you thought little Wells Fargo looks like innocence. He only has a little trouble with his incentive system.

But the heart surgery rate was 20 times normal or something. You'd think you'd notice if you're running a hospital. And — but they did notice. They wanted the other hospitals to be more like it.

WARREN BUFFETT: They had a terrific success ratio.

24. Buffett expects Berkshire will own more utilities

WARREN BUFFETT: OK. Gregg? (Laughs)

GREGG WARREN: Thank you, Warren.

As you look forward, in taking into consideration some of the headwinds faced in the U.S.-based utilities, including weaker electricity demand growth as increasing energy efficiency impacts demand, distributed generation, which hits vertically integrated utilities doubly hard as they face both declining energy sales revenue and increased network cost to support reliable delivery and, third, higher interest rates, which would increase borrowing costs, what are the key attributes that Berkshire Energy would be looking for in future acquisition candidates? In —

WARREN BUFFETT: Yeah. Oh, excuse me. I'm sorry.

GREGG WARREN: I'm sorry. In particular, are there advantages or disadvantages attached to, say, transmission assets relative to generation assets that would make you favor one over the other?

WARREN BUFFETT: Yeah. Well, generation assets, you can say, have inherently more risk because that — some of them are going to —

CHARLIE MUNGER: Be stranded.

WARREN BUFFETT: — stranded, yeah, and obsoleted. Now the question is how they treat stranded and all of that sort of thing.

We — on the other hand, more of the capital investment is in the generating assets. So that tends to be where a good bit of the capital base is.

We like the utility business OK. I mean — electric — electricity demand is not increasing like it was, as you point out. They're going to be stranded assets. They —

If they're stranded because of rank foolishness, you know, they will probably be less inclined — or the utility commissions — will be less inclined to let you figure that in your rate base as you go forward as opposed to things that are — where societal demands are just changing.

But we still think the utility business is a very decent asset. The prices are very high, but that's what happens in a low interest rate environment. I would be —

I'd be surprised if 10 years from now, we don't have significantly more money in not only wind and solar, but probably — we'll probably own more utility systems than we own now.

We're a buyer of choice with many utility commissions. In fact, if we can put up the slide, there's a slide which shows something about our pricing compared to other utilities.

And Greg Abel and his group have done an extraordinary job. They've done it in safety. They've done it in reliability. They've done it in price. They've done it in renewables. It's hard to imagine a better run operation than exists at MidAmerican Energy.

And people want us — with that record — people want us to come to their state in many cases.

But when prices get to the level they have, I mean, some utilities have sold at extraordinary prices. And we can't pay them and have it make sense for Berkshire shareholders.

But just because we can't do it this year doesn't mean it won't happen next year or the year after. So I think we'll get a chance.

CHARLIE MUNGER: And our utilities are not normal. The way Greg has run those things, they're so much better run in every way than normal utilities. They're better regarded by the paying customers. They're better regarded by the regulators. They have better safety records. They charge —

It's just everything about it is way the hell better. And it's a pleasure to be associated with people like that and to have assets of that quality.

And it's a lot safer. If somebody asked Berkshire to build a $50 billion nuclear plant, we wouldn't do it.

WARREN BUFFETT: Yeah. And we have public power here in Nebraska. I mean, it's been sort of the pride of Nebraska for many decades. It's all — there are no privately-held utility systems, and totally public power. And, you know, those utilities have no requirements for earnings on equity. They have —

They can borrow at tax-exempt rates. We have to borrow at taxable rates. And Nebraska — you know, the wind — it's not that much different than Iowa. And we're selling electricity across the river, a few miles from here, you know, at lower prices than exist in Nebraska. So it's an extraordinary utility.

And it was lucky when we got involved in it. I thank Walter Scott, our director, for introducing me to it almost 17 or 18 years ago or so. And —

But I don't think the utility business, as such — I mean, if I were putting together a portfolio of stocks, I don't think there would be any utilities in that group now. But I love the fact we own Berkshire Hathaway Energy.

CHARLIE MUNGER: But it's different —

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: — radically different —

WARREN BUFFETT: A lot —

WARREN BUFFETT: — and better.

WARREN BUFFETT: A lot better, actually.

25. McLane: lots of revenue, but very thin profit margin

WARREN BUFFETT: Station 7.

AUDIENCE MEMBER: Hi.

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: My name's Grant Misterly from beautiful, historic Saint Augustine, Florida.

I've been a fan of yours and of Berkshire since I was a kid, looking through the stock pages and seeing one crazy stock that traded for $10,000 a share.

Unfortunately, I wasn't able to convince my parents to buy it at that point. But now I'm a shareholder as an adult. And I'm here with my daughters, Mabel, who's seven and Willa, who's one year old, my wife.

I voraciously read the letter every year. And I love the stories of — from the different companies, GEICO and See's, BNSF, that kind of teach investing lessons.

And this year, when I was looking through the accounting information in the back, I noticed that one company, McLane, contributes a lot of revenue, a large portion of Berkshire's revenue and, to a lesser extent, earnings. But I don't ever see much about it in the annual report.

So I'm curious why we don't hear more about that company? And are there any investing lessons like we get from See's and GEICO that you can share about that company?

WARREN BUFFETT: Yeah, McLane — the reason you see their figures separately is because the SEC has certain requirements that are based on sales. And McLane is a company that has an extraordinary amount of sales in relation to intrinsic value or to net income.

It, basically, is a distributor of — well, it's a huge customer, for example, of the food companies, the candy companies, the cigarette companies, it — go up and down the line of anything that goes into convenience stores.

But we bought it from Walmart. And Walmart is our biggest customer. I can't tell you the precise volume, but — well, if you get Walmart's and Sam's together, you know, you're getting up to 20 percent-plus.

But it's nationwide. But in the end, it operates on about six percent gross margins and five percent operating expenses, so it has a one percent pre-tax margin.

And, obviously, a one percent pre-tax margin only works in terms of return on capital if you turn your equity extraordinarily fast. And that's what McLane does. Being a wholesaler, it's moving things in, moving things out very fast, very efficiently. And it does this —

It also has a few liquor distribution subsidiaries that have wider margins. But the basic McLane business is, you know, 45 billion-plus, makes one percent pre-tax on sales.

But the return on capital is very decent. But it sort of has an outsized appearance simply because of this huge volume of sales that go through it.

Grady Rosier, who runs it, is exceptional. He was there when we bought it from Walmart, whenever it was, a dozen years ago.

And I've been there once. We've got thousands and thousands of trucks, big distribution centers all over the country. It is a major factor in moving goods at wholesale.

I mean, if you're a Mars Candy or something of the sort, I mean, we — we're — we'll be the biggest customer.

But that pretty well describes the business. You know, it's a business that earns good returns in relation to invested capital and in relation to our purchase price.

But, you know, every tenth of a cent is important in the business. In collect — moving your receivables exceptionally fast, and consequently you have — you know, you have payables moving big time.

So the sales are 30 times receivables and 30 times payables, you've got — and maybe, yeah, 35 or so times inventory. I mean, this is a business that's moving a lot of goods. But, in terms of its —

It’s an important subsidiary but not remotely as important as would be indicated by the sales. It’s still very important making the kind of money that shows up in the 10-K.

Charlie?

CHARLIE MUNGER: You said it all. (Buffett laughs)

WARREN BUFFETT: That was an interesting thing. Walmart wanted to sell it. They came to see us, and we made a deal. And the CFO came. We talked for a while. He went into the other room and called the CEO and came back and said, “You have a deal.”

And Walmart has told me subsequently that they never had a deal that closed as fast as the one with Berkshire. I mean, they — you know, we said what we would pay. It was cash. And we got it done very promptly. And they were terrific on their side.

CHARLIE MUNGER: By the way, that reputation for being quick and simple, and doing what we promised and so on, has helped at Berkshire time after time.

WARREN BUFFETT: Yeah. Yeah, we wouldn’t have made that deal without, essentially, having that reputation. But they knew —

CHARLIE MUNGER: Well, you bought the Northern Natural Gas Company in one weekend. And they wanted the Monday — that money on Monday.

WARREN BUFFETT: They needed the money on Monday.

WARREN BUFFETT: Before the lawyers could complete the legal papers, we managed to do it.

WARREN BUFFETT: Well, not only that, but I think it took some clearance by — in Washington. And, essentially, I think I wrote a letter and said that if they didn’t — if they decided after looking at it they didn’t want to clear it, we’d undo the deal.

But these guys needed the money so bad, we were going to give them the money, essentially, based on the deal clearing. And there wasn’t any reason why it wouldn’t clear, but that was just a procedural problem.

But most companies can’t do that. I mean, we can. We’ve got a flexibility that, really, in most large companies just plain doesn’t exist. There’s too many people have to sign off on it or something of the sort.

So the Northern Natural deal would not have been made if we’d had to follow the normal timetable. It —

CHARLIE MUNGER: And it’s a lovely business to own.

WARREN BUFFETT: Yeah. Absolutely.

26. Buffett wants to be remembered as a (very old) teacher

WARREN BUFFETT: Now, we're moving from one station to another between now and 3:30, so we now go to station 8.

AUDIENCE MEMBER: Good morning or good afternoon, Warren and Charlie, John —

WARREN BUFFETT: Hi.

AUDIENCE MEMBER: — Norwood from West Des Moines, Iowa. You guys have iron bladders. (Laughter)

WARREN BUFFETT: We won't tell you the secret to that.

AUDIENCE MEMBER: Fine — (Laughter)

I was wondering about a contraption under the —

WARREN BUFFETT: No.

AUDIENCE MEMBER: — table there.

WARREN BUFFETT: No. You can come down and inspect.

AUDIENCE MEMBER: All right. (Laughter)

Hey, I had a question for each. Warren, I was fortunate to ask you a question, I think, in 2011 about legacy and what you wanted to be known for a hundred years from now. And I'm kind of curious to hear what Charlie would like to be known for.

Warren, I'm 52. So I guess you started this — doing this — when I was born. And I'm kind of interested in a memory from your first annual meeting.

CHARLIE MUNGER: My first memory when Warren got on this subject and they asked him what he wanted said at his funeral.

He said, "I want them to all be saying 'that's the oldest looking corpse I ever saw.'" (Laughter) And —

WARREN BUFFETT: That may be the smartest thing I ever said. (Laughter)

Oh, it — well — with me, it —very simple. It — I really like teaching.

So, basically, I've been doing it formally and, you could say, somewhat informally, all my life. And I certainly had the greatest teachers you can imagine. So, if somebody thought that I did a decent job at teaching, I'd feel very good about that. (Applause)

CHARLIE MUNGER: Yeah. To make the teaching endurable it has to have a bit of wise-assery in it. And that we've both been able to supply. (Laughter)

WARREN BUFFETT: And for those of you who are old-time basketball fans, have I mentioned that on Wilt Chamberlain's tomb it was reputed that it was going to say, "At last, I sleep alone?" (Laughter)

27. "Don't wait till you're 93"

WARREN BUFFETT: OK. Station 9.

AUDIENCE MEMBER: Good afternoon, Mr. Munger and Mr. Buffett.

My name is Ji Wen Yue (PH). I come from China. It's my first time to come to this meeting. And I think I'm very lucky to have a chance to ask question.

WARREN BUFFETT: We're glad to have you.

AUDIENCE MEMBER: Thank you. Everyone has personal dreams. And at a different age, maybe dreams will come different to you. And what's your dream now?

WARREN BUFFETT: Charlie, we'll let you go first.

CHARLIE MUNGER: I didn't quite hear that.

WARREN BUFFETT: Oh, I — what's your dream now? She says —

CHARLIE MUNGER: My dream. Well — (Laughter)

WARREN BUFFETT: Let's skip the first one. (Laughter)

CHARLIE MUNGER: Sometime when I'm especially wishful, I think, oh, to be 90 again. (Applause)

And I got some advice for the young. If you got anything you really want to do, don't wait till you're 93.

WARREN BUFFETT: No, do it. (Laughter)

No, that's the same thing I would tell students is, you can't always find it the first time or the second time. But when you go out in the world, look for the job that you would take if you didn't need a job.

I mean, don't postpone that sort of thing. Somebody — I think it was Kierkegaard, said that, you know, life must be evaluated backwards but it must be lived forwards.

And you want to sort of — Charlie says all he wants to know is where he'll die so he'll never go there, you know. And so you — (Laughter)

You do want to do a certain amount of reverse engineering in life. I mean, that's not — that doesn't mean you can do everything that way.

But you really want to think about what will make you feel good, when you get older, about your life.

And you, at least generally, want to keep going in that direction. And, you know, you need some luck in life. And you got to accept some bad things that are going to happen as you go along.

But life has been awfully good to me and Charlie, so we have no complaints.

CHARLIE MUNGER: What you don't want to be is like the man, when they held his funeral, and the minister said, "Now, it's the time for somebody to say something nice about the deceased." And nobody came forward. And nobody came forward.

He said, "Surely, somebody can say somebody — something nice — about the deceased." And nobody came forward.

And finally, one man came up. And he said, "Well," he said, "His brother was worse."

WARREN BUFFETT: Yeah. (Laughter)

28. Buffett's regret: "I wish I'd met Charlie earlier"

WARREN BUFFETT: OK. We'll move to station 10 and see if we can improve on it. (Laughter)

AUDIENCE MEMBER: Hi. My name is Andy Lijun Lin from Loyal Valley Innovation Capital from Shanghai.

This is my sixth year from Shanghai to here. I have say — I have to say to you two, Warren and Charlie, you are highly respected and deeply loved by millions and millions, or even billions, globally.

I have two questions today. First question, in your letters to shareholders you said you believe EBITDA is not a good parameter to value a business. Why it's not? Can you elaborate on that?

Second question, you both have very successful and happy lives with great respect. My question is to each of you. In retrospect, from a personal standpoint, do you have regrets in life?

If there is one thing you could have done differently in your life, family, personal, or business, what is it? Thank you very much.

WARREN BUFFETT: Yeah. I don't think you should expect us to answer that on personal.

But in business, I would say I wish I'd met Charlie earlier. (Laughs)

We've had a lot of fun ever since I was 29 and he was 35. But it would've been even more fun if we'd started many, many years earlier. We had a chance to. We worked in the same grocery store but not at the same time.

29. Teaching the "delusion" of EBITDA is "horror squared"

WARREN BUFFETT: In respect to EBITDA, depreciation is an expense. And it's the worst kind of an expense. You know, we love to talk about float. And float is where we get the money first and we have the expense later.

Depreciation is where you spend the money first, you know, and, then, record the expense later. And it's reverse float. And it's not a good thing.

And to have that enter into a multiple — it's much better to buy a business that has, everything else being equal — has no depreciation because it has, essentially, no investment and fixed assets that makes X, than it is to buy a company where there's a lot of depreciation in getting to X.

And I — actually, I may write a little bit more on that next year, just because it's such a mass delusion. And, of course, it's in the interests of Wall Street, enormously, to focus on something called EBITDA because it results in higher borrowing power, higher valuations, and all of that sort of thing.

So it's become very popular in the last 20 years, but I — it's a very misleading statistic that can be used in very pernicious ways.

Charlie, on either one of those subjects?

CHARLIE MUNGER: I think you've understated the horrors of the subject and the disgusting nature of the people that brought that term into the valuation of business. It was just —

It would be like a leasing broker of real estate who's got a thousand square-foot new suite to be leased, and he says it's got 2,000 feet in it. That's not honorable behavior. And that's the way that term got into common usage.

Nobody in his right mind would think that depreciation is not an expense.

WARREN BUFFETT: Yeah. It — but it's very much in the interest of Wall Street.

CHARLIE MUNGER: Yes. That's why —

WARREN BUFFETT: You —

CHARLIE MUNGER: — they did it.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: It made the multiple seem lower.

WARREN BUFFETT: And what's amazing is the way it's accepted, actually.

But anyway, it just illustrates how people use language, you know, and sell concepts that work to their own use.

And "2 and 20" has the same sort of thing. I mean, the number of people — the amount of money that's overperformed after paying 2 and 20, compared to the expenses that have been incurred, I will assure you, makes for a terrible indictment of that particular arrangement.

But as long as it can get sold, it will get sold. And —

CHARLIE MUNGER: And, now, they use it in the business schools. Now, that is horror squared.

I mean — (laughter) — it's bad enough that a bunch of thieves start using a term. But when it gets so common that the business schools copy it, that is not a — that's not a good result.

WARREN BUFFETT: OK. (Applause)

30. "Nobody should be roadkill in this sort of society"

WARREN BUFFETT: Station 11.

AUDIENCE MEMBER: Good afternoon. I'm Whitney Tilson, a shareholder from New York.

My question is related to the ones asked earlier about job cuts. Perhaps, the only thing that makes American workers angrier than layoffs is to shut down an operation entirely and move the jobs overseas.

Ask anyone in Ohio or Michigan, and they'll tell you stories about companies that have been operating in those states for decades, benefitting from the educational system, infrastructure and so forth, things that were paid for by local taxpayers.

But, then, some high-paid consultants came along and showed the company how it could reduce its costs by relocating production to Mexico or China. And poof, the good U.S. jobs disappeared.

My observation is that most investors and those in corporate America today worship at the altar of maximizing shareholder value, which is code for doing whatever is necessary to boost the share price as high as possible.

But in doing so, companies are taking actions that make millions of workers feel, at best, fearful and left behind and, at worst, deeply harmed by corporate America.

It makes so many people so angry that I think it's testing the post-World War II economic order, which is rooted in free trade, and even the strength of our democracy. I'd argue that it was decisive in our last election.

So my question to you is, do you think that businesses should consider factors outside of pure economics when making these types of decisions? What obligations, if any, do they have to their employees and communities in which they operate?

And lastly, if a Berkshire CEO came to you and asked for your approval to close a U.S. operation and relocate it overseas to save money, what questions would you ask beyond the economics of this decision? Thank you.

WARREN BUFFETT: Yeah. Well, the truth is that — (applause) — in certain cases, production that would otherwise — that had formerly been in the United States has definitely been supplanted by production that comes from other parts of the world.

Originally — I was there when Fruit of the Loom was called Union Underwear and bought by Graham-Newman Corp in 1955, I believe. And it was probably all domestic then. And the truth is if it was all domestic now, it wouldn't exist.

We had the same thing happen with Dexter Shoe. And it was a wonderful company and skilled workers. And in the end, if we sold the shoes at a price that yielded what they cost us, they were not competitive with shoes from around the world.

Trade, I would argue — both ways, export, import — massive trade should be — and is, actually — enormously beneficial both to the United States and the world. I mean, it will — it — greater productivity will benefit the world in a general way.

But to be roadkill, to be the textile worker in New Bedford that was put out of a job eventually, to be the shoe worker in Dexter — at Dexter to be — was put out of work, you know, is —

I mean, it would be no fun to go through life and say, "I'm doing this for the greater good and so that shoes or underwear will sell for five percent less," or something, "and the American public will actually never know."

So what you need is two things, in my view. You've got an enormously prosperous country. You've got almost $60,000 of GDP per capita. It's unbelievable — six times what it was when I was born, in real terms.

So we've got the prosperity. And that prosperity is enhanced by trade. We were only exporting five percent of our GDP back in 1970, and that's — I think it's around 12 percent or something like that now.

We're doing what we do best. But we need an educator-in-chief, logically the president — I don't mean this specific president. I mean any president who's been around for decades — has to be able to explain to the American public the overall benefits of, essentially, free trade.

And then, beyond that, we have to have policies that take care of the people that become the roadkill in the process.

Because it doesn't make any difference to me if — as far as I'm concerned, if my life is miserable because I've been put out of business by something that's good for 320-some million people in some infinitesimal way, and it's messed up my life when I've tried to live it in a proper way.

So we have got the resources to take care of those people. The investors, I don't worry about. I wrote about this a few years ago.

The investors can diversify their investments in such a way that, overall, trade probably benefits them and they don't get killed by a specific industry condition.

But the worker, in many cases, can't do that. You're not going to retrain some 55-year-old worker in New Bedford who may not even speak English in our textile mill or something. I mean, they —

If they get destroyed by something that's good for society, they get destroyed, unless government puts in some policies that takes care of people like that. And we've got a rich society that can do that. And we got a society that will benefit by free trade.

And I think we ought to try to hit both objectives of making sure that there is not roadkill and that, at the same time, we get — 320 million people — get the benefits of free trade. (Applause)

Charlie?

CHARLIE MUNGER: Well, I don't quarrel with that. And we have unemployment insurance for that exact reason.

But I'm afraid that a capitalist system is always going to hurt some people as it modifies and improves. There's no way to avoid it.

WARREN BUFFETT: Yeah. Well, capitalism is brutal to capital if you're in the wrong businesses. And, like I say, you can diversify those results.

Capitalism is brutal to people that have the bad luck to be skilled or develop their skills for decades.

But a rich — a very rich society can actually — if it's beneficial to society overall, it can take care of those people. I mean, it just — you know, the new tax —

The bill that was passed a couple days ago reduces my taxes, you know, by 17 percent. You know, and is that needed by the government or anything of the sort?

CHARLIE MUNGER: I wouldn't start spending the money.

WARREN BUFFETT: No. And — (laughter) — but that was the will, I mean, of the —

No, I agree. I don't think — who knows what happens with the bill? But I'm just — to have that happen, and I don't think —

I think if you polled a thousand people in Omaha that were walking to a shopping center as to whether my tax bill had been cut by some very large sum because of what passed, I don't think many people would have the faintest idea what happened, in terms of the coverage of it and all of that that took place.

So I — we've got — we do have — it's probably more like 57- or $58,000 of GDP per capita — family of four, $230,000. But nobody should be roadkill in this sort of society —

CHARLIE MUNGER: Well, remember what Bismarck said: There are two things that nobody should have to watch. One is the making of the sausage. And the other is the making of legislation. (Laughter)

WARREN BUFFETT: Yeah. Well, I would say that somebody ought to watch. (Laughter)

Anyway, we've hit the magic hour of 3:30. We'll reconvene at 3:45 to do — have a formal shareholders meeting.

And that may take a while. So, you're welcome to stay and watch that. Or you're welcome to shop. And I might even have a small preference of that. But go — do whatever you wish. OK. (Applause)

31. Formal business meeting begins

WARREN BUFFETT: OK. Let's regroup.

If you'll all take your seats, we'll begin the formal meeting. And I'll work from a script in this.

The meeting will now come to order. I'm Warren Buffett, chairman of the board of the directors of the company. I welcome you to this 2017 annual meeting of shareholders.

This morning, I introduced the Berkshire Hathaway directors that are present. Also with us today are partners in the firm of Deloitte and Touche, our auditors.

Sharon Heck is secretary of Berkshire Hathaway, and she will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting, and she will certify to the count of votes cast in the election for directors and the motions to be voted upon at this meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg.

Does the secretary have a report of the number of Berkshire shares outstanding —?

VOICES: (Inaudible)

WARREN BUFFETT: if you don't mind, keep the lights on a little more so I can read this — outstanding, entitled to vote, and represented at the meeting?

SHARON HECK: Yes. I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 8th, 2017, the record date for this meeting, there were 770,994 shares of Class A Berkshire Hathaway common stock outstanding, with each share entitled to one vote on motions considered at the meeting, and 1,310,304,247 shares of Class B Berkshire Hathaway common stock outstanding, with each share entitled to 1/10,000th of one vote on motions considered at the meeting.

Of that number, 538,915 Class A shares and 734,450,954 Class B shares are represented at this meeting by proxies returned through Friday afternoon, May 5th.

WARREN BUFFETT: Thank you, Sharon. That number represents a quorum and will therefore — we will therefore directly proceed with the meeting.

The first item of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott, who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of the shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

RON OLSON: I second the motion.

WARREN BUFFETT: The motion has been moved and seconded. We will vote on the motion by voice vote. All those in favor say, “Aye.”

VOICES: Aye.

WARREN BUFFETT: I didn’t hear very many. But opposed? The motion is carried.

32. Election of Berkshire directors

WARREN BUFFETT: The next item of business is to elect directors. If a shareholder is present who did not send in a proxy or who wishes to withdraw a proxy previously sent in, you may vote in person on the election of directors and other matters to be considered at this meeting.

Please identify yourselves to one of the meeting officials in the aisle so that you can receive a ballot.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ron Olson, Walter Scott, and Meryl Witmer be elected as directors.

WARREN BUFFETT: Is there a second?

RON OLSON: I second the motion.

WARREN BUFFETT: It’s been moved and seconded that Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors.

Are there any other nominations or any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark the ballots on the election of directors and deliver their ballot to one of the meeting officials in the aisles.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday afternoon cast not less than 601,375 votes for each nominee.

That number exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. Warren Buffett, Charles Munger, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer have been elected as directors.

33. Advisory vote on Berkshire's executive compensation

WARREN BUFFETT: The next item on the agenda is an advisory vote on the compensation of Berkshire Hathaway's executive officers. I recognize Mr. Walter Scott to place a motion before the meeting at this time.

WALTER SCOTT: I move that the shareholders of the company approve, on an advisory basis, the compensation paid to the company's named executive directors as disclosed pursuant to Item 402 of Regulation S-K, including the compensation discussion and analysis, and the accompanying compensation tables, and the related narrative discussion, in the company's 2017 annual meeting proxy statement.

WARREN BUFFETT: Is there a second?

RON OLSON: I second the motion.

WARREN BUFFETT: It has been moved and seconded that the shareholders of the company approve, on an advisory basis, the compensation paid to the company's named executive officers.

Miss Amick, when you are ready you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday afternoon cast not less than 608,765 votes to approve, on an advisory basis, the compensation paid to the company's named executive officers.

That number exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The motion to approve, on an advisory basis, the compensation paid to the company's named executive officers has passed.

34. Advisory vote on frequency of advisory compensation votes

WARREN BUFFETT: The next item on the agenda is an advisory vote on the frequency of a shareholder advisory vote on compensation of Berkshire Hathaway's executive officers. I recognize Mr. Walter Scott to place a motion before the meeting on this item.

WALTER SCOTT: I move that the shareholders of the company determine, on an advisory basis, the frequency, whether annual, biannual, or triannual, with which they shall have an advisory vote on the compensation paid to the company's named executives as set forth in the company's 2017 annual meeting proxy statement.

WARREN BUFFETT: Is there a second?

RON OLSON: Second the motion.

WARREN BUFFETT: It has been moved and seconded that the shareholders of the company determine the frequency with which they shall have an advisory vote on compensation of named executive officers with the option being every one, two, or three years.

Miss Amick, when you are ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday afternoon cast 131,268 votes for a frequency of every year, 1,954 votes for a frequency of every two years, and 476,661 votes for a frequency of every three years of an advisory vote on the compensation paid to the company's named executive officers.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The shareholders of the company have determined, on an advisory basis, that they shall have an advisory vote on the compensation paid to the company's named executive officers every three years.

35. Shareholder motion to disclose political contributions

WARREN BUFFETT: The next item of business is the motion put forth by Clean Yield Asset Management on behalf of shareholders, Tom Beers and Mary Durfee. The motion is set forth in the proxy statement.

The motion requests that the company provide a report on its political contributions. The directors recommended that the shareholders vote against the proposal.

I will now recognize Eileen Durry (PH) — I hope I'm pronouncing that right — to present the motion.

To allow all interested shareholders present their views, I ask to limit the — I ask to limit her remarks to five minutes.

And the microzone — the microphone at zone 1 is available for those wishing to speak for or against the motion. Zone 1 is the only microphone station in operation.

For the benefit of those present, I ask that each speaker for or against the motion, with the exception of the original proposer, limit themselves to two minutes and confine your remarks solely to the motion.

And do we have, at station 1, the representative of Clean Yield Management? Or, wait. Sorry. Clean Yield Asset Management.

EILEEN DURRY: Good afternoon, Mr. Chairman, board of directors, and my fellow shareholders.

My name is Eileen Durry. And I have been asked to read the following statement by the filers of this proposal, Tom Beers and Mary Durfee.

Our proposal, number four on the proxy ballot, calls on Berkshire Hathaway to fully disclose the extent of its political spending.

Why do we ask for this? Corporate political spending is a controversial activity that must be carefully managed and overseen at the most senior levels of management.

Mismanagement or misjudgment around political contributions can bring reputation damage, political risks, and legal consequences.

In recent years, at the urging of shareholders and other stakeholders, scores of companies have adopted stronger disclosure and better oversight of political contributions.

Best practices in this area include full disclosure of direct and indirect political contributions, descriptions of policies and procedures to ensure full legal compliance, and a commitment to board oversight.

But our company's policies in this area are so nonexistent or hidden that they have earned it a score of zero for six years running on the leading rating system for corporate political disclosure and accountability, the CPA-Zicklin Index.

In contrast, 56 percent of the S&P make public a detailed policy governing political expenditures from corporate funds. Peers such as GE, Travelers, Unum, CSX, and Norfolk Southern disclose political spending.

In contrast, all we know about Berkshire's political spending is contained in the two paragraph response to our proposal in this year's proxy statement, which seeks to reassure us that Berkshire's political spending is small, relative to its size.

But management's statement raises more questions than it answers. It says nothing, for example, about whether Berkshire gives to third party, like trade associations and 501(c)(4)s, which are leading sources of dark money contributions that are nearly impossible to trace.

Since 2012, over $670 million in dark money was spent in the U.S. elections with no disclosure of who the underlying donors were.

Fellow shareholders, as you know, our company is a large and complicated enterprise. Berkshire Hathaway ranks number four in the Fortune 500.

At a time when the trend among large companies is to be more open about their political spending and their policies regarding dark money vehicles, it doesn't behoove or benefit Berkshire Hathaway to be so secretive if it has nothing to hide. If you agree, please vote in favor of proposal number four.

WARREN BUFFETT: Thank you. Are there other people that wish to speak on the motion?

EILEEN DURRY: Not that I know of.

WARREN BUFFETT: OK. Thank you.

And I will tell you that, to my knowledge, in 52 years, Berkshire Hathaway, at the parent company level, has not made a political contribution. I don't — I, personally, disagree strongly with the Citizens United decision, which was a five-to-four vote.

And I think that having unlimited contributions by wealthy individuals through super PACs and — or wealthy corporations — I do not think it's a plus at all. And I think it's a minus in our democracy. And I think that big money does — can often distort the political process.

It's a reality that any of our subsidiaries in heavily regulated industries are probably going to have to make some political contributions. Their competitors do it.

And I tell our managers, basically, if they — I don't want them making contributions on their own personal preferences in elections to be made from corporate funds. And I would regard that as a breach of trust with Berkshire.

But I do recognize that if they're in the railroad industry, or the electric utility industry, or whatever it may be, that there is a necessity, essentially, to make political contributions. And I'm sure they give money to people that I wouldn't vote for.

But that is a reality of doing business in certain businesses which have a significant political aspect to their activities.

So, I (inaudible) and my heart is with you to some extent, in terms of I wish Citizens United had gone the other way. I don't like the idea of great sums being spent.

But I do not think we — I think it — personally, I think that it could be disadvantageous to actually list all of the political organizations to which people contribute when competitors don't. And I think there's expense involved in all three of the proposals that are coming up on this one.

So I, personally, voted against the proposition. But I do hope, like you, that money plays a lesser part in politics — big money — in the future — and undisclosed money — than it does now. And I don't think the odds are good that the Supreme Court is going to reverse Citizens United.

So with that, I would say the motion is now ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballot on the motion and deliver their ballot to one of the meeting officials in the aisles.

Miss Amick, when you're ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday afternoon cast 64,449 votes for the motion and 542,399 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares properly cast on the matter, as well as all votes outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The proposal fails.

36. Shareholder motion on methane emissions

WARREN BUFFETT: The next item of business is put forth by Baldwin Brothers Inc. on behalf of shareholder Marcia Sage. The motion is set forth in the proxy statement.

The motion requests that the company provide a report reviewing the company's policies, actions, plans and reduction targets related to methane emissions from all operations. The directors have recommended that the shareholders vote against the proposal.

I will now recognize Eileen Durry to present the motion. To allow all interested shareholders to present their views, I ask her to limit her remarks to five minutes.

The microphone at zone 1 is available for those wishing to speak for or against the motion. Zone 1 is the only microphone station in operation.

For the benefit of those present, I ask that each speaker for and against — or against the motion — limit themselves to two minutes — although, Miss Durry, that's five minutes in your case — and to confine your remarks solely to the motion.

EILEEN DURRY: Good afternoon, Mr. Chairman, members of the board, and fellow shareholders.

My name is Eileen Durry. I am here to move Arjuna Capital and Baldwin Brothers' proposal on behalf of Marcia Sage, a long-term investor in our company.

Proposal five seeks to protect shareholder value by ensuring the transparent disclosure for information regarding methane emissions.

The reason for this proposal are clearly in the interest of protecting long-term shareholder value. Leaked gas has a direct economic impact on our company as it is no longer available for sale, establishing a clear business case for reduction targets and control processes.

In fact, leaked methane represented $30 billion of lost revenue in 2012, equivalent to three percent of gas produced globally.

The National Resources Defense Council estimates that capturing currently wasted gas for sale could reduce methane pollution by roughly 80 percent.

And while the climate benefit of replacing coal with natural gas has been widely publicized, that benefit is negated when leakage rates exceed 2.7 percent, as methane carries 84 times the global warming impact of CO_2 over a 20-year period.

Recent academic studies are particularly troubling as they have identified methane leakage far north of current EPA estimates. Additionally, gas storage presents outsized risks.

The 2015 failure of a gas injection well at Southern California Gas Company's Aliso Canyon storage field in Los Angeles revealed major vulnerabilities in the maintenance and safety of natural gas storage facilities. The incident exposed both a lack of oversight and contingency planning in the face of a well blowout.

Berkshire Hathaway has storage facilities that face similar risks as it is estimated to hold the 11th highest volume in natural gas in the country.

There are over 400 gas storage facilities around the country, many of which were drilled decades ago. Numerous independent researchers have concluded that if natural gas is to lead to a more sustainable energy future, then missing emissions must be addressed.

Ongoing concerns have spurred public debate and led to regulatory action at the state and federal level. A strong program of target-setting measurement, mitigation, and disclosure would indicate a reduction in regulatory risk as well as efficient operations maximizing gas for sale and shareholder value.

Given this, we believe our company has a tremendous opportunity to move forward by providing shareholders with this important information.

ISS, the leading provider of proxy voting advice, agrees and has a recommended a vote in favor, noting such disclosures would allow shareholders to better understand the company's management of its methane emissions and any related risks. Thank you for your consideration.

WARREN BUFFETT: Are there other people who wish to speak on this motion?

EILEEN DURRY: I don't believe so.

WARREN BUFFETT: OK. The motion is now ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballot on the motion and deliver their ballot to one of the meeting officials in the aisles. Miss Amick, when you're ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday afternoon cast 57,600 votes for the motion and 542,870 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares properly cast on the matter, as well as all votes outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Greg, incidentally — is there a live microphone? You're — yeah, there we — you might talk a little bit about the methane situation.

GREGORY ABEL: Sure, Warren. So thank you for your comments.

And when you think about methane emissions, it is a serious issue, relative to carbon. It was highlighted 84 times worse than a carbon emission. But I'd be very pleased to report on our situation at Berkshire Hathaway.

So, three different issues were raised in the comment. One was overall emissions from oil and gas production. So, the first thing I would just highlight is that we do not own any oil and gas producing assets. So we don't have any wells and, effectively, don't have that risk.

The second thing that was highlighted was the significant loss of gas at Aliso Canyon. It was a injection well that failed. Took many months to fix the well.

And if you fundamentally look at the problem there — and we do own other storage facilities, but we do not use their technology or that type of well. All of our wells are cased to the top which creates a very different risk and, literally, can be mitigated within hours.

And, then, the third issue which was raised was leakage rates. And it was highlighted, at least in a second response to the proposal, that the leading companies in the industry have a leakage rate of one percent, or they've put together programs to achieve a leakage rate of one percent.

And I'm happy to report, when we look at our leakage rate from our pipelines, we're at 0.53 of one percent. So, basically, half of the leading companies in the industry. So that, obviously, support the recommendation of the shareholders. Thank you.

WARREN BUFFETT: Thanks, Greg. You've heard the vote. And the proposal fails.

37. Shareholder motion to divest fossil fuel holdings

WARREN BUFFETT: The next item of business is a motion put forth by a shareholder, the Nebraska Peace Foundation. The motion is set forth in the proxy statement. The motion requests that the company divest of its holdings in companies involved in the extracting, processing, or burning of fossil fuels.

The directors have recommended the shareholders vote against the proposal.

I will now recognize Mark Vasina to present the motion. And, again, to allow all interested shareholders to present their views, I asked him to limit his remarks to five minutes.

And the microzone at zone 1 is available for those wishing to speak for or against the motion. Zone 1 is the only microphone station in operation.

And for the benefit of those present, subsequent speakers should — I ask that they limit themselves to two minutes and confine your remarks solely to the motion. With that, if you'll proceed.

MARK VASINA: Thank you. My name's Mark Vasina. I represent the Nebraska Peace Foundation. We're here to present our proposal asking Berkshire Hathaway to divest of its carbon-based assets over a period of 12 years, a period of time we believe is a very modest proposal indeed.

Last year, we were here with a proposal that Berkshire Hathaway evaluate and report on the impact of climate change on their insurance companies.

After our — after the meeting, we were approached by a number of shareholders who suggested we were pulling our punches. And they suggested the real question is divestiture. So we thought about it. We came back to ask for divestiture of the carbon-based assets.

We recognize that for a public company that's involved in investing in other companies, divestiture represents different kinds of challenges from those of university endowments, pension plans, public foundations, such as the Bill and Melinda Gates Foundation — organizations which have divested or have implemented divestiture plans.

However, we believe that the necessity for divestiture involves more than just a social, ethical, or even moral question, but also involves financial risk.

As the Bank of England, in their recommendation to the insurance companies that they regulated, that they investigate and report on the climate change risk to these companies, they pointed out that financial risk of holding these carbon-based assets was real — unpredictable.

Things like regulatory risk, political risk, technology changes, investment — investor sentiment changes — these things pose risks towards the financial value of assets in this type of investment.

So we are proposing, as I said, divestiture of all carbon-based assets over 12 years.

I'm going to be followed by three prominent American climate scientists, Frank LaMere of the Winnebago tribe of Nebraska, and Richard Miller, Creighton University theologian. Thank you for giving us the opportunity to make our case for this proposal.

WARREN BUFFETT: Thank you. And we'll proceed to the next speaker, please.

MICHAEL MANN: Chairman Buffett, board members and shareholders, my name is Michael Mann. I'm a professor at Penn State University and a climate scientist.

And as a scientist who spends much of my time communicating the reality and threat of climate change, it's an honor to have this opportunity to speak to you today.

Warren Buffett, known as the Wizard of Omaha, is an inspiration to many, a symbol of the value of work ethic, self-made success, and the great reward that comes with foresight.

Now, foresight means recognizing both opportunity and risk. And when it comes to risk, there is no better example than climate change. I recently co-authored an article in the journal, "Scientific Reports," for example, demonstrating that climate change played a key role in the onslaught of unprecedented, devastating droughts, floods, and heat waves in recent years.

And the impacts we're seeing now are just the veritable tip of the iceberg. Carbon emissions must be brought down dramatically within the next few years if we are to avert the worst impacts of climate change.

Mr. Buffett coined the term "Noah's Law" in his 2015 shareholder letter to describe the risk posed by climate change, stating, "If there is only a one percent chance the planet is heading toward a truly major disaster and delay means passing a point of no return, inaction now is foolhardy."

Well, I couldn't agree more. And the science tells us that we are heading toward disaster in the absence of substantial reductions in greenhouse gas emissions.

Board member Bill Gates demonstrated bold leadership a year ago when the Bill and Melinda Gates Foundation announced it was divesting of fossil fuel holdings.

Were Mr. Buffett to follow suit, it would send a profound message to the rest of the global business community, a message that we can both mitigate risk and seize opportunity in the form of massive growth in clean energy technology by tackling this problem now head-on before it's too late. Thank you.

WARREN BUFFETT: Thank you. And I believe there's another speaker or maybe two. If you'll identify yourself, please.

RICHARD SOMERVILLE: My name is Richard Somerville. I'm a climate scientist and a professor at the University of California San Diego.

Chairman Buffett, board and shareholders, the world is warming. It is due to human activities. It is getting worse. The observational evidence is overwhelming.

All the warmest years, globally, are recent years. We see the weather changing. We see more severe floods and droughts. Sea level rise is accelerating. Ice sheets and glaciers are shrinking worldwide.

Climate change will become more and more serious unless emissions of heat-trapping gases and particles are quickly and drastically reduced.

The biggest unknown about future climate is human behavior. Everything depends on what humanity does now. We have our hands on the thermostat that controls the climate of our children and grandchildren.

In 2015, the nations of the world agreed in Paris on how much warming can safely be allowed. The Paris target was informed by science. And the science shows that to meet the target, emissions need to be reduced drastically and quickly.

We cannot just muddle through. Dithering and procrastinating lead to catastrophe. Alleviating the disruption of climate change is cheap compared to coping with the damage that unmitigated climate change will cause.

Want an example? Doing nothing about climate change means that sea level will become so high that coastal cities must eventually be abandoned.

We caused this problem. We can solve it. And polls show that most Americans want strong actions to limit climate change.

The forces driving clean energy are powerful. The market is turning against fossil fuels. The prices of solar and wind energy are dropping. They can already compete without subsidies. Vehicle electrification is happening fast.

Clean energy provides jobs and economic growth. Progress and prosperity do not require emitting heat-trapping gasses.

Berkshire Hathaway and Warren Buffett are rightly admired and respected worldwide. Helping the world confront climate change should be an important part of their legacy. We owe it to our children and grandchildren. Thank you.

WARREN BUFFETT: Thank you. I believe there’s one more speaker. (Applause)

DAVID TITLEY: Thank you, sir. I am David Titley, retired rear admiral, former oceanographer of the Navy and now a professor of practice at Penn State.

I’ve been a shareholder of Berkshire Hathaway since December of 2000. Thank you, sir, for your leadership of this enterprise.

When I was stationed at the Pentagon, I had the privilege of working directly for the Pentagon’s foremost strategic planner, Mr. Andrew Marshall.

He taught me how to think about risk, and especially risks that may seem distant or low probability, but one with very high impact, such as weapons of mass destruction. Climate change is a fat tail, emerging risk.

It's really a risk to people, to us. And when this risk is not managed, we have a security problem.

One example would be Syria. Climate is one of the links in a long chain of events that led to the tragic outcome. Non-climate events, such as over a million refugees pouring into Syrian cities from the Iraq War, stress Syrian governance.

Then, about a decade ago, an exceptionally intense drought and heat spell, linked with high confidence to a changing climate, devastated Syrian agriculture. Now, you have millions of desperate people with nothing and a breeding ground for extremists.

Syria is an example of why, in the security community, we say that climate change accelerates the risks of instability. It can make bad places worse, a lot worse.

Senior military officers know you must address risks and take precautions while you can, before it's too late. The U.S. Defense Department understands the risks of climate change. And it's been working quietly to adapt to the changing climate for years.

Winston Churchill is alleged to have said, "Americans can always be counted upon to do the right thing after exhausting every other possibility." But we will prevail. And you, sir, can help.

Here's my ask. What are government and business leaders doing to stabilize the climate? We should reduce rather than accept the risks of unchecked climate change because the ice doesn't care which party controls the White House or the Congress. It just melts. Thank you. (Applause)

FRANK LAMERE: I am Frank LaMere, of the Bear Clan of the Winnebago Tribe of Nebraska.

It was the indigenous people of this continent who first consecrated the ground on which we live and grow, who offered up prayers and petitions asking that we be allowed to live and to provide a way for the generations to come.

In exchange for the blessings given by the creator, our forbearers agreed to be good stewards of the land. The stewardship of our Mother Earth, who provides for us, has now changed. But the covenant remains the same. Let there be no mistake about that.

If we continue to disrespect our earth mother, those things given us, bountiful harvest, protection from the elements and good, clean water will surely be taken from us. Our elders speak of this. It has been foretold.

On Christmas Eve, my son came from Standing Rock to visit us for one hour. His mother and I worried about him. “How is it there? Why did you go?” I asked. He said, “It is dangerous, dad. But someone has to protect our water.”

I nodded and said, “Ahoo! That is good.” He is a water protector. I stand on his shoulders. Mni wiconi. The protectors proclaim water is life.

Bearing that in mind, I am told that this waterway flowing south from Standing Rock and passing just a short walk from here would be fouled by any kind of breach in the Dakota Access Pipeline.

My sense and my years tells me that this will happen. Millions would be poisoned.

I’m further told that this collective body holds a 15 percent interest in the — an oil company that is a 25 percent shareholder in the Dakota Access Pipeline.

I would ask that you walk away from that investment, stand with Mother Earth today.

I’m a Winnebago Indian. The Missouri River brought us here when we had no place to go.

We stand with our Mother Earth now as she stood with us. Think about that. Mni wiconi. Water is life. Pinagigi. Thank you.

WARREN BUFFETT: Thank you. (Applause)

RICHARD MILLER: Dear Chairman Buffett, board members and shareholders.

I am Richard Miller. I am an associate professor of philosophical theology and sustainability studies at Creighton University. I write and teach on ethical issues raised by the climate crisis.

As a rationale for voting no on the divestment resolution, the board maintained that Berkshire should not limit its universe of potential investments based upon complex social and moral issues, and that following state and federal laws was sufficient to meet your obligations.

There is not only an overwhelming consensus in the scientific community about the reality and dangers of climate change, but there is also an overwhelming consensus among all major ethical theories that is one not morally justified to use increased profit as a rationale for doing harm to others.

By continuing to invest in, and thus promote, the extracting, processing, and burning of fossil fuels, Berkshire is doing harm to people around the world and creating conditions that will threaten future generations.

While one is not morally justified to use increased profits as a rationale for doing harm to others, one cannot also opt out of ethical considerations by appealing to moral complexity. When you're doing harm to others, especially at that — this scale, there is no neutral space.

Nor can you simply appeal to the fact that Berkshire is following state and federal laws when those laws are, themselves, unethical in that they allow the United States to violate the human rights of people around the world and set in motion catastrophic future for young people.

The consensus among ethical theories will, in due time, become self-evident to the average person, analogous to the way slavery, as an evil, is self-evident today.

Indeed, the recognition of the immorality of investing in fossil fuels is rapidly gaining ground as more and more institutions divest their fossil fuel holdings.

Mr. Buffett, you're standing on an ethical house of cards. It is only a matter of time before it comes tumbling down.

Like the thousands gathered here and the millions on live stream, I admire your considerable achievements. But I am afraid that if you do not change course very soon, history will not judge you kindly. Thank you for your time.

WARREN BUFFETT: OK. Thank you. (Applause)

The motion is now ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the motion and deliver their ballots to one of the meeting officials in the aisles.

Miss Amick, when you're ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Friday afternoon cast 7,784 votes for the motion and 594,044 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares properly cast on the matter, as well as all votes outstanding, the motion has failed.

The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The proposal fails. And Mr. Scott, do you have a motion?

WALTER SCOTT: I move the meeting be adjourned.

WARREN BUFFETT: Is there a second?

RON OLSON: I second the motion.

WARREN BUFFETT: The motion to adjourn has now been made and seconded. We will vote by voice. Any discussion, if not, all in favor say, “Aye.”

VOICES: Aye.

Morning Session - 2018 Meeting

1. Buffett opens a box of peanut brittle for Munger

WARREN BUFFETT: Good morning.

VOICE: Warren and Charlie, we love you! (Applause)

WARREN BUFFETT: I'm Warren. He's Charlie. Charlie does most things better than I do, but - (laughter) - you know, this one's a little tough. Charlie, maybe you can chew on that a while. OK. (Laughter)

At the formal meeting that will begin at 3:45, we will elect 14 directors. Charlie and I are two of them, and I would like to introduce the other 12. I'll do it in alphabetical order.

If they will stand as I announce their name. Withhold your applause. May be hard to do, but give it your best. And when we get all through, then you can let loose, but -

We'll do this alphabetically beginning with Greg Abel, if you'll stand and stay standing. Howard Buffett, Steve Burke, Sue Decker, Bill Gates, Sandy Gottesman, Charlotte Guyman, Ajit Jain, Tom Murphy, Ron Olson, Walter Scott, and Meryl Witmer. (Applause)

2. Accounting-rule net loss "not representative" of the business

WARREN BUFFETT: Let's see. This morning, we posted both our earnings and our 10-Q. And if we can put up slide one, you can take a look at what was reported.

And as I warned you in the annual report, a new accounting rule was introduced at the beginning of this year. And it provides that our equity securities, whether we sell them or not, are marked to market every day.

So we can have a gain or loss of a couple billion dollars in our equity securities portfolio, and that day, according to the accounting principles now in effect, which are a change, will be recorded as making a couple billion dollars that day or losing a couple billion.

And I told you that would produce some very unusual effects from quarter to quarter. And it further explains why I like to release our earnings early Saturday morning and - as well as the 10-Q - to give people a chance to read through the explanation.

Because if you just were handed this with a TV monitor, you know, at 3:30 in the afternoon or whatever it might be, you would report the net earnings figure, understandably, very quickly. And it really is not representative of what's going on in the business at all.

So, if you look at the figure of operating earnings, which is what we look at, we actually earned a record amount for any quarter we've ever had.

And that includes no realized gains or losses on securities, or on the few remaining derivatives we have.

You might leave that slide up there just a little longer. Maybe it is up -

The insurance underwriting - GEICO had a quite a good-sized turnaround in profitability and a good gain, although not as big a gain as last year, which was a record in terms of policies in force and, really, throughout most of our businesses.

And the details are in the 10-Q, which is up on our website now.

And as you can see, the railroad was up significantly, and we had - most of our businesses tended to be up.

Now we were aided in that, in a material way, by the reduction in the federal income tax rate from 35 percent to 21 percent. Our businesses were up significantly on a pretax basis, but the gain was further enhanced by the change in the income tax rate.

So that pretty well sums up the first quarter. We'll probably get some - may well get some questions on it when we get into the question and answer section.

3. Master class: How to think about investments

WARREN BUFFETT: The questions we'll be getting, we've got the press over here, and then we have the analysts on my left. And of course, we have our partners out in front of me. And we will rotate among you.

And the questions we get, as we go through the next six hours or so, will understandably relate to a lot of current events. You know, you will -

We may get asked, and we don't know the questions, but we may get asked, you know, about Fed policy, or whether we're seeing any inflation, or whether business is speeding up or down, or the threats we may face competitively in our businesses as we go along.

And you - anything goes on the questions, except we won't tell you what we're buying or selling. But it really can be a question sometimes of confusing the forest with the trees.

And I would like to just spend just a couple of minutes giving you a little perspective on how you might think about investments, as opposed to the tendency to focus on what's happening today, or even this minute, as you go through.

And to help me in doing that, I'd like to go back through a little personal history.

And we will start - I have here a New York Times of March 12th, 1942. I'm a little behind on my reading. (Laughter)

And if you go back to that time, that - it was about, what? Just about three months since we got involved in a war which we were losing at that point.

The newspaper headlines were filled with bad news from the Pacific. And I've taken just a couple of the headlines from the days preceding March 11th, which I'll explain was kind of a momentous day for me.

And so you can see these headlines. We've got slide two up there, I believe. And we were in trouble, big trouble, in the Pacific. It was only going to be a couple months later that the Philippines fell, but we were getting bad news.

We might go to slide three for March 9th. Hope you can read the headlines, anyway. The price of the paper's three cents, incidentally.

The - and let's see, we've got March 10th up there, as slide - I - when I get to where there's advanced technology of slides, I want to make sure I'm showing you the same thing that I'm seeing in front of me.

So anyway, on March 10th, when again, the news was bad: "Foe Clearing Path to Australia." And it was like it - the stock market had been reflecting this.

And I'd been watching a stock called Cities Service preferred stock, which had sold at $84 the previous year. It had sold at $55 the year - early in January, two months earlier - and now it was down to $40 on March 10th.

So that night, despite these headlines, I said to my dad - I said, "I think I'd like to pull the trigger, and I'd like you to buy me three shares of Cities Service preferred" the next day.

And that was all I had. I mean, that was my capital accumulated over the previous five years or thereabouts. And so my dad, the next morning, bought three shares.

Well, let's take a look at what happened the next day. Let's go to the next slide, please. And it was not a good day. The stock market, the Dow Jones Industrials, broke 100 on the downside.

Now they were down 2.28 percent as you see, but that was the equivalent of about a 500-point drop now. So I'm in school wondering what is going on, of course.

Incidentally, you'll see on the left side of the chart, the New York Times put the Dow Jones Industrial Average below all the averages they calculated. They - they had their own averages, which have since disappeared, but the Dow Jones has continued.

So the next day - we can go to the next slide - and you will see what happened. The stock that was at 39 - my dad bought my stock right away in the morning because I'd asked him to, my three shares. And so I paid the high for the day.

That 38 1/4 was my tick, which was the high for the day. And by the end of the day, it was down to 37, which was really kind of characteristic of my timing in stocks that was going to appear in future years. (Laughs)

But it was on the - what was then called the New York Curb Exchange, then became the American Stock Exchange.

But things, even though the war, until the Battle of Midway, looked very bad and - and if you'll turn to the next slide, please - you'll see that the stock did rather well. I mean, you can see where I bought at 38 1/4.

And then the stock went on, actually, to eventually be called by the Cities Service Company for over $200 a share. But this is not a happy story because, if you go to the next page, you will see that I - (Laughter)

Well, as they always say, "It seemed like a good idea at the time," you know. (Laughter)

So I sold - I made $5 on it. It was, again, typical - (laughs) - of my behavior. But when you watch it go down to 27, you know, it looked pretty good to get that profit.

Well, what's the point of all this? Well, we can leave behind the Cities Service story, and I would like you to, again, imagine yourself back on March 11th of 1942.

And as I say, things were looking bad in the European theater as well as what was going on in the Pacific. But everybody in this country knew America was going to win the war. I mean, it was, you know, we'd gotten blindsided, but we were going to win the war. And we knew that the American system had been working well since 1776.

So, if you'll turn to the next slide, I'd like you to imagine that at that time you had invested $10,000. And you put that money in an index fund - we didn't have index funds then - but you, in effect, bought the S&P 500.

Now I would like you to think a while, and don't - do not change the slide here for a minute.

I'd like you to think about how much that $10,000 would now be worth, if you just had one basic premise, just like in buying a farm you buy it to hold throughout your lifetime and depend - and you look to the output of the farm to determine whether you made a wise investment.

You look to the output of the apartment house to decide whether you made a wise investment if you buy an apartment - small apartment house - to hold for your life.

And let's say, instead, you decided to put the $10,000 in and hold a piece of American business, and never look another stock quote, never listen to another person give you advice or anything of this sort.

I want you to think how much money you might have now. And now that you've got a number in your head, let's go to the next slide, and we'll get the answer.

You'd have $51 million. And you wouldn't have had to do anything. You wouldn't have to understand accounting. You wouldn't have to look at your quotations every day like I did that first day - (laughs) - when I'd already lost $3.75 by the time I came home from school.

All you had to do was figure that America was going to do well over time, that we would overcome the current difficulties, and that if America did well, American business would do well.

You didn't have to pick out winning stocks. You didn't have to pick out a winning time or anything of the sort. You basically just had to make one investment decision in your life.

And that wasn't the only time to do it. I mean, I can go back and pick other times that would work out to even greater gains.

But as you listen to the questions and answers we give today, just remember that the overriding question is, "How is American business going to do over your investing lifetime?"

I would like to make one other comment because it's a little bit interesting. Let's say you'd taken that $10,000 and you'd listened to the prophets of doom and gloom around you, and you'll get that constantly throughout your life. And instead, you'd used the $10,000 to buy gold.

Now for your $10,000 you would have been able to buy about 300 ounces of gold. And while the businesses were reinvesting in more plants, and new inventions came along, you would go down every year in your - look in your safe deposit box - and you'd have your 300 ounces of gold.

And you could look at it, and you could fondle it, and you could - I mean, whatever you wanted to do with it. (Laughter)

But it didn't produce anything. It was never going to produce anything.

And what would you have today? You would have 300 ounces of gold just like you had in March of 1942, and it would be worth approximately $400,000.

So if you decided to go with a nonproductive asset - gold - instead of a productive asset, which actually was earning more money and reinvesting and paying dividends and maybe purchasing stock - whatever it might be - you would now have over 100 times the value of what you would have had with a nonproductive asset.

In other words, for every dollar you had made in American business, you'd have less than a penny by - of gain - by buying in this store of value, which people tell you to run to every time you get scared by the headlines or something of the sort.

It's just remarkable to me that we have operated in this country with the greatest tailwind at our back that you can imagine. It's an investor's haven - I mean, you can't really fail at it unless you buy the wrong stock or just get excited at the wrong time.

But if you'd - if you owned a cross-section of America and you put your money in consistently over the years, there's just - there's no comparison against owning something that's going to produce nothing.

And there - frankly - there's no comparison with trying to jump in and out of stocks and pay investment advisors.

If you'd followed my advice, incidentally - or this retrospective advice - which is always so easy to give - (Laughs)

If you'd follow that, of course you - there's one problem. Your friendly stock broker would have starved to death.

I mean, you know, and you could have gone to the funeral to atone for their fate. But the truth is, you would have been better off doing this than a very, very, very high percentage of investment professionals have done, or people have done that are active that - it's very hard to move around successfully and beat, really, what can be done with a very relaxed philosophy.

And you do not have to be - you do not have to know as much about accounting or stock market terminology or whatever else it may be, or what the Fed is going to do next time and whether it's going to raise three times or four times or two times.

None of that counts at all, really, in a lifetime of investing. What counts is having a philosophy that you've - that you stick with, that you understand why you're in it, and then you forget about doing things that you don't know how to do.

4. Nothing's changed - Buffett's still "semi-retired"

WARREN BUFFETT: So with all those happy words, we will move on and start the questioning, and we'll start with Carol.

CAROL LOOMIS: Good morning. In choosing a first question to ask each year, I look for a question that is definitely Berkshire-related and is timely. And this question seemed to fill the bill. The question came from William Anderson (PH) of Salem, Oregon.

And he said, "Mr. Buffett, you have previously said that there are two parts to your job, overseeing the managers and capital allocation. Mr. [Greg] Abel and Mr. [Ajit] Jain now oversee the managers, which leaves you with capital allocation.

"However, you share capital allocation with Ted Weschler and Todd Combs. Question. Does all that mean you are semi-retired? Or if not, please explain." (Laughter)

WARREN BUFFETT: I've been semi-retired for decades. (Laughter)

The answer is that I was probably - well, it's hard to break down the percentage of the time that I was involved in but now - the jobs that are now done by Ajit and Greg, and in the case of investing, the sub part of the job that is done by Ted and Todd.

Ted and Todd each manage 12- or $13 billion, so in total, that's 25 billion. And we have in equities 170-some billion, probably now, and 20 billion in longer-term bonds, and another hundred billion in cash and short-term.

So they're managing 20 - 25 and doing a very good job. And I still have the responsibility, basically, for the other 300 billion. So - (Laughter and applause)

I think Charlie will tell you - in fact, I'd like him to comment - nothing's really changed that much. We've got - clearly we've got two people in Ajit and Greg that are smarter, more energetic, just bring more to the job every day.

But they don't bring too much, because the culture is that our managers are running their business. But there's a lot - there's a good bit to oversee. So they do a superb job.

And Ted and Todd not only do a great job with the 12 or 13 billion each - they started with a couple billion each - not that it's all been the growth of the 2 billion - but they also do - have done a number of things for Berkshire that they do it cheerfully, but more important, very skillfully.

So there's just - there's one thing after another that I will have them looking into or working on. And sometimes I steal their ideas and -

But I think, actually, semi-retired is probably - catches me at my most active point. I think if - (laughter) - your questioner's got a good point.

OK, Charlie?

CHARLIE MUNGER: Well, I've watched Warren for a long time, and he sits around reading most of the time and thinking. And every once in a while he talks on the phone or talks to somebody. I can't see any great difference. A lot of people - (Laughter)

Part of the Berkshire secret is that when there's nothing to do, Warren is very good at doing nothing. (Laughter)

WARREN BUFFETT: I'm still looking forward to being a mattress tester. (Laughter)

5. Precision Castparts is "a very good business"

WARREN BUFFETT: OK, Jonathan Brandt.

JONATHAN BRANDT: Hi Warren. Hi Charlie. Given the growth in airplane build rates, it seems surprising that Precision Castparts isn't doing better on the top or bottom line.

I understand the issue with a bumpy transition from old to new programs, but I've also heard from industry sources that Precision's market position is not as strong as it used to be amid intensifying competition and some technological disruption.

What does Precision need to do to solidify and strengthen its preeminent position with its aerospace customers so that it can deliver the growth you expected when Berkshire acquired it?

WARREN BUFFETT: Yeah -

JONATHAN BRANDT: More generally, two years after the acquisition, what is your outlook for that business?

WARREN BUFFETT: Give me the last part again. The outlook.

JONATHAN BRANDT: More generally, two years after the acquisition, what is your updated outlook for that business longer term?

WARREN BUFFETT: Oh, longer term, I think - and in the reasonably shorter term - it's a very good business. I mean, you were -

You mentioned aircraft, but we get into other industries. But certainly aircraft's the most important. You have manufacturers that are very dependent on both the quality of the parts and the promptness of delivery.

You do not want to have an aircraft with 75- or 100- or maybe $200 million and be waiting for a part or something of the sort. So it's -

Reliability is, both in terms of quality and delivery times and all of that sort of thing, is enormously important. And we get contracts that extend out many years. And sometimes we - I mean, we will get them well before the plane even starts in production. So there's very long lead times.

And we have found in the last year - found it earlier, but I know of some specific cases in the last year - where other suppliers have failed in their deliveries and then the manufacturers come to us and say, "We would like you to help us out."

And we say, "Well, we'd be glad to help you out, but we'd like about a five-year contract, if we're going to do it because we're just not going to make up for these other guys' shortfalls periodically." But that sort of thing has a very long lead time.

The business is a very good business. One thing you will see their earnings charged with is about $400 million - little over $400 million a year - of intangible - nondeductible in that case - amortization of goodwill, which is really - is not an economic cost in my view.

We have a significant amount of that through Berkshire, but by far, the largest amount is related to the Precision acquisition. So whatever you see, you can add about 400 million that in my view is not an economic expense, but the accountants would argue otherwise. But it's our money, so we'll take my view. The - (Laughter)

Mark Donegan, who runs that operation, is incredible, and he has been not only - he's a fabulous manager. I wouldn't have bought it without him in charge. He also has been very helpful to us in other areas, and he loves to do it. So you can't beat him, both as a manager in his own operation, but with his devotion to really doing everything that will help Berkshire.

It was - it's a very good acquisition with very long tails to the products that are being developed.

Charlie?

CHARLIE MUNGER: Well, yeah, I think we'd buy another one just like it tomorrow if we had the chance.

WARREN BUFFETT: Yeah, that's the answer. (Laughter)

Man of few words, but he gets the point. (Laughter)

6. Trade benefits are huge, so U.S. and China won't do something "foolish"

WARREN BUFFETT: OK, now we will go to the shareholder in Station 1. I believe that's probably up here to my right.

AUDIENCE MEMBER: Hello. This is Chao (PH) from Wuxi, China, (Inaudible) Capital. I've been to the meeting for 12 years. Wish you and Charlie good health, so we could see you both from meeting for 12 more years.

WARREN BUFFETT: Thank you. (Applause)

AUDIENCE MEMBER: Quick question. We know both you and China delegations - U.S. and China delegations - are in China for intense discussion, also called a trade war.

Let's go one step beyond the trade war. Do you think there's a win-win situation for both countries or the world is just too small for both to win and we have to revisit your 1942 chart again? Thank you.

WARREN BUFFETT: Thank you. I'd like to just mention one thing. In August, I'm going to be 88, and that will be the eighth month of the year, and it's a year that ends with an eight.

And as you and I both know, eight is a very lucky number in China. So if you find anything over there for me, this is the time we should be acquiring something. All those eights.

AUDIENCE MEMBER: Will do. (Buffett laughs)

WARREN BUFFETT: The United States and China are going to be the two superpowers of the world, economically and in other ways, for a long, long, long time.

We have a lot of common interests, and like any two big economic entities, there are times when there'll be tensions.

But it is a win-win situation when the world trades, basically. And China and the U.S. are the two big factors in that, but there's plenty of other citizens of the world that are involved in how this comes out. And there is no question -

The nice thing about in this country I think is that both Democrats and Republicans basically, on balance, believe in the benefits of free trade.

And we will have disagreements with each other. We'll have disagreements with other countries on trade.

But it's just too big and too obvious for - that the benefits are huge, and the world's dependent on it in a major way for its progress, that two intelligent countries will do something extremely foolish.

We both may do things that are mildly foolish from time to time, and there is some give and take, obviously, involved.

But U.S. exports in 1970 and U.S. imports in 1970 were both about 5 percent of GDP. I mean, here we we were, selling 5 percent of our GDP and buying up 5 percent of our GDP, basically.

Now people think we don't export a lot of things. Our exports are 11 and a fraction percent of GDP. They've more than doubled as a share of this rising GDP. But the imports are about 14 1/2 percent, so there's a gap of three percent or thereabouts.

And I would not like that gap to get too wide. But when you think about it, it's really not the worst thing in the world to have somebody send you a lot of goods that you want and hand them little pieces of paper.

I mean, because the balancing item is, if you have a surplus or deficit in your trade, you're going to have a surplus in investment.

And so the world is getting more claim checks on the United States, and they - to some extent they buy our government securities, they can buy businesses.

And over time, you don't want the gap to get to be too wide because the amount of claim checks you are giving out to the rest of the world could get a little unpleasant under some circumstances.

But we've done remarkably well with trade. China's done remarkably well with trade. The countries of the world have done remarkably well with trade. So it is a win-win situation.

And the only problem gets to be when one side or the other may want to win a little bit too much, and then you have a certain amount of tension.

But we will not sacrifice - the world, I mean - will not sacrifice world prosperity based on differences that arise in trade.

Charlie?

CHARLIE MUNGER: Yeah, well I think that both countries have been advancing. And of course China is advancing faster economically, because it started from a lower base and they've had a little more virtue than practically anybody else in the world in having a high savings rate.

And of course, a country that was mired in poverty for a long, long time, and that assimilates the advanced technology of the world, and has a big savings rate, is going to advance faster than some very mature company like Britain or the United States. And that's what's happened.

But I think we're getting along fine, and I'm very optimistic that both nations will be smart enough to realize that the last thing they should do is have any ill will for the other.

7. Deals don't depend on Buffett: "The reputation belongs to Berkshire now"

WARREN BUFFETT: OK, Becky Quick. (Applause)

BECKY QUICK: This question comes from Kirk Thompson.

He says, “Warren, in this year’s annual letter to shareholders, you referenced both cheap debt and a willingness by other companies to leverage themselves as competitive examples as to why it’s hard to get more acquisition deals done.

“It seems like the trust in - and prestige of doing a deal with Warren Buffett and Charlie Munger allow Berkshire to get a hometown discount and beat out other firms that might pay a little more to a prospective seller.

“Have you given thought to having other Berkshire managers have more public exposure, so future generations of successful business owners continue to bring deal opportunities to Berkshire like they have in prior decades?”

WARREN BUFFETT: Yeah, that sort of reminds me of - who was it? Tony O’Reilly remarked one time about the responsibility of a CEO.

That the very first job of the CEO was to search through his organization and find that person who had the initiative and the brains, the determination, all of the qualities to be his logical successor, and then fire the guy. (Laughter)

The - there’s no question. I think the reputation of Berkshire as being a very good home for companies - particularly private companies - but a good home for companies, I don’t think that reputation is dependent on me or Charlie.

It may take a little, you know, there’ll be a little testing period for whoever takes over, in that respect. But, you know, basically we’ve got the money to do the deals. We’ll have the money to do the deals subsequently. People can see how our subsidiaries operate in the future.

And the truth is that, I think some of the other executives are going - are getting better known. But there will be a - you know, I’ll tell you this, if things get bad enough, you don’t have to worry. They’ll be calling us no matter what. (Laughs)

So I do not worry about the so-called “deal flow,” which is a term I hate. But I don’t think there’s - I think that’s dependent on Berkshire and not dependent on me.

And, you know, as I’ve mentioned, my phone isn’t ringing off the hook with good deals. So apparently this big winning personality or something is not delivering for you. (Laughter)

So it may be the next person will be even more - get even more calls.

Berkshire - the reputation belongs to Berkshire now. And we are, for somebody that cares about a business that they and their parents and maybe their grandparents lovingly built over decades - if they care about where that business ends up being after, for one reason or another, they don't want to keep it or can't keep it in the family, we absolutely are the first call.

And we will continue to be the first call, whether Charlie or I answer the phone or somebody else does.

Charlie?

CHARLIE MUNGER: Well, a lot of the subsidiaries have for a long time already been making all kinds of acquisitions with people they know and we don't. So it's already happening. And, in fact, it's happening more there than it is at headquarters, so -

WARREN BUFFETT: Don't tell them, Charlie.

CHARLIE MUNGER: You're getting your wish. (Laughter)

And it is weird that about 99 percent of the public companies that change hands, in terms of control, change hands in a sort of auction presided over by an investment banker.

And the people that buy are usually just leverage it to the gills, and when it starts doing a little better, they re-leverage it.

And that money is coming out of the charitable endowments and pension plans who are making these highly-leveraged investments in all these companies changing hands at very high prices. Sooner or later, this is not going to work perfectly.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And it's going to have an unpleasant episode. And I think we'll be around and in good shape at that time.

WARREN BUFFETT: There was one fellow who came to me many years ago. And he had a wonderful business. And he had been worried because he had seen a friend of his die.

And the problems that arose later when the managers, to some extent, tried to take advantage of the widow. And it became a disaster.

So he said he thought about it a lot the previous year. And he decided he didn't want to sell the business to a competitor, who would be a logical buyer, because they would fire all of his people. And the CFO that would remain, and, you know, all up and down the line, they'd all be the acquirer's people. He didn't want to do that to his people.

And then he thought, and he didn't want to sell it to a private equity firm, because he thought they'd leverage it up. He never liked to leverage that much, and then they'd just resell it later on to somebody, so it would be totally out of control of what he wanted to do.

And he wanted to keep running it himself. So he said, "Warren," he said, "It isn't that you're such a great guy," he says, "It's you're the only one left." So - (Laughter) -

Berkshire will continue to be the only one left in many cases.

8. "We don't know what we're doing" in cyber insurance

WARREN BUFFETT: Gary Ransom.

GARY RANSOM: Good morning. Warren, in your annual letter, you wrote about a potential for a $400 billion natural catastrophe event, something out in the tail of the loss distribution. I can think of another risk that could have a similar order of magnitude, and that would be cyberrisk.

I'm sure all your managers have taken steps against that potential, but in - out in the tail of the cyberrisk distribution, it could hit a lot of industries, a lot of your companies. So how do you think about and prepare for the big one in cyber?

WARREN BUFFETT: Yeah. Well, I include, incidentally, in my - that part I wrote in the annual report where I said that roughly - nobody knows the answer on this. I mean, I could stick down two, and somebody else much smarter in insurance would stick down a different figure.

But I think it's about a 2 percent risk of what I call a 400 billion super-cat of all time. And -

But cyber is in that equation. I mean, that's not just earthquakes and that sort of thing. And frankly, I don't think we, or anybody else, really knows what they're doing when writing cyber. I mean, we - it is just very, very, very early in the game.

And we don't know what the interpretations of the policies, necessarily, will be. We don't know the degree to which they'll be what - there'll be correlated incidents, which we don't really think are correlated now or haven't had the imagination to come up with.

We know that every year when I go and hear these people from the CIA or wherever it may be, they tell me that the offense is ahead of the defense, and will continue that way.

And I can dream of a lot of cyber incidents, which I'm not going to spell out here, because people that have twisted minds may be - they've probably got more - way more - ideas than I've got, but I don't believe in feeding them any.

But it's a business where we don't - we have a pretty good idea of the probabilities of a quake in California, or the probabilities of a three or a four hurricane hitting Florida, or whatever it may be.

We don't know what we're doing in cyber, and we try to keep - we don't want to be a pioneer on this. We do some business in that arena in Berkshire Hathaway Specialty.

But if you're doing something for competitive reasons - which I'm OK with - but when I'm doing something where I - that people tell me is a competitive necessity, we are going to try not to have - we don't want to be number one or number two or number three in exposures on it. And I don't - and I am sure we are not in cyber. But I don't -

I think anybody that tells you now that they think they know in some actuarial way, either what general experience is likely to be in the future, or what the worst case would be, I think, is kidding themselves.

And that's one of the reasons that I say that a $400 billion event has a - I think has roughly a 2 percent probability per year of happening.

Cyber's uncharted territory, and it's going to get worse, not better. And then the question is whether, if we have a whole bunch of $25 billion commercial limits out there, whether there's some aggregation that we didn't foresee or that the courts interpret those policies differently, then you know - they are generally going to give the benefit of the doubt to the insured.

So you're right in pointing that out as a very material risk, which didn't exist 10 or 15 years ago and that - and will be much more intense as the years go along.

And all I can tell you, Gary, is that, that's part of my 400 billion and my 2 percent. But if you've got a different guess, it's just as likely that yours is right than mine on that.

Charlie?

CHARLIE MUNGER: Yeah, well, something that's very much like cyberrisk is, you've got computers programmed to do your security trading and your computer goes a little wild from some error.

And that's already happened at least once where somebody just was fine one morning and by the afternoon they were broke because some computer went crazy. We don't have any computers we allot - we allow to do big, automatically trading securities.

I think, generally, Berkshire is less likely than most other places to be careless in some really stupid way.

WARREN BUFFETT: I do think if there's a mega-cat from cyber, and let's say it hits 400 billion, I do not think we'll have more than a 3 percent -

CHARLIE MUNGER: No, no -

WARREN BUFFETT: - exposure.

CHARLIE MUNGER: No, no, we'll get our share.

WARREN BUFFETT: And but it, you know, it will destroy - what will destroy a lot of companies - that we will actually, if we had a $12 billion loss, I would think, except for the new accounting rule, but I believe from what I call operating earnings, we would probably still have a reasonable profit that year.

I mean, we are in a different position than any insurance company I know of in the world, in our ability to handle the really - really super, super-cat.

OK, shareholder from station 2.

CHARLIE MUNGER: May I point out that the main shareholder to my right here has almost all his net worth in one security. That's likely to be more carefully managed than some public place with people just passing through.

WARREN BUFFETT: Yeah, you don't want a guy that's 64 and is going to retire at 65. And a lot of decisions you really don't want him or her to be making. (Laughter)

9. Capital allocation in the public sector

WARREN BUFFETT: Station 2?

AUDIENCE MEMBER: Wally Obermeyer, Obermeyer Wood Investment Counsel, Aspen, Colorado.

Warren and Charlie, you two have demonstrated great talent in private sector capital allocation and shown the world the power of excellence in this area.

Do you think there is a similar opportunity for outstanding capital allocation in the public sector, at both the state and federal levels? And if so, what approach and/or changes would you suggest for society to achieve these benefits?

CHARLIE MUNGER: That's too tough. Why don't we go on to a new question? (Laughter)

WARREN BUFFETT: I'm afraid I have nothing to add. (Laughter and applause)

I don’t mean to be unfair to somebody asking a question, but it - you know, it is unfortunately an entirely different game. And the electorate - the motivations are different, the terms, the reward system is different.

I mean, everything is different. And if we knew how to solve that, we wouldn’t - we can’t add anything to what you had in your view. I’m sorry on that.

10. Wells Fargo will emerge stronger after its “big mistake”

WARREN BUFFETT: OK, Andrew?

ANDREW ROSS SORKIN: Hi Warren. This question comes from Paul Spieker (PH) of Chicago, Illinois. I believe he may be here today.

He writes, “One of your more famous and perhaps most insightful quotes goes as follows:

"‘Should you find yourself in a chronically leaking boat, energy devoted to changing vessels is likely to be more productive than energy devoted to patching leaks.’

“In light of the unauthorized accounting scandal at Wells Fargo, of its admission that it charged customers for duplicate auto insurance, of its admissions that it wrongly fined mortgage holders in relation to missing deadlines caused by delays that were its own fault, of its admission that it charged some customers improper fees to lock in mortgage interest rates, of the sanction placed upon it by the Federal Reserve prohibiting it from growing its balance sheet, and of the more than recent $1 billion penalty leveled by federal regulators for the aforementioned misbehavior, if Wells Fargo company is a chronically leaking boat, at what magnitude of leakage would Berkshire consider changing vessels?”

WARREN BUFFETT: Yeah, well, Wells Fargo (Applause) -

Wells Fargo is a company that proved the efficacy of incentives, and it’s just that they had the wrong incentives. And that was bad.

But then they committed a much greater error - and I don’t know exactly how or who did it or when, but - ignoring the fact that they had a faulty incentive system which was incenting people to do things that were kind of crazy, like opening nonexistent accounts, et cetera.

And, you know, that is a cardinal sin at Berkshire. We know people are doing something wrong, right as we sit here, at Berkshire.

You can’t have 377,000 employees and expect that everyone is behaving like Ben Franklin or something out there. They - we - I don’t know whether there are ten things being done wrong as we speak, or 20, or 50.

The important thing is, we don't want to incent any of that if we can avoid it, and if we find - when we find it's going on, we have to do something about it. And that is absolutely the key to it.

And Wells Fargo didn't do it, but Salomon didn't do it. And the truth is, we've made a couple of our greatest investments where people have made similar errors.

We bought our American Express stock - that was the best investment I ever made in my partnership years - we bought our American Express stock in 1964 because somebody was incented to do the wrong thing in something called the American Express Field Warehousing Company. We bought -

A very substantial amount of GEICO we bought that became half the - half of GEICO, for $40 million because somebody was incented to meet Wall Street estimates of earnings and growth. And they didn't focus on having the proper reserves.

And that caused a lot of pain at American Express in 1964. It caused a lot of pain at GEICO in 1976. It caused a layoff of a significant portion of the workforce, all kinds of things. But they cleaned it up.

They cleaned it up, and look where American Express has moved since that time. Look at where GEICO has moved since that time.

So the fact that you are going to have problems at some very large institutions is not unique. In fact, almost every bank has - all the big banks have had troubles of one sort or another.

And I see no reason why Wells Fargo as a company, from both an investment standpoint and a moral standpoint going forward, is in any way inferior to the other big banks with which it competes on -

It - they made a big mistake. It cost - I mean, we still got - I mean we have a large, unrealized gain in it, but that doesn't have anything to do with our decision-making. But the -

I like it as an investment. I like Tim Sloan as a manager, you know, and he is correcting mistakes made by other people.

I tried to correct mistakes at Salomon, and I had terrific help from Deryck Maughan as well as a number of the people at Munger, Tolles. And I mean, that is going to happen. You try to minimize it.

Charlie says that, "An ounce of prevention isn't worth a pound of cure, it's worth about a ton of cure." And we ought to jump on everything. He's pushed me all my life to make sure that I attack unpleasant problems that surface. And that's sometimes not easy to do when everything else is going fine.

And at Wells, they clearly - and I don't know exactly what - but they did what people at every organization have sometimes done, but it got accentuated to an extreme point.

But I see no reason to think that Wells Fargo, going forward, is other than a very, very large, well-run bank that had an episode in its history it wished it didn't have.

But GEICO came out stronger, American Express came out stronger. The question is what you do when you find the problems.

Charlie?

CHARLIE MUNGER: Well, I agree with that. I think Wells Fargo is going to be better going forward than it would have been if these leaks had never been discovered.

WARREN BUFFETT: Or happened.

CHARLIE MUNGER: Yeah, so I think it's - it - but I think Harvey Weinstein has done a lot for improving behavior, too. (Laughter)

It was clearly an error, and they're acutely aware of it and acutely embarrassed, and they don't want to have it happen again.

You know, if I had to say which bank is more likely to behave the best in the future, it might be Wells Fargo, of all of them.

WARREN BUFFETT: This New York Times that I have here from March 12th, 1942, if you go toward the back of it, in the classified section, you have one big section that says, "Help Wanted Male," and another one that says, "Help Wanted Female."

You know, was the New York Times doing the right thing in those days? You know, I think the New York Times is a terrific paper. But people make mistakes.

And you know, the idea of classifying between - taking ads and saying, "Well, we'll take them and divide them up between men and women, what jobs we think are appropriate," or that the advertiser thinks is appropriate.

We do a lot of dumb things in this world. And GEICO, as I say, in the early 1970s, they just ignored - and you can do it in the setting of proper reserves, which mean they charged the wrong price to new customers because they thought their losses were less than they were.

And I'm sure some of that may have been a desire to please Wall Street or just because they didn't want to face how things were going. But it came out incredibly stronger. You know, and now it's got 13 percent of the households in the United States insured.

And it came out with an attention to reserves and that sort of thing that was heightened by the difficulties that they'd found themselves in where they almost went bankrupt. Forty-two -

CHARLIE MUNGER: It was a lot more stupid than Wells Fargo. It was really stupid what they did way back, right?

WARREN BUFFETT: Yeah. They had the world by the tail, and then they quit looking at the reserve development. But - and American Express was just picking up a few dollars by having the field warehousing company in 1963. And, you know, they were worried whether it was going to sink the company.

And when some guy named Tino De Angelis in, I think it was Bayonne, New Jersey -

In fact, I went to the annual meeting in 1964 of American Express after the scandal developed, and somebody asked if the auditor would step forward.

And the auditor from one of the big firms, which I won't mention, came up to the microphone, and somebody said, "How much did we pay you last year?"

And the auditor gave his answer, and then the questioner said, "Well, how much extra would you have charged us to go over to Bayonne, which was ten miles away, and check whether there's any oil in the tanks?" (Laughs)

So it - you know, here was something - a tiny little operation - some guy was calling him from a bar in Bayonne and telling him this phony stuff was going on, and they didn't want to hear it. They shut their ears to it.

And then what emerged was one great company after this kind of, what they thought was a near-death experience. So it's - we're going to make mistakes.

I will guarantee you that we will get some unpleasant news at Berkshire. I don't know what it'll be, you know - the most important thing is we do something about it.

And there have been times when I procrastinated, and Charlie has been the one that jabs me into action. And so he's performed a lot of services you don't know about. (Laughter)

11. "I like to think I'll be missed a little bit, but you won't notice it"

WARREN BUFFETT: OK. Gregg, Gregg Warren.

GREGG WARREN: Good morning, Warren. I have a little bit of a follow-up on Becky's question.

At the 2014 annual meeting, as well as this morning, you noted that the power of Berkshire brand and its reputation, as well as the strength of Berkshire's balance sheet, would allow the company's next managers to replicate many of the advantages that have come with your being the face of the organization, one of which has been an ability to extract high rents from firms in exchange for a capital infusion and the Buffett seal of approval during times of financial distress.

I buy the argument about the strength of the balance sheet and believe that deals will continue to be done with sellers still lining up to become part of the Berkshire family, especially if the company's next managers are allowed to keep a ton of cash on hand.

But I'm not entirely convinced that they'll be able to garner the same 8, 9, 10 percent coupons, as well as other add-ons, that you've been able to extract from firms like Goldman Sachs and Bank of America in times of distress.

I'd expect those rents to be at least a few percentage points lower once you're no longer running the show. That is, until those managers build up a reputation to warrant higher returns. Am I right to think about it that way?

WARREN BUFFETT: I'm not sure. The - when we, in two - you mentioned Goldman Sachs, and we also did with General Electric, in September or early October of 2008. We probably could actually have extracted better terms.

You know, I think it might have been counterproductive in the end, but I was - we would have done better, incidentally, financially, if we'd really waited until the panic developed further - because I didn't know how far it would develop - but we could have made a lot better purchases three or four or five months later than we did at that time.

And we also did not want to do something that looked to be so high as to in - make the transaction disadvantageous to Goldman or to GE.

They were going to take the terms we offered, but we actually didn't push it to the limit, because there really wasn't anybody else around.

I think - and we're working on something right now that probably won't happen. It's not huge.

But actually, in this case, both Todd [Combs] and Ted [Weschler] have brought deals to me. One of them brought something to me, and, you know, he was thinking in the same terms that I got - was thinking about - and he's the one that returned the call that he had received about a transaction.

And I do not think the party on the other side is going to care about the fact that they had him on the phone rather than me on the phone. I -

You know, there may - there could be just a little bit at certain times in history. But, you know, we will continue to have our standards of what we think money is worth at any given time. And Ted and Todd think just as well about that as I do.

And there will be times, very occasionally, when our phone will ring a lot. And I don't think they'll hang up because I don't answer it, if they need the money.

Charlie?

CHARLIE MUNGER: Well. The times he's referring to, a lot of them, were like the worst in 50 years. So that's a really rare kind of an occurrence. And we didn't make all that many deals. So I think he's right that it'll be harder for us to make similar deals in the future.

WARREN BUFFETT: Yeah, the problem is the sums involved now, more than the problem of deciding what the proper terms should be. And sometimes we can get what we think is appropriate and sometimes we - most of the time, today, we can't.

But you may see a transaction or two that - not in terms of buying business but in terms of securities - that strike you as perfectly decent ways to invest Berkshire's money.

And they may well have come through Todd or Ted instead of directly to me.

I like to think I'll be missed a little bit, but I - you won't notice it. (Laughter)

12. Buffett talks to Ajit Jain about insurance pricing because it's fun

WARREN BUFFETT: OK, Station 3.

AUDIENCE MEMBER: I'm Todd Lichter (PH) from Boulder, Colorado.

Mr. Buffett, are you still involved in pricing decisions at See's Candies and The Buffalo News? And with what other Berkshire subsidiaries do you take more than a hands-off approach?

WARREN BUFFETT: Yeah, you're correct that at one time I, and for some - for quite a while - both Charlie and I took part in the pricing decisions at See's Candy.

And certainly, for some years, particularly with the question of the survival of The Buffalo News was really in question, I definitely took part in those decisions.

In both cases, we had good managers, but still we wanted to - we thought those decisions were important. But it's been a long, long time - very long time - since we've participated in anything like that.

I can’t tell you what the per pound price is for See’s Candy, which is because people, and you’re invited to join this group, send me free candy from time to time. (Laughter)

And I can’t - I really, I can’t tell you the prices at The Buffalo News. All I know is it’s very, very, very hard to move up prices on advertising, generally. So no, we -

The only thing is, Ajit [Jain] and I talk frequently. And if there’s some very big risk, if somebody wants a $5 billion cover on a chemical plant some way excessive loss of over 3 billion or something - we have a certain amount of fun with him deciding on the price in his head. And I decide in my head, and then we compare notes.

It’s the kind of risk that you really can’t look up in a book and see, actuarially, what it’s fairly - the parameters - are fairly likely to be.

I enjoy thinking through the pricing of that, and I particularly enjoy comparing it with Ajit. So the -

These are just oddball situations, but we do that sort of thing, and we’ve done it for three decades. And it’s part of the fun of my job.

The candy prices, if you got to complain about those, you have to go to Charlie. (Laughter)

CHARLIE MUNGER: Well, the answer is, Warren is still doing it and talking to Ajit, and - but that’s because Ajit likes it that way.

WARREN BUFFETT: Yep.

CHARLIE MUNGER: We have a very peculiar place where the - where Warren’s contact with the various people elsewhere in the organization largely depends on what they want, not what he wants.

WARREN BUFFETT: The CEO of one of our -

CHARLIE MUNGER: It’s very unusual, and it’s worked beautifully.

WARREN BUFFETT: The CEO of one of our most successful subsidiaries, I may have talked to - unless I saw him here and just said hello - I probably talked to him three times in the last ten years.

And he does remarkably well. (Laughs)

He might have done even better if I hadn’t talked to him those three times. (Laughter)

And on the other hand, Ajit and I talk very, very frequently. And he's got the kind of business, A, I do know - I know more about the insurance business than I know about a good many of the other businesses.

And it's interesting. And we are evaluating things that you don't look up in a book, you know. I mean, actuarial talent is not what's important in the things that Ajit talks to me about. It's plenty important throughout our insurance operation.

But in these particular cases, you know, we're making judgments, and his judgment's better than mine. But I like to - I just like to hear about them. They're interesting propositions.

13. Putting business values in income account is "enormously deceptive"

WARREN BUFFETT: OK, Carol.

CAROL LOOMIS: ... shareholder named Jack Ciesielski . He's a well-known accounting expert, who for many years has written "The Accounting Observer."

"Mr. Buffett, in this year's shareholder letter you have harsh words for the new accounting rule that requires companies to use market value accounting for their investment holdings.

"'For analytical purposes,' you said, 'Berkshire's bottom-line will be useless.'

"I'd like to argue with you about that. Shouldn't a company's earnings report cite everything that happened to, and within, a company during an accounting period?

"Shouldn't the income statement be like an objectively written newspaper informing shareholders of what happened under the management for that period, showing what management did to increase shareholder value and how outside forces may have affected the firm?

"If securities increased in value, surely the company and the shareholders are better off. And surely they're worse off if securities decreased in value.

"Those changes are most certainly real. In my opinion, ignoring changes in the way that some companies ignore restructuring costs, is censoring the shareholders' newspaper.

"So my question is, how would you answer what I say?" (Laughter)

WARREN BUFFETT: Well, my answer to the question that asks what my answer would be to what he said - the - I would ask Jack, if we've got $170 billion of partly-owned companies, which we intend to own for decades, and which we expect to become worth more money over time, and where we reflect the market value in our balance sheet, does it make sense to, every quarter, mark those up and down through the income account, when at the same time we own businesses that have become worth far more money, in most cases, and become, you know, since we bought - you name the company - take GEICO, an extreme case - we bought half the company for $50 million, roughly - do we want to be marking that up every quarter to the value - and having it run through the income account?

That becomes an appraisal process. There's nothing wrong with doing that, in terms of evaluation. But in terms of - and you can call it gain in net asset value or loss in net asset value - that's what a closed-end investment fund, or an open-investment fund would do.

But to run that through an income account - if I looked at our 60 or 70 businesses, or whatever number there might be, and every quarter we marked those to market, we would have, obviously, a great many, in certain cases, where over time we'd have them at 10 times what we paid, but how quarter-by-quarter we should mark those up and run it through the income account, where 99 percent of investors probably look at net income as being meaningful, in terms of what has been produced from operations during the year, I think would be - well, I can say it would be enormously deceptive.

I mean, in the first quarter of this year - you saw the figures earlier - where we had the best what I would call operating earnings in our history, and our securities went - were down six billion, or whatever it was, to keep running that through the income account every day you would say that we might have made on Friday, we probably made 2 1/2 billion dollars. Well, if you have investors and commentators and analysts and everybody else working off those net income numbers and trying to project earnings for quarters, and earnings for future years, to the penny, I think you're doing a great disservice by running those through the income account.

I think it's fine to have marketable securities on the balance sheet - the information available as to their market value - but we have businesses there - if we - we never would do it - but if we were to sell half, we'll say, of the BNSF railroad, we would receive more than we carried - carried for them - we would turn - we could turn it into a marketable security and it would look like we made a ton of money overnight. Or if we were to appraise it, you know, appraise it every three months and write it up and down, A, it could lead to all kinds of manipulation, but B, and it would just lead to the average - to any investor- being totally confused.

I don't want to receive data in that manner and therefore I don't want to send it out in that manner.

Charlie?

CHARLIE MUNGER: Well, to me it's obvious that the change in valuation should be noted, and it is and always has been - it goes right into the net worth figures.

So the questioner doesn't understand his own profession. (Laughter and applause)

I'm not supposed to talk that way but it slips out once in a while. (Laughter)

WARREN BUFFETT: Sometimes he even gives it a push. (Laughter)

14. McLane profits hurt by severe competitive pressure

WARREN BUFFETT: OK. Jonathan.

JONATHAN BRANDT: McLane's core operating margins have dropped about 50 percent from where they've generally been since acquisition [from Walmart].

Could you elaborate on the competitive pressures in the grocery and convenience store distribution business that have caused the deterioration in profits? And do you expect the margin structure of that business to eventually get back to where it was, or is this the new normal?

WARREN BUFFETT: Well, I don't know the answer to the second part about the future, but there's no question that the margins have been squeezed. They were very, very narrow, as you know, they were about one cent on the dollar pretax, and they have been squeezed from that. Payment terms get squeezed.

In some cases we have fairly long-term contracts on that, so it will go on for five years (inaudible).

It's a very, very tight margin business. And the situation is even worse than you portray because within McLane we have a liquor distribution business in a few states and that business has actually increased its earnings moderately, and we've added to that business, so within McLane's figures there are about 70 million or so pretax from the liquor part that have nothing to do with the massive parts you're talking about, in terms of food distribution.

So it's even - the decline is even greater in what you're referring to than you've (inaudible).

That's just become very much more competitive. We have to decide - if you'll look at our competitors, they're not making much money either. And that's capitalism.

I think, you know, there comes a point where the customer says, you know, "I'll only pay X," and you have to walk away.

And there's a great temptation when you're employing - particularly employing thousands of people -and you've built distribution facilities, and all of that sort of thing - take care of them - to meet what you'd like to term as "irrational competition," but that is capitalism.

And - you're right. We took - the earnings went up quite a bit from the time we bought it. And we're still earning more than then. And we've earned a lot of money over time.

But, as I say, a fair amount of that is actually coming from liquor distribution, activities in about four states that we purchased - very well-run.

And - we will do our best to get the margins up. But I would not - I could not tell you - give you a really - your guess is almost as good as mine, or better than mine, maybe, as to what margins will be in that distribution business five years from now.

It's a very essential service. We do $40-some billion. And we move more of the product of all kinds of companies that names are known to you, than anybody else. But - when you get - when you get - Kraft Heinz for that matter, or Philip Morris, or whomever it may be, on one side of the deal, and you get Walmart and some other - 7/11 - on the other side of the deal, sometimes they don't leave you very much room in between.

Charlie?

CHARLIE MUNGER: I think you've described it very well. (Buffett laughs)

15. Health care costs partnership with Amazon and JPMorgan

WARREN BUFFETT: OK. (Laughter) Station 4.

AUDIENCE MEMBER: Good morning, Charlie and Warren. I know that seems a little bit out of order, but I'm a huge fan of yours, Charlie, mostly for your 25 Cognitive Biases.

I'm from Seattle, Washington. I run a one-person digital marketing firm that specializes in Facebook ads and email marketing. I use these a lot. I - your breakdown of Coca-Cola was really, really solid.

And I use that as reference when looking to how to understand the mechanics of my clients' products and how to promote them. So I'm fairly certain that your cognitive biases work for internet-related companies.

Now that you're partnering with Amazon [and JPMorgan] on health care, I'm curious, have you started to understand how to apply these biases to internet-related companies? Or is there another set of tools you use to decide if you understand a business? Because you guys talk a lot about not investing in businesses that you don't understand.

WARREN BUFFETT: Well, health care is a - we don't plan to start health care companies or, necessarily, insurers or anything. We simply have three organizations with leaders that I admire and trust. And we - mutually goes around all three.

And we hope to do something which Charlie correctly would probably say is almost impossible to change in some way a system which is - was taking 5 percent of GDP in 1960, and now is taking close to 18 percent.

And we have a hugely noncompetitive medical cost in American business, relating to any country in the world. The countries that - there were some countries that were around our 5 percent when we were at 5 percent. But we've managed to get to 18 without them going beyond 11 or so.

Literally, in 1960, we were spending $170 per capita on medical costs in the United States. And now we're spending over 10,000.

And, you know, every dollar only has a hundred cents. So there is a cost problem. It is a tapeworm, in terms of American business and its competitiveness.

We don't - we have fewer doctors per capita. We have fewer hospital beds per capita, fewer nurses per capita, than some of the other countries that are well below us.

And you've got a system that is delivering $3.3 trillion - that's almost as much as the federal government raises - it's delivering 3.3 trillion, or some number like that, to millions and millions and millions of people who are involved in the system. And every dollar has a constituency. It's just like politics.

And whether we can find the chief executive, which we're working on now, and which I would expect we would - we would be able to announce before too long - that - but that's a key part of it.

And whether that person will have the imagination and support of people that will enable us to make any kinds of significant improvements in a system which everybody agrees is sort of out of control on cost, but what - but - but they all think it's the other guy's fault, generally - we'll find out. It won't be - it won't be easy.

But it is not a - the motivations are not primarily profit-making. They're - we want to deliver - we want our employees to get better medical service at a lower cost. We're not going to - we're certainly not going to come up with something where we think the service that they receive is inferior to what they're getting now.

But we do think that there may be ways to make a real - significant changes - that could have an effect. And we know that the resistance will be unbelievable.

And if we fail, we've at least tried. And - but they - the idea is not that I will be able to contribute anything to, you know, in some breakthrough moment, by reading a few medical journals or something - (laughs) - changing something that is as embedded as the medical system.

But the idea is that maybe the three organizations, which employ over a million people and which, after we announced it, we had a flood of calls from people that wanted to join in, but there isn’t anything to join into now. But they will if we have - come up with any ideas that are useful.

Whether we can - bring the resources, bring the person. And the CEO is terribly important. And then bring the person, support that person. And somehow, figure out a better way for people to continue to receive better medical care in the United States without that 8 percent - 18 percent - going to 20 or 22 percent, you know, in the lifetime of, you know, our children or something of the sort - because there are only a hundred cents in the dollar.

And we will see what happens. It’s - you know - if you were Ajit [Jain], actuarially figuring, it would not - you would not bet on us. But - I think there is some chance we will do something.

There’s a chance - nobody can quantify it - that we can do something significant. And we are positioned better than most people to try. And we’ve certainly got the right partners. So, we will give it a shot and see what happens.

Charlie? (Applause)

CHARLIE MUNGER: There is some precedent for success in this public service activity. If you go back many decades, John B. Rockefeller I, using his own money, made an enormous improvement in American medical care. Perfectly enormous. In fact, there’s never been any similar improvement done by any one man since that rivals it.

So Warren, having imitated Rockefeller in one way, is just trying another. And maybe it’ll work.

WARREN BUFFETT: Rockefeller, incidentally, lived a very long time. So I actually am trying to imitate him three ways there. (Laughter)

We’ll see what happens. But we are - we’re making a lot of progress. And I think we’ll probably have a CEO within a couple of months. But if we don’t have one, then we’re not going to pick somebody just because we want to meet any deadline or anything like that. We’ve got these wonderful partners.

We don’t have a partnership agreement among us. Somebody started drawing up one in a legal department and the CEO just put a stop to it.

They - you do have places that have a lot of resources. And while we all have our share of bureaucracy, we can cut through it if we’ve got something that we really think makes sense.

And we will get the support - we’ll get - we’ll get a lot of resistance, too. But we will get the support of a lot of American business, if we come up with something that makes sense.

But if it was easy, it would’ve already been done. There’s no question about that.

CHARLIE MUNGER: It's not easy.

WARREN BUFFETT: No. (Laughs) But it should be tried.

16. Weschler and Combs "slightly ahead" of S&P

WARREN BUFFETT: OK. Becky?

BECKY QUICK: This question comes from David Rolfe, who is with Wedgewood Partners, and has been - the company - has been shareholders in Berkshire since 1989. The stock is currently the largest holding in their stocks - 18 stocks.

He asks this question: "Over the past two years, you have listed the individual fund-of-funds performance from Protégé Partners. When will you start showing the annual performance on 25 billion that Ted [Weschler] and Todd [Combs] manage? Can you state if either Ted or Todd has beaten the S&P 500 index over the last five years?

WARREN BUFFETT: Yeah. Both - A, we'll probably never report their individual performance.

But you can be sure that I have an enormous interest in - as does Charlie - in how much we think they contribute to Berkshire. And they have - they've been terrific. They've - they not only have the intellect, and the record, but they are exceptional human beings. And they -

Todd has done a tremendous amount of work, for example, on the medical project.

And - Ted is - I've given him several things, and he's done them better than I could do them.

So the record, since inception - and I'm measuring it - Ted came later than Todd, a year or so later - but the record, since inception, is almost identical - both for the two managers - from their different inception and matching the S&P.

And they've received some incentive compensation, which they only get if they beat the S&P. And as I say, they're just slightly ahead. That really hasn't -

It's been better than I've done, so naturally, I can't criticize it. (Laughs)

They - they were the - they were two very, very, very good choices.

Charlie?

CHARLIE MUNGER: You did report it in a previous year. You just didn't do it this year. And - but now you have your report. (Laughter)

WARREN BUFFETT: I would - the problem that all of us has is size. It's actually - it's harder to run even 12 or $13 billion, frankly, than it is to run a billion. And if you're running a million dollars or something of the sort, it's a whole different game. You'd agree with that, wouldn't you, Charlie?

CHARLIE MUNGER: Of course.

WARREN BUFFETT: Yeah, OK. (Laughter)

Just like any good lawyer, you never ask him a question unless you think you know the answer they're going to give. (Laughter)

17. GEICO is on a good growth and profit track

WARREN BUFFETT: OK. Gary?

GARY RANSOM: My question's on GEICO. Last year, you promised growth and delivered. But along the way, the combined ratio was moving up, and it was the first time it was over a hundred in about 15 years.

Granted, some of that was catastrophes. But even excluding catastrophes, there was something going on in the loss trends that caused you to slow down that growth, at least at the - as we got to the latter part of the year.

And I wondered if you could tell us what was going on. And I did look this morning, too, so it looked like the first quarter has settled down a little bit, but I'd still like to know about the fourth quarter.

WARREN BUFFETT: Yeah, sure. It - the only thing I differ with the question on slightly - when you say it caused us to slow down - we didn't want to slow down the growth. I mean, you're looking at a guy here that has never wanted to slow down the growth of GEICO. The growth did slow down, but it wasn't because we wanted it to.

Our prices that led to the underwriting loss - we actually - we'd have been slightly in the black without the catastrophes.

But, you know, if we hadn't have paid our light bills, we might have been in the black, too. I mean, this "except for" stuff doesn't mean much in insurance as far as I'm concerned.

The - if you'll look at the first quarter - our margins were around 7 percent, which is actually a little more than we aimed for. And I received the unaudited - I mean, the preliminary - figures for April, and they're similar.

So, the underwriting gain is - or margins - are perfectly satisfactory now. And we'd love to get all the growth we can. And we will gain market share this year. And we gained market share - Tony - when Tony [Nicely] took over the place, it was - in 1993 - it was two and a very small fraction percent. And it'll be 13 percent of the - you know - 13 percent of the households in the country now. And we will keep gaining share. We will keep writing profitably - most of the time.

And every now and then, our rates will be slightly - modestly inaccurate - inadequate, I should say. And/or we'll have, maybe, some big losses on hurricanes or something of the sort, or we'll have a [Hurricane] Sandy in New York.

The - but GEICO is a jewel. And it's - you know, it's really a - we've got some others we feel awfully close to similarly about, but it's an incredible company. It has a culture all of its own. It's saving its customers probably 4 or $5 billion a year against which they would - against what they would otherwise be paying, based on the average in auto insurance. And it will be profitable on underwriting a very high percentage of the year. It contributed another $2 billion to float last year.

It is a terrific company. And like I say, the first four months are dramatically better.

Now, there's some seasonal in auto insurance. So, the first quarter is usually the best of the four quarters. But it's not a dramatic seasonal. So, I think when you read the 10-Q - and you can take my word for April - I think GEICO is on a good profit track as well as a good growth track. And the more it grows, the better I like it.

Charlie?

CHARLIE MUNGER: Well, I think you've said it perfectly.

WARREN BUFFETT: Huh.

CHARLIE MUNGER: It was never very bad, and it's better now. (Buffett laughs)

18. Munger on steel tariffs: "Even Donald Trump can be right"

WARREN BUFFETT: OK. Station five.

AUDIENCE MEMBER: Good morning, Warren Buffett and Charlie Munger. My name is Ethan Mupposa (PH), and I am from Omaha, Nebraska.

My question is, how will Donald Trump's tariffs affect the manufacturing business of Berkshire Hathaway?

WARREN BUFFETT: Well, to date - (applause) - steel costs - we've seen steel costs increase somewhat. But as I said earlier, I don't think the United States or China - there'll be some jockeying back and forth, and there will be something that leaves some people unhappy and - but I don't think - I don't think either country will dig themselves into something that precipitates and continues any kind of real trade war in this country.

We - we've had that in the past a few times. And I think we've learned a general lesson on it.

But there will - there will be some things about our trade policies that irritate others. And there will be some from others that irritate us. And there will be some back and forth. But in the end, I don't think we'll come out with a terrible answer on it.

Charlie, I'll let you -

CHARLIE MUNGER: Well, steel has - it reached - the conditions in steel were almost unbelievably adverse to the American steel industry.

You know, even Donald Trump can be right on some of this stuff. (Laughter and applause)

WARREN BUFFETT: The - the thing about trade - you know, I've always said that the president, whether it's president - any president - needs to be an educator-in-chief, which [Franklin] Roosevelt was in the Depression. That's why he had those Fireside Chats, and it was very important that he communicated to the people what needed to be done and what was happening around them, and -

Trade is particularly difficult, because the benefits of trade are basically not visible, you know. You don't know what you would be paying for the clothes you're wearing today if we'd had a rule they all had to be manufactured in the United States, or what you'd be paying for your television set, or whatever it may be.

No one thinks about the benefits day-by-day as they walk around buying things and carrying on their own business.

The negatives, and there are negatives, are very apparent and very painful. And if you're laid off - like happened in our shoe business [Dexter Shoes] in Maine - and you know you are - been a very, very, very good worker, and you were proud of what you did, and maybe your parents did it before you, and all of a sudden you find out that American shoes - shoes manufactured in America - are not competitive with shoes made outside the United States.

You know, you can talk all you want about Adam Smith or David Ricardo or something and explain the benefits of free trade and comparative advantage and all that sort of thing, and that doesn't make any difference.

And if you're 55 or 60 years old, to talk about retraining or something like that, you know, so what?

So, I - it is tough in politics where you have a hidden benefit and a very visible cost to a certain percentage of a - of your constituency.

And you need to do two things under those circumstances, if you have that situation. You know what's good for the country. So, you have to be very good at explaining how it does really hurt, in a real way, somebody that works in a textile mill, like we had in New Bedford, where you only spoke Portuguese - half our workers only spoke Portuguese. And suddenly, they have no job. And they've been doing their job well for years.

You've got to do two things. You can - you'll have to - you have to understand that that's the price individuals pay for what's good for the collective good.

And secondly, you've got to take care of the people that are - that - where retraining is a joke because of their age, or whatever it may be. And you've got to take care of the people that become the roadkill in something that is collectively good for us as a country. And -

That takes society acting through its representatives to develop the policies that will get us the right collective result, and not kill too many people economically in the process. And you know, we've done that in various arenas over the years.

The people in their productive years do help take care of the people that are too old, and too young. I mean, every time a baby is born in the United States, you know, we take on an obligation of educating them for 12 years. It'll cost $150,000 now, you know? It -

We have a system that has a bond between the people in their productive years and the ones in the young and old. And it gets better over time. It's far from perfect now. But it has gotten better over time.

And I believe that trade, properly explained, and with policies that take care of the people that are roadkill, is good for our country and can be explained.

But I think it's a tough - it's been a tough, tough sell to a guy that made shoes in Dexter, Maine or worked on a loom in New Bedford, Mass, or works in the steel mill in Youngstown, Ohio. (Applause)

19. Buffett won't impose his political opinions on Berkshire

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: OK, Warren. This question comes from a Berkshire shareholder who says they've been a shareholder for ten years. I should say this may be one of the most pointed questions I've ever received for you. So -

WARREN BUFFETT: But you elected to give it, though.

ANDREW ROSS SORKIN: But I did. (Laughter)

The shareholder writes, “I have watched the movie every year at this meeting, when you testify in front of Congress on behalf of Salomon, as the symbol of what it means to have a moral compass. Investors are increasingly looking to invest in companies that are socially and morally responsible.

“So I was disturbed when you were asked on CNBC about the role that business could play in sensible policies around the sales of guns.

“You said you didn’t think business should have a role at all, and you wouldn’t impose your values on others. I was even more surprised when you said you’d be OK with Berkshire owning shares in gun manufacturers.

“At this meeting years ago, you said you wouldn’t buy a tobacco company because of the social issues. The idea that Berkshire would associate with any company as long as it isn’t illegal seems at odds with everything I think you stand for. Please tell us you misspoke.”

WARREN BUFFETT: Well - (applause) - let’s explore that a little. (Laughter)

Should it be just my view, or should it be the view of the owners of the company? So, if I decide to poll the owners of the company on a variety of political issues, and one of them being whether, you know, Berkshire Hathaway should support the NRA, I don’t - if a majority of the shareholders voted to do it, or if a majority of the board of directors voted to do it, I would - I wouldn’t - I would accept that.

I don’t think that the - my political views - I don’t think I put them in a blind trust at all when I take the job. And I - in the elections of 2016, I raised a lot of money. In my case, I raised it for Hillary [Clinton]. And I spoke out in various ways that were quite frank, but - (applause) - I don’t think that I speak -

When I do that, I don’t think I’m speaking for Berkshire. I’m speaking as a private citizen. And I don’t think I have any business speaking for Berkshire. We have never - at the parent company level - we have never made a political contribution, you know -

And I don’t go to our suppliers. I don’t do anything of that sort where I raise money either for the school I went to, or for a political candidate I went to, or anything else.

And I don’t think that we should have a question on the GEICO policyholder form, “Are you an NRA member?” you know, and if you are, you just aren’t good enough for us, or something. That - I think -

I do not believe in imposing my political opinions on the activities of our businesses.

And if you get to what companies are pure and which ones aren't pure - (applause) - I think it is very difficult to make that call. Thank you.

I think with that response, I'm almost afraid to call on Charlie. But go ahead, Charlie. (Laughter)

CHARLIE MUNGER: Well, obviously, you do draw a limit, Warren -

WARREN BUFFETT: Yeah, we did.

CHARLIE MUNGER: - in all kinds of thing -

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: - which are beneath us, even though they're legal. But we don't necessarily draw it perfectly because we've got some sort of supreme knowledge. We just do the best we can.

And certainly, we're not going to ban all guns, surrounded by wild turkeys in Omaha. (Laughter)

20. "Very unlikely" Berkshire would pay a special dividend

WARREN BUFFETT: OK, Gregg. (Laughter)

GREGG WARREN: Warren, this question's also based on something you said more recently, so I can't guarantee it's going to be any easier. (Buffett laughs)

You recently noted that you prefer share repurchases over dividends as a means for returning capital to shareholders should Berkshire's cash balances continue to rise and hit the $150 billion threshold you noted as being difficult to defend to shareholders at last year's annual meeting.

While I understand the rationale for not establishing a regular dividend, a one-time special dividend could be a useful option for returning a larger chunk of Berkshire's excess capital to shareholders without the implied promise to keep paying a regular dividend forever.

The drawback with the special dividend, though, is that it would lead to an immediate decline in book value and book value per share. Whereas a larger share repurchase effort, while depressing book value, would reduce Berkshire's share count, limiting the impact on book value per share.

If we do happen to get a few years out and Berkshire does hit that $150 billion threshold, because valuations continue to be too high, both for acquisitions and for the repurchase of company stock, would you consider a one-time special dividend as a means for returning capital to shareholders?

WARREN BUFFETT: Well, if we thought we couldn't use capital effectively, we would figure - we would try to figure out the most effective way of returning capital to shareholders. And - you could - I would have probably - I think it'd be unlikely we'd do it by a special dividend.

I think it'd be more likely we'd do it by a repurchase, if the repurchase didn't result in us paying a price above intrinsic value per share. We're never going to do anything that we think is harmful to continuing shareholders.

So if we think the stock is intrinsically worth X, and we would have to pay some modest multiple even above that to repurchase shares, we wouldn't do it because we would be hurting continuing shareholders to the benefit of the people who are getting out.

But we will try and do whatever makes the most sense, but not with the idea that we have to do something every day because we simply can't find something that day.

We had a vote as you know - I don't know, a few years back - on whether people wanted a dividend. And - the B shares - so I'm not talking my shares or Charlie's or anything - but the B shares voted 47 to one against it.

So I think through self-selection of who become shareholders - I don't think shareholders world - or countrywide - on all stocks would vote 47 to one at all.

But we get self-selection in terms of who joins us. And I think they expect us to do whatever we think makes sense for all shareholders. And obviously, if we really thought we never could use the money effectively in the business, we should get it out, one way or another. And -

You've got a bunch of directors who own significant - very significant - amounts of stock themselves. And you can expect them to think like owners. It's the reason they're on the board.

And you can expect the management to think like owners and - owners will return money to all of the owners if they think it makes more sense than continuing to look for things to do.

But we invested in the first quarter, maybe - have to look it up on the - well, certainly through April - probably close to 15 billion or something like that, net, so -

And we won't always be in a world of very low interest rates - or high private market prices.

So we will do what makes the most sense. But I can't see us ever making a special - almost - it's very unlikely we would just pay out a big, special dividend. I think that if we put that to the vote of the shareholders, and Charlie and I did not vote, I think we would get a big negative vote. And I'd be willing to - be willing to make a bet on that one.

Charlie?

CHARLIE MUNGER: Well, as long as the existing system continues to work as well as it has, why would we change it? We've got a whole lot of people that are accustomed to it, have done well under it. And if conditions change, why, we're capable of changing our minds, if the facts change.

WARREN BUFFETT: Yeah, and we've done that several times.

CHARLIE MUNGER: Yes.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Although, I must say, it's a little hard. (Laughter)

WARREN BUFFETT: He always brings me back to earth.

21. Munger is more interested than Buffett in Chinese stocks

WARREN BUFFETT: OK. Station 6?

STEPHANIE YU: Hi, good morning, Mr. Buffett and Mr. Munger. My name is Stephie Yu from Horizon Insights, a China-focused research firm based in Shanghai. So I have a lot of mutual fund clients in China, who are very young - relatively younger - and they manage a smaller portion of funds.

So my question is, if you only have $1 billion in your portfolio today, how would you change your investments? Would you consider more investment opportunities in emerging markets such as China? Thank you.

WARREN BUFFETT: Yeah. I would say, if I were working with a billion, I would probably find - within a $30 trillion market in the United States, where I understood things better, generally, than I do around the world - I'd probably find opportunities there that would be better, incidentally, by some margin, than what we can find for hundreds of billions.

But I wouldn't - there's no way I'd rule out emerging markets. There was a time, 15 years ago or so, when just because it was kind of interesting and it took me back to my youth, I - on the weekend, I went through a directory of Korean stocks. And I bought - and these were small stocks - well, they weren't small by standards of either Korean or American business. They were big, big companies.

But I found 15 or 20 in - that were statistically cheap and bought some of each one myself.

And there are opportunities with smaller amounts of money to do things that we just can't do. And - but I - my first inclination always would be to comb through things in the United States. And -

But I've combed through - in other countries. I probably wouldn't get into very, very small markets because there can be a lot of difficulties even in market execution and taxation, (inaudible).

You can find - if you can't find it, you know, in America and China and Britain and a few other places - (laughs) - you probably aren't going to find it someplace else. You may think you've found it. But that may be - it may be a different game than you know. Our problem is size, not geography.

Charlie?

CHARLIE MUNGER: Well, I already have more stocks in China than you do, as a percentage, so I'm with the young lady. (Laughter)

WARREN BUFFETT: OK. Well, you can - you want to name names? Do these stocks have names? Or - (Laughs)

CHARLIE MUNGER: No, I don't. (Buffett laughs)

WARREN BUFFETT: Carol?

CAROL LOOMIS: This question is -

WARREN BUFFETT: I should just add one thing. You will find plenty of opportunities in China. Charlie would say you've got a better hunting ground than even a person with similar capital in the United States. Would you agree with -?

CHARLIE MUNGER: Yes, I do.

WARREN BUFFETT: Yeah, yeah. So - and in the sense they're - it's logical that should be the case because it's a younger market, but still a large market. So that -

Markets probably work toward efficiency as they age. Japan had this very strange situation with warrants being priced out of line and all of that 30 years ago. And people notice after a while and it disappears. But there can be - some very strange things happen in markets as they develop. I think you'd agree with that, Charlie, wouldn't you?

CHARLIE MUNGER: Absolutely.

WARREN BUFFETT: Yeah.

22. Munger: Keep the faith and don't sell your stock when we're gone

WARREN BUFFETT: Jonathan?

JONATHAN BRANDT: Hello -

CAROL LOOMIS: You skipped me.

WARREN BUFFETT: Did I skip -? I skipped Carol?

CAROL LOOMIS: Yup.

WARREN BUFFETT: Oh. I'm sorry.

CAROL LOOMIS: OK.

WARREN BUFFETT: OK.

CAROL LOOMIS: This question, and I would concede it is not a small one, comes from Gideon Pollack of Montreal.

He says, "The world knows generally how the looks of Berkshire Hathaway have changed since you began to run the company in 1965. Berkshire was then a tiny northeastern, textile company. And now it is the number-four company on the Fortune 500.

"What about the next 50 years? Could you give us your view of what Berkshire looks like in 2068?"

WARREN BUFFETT: I think it'll look a long way away. (Laughter)

No, the answer is I don't know. And I didn't know, 50 years ago, what it would like now, I mean -

It will be based on certain principles. But where that leads, you know, we will find out and we'll have people that are thinking about different things than I am. And we'll have a world that's different. But -

We will be - I very much hope and believe that we will be - that we'll be as shareholder-oriented as any large company in the world. We will look at our shareholders as partners and we will be trying to do with their money exactly what we'd do with our own, not seeking to get an edge on them. And who knows what else will be happening then?

Charlie?

CHARLIE MUNGER: Well, I want to talk to the younger shareholders in the group. Those of you who, after we are gone, sell your Berkshire stock and do something else with it, helped by your many friends, I think are going to do worse. (Laughter)

So I would advise you to keep the faith. (Applause)

By the way, some of that has already happened in many families.

WARREN BUFFETT: I'll give his answer next time now that I see it get all of that applause. (Laughter)

23. "Duracell should be earning more money than it is now"

WARREN BUFFETT: Jonathan.

JONATHAN BRANDT: Duracell's $82 million of pretax profits in 2017 were still well below what it earned as a subsidiary of P&G. Can you clarify or quantify to what extent transition costs or purchase price accounting impacts at the segment level were still temporarily burdened last year? Or is it possible that the gap in earnings contribution simply reflects a commoditization of the category given the entry of Amazon into the battery market?

I did see that Duracell's earnings were up in the first quarter. Is that a sign of a more meaningful contribution in 2018 and beyond, as you finish right-sizing the manufacturing footprint and acquisition-related charges fall away?

WARREN BUFFETT: Yeah. Duracell should be earning more money than it is now, and will be. And as you mentioned, it's well on its way there. But it is not earning an appropriate amount now, based on the history of the company.

I was around when - I was on the board of Gillette when Gillette bought Duracell. And I've seen what it does when it is managed to its full extent. And I saw what Jim Kilts did with it at Gillette when he ran it. And there were a lot more transition problems in the purchase. For one thing, there's a lot of rules connected with our swap of our stock in P&G for Duracell. There are a lot of things which you cannot do that made sense to do in that period of transition from P&G's management to ours. But Duracell - the brand is strong. Very strong.

The product line is very strong. And we are making more money. And we should, and I believe we will earn, really, what the property is capable of earning. We should be earning that relatively soon.

But you're absolutely right that it is - from a profit standpoint - is underperforming.

We're making a lot of changes. And some of those are involved in jurisdictions - countries - where it is really expensive to change in terms of employment - payments that have to be made if a plant is changed or something of the sort.

But I like the Duracell deal absolutely as well as when we made it.

Charlie?

CHARLIE MUNGER: I like it better than you do. (Laughter)

WARREN BUFFETT: No. Duracell is a very, very - is our kind of business.

CHARLIE MUNGER: It is.

24. Long-term bonds are "almost ridiculous" at current rates

WARREN BUFFETT: OK. Station 7.

AUDIENCE MEMBER: Good morning. And I have a question related to the bond market - U.S. Treasury bond market. And my name is Ola Larsson (PH). I live in the San Francisco bay area.

And I never worked in the financial industry. I started out buying penny mining stocks on the Vancouver Stock Exchange. And then decades later, I got married. And my wife convinced me to buy Berkshire shares. That was probably a good decision. (Laughter)

So my question is, I read the newspapers about the Federal Reserve and the inflation numbers. And there must be an increase supply of Treasury bonds that must go to auction. And my question is how would - what do you expect that to impact yield or interest rate?

WARREN BUFFETT: Yeah. The answer is, I don't know. And the good news is, nobody else knows, including members of the Federal Reserve and everyone -

There are a lot of variables in the picture. And the one thing we know is we think that long-term bonds are a terrible investment, and we - at current rates or anything close to current rates.

So basically all of our money that is waiting to be placed is in Treasury bills that, I think, have an average maturity of four months, or something like that, at most.

The rates on those have gone up lately, so that in 2018, my guess is we'll have at least $500 million more of pretax income than we would've had in the bills last year.

But they still - it's not because we want to hold them. We're waiting to do something else.

But long-term bonds - they're basically, at these rates - it's almost ridiculous when you think about it. Because here the Federal Reserve Board is telling you we want 2 percent a year inflation. And the very long bond is not much more than 3 percent. And of course, if you're an individual, then you pay tax on it. You're going to have some income taxes to pay.

And let's say it brings your after-tax return down to 2 1/2 percent. So the Federal Reserve is telling you that they're going to do whatever's in their power to make sure that you don't get more than a half a percent a year of inflation-adjusted income.

And that seems to me, a very - I wouldn't go back to penny stocks - but I think I would stick with productive businesses, or productive - certain other productive assets - by far.

But what the bond market does in the next year, you know - you've got trillions of dollars in the hands of people that are trying to guess which maturity would be the best to own and all that sort of thing. And we do not bring anything to that game that would allow us to think that we've got an edge.

Charlie?

CHARLIE MUNGER: Well, it really wasn't fair for our monetary authorities to reduce the savings rates, paid mostly to our old people with savings accounts, as much as they did. But they probably had to do it to fight the Great Recession, appropriately.

But it clearly wasn't fair. And the conditions were weird. In my whole lifetime, it's only happened once that interest rates went down so low and stayed low for a long time.

And it was quite unfair to a lot of people. And it benefited the people in this room enormously because it drove asset prices up, including the price of Berkshire Hathaway stock. So we're all a bunch of undeserving people - (laughter) - and I hope that we continue to be so. (Laughter)

WARREN BUFFETT: At the time this newspaper came out in 1942, it was - the government was appealing to the patriotism of everybody. As kids, we went to school and we bought Savings Stamps to put in - well, they first called them U.S. War Bonds, then they called them U.S. Defense Bonds, then they called them U.S. Savings Bonds. (Laughs) But they were called war bonds then.

And you put up $18.75 and you got back $25 in ten years. And that's when I learned that that $4 for three - in ten years - was 2.9 percent compounded. They had to put it in small print then.

And even an 11-year-old could understand that 2.9 percent compounded for ten years was not a good investment. But we all bought them. It was - you know, it was part of the war effort, basically.

And the government knew - I mean, you knew that significant inflation was coming from what was taking place in finance, in World War II.

We actually were on a massive Keynesian-type behavior, not because we elected to follow Keynes, but because war forced us to have this huge deficit in our finances, which took our debt up to 120 percent of GDP. And it was the great Keynesian experiment of all time, and we backed into it, and it sent us on a wave of prosperity like we've never seen. So you get some accidental benefits sometimes.

But the United States government (inaudible) every citizen to put their money into a fixed-dollar investment at 2.9 percent compounded for ten years. And I think Treasury bonds have been unattractive ever since - (laughs) - with the exception of the early '80s. That was something at that time.

I mean, you really had a chance to buy - you had a chance to invest your money by buying zero-coupon Treasury bonds, and in effect, guarantee yourself that for 30 years you would get a compounded return, you know, something like 14 percent for 30 years of your lifetime.

So every now and then, something really strange happens in markets and the trick is to not only be prepared but to take action when it happens.

Charlie, did you ever buy any war bonds?

CHARLIE MUNGER: No. No. I never bought war bonds.

WARREN BUFFETT: No. Used to be like take me -

CHARLIE MUNGER: I didn't have any money when I was in the war. (Laughter)

WARREN BUFFETT: That's a good reason not to buy. (Laughs)

25. "A bureaucracy is sort of like a cancer"

WARREN BUFFETT: OK, Becky?

BECKY QUICK: This question comes from Angus Hanton (PH), who - he and his wife are based in London, and he says they've been shareholders in Berkshire Hathaway for over 30 years.

He says, "We have all read about the zero-based budgeting that has been so effective with Kraft Heinz and other investments that you've done with 3G Partners. Can we expect these cost-reduction techniques to be used by your managers in other parts of the Berkshire Hathaway enterprise?"

WARREN BUFFETT: Well, in general, we do not expect the managers, generally, to get in the position where there would be a lot of change in terms of zero-based budgeting. In other words, why in the world aren't you thinking that way all of the time?

The 3G people have gone into certain situations where there were - probably primarily in personnel, but in other expenses as well - a lot of expenses that were not delivering a dollar of value per dollar expended.

And so, they made changes very fast that - to a situation that probably shouldn't have existed in the first place.

Whereas, we hope that our managers - take a GEICO. GEICO's gone from, I think, 8,000 to 39,000 people since we bought control. But they're all very productive. I mean, you would not find a way for a 3G operation to take thousands of people out of there.

On the other hand, I can think of some organizations where you could take a whole lot of people out, where it isn't being done because the businesses are very profitable to start with.

That's what happened with the tobacco companies, actually. They were so profitable that they had all kinds of people around that didn't - weren't really needed. But they - the money just flowed in.

So I - our managers have different techniques of keeping track of - or of - trying to maximize customer satisfaction at the same time that they don't incur other than necessary costs.

And I think, probably, some of our managers may well use something that's either zero-based budgeting or something akin to it. They do not submit budgets - never have - to me. I mean, they've never been required to. We've never had a budget at Berkshire.

We don't consolidate our figures monthly. I mean, I get individual reports on every company. But there's no reason to have some extra time spent, for example, by having consolidated figures at the end of April, or consolidated figures at the end of May.

We know where we stand. And - you know, I'm sure we're the only company that - probably in the whole Fortune 500 - that doesn't do it. But we don't do unnecessary things around Berkshire. And a lot of stuff that's done at big companies is unnecessary. And that's why a 3G finds opportunities from time to time.

Charlie?

CHARLIE MUNGER: Well, if you've got 30 people at headquarters and half of those are internal auditors, that is not the normal way of running a big company in America.

And what's interesting about it is, obviously, we lose some advantages from big size. But we also lose certain disadvantages from having a big bureaucracy with endless meeting after meeting after meeting around headquarters.

And net, I think we've been way ahead with our low overhead, diversified method. And also, it makes our company attractive to very able, honorable people who have companies.

So generally speaking, the existing system has worked wonderfully for us. I don't think we have the employment that could be cut effectively that a lot of other places have. And I think our methods have worked so well that we'd be very unlikely to change them.

WARREN BUFFETT: Yeah. I think if some - at headquarters, you could say we have kind of subzero-based budgeting. (Laughter)

And we hope that the example of headquarters is, to a great extent, emulated by our -

CHARLIE MUNGER: But it isn't just the cost reduction. I think the decisions get made better if you eliminate the bureaucracy.

WARREN BUFFETT: Oh yeah.

CHARLIE MUNGER: I think a bureaucracy is sort of like a cancer. And it functions sort of like a cancer. (Applause)

And so, we're very anti-bureaucracy. And I think it's done us a lot of good. In that case, we're quite different from, say, Anheuser-Busch at its peak.

26. We're experimenting with lower-cost commercial insurance

WARREN BUFFETT: OK. Gary.

GARY RANSOM: My question is on small commercial, and specifically, direct small commercial.

You seem to have some websites that enable buyers to purchase small commercial insurance directly; biBERK is one of them.

It's a very competitive, fragmented market. But what is your strategy for that market? And then, can you ultimately GEICO-ize the small commercial market?

WARREN BUFFETT: Well, we'll find out. I mean, it's a very good question because that's exactly the question we ask ourselves.

And we have this incredible company at GEICO, which has gone direct in the personal auto field, and was, you know, first started it in 1936.

And there's no question in my mind that over a lot of years - and maybe not so many years - something like small commercial - anything that takes cost out of the system, you know, makes it easier for the customer, is going to work over time, if you've got a system that was based on something that had more layers of agency costs and that sort of thing.

So we are experimenting, and we'll continue to experiment, on something like small commercial, workers' comp, whatever it may be. We'll try and figure out ways to take cost out of the system, offer the customer an equivalent product or better at lesser price, and we'll find out what can be done and what can't be done.

And we're not the only ones doing it, as you know. But we are not going - we've got some managers that are going to be quite, I'm sure, enterprising on that. And we back them. And we expect some to fail and some - and if a few succeed - we'll have some very good businesses. And the world is going in that direction. So - you could expect us to try and go with it.

Charlie?

CHARLIE MUNGER: Well, if it were easy, I think it would've happened more fast -

WARREN BUFFETT: Yeah -

CHARLIE MUNGER: - than it has.

WARREN BUFFETT: It will happen as we go along. I mean, it wasn't easy in auto, I mean, when you think about it.

CHARLIE MUNGER: No, it wasn't.

WARREN BUFFETT: No. I mean, it was a system with all kinds of extra costs that go back to the turn of the 19th century into the 20th. I mean, it was built on fire insurance and strong general agencies. And that slopped over into auto when the auto came along in 1903 from Ford or whenever. And - so it grew within a system that really wasn't very efficient compared to what was available.

But it took State Farm initially to go to a direct, or a captive agency system. And then it took USAA, and then later, GEICO, and then later, Progressive, to go to direct systems that are even more efficient and consumer-friendly.

And the same thing is going to happen, to some degree, in all kinds of industries, and certainly small commercial - somebody will -

CHARLIE MUNGER: It could happen, but it will be slow.

WARREN BUFFETT: It takes an amazingly long time. I mean, it - but you know, the battle doesn't always go to the strong and the race to the swift. But that's the way to bet, you know, as they say. So - (Laughs)

27. Health care partnership is attacking a huge "industry moat"

WARREN BUFFETT: OK, station eight?

AUDIENCE MEMBER: Austin Merriam, from Jacksonville, Florida.

Mr. Buffett, with the recent news of the partnership between you, Mr. [Jeff] Bezos, and Mr. [Jamie] Dimon, to challenge the health care industry and the self-admitted difficulties you are running across, this would lead me to believe the industry has higher barriers to entry than may have originally been hypothesized; a larger moat, if you will.

Would that justify a higher earnings multiple for established players in the industries, such as PBMs, for example?

WARREN BUFFETT: Well, just - though the system may have a moat against intruders, it doesn't mean that everybody operating within the system has individual moats, for one thing.

Now, I - we are - if this new triumvirate succeeds at all, we are attacking an industry moat. And I'm defining industry very broadly; health care, not just, you know, health care insurers or this or that.

We're trying to figure out a better way of doing it and making sure that we're not sacrificing care. And the goal is to improve care.

And like I say, that is a - that's a lot bigger than a single company's moat. It's bigger than a component of the industry's moat. The moat held by the whole system, since it interacts in so many ways, is actually - that's the moat that essentially has to be attacked, and that's a huge moat.

And like I say, we'll do our best. But - I hope if we fail, I hope somebody else succeeds.

Charlie?

CHARLIE MUNGER: Well, I suspect that eventually when the Democrats control both houses of Congress and the White House, we will get single-payer medicine. And I don't think it's going to be very friendly to many of the current PBMs. (Applause)

And I won't miss them. (Laughter)

28. Buffett vs Elon Musk on whether competitive moats are "lame"

WARREN BUFFETT: Andrew?

ANDREW ROSS SORKIN: This question comes from Kiwi (PH) and actually is directly about the issue of moats.

He notes that - “Elon Musk, this week, on his Tesla earnings call, said the following, quote, ‘I think moats are lame. They are, like, nice in a sort of quaint, vestigial way. And if your only defense against invading armies is a moat, you will not last long. What matters is the pace of innovation. That is the fundamental determinant of competitiveness,’ unquote.

“So, Warren, it seems the world has changed. Business is getting more competitive. Pace of innovation. Technology is impacting everything. Is Elon right?”

CHARLIE MUNGER: Let me answer that one, Warren.

Elon says a conventional mode is quaint. And that’s true of a puddle of water. And he says that the best moat would be to have a big competitive position. And that is also right. You know, it’s ridiculous. (Laughter)

Warren does not intend to build an actual moat. (Laughter)

Even though they’re quaint.

WARREN BUFFETT: Yeah. (Laughter)

There’s certainly a great number of businesses - this has always been true, but it does seem like it - the pace has accelerated and so on, in recent years. There’s been more moats that have been - become susceptible to invasion - than seemed to be the case, earlier. But there’s always been the attempt to do it.

And there - here and there, there are probably places where the moat is as strong as ever. But certainly - you could work at - certainly should be working at improving your own moat and defending your own moat all of the time. And then - Elon may turn things upside down in some areas.

I don’t think he’d want to take us on in candy. But - (Laughter)

And we’ve got some other businesses that wouldn’t be so easy to -

You can look at something like Garanimals out there in the other room. And - it won’t be technology that takes away the business in - (laughs) - Garanimals. Maybe something else that catches the young kid’s fantasy or something.

But - there are some pretty good moats around. Being the low-cost producer, for example, is a terribly important moat. And something like GEICO - technology has really not brought down the cost that much. I think our position as - there is a couple of companies that have costs as low as ours. But among big companies, we are a low-cost producer, and that is not bad when you’re selling an essential item.

29. Not surprised "if we find good uses" for Berkshire Hathaway Energy's capital

WARREN BUFFETT: OK, Gregg?

GREGG WARREN: Warren, Berkshire Energy has benefited greatly from operating under the Berkshire umbrella. By not having to pay out 60 to 70 percent of earnings annually as a dividend, the company was able to amass 9 billion in capital the past five years, and closer to 12 billion in the past ten, money that can be allocated to acquisitions and capital spending, especially on renewables.

While tax credits for solar energy don't run out until next year, we've already seen a dramatic reduction in Berkshire Energy's capital commitment to solar projects. And even though spending on wind generation capacity is projected to be elevated this year and next, it does wind down in 2020 as the wind production tax credits are phased out.

Absent a major commitment to additional capital projects, it looks like Berkshire Energy's expenditures in 2021 will be its lowest since 2012, leaving the firm with more cash on hand than it has had in some time.

Do you think it is likely at that point that Berkshire Energy starts funneling some of that cash up to the parent company? Or will it be earmarked for debt reduction, or just be left on the balance sheet as dry powder for acquisitions?

WARREN BUFFETT: Yeah. The - you're right about when tax credits phase out and all of that. Although, as you know, they've extended that legislation in the past. Who knows exactly what the government's position will be on incentivizing various forms of alternative energy?

But my guess is - I mean, if you take the logical expenditures that may be required in all aspects of the public - like regeneration and the utility business generally - I think there'll be a lot of money spent.

And the question is whether we can spend it and get a reasonable return on it. There again, we'll do what's logical.

There are three shareholders, basically, of Berkshire Hathaway Energy. Berkshire Hathaway itself owns 90 percent of it. And Greg Abel and his family, perhaps, and Walter Scott and, again, family members - own the other 10 percent. And we all have an interest in employing as much capital as we can at good rates.

And we'll know when it can be done and when it can't be done. And we'll do - there's no tax consequences to Berkshire at all. So - but the three partners will figure out which makes the most sense.

But when you think of what might be done to improve the grid in the U.S. and the fact that we do have the capital, I wouldn't be surprised if we find good uses for capital in Berkshire Hathaway Energy for a long time in the future.

Charlie?

CHARLIE MUNGER: Yeah. Well, I think there'll be huge opportunities in Berkshire Energy as far ahead as you can see to deploy capital very intelligently. So I think the chances of a big dividend is approximately zero.

WARREN BUFFETT: Yeah. And we've not only got the money to an extent that virtually no utility company does - we've also got the talent, too. I mean, we've got a very, very talented organization there.

So it's a big field and we've got shareholders that are capitalists. And we've got managers that are terrific. And you would think we'd find something intelligent to do over time in the field.

So far, we have. I mean, we've owned it now for close to 20 years. And we've deployed a lot of capital and so far, so good. I mean, it's -

If you look at the improvements that can be made in our utility system in the United States, you're talking hundreds and hundreds and hundreds of billions of dollars, if not trillions. So - you know, where else but Berkshire would you look for that kind of money? (Laughs)

30. "We do expect that normalized earning power to increase over time"

WARREN BUFFETT: OK, station 9.

AUDIENCE MEMBER: I'm Richard Sercer (PH) from Tucson, Arizona.

"At Berkshire what counts most are increases in our normalized per-share earning power." That was in your last letter. What is our normalized per-share earning power, as you estimate it?

WARREN BUFFETT: Well, I would say that what you saw in the first quarter, under these tax rates, would probably be a reasonable guess. You know, obviously, it depends on the economy in any given year. I would say that would - is a reasonable estimate.

But we have firepower we haven't used. And we'll have more firepower as we go along. So we do expect that normalized earning power to increase over time. And if it doesn't, you know, one way or another, we're failing you because we're retaining those earnings.

So - I don't see anything abnormal in our earnings, figured now at a 21 percent federal rate. But as I look at the 5 1/4 billion in the first quarter - seasonally, insurance is better in the first quarter - but seasonally, most of our businesses, the first quarter is not the strongest quarter for us. I don't see anything abnormal with it.

And then I think you can expect, you should expect, we expect, substantial capital gains over time in addition to what comes from the operating businesses.

So how much you figure in for that - I would say that the retained earnings beyond dividends of our 770 billion of equities - in other words, how much they're keeping from us, but that our share of the earnings, which can be used by them, whether it's Apple or American Express or Coca-Cola or Wells Fargo or whatever, our share, you know, is in many billions of dollars annually. And one way or another, we think that those dollars will benefit us as much as if they had been paid out.

Now, in certain cases, they won't. But in certain cases, they'll excel the amount, in terms of market value created.

So there's many billions of dollars we are not showing in our earnings that is being retained by our investees. And one way or another, I think we'll get value received out of those.

So you can take 20 or 21 billion under present tax rates, present economic conditions, and then we should get something from that and we should get more when we get 100 billion of cash invested. And we should get more as we retain the earnings. So we hope it adds up to a bigger number as we go along.

Charlie?

CHARLIE MUNGER: Well, I don't think our shareholders are going to see another increase in net worth of $65 billion in a single year. They may have to wait a while for another. But I don't think that - I think eventually there - another will come, and then another. Just be patient. (Laughter)

WARREN BUFFETT: We don't regard the present situation as, you know, as disadvantageous, except we'd like to get more money out. But we like the businesses we have. We like the businesses that we own part of. We are not reflecting - in the way we look at earnings - the dividends we get from those partially-owned companies falls far short of what they're going to contribute, in our view, to Berkshire's overall earnings over time. We wouldn't own those stocks otherwise. So -

CHARLIE MUNGER: And you also like the Apple and airline stocks you've recently purchased better than the cash you parted with.

WARREN BUFFETT: Absolutely. Yeah.

CHARLIE MUNGER: And that's quite a lot.

WARREN BUFFETT: Yeah, yeah, yeah. OK. We won't pursue that further. Carol? (Laughter)

31. No "unusual profits involved in being a real estate agent"

CAROL LOOMIS: This question is from Daniel Kane (PH) of Atlanta.

"Your annual letter this year pointed out that Berkshire has become a leader in real estate brokerage in the United States. Congratulations. That is a significant feat in less than 20 years.

"But let me mention a sticky point. If fees charged by stock market active managers are a drag on investor performance, I would argue that real estate commissions are no different, and perhaps more detrimental, especially when one considers the lifetime effects of large, forgone, upfront cash flows and the power of compounding interest. I would be pleased to hear your rejoinder on the points I've raised."

WARREN BUFFETT: Well, the purchase of a home is the largest financial transaction, for a significant percentage of the population, that they make. And - people - a lot of people need a lot of attention. And you can show a lot of houses before you sell one.

I would say this. If you look at our close to 50,000 agents now, I think they make a good living - or a decent living. But I would say that that people who manage money make a whole lot more money with perhaps less contribution to the welfare of the person that they are dealing with.

So I don't think that there are unusual profits involved in being a real estate agent. I don't think there are unusual profits involved in the ownership. We like it because it's fundamentally a good business.

But here we are, doing 3 percent of all the real estate transactions in the United States, and we're making, maybe, $200 million a year - which - well, we won't get into what the comparative efforts are in Wall Street to earn $200 million. But -

I think I have to tell them about Roy Tolles a little bit on this. Roy Tolles, for example - Charlie's partner - many, many, many years ago, decided he was going to want to buy a house in San Marino. He's going to have a number of kids.

So he sent his wonderful wife, Martha, out. And for six months, he had her look at houses in San Marino. And this was many years ago. And if they were priced at 150,000, she would offer (inaubible), or offer 75,000. And of course, the real estate agents were going crazy because they're never going to get something listed at 150 sold at 75.

And then finally, when she found one that they both really liked, he had her offer something like 120 and the real estate was so happy to get a bid that was in the general area - (laughs) - of the offering price that he would work very hard on the seller to take that bid. Because he knew what - (laughs) - he did not want six more months of Roy bidding at the lower prices. So you don't sell them on the first trip.

Incidentally, I had Roy buy a house for me, sight unseen, because this was a guy that - (laughs) - knew human nature.

You don't get rich - real estate agency - you know, the people earn their money, and they earn it in a perfectly respectable and honorable manner in terms of what they get paid. And as in every single industry there is, you know, there can be excesses or mistakes or that sort of thing.

But we will continue to buy more brokers. In fact, we'll probably have another couple to announce before long.

And we will feel that if we get to where we're doing 10 percent of the real estate brokerage business in the country and we're making 6- or $700 million a year, pretax, we will not think that's a crazy amount of money to make for enabling 10 percent of 5 million people to change their homes every year in the United States.

Charlie?

CHARLIE MUNGER: Well, the commissions in real estate may get unreasonable if you're talking about $20 million houses. It seems a little ridiculous to pay a 5 percent commission on a $20 million transaction.

But do any of us really care if the kind of people who pay $20 million for a house have a slightly higher commission? (Laughter)

The ordinary commission is pretty well-earned.

WARREN BUFFETT: Yeah. We have a number of brokerage firms. So the highest has their average transaction - in one section of the country - would be close to $600,000 a unit. But the - in terms of the sales price of the house. But the - in most of our real estate operations - the average price is more like $250,000 or something in that area. And you can show a lot of houses to make one $250,000 sale.

And of course, you split - the listing company and the selling company are usually two different companies. So it's - it does not strike me as excessive.

And incidentally, it doesn't strike the people in the industry that way either. It has not been particularly susceptible to online-type substitution or something of the sort. The real estate agent earns their commission in most cases.

But Charlie's had more experience with $20 million houses. So he will comment on that area. (Laughter)

32. Some Kraft Heinz products "enjoy fairly healthy" growth

WARREN BUFFETT: OK, we'll have one more question before we break. Jonathan?

JONATHAN BRANDT: Given the changes in consumer tastes in the food business, and Kraft Heinz's already high margin structure, do you think the brands they own today, plus new product introductions, can together maintain or increase the current level of profits over the next ten years without the benefit of acquisitions? Is there anything in their portfolio besides ketchup that is enjoying growing demand?

WARREN BUFFETT: Well, in effect, you're asking me whether Kraft Heinz is a good buy. And we don't - (laughs) - we don't want to give information on marketable securities in that manner.

But - yeah, there are a number of items besides ketchup that enjoy growing demand. And some vary quite a bit by geography. There's enormous differences in the penetration of various products in the portfolio.

Consumer packaged goods are still a terrific business in terms of return on invested assets. And you know - but the population, worldwide, grows fairly smally and at - a fairly minor rate. And - people are going to eat about the same amount. And there is some more willingness to experiment, you know, or go for organic products of the sort.

It's a very good business. And there are new products coming out constantly. It's not one where you're going to get terrific organic growth, but it never has been. And - you know, I like the business and we own 26 or so percent of it.

But there are a number of items within Kraft Heinz that enjoy pretty - fairly - healthy growth. And I think you'd find that at most food companies. And I think you'd find very good returns on invested - on tangible net assets - at those businesses.

Afternoon Session - 2018 Meeting

1. Thanks to meeting organizer Melissa Shapiro

WARREN BUFFETT: OK. Last year, for several years, we had a wonderful woman who carried this meeting off without a hitch, Carrie Sova. And she just had her third child here about a few weeks ago, and decided that — she decided right after the last meeting that that was going to be her full-time occupation.

And this year, again, we've had everything carried off without me having to do anything, without a hitch.

And I would just like to have Melissa Shapiro stand up. And we'll get a spotlight on her. (Applause)

I can't believe it, how she does it. It's just been — it's remarkable. I mean, we — I just tell her the date and then that's all the help I am — (laughs) — and it goes on from there. So, Melissa, thank you.

OK, I think we next go to station ten, and we will continue until 3:30. Then we'll take a 15-minute break, and at 3:45 we'll convene the actual annual meeting.

2. Why Berkshire won't be buying Microsoft stock

WARREN BUFFETT: Station 10?

AUDIENCE MEMBER: Hi, I'm Theresa Lukasinski (PH). I'm from Omaha, Nebraska. And I have a question about Microsoft.

You have gotten into the tech world with buying Apple. You have Mr. [Bill] Gates there. I'm just wondering why you've never bought Microsoft.

WARREN BUFFETT: Well — (laughter) — in the earlier years, it's very clear it's — the answer's stupidity. But the — (Laughter)

Since Bill has — particularly since Bill has joined the board, but even earlier than that because of our friendship, it would be — it just would be a mistake for Berkshire to buy Microsoft.

Because if something happened a week later, a month later, in terms of them having better earnings than expected, or making an acquisition — anything — both Bill and I would — incorrectly, but — would be a target of suggestions and accusations, perhaps even, that somehow he had told me something or vice versa.

I stay away from — I try to stay away from a few things just totally because the inference would be drawn that we might have talked — that I might have talked to somebody about something.

So I’ve told the fellows, Ted [Weschler] and Todd [Combs] for example, that there are just a few things that are off the list because there would be a lot of people who wouldn’t believe us if something good immediately happened after we bought it.

And of course, we — to buy a lot of stock, it can take six months to buy it or something of the sort. We just don’t need it.

But both that and my stupidity have cost us a lot of money. (Laiughs)

It’s a very — it’s a good question, and I think the answer makes sense.

Charlie?

CHARLIE MUNGER: Well, it’s part of theology that a late conversion is better than never — (laughter) — and you’ve greatly improved yourself. (Laughter)

3. “Through it all … America really, really moves ahead”

WARREN BUFFETT: Becky. (Laughs)

BECKY QUICK: All right, this question comes from Dave Shane (PH). He says, “Warren, you are a big believer in the U.S. political system, the financial system, and in every American.

You’ve said that regardless of who is president, the economy and the U.S. consumer will continue to prosper over the long run. All that said, do you believe that people in this country are more divided today than 50 years ago?

Or is it just social media, and media in general, that blows this divide out of proportion? And if you do believe the divide has grown, what words of wisdom do you have to possibly help remedy it?”

WARREN BUFFETT: Yeah, I would say this. Multiple times in my life, people have felt the country was more divided than ever.

And I’ve gone through periods where people I knew and admired thought that, because the other party was in power, that there never would be another election. That the Constitution would —

I’ve heard everything. Now, the interesting thing is this paper from 1942. Since then, there have been 14 American presidents, just since my young venture into the stock market at 11, I’ve lived under 14 of the 44 presidents the United States has had.

Now, they call Trump 45, but they count Grover Cleveland twice, so there's really only been 44 presidents of the United States. And 14 of the 44 have been during this period when that $10,000 became 51 million.

Seven have been Republicans, seven have been Democrats. One has been assassinated, one has resigned under pressure.

It works, you know. It — if you'd told me at the start, you know, that you'd have a Cuban Missile Crisis, and you've have nuclear weapons, and you'd have a panic in 200[8] — a financial panic — and you'd have many recessions, and you'd have war in the streets in the late '60s from a divided country, you'd say, "Why the hell are you buying stocks?"

And through it all, you know, America — in fits and starts — but America really, really moves ahead.

And we are always — we survived the Civil War. I mean, it — I hate to think of having to do it that way. But this country, in only less than three of my lifetimes —

If you go back three of my lifetimes, you go back 263 years, I guess, and Thomas Jefferson is 12 years old. And that's just three — and there was nothing here.

You know, you've flown in from all over to Omaha today, and you flew over a country with more than 75 million owner-occupied homes, and 260 million vehicles, and great universities, and medical systems, and everything. And it's all a net gain in less than three of my lifetimes.

So — and we've had these events since I started buying my first stock. This country really, really works. And it always will have lots of disagreements, and after every election you'll have people feeling the world is coming to an end and, you know, "How could this happen?"

And I remember my future father-in-law in 1952, he wanted to have a talk with me before his daughter and I got married. So kind of reluctantly I sat down with him, and he said, "Warren," he said, "there's just one thing I want to tell you." He said, "You're going to fail."

He said — (laughter) — you know, "The Democrats are going to get in," you know, they're going to take over the country. And you're going to fail, but don't feel responsible for it because it's not your fault."

And he wanted to absolve me from this feeling that, while his daughter was starving to death, it was my fault. And — (laughter) — I kept buying stocks and doing a little bit better all the time. And, but —

And if the Republicans were in, it was OK, and it was because of them that I was doing well. And if they were out, forget it, it was all going to disappear and stuff.

I mean, I've seen a lot of American public opinion over the years. I've seen a lot of media commentary. I've seen the headlines. And when you get all through with it, this country has six times the per capita GDP growth — the GDP per capita — that it had when I was born.

One person's lifetime, six-for-one change. Everybody in this room, essentially, is living better in multiple ways, than John D. Rockefeller Sr. was, who was the richest person, you know, in the world at that — during my early years. And we're all living better than he could live.

So this is a remarkable, remarkable country, and we found something — (applause) — very special.

CHARLIE MUNGER: (Inaudible)

WARREN BUFFETT: I would love to be a baby being born in the United States today. Charlie. OK, Charlie, you give the other side of this.

CHARLIE MUNGER: Well — (laughter) — there's a tendency to think that our present politicians are much worse than any we had in the past. But we tend to forget how awful our politicians were in the past. I can — (Laughter)

I can remember a prominent senator [Roman Hruska] arguing with an absolute earnestness that mediocre people ought to have more representation on the United States Supreme Court.

WARREN BUFFETT: Yeah. He came from Nebraska, incidentally.

CHARLIE MUNGER: He did. He came from Nebraska. (Laughter) So we're not quite as bad as that yet.

WARREN BUFFETT: Yeah. He succeeded my dad in the House of Representatives.

4. "We'll have a somewhat larger operation at Gen Re"

WARREN BUFFETT: OK. Gary.

GARY RANSOM: Yes, on reinsurance. I know we've talked in the past about reinsurance not really being as attractive an industry in, say, the next ten years as the last ten. But I don't think we've talked specifically about General Re.

And I looked this morning at the 10-Q and I see General Re has grown nicely. I know there's been some changes in the management.

And I wondered if you could just give us a sense of what's going on at the company to bring about some of that growth and what looks like improvement.

WARREN BUFFETT: Yeah. Well, the reinsurance business — I don't think I'd say that it's tougher than it was ten years ago. But you go to 40 or 50 years ago, it was not brutally competitive, I'll put it that way.

And at Gen Re — Tad Montross, who did a fantastic job for us at Gen Re, retired. And we have under Ajit [Jain] — and then Kara [Raiguek] in addition — but under Ajit, the focus of the place has changed somewhat.

And it probably is more growth oriented than before. But I can assure you that anything associated with Ajit is — also has underwriting discipline attached to it.

But, I — there has, as you've correctly noticed, there's been some pick-up. And I think you actually will see the property-casualty reinsurance business grow a fair amount.

And the life business — reinsurance business — and this is really the only place we do much in life — but that has grown very substantially ever since we took it over, particularly internationally. And so that part, I like.

And we will have a somewhat — I think we'll have a somewhat larger operation at Gen Re.

But we have various methods, as you know, of being in reinsurance. We do these huge bulk deals. That's why our net revenues are down this year. We did that $10 billion deal with AIG, which was the biggest deal in history, last year. And we don't have a repeat of it this year.

We will be in the reinsurance business five years from now, 10 years from now, 20 years from now, and 50 years from now, in my view. And we will have some unusual advantages that stem both from our capital position, our attitude toward the business, and the talent that we have.

We have an — we have a way better than average insurance business, generally. We have some real gems that nobody really knows much about.

And we have a very, very good reinsurance business that will be subject to more ups and downs than something like GEICO will be, which just moves ahead every year. But it will be an important part of Berkshire.

Charlie?

CHARLIE MUNGER: Yeah. I would argue the part that any idiot financier can easily get into has gotten way tougher. And why wouldn't it?

WARREN BUFFETT: Charlie is my substitute for my father-in-law that was — (Laughter)

5. "I can't reduce that to a formula for you"

WARREN BUFFETT: OK, Station 11.

AUDIENCE MEMBER: Hey, Warren. Charlie. Thank you again for having us and having me. I just can't thank you guys enough and appreciate you guys enough for the body of work that you guys have delivered to us and the exemplar example that you guys have set with your principles. Thank you. (Applause)

Charlie, you've mentioned that, if given the chance — or the same chance with a smaller capital base — you would still look for mispriced stock opportunities.

CHARLIE MUNGER: Of course.

AUDIENCE MEMBER: And that would be determined through, obviously, what we've called the intrinsic value of the organization — or the company in question — an aggregate of the discounted future cash flows.

Would you work the arithmetic using a fictional data set to illustrate the mathematical principia to determine an intrinsic value?

And I hope you include the comprehensive mental model of the key metrics considered, and quantitative assessments of the management, and any assumptions of its industry to determine the durability of its earning power.

And, Warren, same to that effect. Would you also demonstrate or illustrate an arithmetic problem set using, with a significant capital base, and provide the object lessons on how those have changed from a small to a large capital base?

CHARLIE MUNGER: Well, I can't give you a formulaic approach because I don't use one. (Laughter)

And I just mix all — (laughter) — I just mix all the factors and if the gap between value and price is not attractive, I go on to something else.

And sometimes it's just quantitative. For instance, when Costco was selling at about 12 or 13 times earnings, I thought that was a ridiculously low value, just because the competitive strength of the business was so great and it was so likely to keep doing better and better.

Well, I can't reduce that to a formula for you. I liked the cheap real estate. I liked the competitive position. I liked the way the personnel system worked. I liked everything about it.

And I thought, even though it's three times book, or whatever it was then, that it's worth more. But that's not a formula that anybody —

If you want a formula, you should go back to graduate school. (Laughter)

They'll give you lots of formulas that won't work. (Applause)

WARREN BUFFETT: This is the longest we've ever gone in a Berkshire meeting without Charlie saying that — getting to the point where he prefers Costco to Berkshire. (Laughter)

6. Why Apple and thoughts on Apple's buybacks

WARREN BUFFETT: OK, Andrew?

ANDREWROSS SORKIN: We got a handful of questions relating to Apple. This is a bit of a mash-up of a couple of them.

Warren, you have bought in and sold out of IBM. You have praised [Amazon CEO] Jeff Bezos but never bought Amazon. And you have doubled down on Apple. Can you tell us what it is about Apple?

And given your sometimes critical views on buybacks, do you think Apple would do better spending a hundred billion dollars on buybacks, or buying other productive businesses the way you have generally preferred? A hundred billion dollars is a lot of money.

WARREN BUFFETT: I used to think so. (Laughter) The —

Apple has a incredible consumer product which you understand a lot better than I do. Whether they should buy in their shares — they shouldn't buy in their shares at all, unless they think that they're selling for less than they're worth.

And if they are selling for less then they're worth, and they have the money, and they don't see an acquisition that's even more attractive, they should buy in their shares. And I think that that's very —

Because I think it's extremely hard to find acquisitions that would be accretive to Apple that would be in the 50 or 100 billion, or $200 billion range. They do a lot of small acquisitions.

And, you know, I'm delighted to see them repurchasing shares. We own — let's say we own 250 million or so shares. They have, I think, 4 billion, 923 million or something like that. And mentally, you can say we own 5 percent of it.

But I figure with, you know, with the passage of a little time we may own 6 or 7 percent simply because they repurchase shares. And it —

I find that if you've got an extraordinary product, and ecosystem, and there's lots to be done, I love the idea of having our 5 percent, or whatever it may be, grow to 6 or 7 percent without us laying out a dime. I mean, it's worked for us in many other situations.

But you have to have some very, very, very special product, and — which has an enormous wide — enormously widespread ecosystem, and the product's extremely sticky, and all of that sort of thing.

And they're not going to find 50 or a hundred billion dollar acquisitions that they can make at remotely a sensible price that really become additive to that.

And they may find it, who knows? But there certainly, as I look around the horizon, I don't see anything that would make a lot of sense for them in terms of what they'd have to pay and what they would get.

Whereas I do see a business that they know everything about, and where they may or may not be able to buy it at an attractive price when they repurchase their shares. That remains to be seen.

Incidentally, that's one thing that I always enjoy. People say, "Well, you're talking your book," or something if you talk —

From our standpoint, we would love to see Apple go down in price. They're going to — well, just put it this way. If Andrew and Charlie and I were partners in a business that was worth $3 million so each of us had a million dollar interest in it, if Andrew offered to sell out his one-third interest at 800,000 and we had the money around, we'd jump at the chance to buy him out. I mean, it's so simple.

But people get all lost — and if he'd wanted a million-two for it, we wouldn't pay it to him. (Laughs)

It's very simple math, but it gets lost in all these discussions. And of course, like I say, Tim Cook could do simple math. And he could probably do very complicated math, too. So, we very much approve of them repurchasing shares.

Charlie?

CHARLIE MUNGER: I think, generally speaking in America, when companies go out hell-bent to buy other companies, they do — they're worth less after the transaction is made than they were before.

So I don't think you have a general way to wealth for American corporations to go out and buy other corporations. Averaged out, it's a way down, not up.

And I think that a great many places have nothing better to do than to buy in their own stock, and nothing as advantageous to do as they can — as buying in their own stock.

So, I think we know pretty damn well what's going to happen to Apple. They'd be very lucky to — if there was something available at a low price that they could buy. It's —

I don't think the world's that easy. I think that the reason these companies are buying their stock is that they're smart enough to know that it's better for them than anything else.

WARREN BUFFETT: And that does not mean we approve of every buyback, at all, though. I mean, we've seen —

CHARLIE MUNGER: No, no, no. I think some people just buy it to keep the stock up. And that, of course, is insane. And immoral. But apart from that, it's fine. (Laughter)

7. "I like very much our holdings of American Express"

WARREN BUFFETT: OK, Gregg?

GREGG WARREN: Warren, if we look at the performance of your equity investment portfolio the last three to five years, some of the strongest performances come from Visa and MasterCard, which put up returns that are three to four times greater than American Express.

Unfortunately, your holdings of the two names, which we assume were held by Todd [Combs] or Ted [Wechsler], have accounted for less than one percent of stock holdings on a combined basis the past five years, while American Express has tended to be a top-five holding, accounting for 10 percent of the portfolio, on average, and closer to 8 percent of late.

Given that all three firms benefit from powerful network effects along with valuable brands, were there any particular reasons Berkshire did not ramp up its stakes in Visa and MasterCard to more meaningful levels, especially during those years when American Express was struggling?

After all, you've shown a willingness to own several stocks from the same industry, holding shares in several competing banks, and buying stakes in all four domestic airlines in fairly equal amounts when you picked them up in late 2016.

WARREN BUFFETT: Yeah. When Ted and Todd, or either one of them — I won't get into which specifically — which one of them specifically — bought, or for that matter they could both have bought — Visa and MasterCharge — they were significant portions of their portfolio.

And there was no embargo or anything on them owning those stocks because we had a big investment in American Express. And I could have bought them as well. And, looking back, I should have.

On the other hand, I think American Express has done a fabulous job, and now we own 17 and a large fraction percent of a company that not that long ago we may have owned 12 percent.

We've done it without spending a dime and without — you know, it's a company that has really done a fantastic job in a very competitive field where lots of people would love to take their customers away from them. But they have more customers than ever, and they're spending more money than ever. The customers are.

And the international growth has accelerated. The small business penetration is terrific. It's really quite a business. And, you know, we love the fact we own it.

Like I say, it didn't preclude me from, in any way, from buying MasterCharge or Visa. And if I had been as smart as Ted or Todd, I would have. (Laughs)

Charlie?

CHARLIE MUNGER: Well, we would have been a little — a lot better with all of our stock picking if we could do it in retrospect.

But — (laughter) — at the time, we have a big position in American Express, and there is one tiny cloud on the horizon of the payments processors and that is the system of WeChat in China.

And so it isn't as though there isn't a little cloud somewhere off in the — and I don't have the faintest idea how important that cloud is, and I don't think Warren does either.

WARREN BUFFETT: No. No. Payments are a huge deal worldwide. And you've got all kinds of smart people working at various ways to change the payment arrangements. And —

CHARLIE MUNGER: To destroy what we have now.

WARREN BUFFETT: Sure, sure. And you've got some very smart people that, you know, I am — the — but there — building a company.

And American Express made a decision a few years ago not to bid as low as somebody else did to retain the Costco business. And I think — Charlie and I disagree on this — but I think it was a smart decision. He doesn't think it was a smart decision. But one of us will be right. And — (laughter) — and one of us will remind you that they were right. (Laughter)

The — but if you look at American Express, it is — it's a remarkable company. I mean, you know, they came after them with Sapphire last year. People want that business. And payments are changing.

And you can see in different countries different ways things are going on in that. And there are a lot of people that will play the game of gaming the system, and switch from one to another based on the rewards on this card or that, and all of that sort of thing.

But there also is a — I think there's a very substantial group for which American Express does something very special, and they keep capitalizing on that premier position with that group.

And they're doing it successfully around the country. And you'll see in the first quarter — you've seen in the first quarter — you know, where in Britain, in Mexico, in Japan, you're seeing gains of 15 percent or better in local currencies.

And the base is not tiny, but it's not huge, so there's a lot of room left to go in that. And the small business penetration is good. The loan portfolio has behaved sensationally compared to, really, just about anybody.

So, I like very much our holdings of American Express.

The first half, because of the accounting changes, they had to suspend their repurchase program for six months. But I — they've announced that they expect to renew it.

And someday we'll even, you know, we'll own a greater percentage of American Express and it will be a bigger company, in my opinion. And I think we'll do very well.

But as Charlie says, nobody knows how payments is — for sure — comes out. And nobody knows how autos for sure come out. And there — that is true of a great many businesses we're in, and we've faced it before.

We used to buy things that were certain failures, like textiles and second-rate department stores and trading stamps in California. Now we just face things that face real difficulty. So we're actually moving up the ladder. (Laughter)

8. Capital-intensive businesses are "good enough"

WARREN BUFFETT: OK, Station 1.

AUDIENCE MEMBER: Mr. Buffett, my name is Daphne Collier Starr (PH). I'm eight years old and live in New York City. I've been a shareholder for two years and this is my second annual shareholders meeting.

Berkshire Hathaway's best investments on which the company built its reputation have been in very capital-efficient businesses — (laughter) — such as Coke, See's Candy, American Express, and GEICO.

But recently, Berkshire has made really big investments in a few businesses that require huge capital investments to maintain and that offer only a regulated low rate of return such as — (laughter) — Burlington Northern Railroad.

My question to you, Mr. Buffett, is could you please explain why Berkshire's largest recent investments have been departed from your old capital-efficient philosophy?

And why specifically have you invested Burlington Northern instead of buying a capital-efficient company like American Express? (Applause)

WARREN BUFFETT: You're killing me, Daphne. (Laughter) Yeah.

CHARLIE MUNGER: I'm certainly glad she's not nine years old.

WARREN BUFEFTT: Yeah. (Laughter)

I'm just sitting here thinking which of the six panelists we're going to bump next year and put you in. (Laughter)

Well, I thought I was doing well when I bought that City Service at 11. (Laughs)

The answer is that we have — we'd love — we always prefer the businesses that earn terrific returns on capital, like a See's Candy when we bought it or a good many of the businesses.

And, we've — and, you know, American Express, you know, earns a terrific return on equity, and has for a very long time.

The fact that we buy a Burlington — BNSF, Burlington Northern — means that, essentially, we can't get more money deployed in capital-light businesses at prices that make sense to us. And so we have gone into more capital-intensive businesses that are good businesses.

But wouldn't it be wonderful if we could run the railroad without trains, and track, and tunnels, and bridges, and a few things?

We get a decent return on the capital-intensive businesses. We bought most of them at very decent prices, and they've been run very well since we bought them.

We still love a business that takes very little capital and earns high returns, and continues to grow, and requires very little incremental capital.

We can't deploy as much money as we have in doing that. And so as the second-best choice, still a good choice, the answer is yes. It's not as good as the best choice.

Charlie?

CHARLIE MUNGER: Yes, I like the aspiration of that young lady. She basically wants her royalty on the other fellow's sales. And of course that's a very good model, and if everybody could do that, why, nobody would do anything else.

The reason we're satisfied with our utility returns and our railroad returns is they're quite satisfactory. And we — and the — quite satisfactory. I wish we had two more just like them. Don't you, Warren?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: So —

WARREN BUFFETT: Definitely.

CHARLIE MUNGER: So the answer is they're good enough, and you're asking us to get perfection if you would want us to have all our money in Coke at, say five percent of what it's now selling for.

WARREN BUFFETT: Yeah. And a business like Apple really doesn't take much capital.

But — so, you've got to spend a lot of money to buy businesses like that. Very few are for sale.

And the answer is we have not foregone any opportunity to buy businesses that earn high returns — very high returns — on equity capital, when we could buy them at a sensible price, to buy these other businesses.

So they haven't shoved anything else off the table. But you are — you definitely have a job in our capital allocation department. (Laughter)

9. Buffett "surprised" rate of decline for newspapers hasn't moderated

WARREN BUFFETT: OK, Carol.

CAROL LOOMIS: This question is from Max Taylor (PH) of Chicago, and it concerns the newspapers that Berkshire owns.

In your 2012 letter to shareholders, Mr. Buffett, you had a section devoted to Berkshire's buying 28 newspapers during the year just past. Since then, you have not come back to the newspaper subject.

But this year, at the end of the annual report, you published a list of the newspapers Berkshire owns today, along with their circulation. I compared that list with the one you published five years ago at the end of 2012.

As you no doubt know better than anyone, the circulation of the 26 newspapers that Berkshire still owns, of the 28 originally bought, fell sharply. In many cases, by big amounts like 30 percent to almost 50 percent.

I know that five years ago, you acknowledged the risk in owning newspapers, but you still said, 'Charlie and I believe that papers delivering comprehensive and reliable information to tightly-bound communities, and having a sensible internet strategy, will remain viable for a long time.'

Skip to today, and imagine that you are writing about Berkshire's experience with newspapers. What would you be saying?"

WARREN BUFFETT: Yeah. I would say that — I forget the modifying word on internet strategy — but I could say (Inaudible).

The problem has been — about 1,300 daily newspapers in the United States — there were 1,700 not that long ago — is that no one except The Wall Street Journal, The New York Times, and now probably The Washington Post has come up with a digital product that, really in any really significant way, will replace the revenue that is being lost as print newspapers lose both circulation and advertising.

And if you look at the communities in which we operate, or the communities in which, you name it — other newspapers operate, the community could be prospering. We're in a prosperous economy presently. And all are losing daily circulation, they're losing Sunday circulation, they're losing street — all street sales, they're losing home-delivered.

And it is — I've been surprised that the rate of decline has not moderated in the last five years.

We bought all the papers at reasonable prices, so it is not of great economic consequence to Berkshire. But I would like to see daily newspapers, actually, you know, be economically viable, because of the importance to society.

But I would say that the trends which — I put those circulation figures in there because I think the shareholder's entitled to look, year-to-year, at what is happening. And it's not only —

It's happening to 1,300 newspapers throughout the United States. And it happens in small towns, where you would think that the alternative sources of information would not be that good. It happens every place.

And The Journal, The Times, and probably The Post, have a viable economic model in the digital world, and probably will continue to shrink — I'm almost certain will continue to shrink — in the print world.

But the digital world will be big enough that — and they'll be successful enough — so that they have, in my view, a sustainable business model.

But it is very difficult to see, with the lack of success, in terms of important dollars arising from digital, it's difficult to see how the print product survives over time. And that's — I'm afraid that's true of 1,300 papers in this country.

And we'll keep looking to see if there is a way to do it. But you'd have to look at our experience, and look at the experience of everyone else's.

McClatchy newspapers came out the other day, you know, and I think that newspaper — which is very good — fine cities that they operate in — and advertising revenue is down something like 17 or 18 percent, and circulation. But it isn't just them, it's everybody in the business. And I wish I had a better answer for you, but I don't.

I would say that the economic significance to Berkshire is almost negligible, but the significance to society, I think, actually is enormous.

And, you know, I hope that we find something. I hope others find something because we'll copy it. But so far, we have not succeeded in that.

Charlie?

CHARLIE MUNGER: Well, the decline was faster than we thought it was going to be. So it was not our finest bit of economic prediction. And I think it's even worse.

I think, to the extent we miscalculated, we may have done it because we both love newspapers and are — and have considered them so important in our country.

These little local newspaper monopolies tended to be owned by people who behaved well and tended to control the politicians. And we're going to miss these newspapers if they disappear. We're going to miss them terribly. And —

WARREN BUFFETT: I think you may continue —

CHARLIE MUNGER: — I hope to God it doesn't happen, but the figures are not good, Warren.

WARREN BUFFETT: No. No, they aren't. And it isn't just — you know, it isn't some town that has a particular problem with unemployment or anything of the sort. And it isn't due to general economic conditions.

It's due to the fact that a newspaper, if you wanted to know the baseball results from the present day, and the box scores, and everything else, they told you the following morning and it was still news to you.

And the financial material that I read from there, and in terms of looking at the stock prices and everything, they were news to you the following morning. And the —

What was developing in the Pacific in terms of the war was news to you when you read about it in the morning in The New York Times. And it's — news is what you don't know that you want to know. And the —

And those Help Wanted ads, you know, segregated as they may have been, still were the place to go to look to find a job. And you can go up and down the line and one element after another where the daily print newspaper was primary, they're no longer primary.

And the business has changed in a very material way, and we haven't been able to figure out any solutions to that, and we'll keep trying.

Like I say, it's not of economic consequence, but I think it is societal consequence. And we haven't been able to solve it.

10. TTI has "improved dramatically in the past year"

WARREN BUFFETT: OK, Jonathan?

JONATHAN BRANDT: TTI has been a nice growth story since Berkshire acquired it 11 years ago, more than doubling its pre-tax earnings to about $400 million due to fine organic growth and at least two successful bolt-on acquisitions. Business momentum appeared to accelerate in the first quarter.

Can you please talk about the competitive landscape in the electronic components distribution industry and what TTI's advantages are? Is it just a great industry to be in or is TTI's business model and/or management team special?

WARREN BUFFETT: Well —

JONATHAN BRANDT: Do you expect it to continue to be one of Berkshire's faster growing non-insurance subsidiaries?

WARREN BUFFETT: TTI is run by a fellow named Paul Andrews who's done an absolutely sensational job with us. He's a wonderful man. He's a wonderful manager.

And in the last — he's quadrupled the business, basically, but in the last year and accelerating right to this point.

They distribute little electronic components. They actually — their average — they're a many-billion dollar business — and their average item is less than a nickel that they sell. So it's kind of like being in the jellybean business or something like that. Except these things go into all kinds of fancy machines that I don't understand.

And we have a worldwide operation based in the Dallas, Fort Worth area. And built by one man who left a division of General Dynamics 45 or 50 years ago. And step-by-step built up this business — like we just bought within the last two months, we bought an operation in South Korea that will be another substantial addition. We do business worldwide. And electronic components that have absolutely taken off in the last year.

And they use something called, you know, well, it's essentially a measure of backlog. And book-to-build is the ratio they call it. But it's just kind of a special term.

The — but, it's grown — I mean, it's just improved dramatically in the last year. And it continues month after month. So something is going on out there because nobody buys these things to store them in their basement or anything of the sort. I mean, these get used, these electronic components.

Some of them are on allocation. We have a great relationship with suppliers. We have a very good relationship with our customers because we carry more inventory than most of our competitors. So particularly when the business is tight we can deliver and do a very first-class job doing it.

So I give credit to Paul. He increased his physical facility, started on that a few years ago. And it's a godsend that he did it because with the business going through there now we wouldn't have been able to handle it.

But it's a competitive business. I mean, if you look at Arrow Electronics, you know, on the New York Stock Exchange — we've got competitors. I think Paul is doing a better job, by a considerable margin, than they are. And I'm delighted as a part of the Berkshire family.

There will be times when that business slows down because their customers, you know, will have their own cycles. And what it does will go down. But over time that business is going to grow.

Charlie?

CHARLIE MUNGER: Yeah, it's a wonderful business because it's so difficult to do that competitors don't want try it. When I lived in Omaha there was a man who lived in great prosperity and almost no work. And his business was gathering up and rendering dead horses. And he never had any competitors. (Laughter)

He used to come up to the Omaha Club and start drinking about 11 in the morning. It was not a difficult business. But nobody ever crowded him with new competition.

And very few people want to distribute zillions of electronic parts that are worth a nickel each. It's very complicated.

And of course that business is terribly good at it. And it keeps getting more and more of the same. So you're right. It's a huge growth business which is sort of the electronic equivalent of gathering up and rendering dead horses. (Laughter)

WARREN BUFFETT: Imagine keeping track of close to a million different items, you know, with very small values attached to them and getting them out to your customer fast because they want them fast, all over the world. You know, and those things are not easy to manage. I mean, yeah.

CHARLIE MUNGER: And staying in stock on so many items. It’s very complicated. And that business is very good at it.

WARREN BUFFETT: Yeah, we’re luck —

CHARLIE MUNGER: And of course it’ll grow. The horses went away but these parts aren’t going to go away. (Laughter)

WARREN BUFFETT: Charlie made a profession of studying businesses where the owners could sit around and drink all day and have — (laughter) — he thought that was where we ought to be competing but — or buying.

CHARLIE MUNGER: My theory, Warren, is if it can’t stand a little mismanagement, it’s no business. (Laughter)

WARREN BUFFETT: Yeah and we’re testing that sometimes. (Laughter)

11. Phillips 66 and staying below 10 percent ownership

WARREN BUFFETT: OK, Station 2.

AUDIENCE MEMBER: Hi, Ben Sherber (PH), Topeka, Kansas. Just want to say, Warren and Charlie, thank you again for hosting us all. This is a great event.

WARREN BUFFETT: Thank you.

AUDIENCE MEMBER: My question is about the recent decision to sell shares back of Phillips 66. Not to put you on the hot seat. But right after that, share prices jumped up about $22 a share.

You mentioned at the time that there’s some regulatory requirements if you own over 10 percent of a company. Could you talk about the factors that go into how you decide whether to retain more than that or get under that threshold? And then what are your thoughts long-term on Phillips 66, like, their business mid-stream refining?

WARREN BUFFETT: Yeah, well, it was the City Service preferred of last year. (Laughter)

We sold the stock at around 93 or ’4. And it’s probably 115 now. But we own just under 10 percent of the company. And the more Ted [Weschler] and Todd [Combs] and I think about various problems connected with regulatory problems and trading problems and so on, overwhelmingly we will stick below 10 percent on marketable security holdings.

We've done it with the airlines. Now that does not mean we're going to reduce our holdings in American Express or anything of the sort.

But — and Greg Garland has done a great job at Phillips 66. We've had very good relations with the company. They're very — he's a very, very, very experienced and sensible manager.

But I did decide that I wanted to be below 10 percent in that holding. And we, like I say, we'll stay just slightly under 10 percent of Wells Fargo.

We've actually sold a few shares just to stay below 10 percent in the case, I think, of both American Airlines and United Continental.

Unless there's something unusual we're going to stay under ten. But we have nine and a significant fraction percent of Phillips. And I think they've been good at operations. I think they've been good at capital allocation.

We traded them a business — we traded them stock for a business some years ago, which has been a very nice business that we've retained in operation.

So we've got a lot of money still in Phillips. And I wish I'd made the deal at a higher price. But we made money on what we sold and we accomplished an objective.

Charlie?

CHARLIE MUNGER: Well, we like the subsidiary we traded the stock for. (Laughter)

WARREN BUFFETT: I missed that —

CHARLIE MUNGER: We traded the stock for a subsidiary.

WARREN BUFFETT: Yeah, well, yeah.

CHARLIE MUNGER: We like the subsidiary.

WARREN BUFFETT: Oh yeah. Well, it improved —

CHARLIE MUNGER: It isn't like the stock went away for nothing.

WARREN BUFFETT: Yeah. Yeah, actually we've done pretty well with Phillips.

12. Cryptocurrency craze will "come to a bad ending"

WARREN BUFFETT: Becky?

BECKY QUICK: This question comes from Vlad Koptev (PH) in Ukraine. He says, “Capitalization of cryptocurrency has approached that of Berkshire and Apple last year. And clearly the idea behind crypto will affect conventional banking groups where Berkshire is a shareholder. You always say you didn’t go into too much detail to obtain an understanding on cryptocurrencies. So what factors caused you to say that it’s a bubble?”

WARREN BUFFETT: Well, generally non-productive assets remain not only — if you’d bought gold at the time of Christ and you figured the compound rate on it, you know, it may be a couple tenths of 1 percent.

It essentially is not going to deliver anything other than supposed scarcity, you know, because they’ll only — you can only mine so many. But so what? I mean, what does it produce itself?

You know, the check is a wonderful idea. Just imagine how the world would be without being able to write checks or have wire transfer of funds. But it doesn’t make the check intrinsically itself worth a lot of money.

And if you said you can’t use something called “check” with a little piece of paper you’d do something else to transfer money.

I think that anytime you buy a nonproductive asset you are counting on somebody else later on to buy a nonproductive asset because they think they can sell it to somebody for more money.

And it’s been tried with tulips and it’s been tried. It’s been tried with various things over time. And it does come to a bad ending.

I mean, having — you have a hard time. You can think of raw land. I mean, the Louisiana Purchase was, say, $15 million for 800,000 or so square miles of land. In fact, you’re sitting on land that came with the Louisiana Purchase.

And so what’d we pay? We paid 20 bucks a square mile. And, you know, 640 acres in a square mile. And you’re down to three cents or something. So that was a pretty good purchase of what was then a nonproductive property. But it’d depend — but it’s very hard. You can buy stamps. Bill Gross got, you know, collected a wonderful stamp collection. It sold for more money in the end.

But it’s dependent on somebody else wanting to buy, hoping they will sell it for more money and so on.

And in the end you make your money on productive assets. If you buy a farm, you try to estimate what the crops, what amount per acre of soybeans or corn or whatever may be raised, and how much you have to pay the farmer that farms it for you, and what your taxes will be, and various things. And you make a conclusion based on what the asset itself will produce over time. And that’s an investment.

When you buy something because you're hoping tomorrow morning you're going to wake up, you know, and the price will be higher, the only reason, you know, you need more people coming into it than are leaving.

And you can get that. And it will feed on itself for a while, and sometimes for a long while, and sometimes to extraordinary numbers. But in the end — but they come to bad endings. And cryptocurrencies will come to bad endings.

And along with the fact that there's nothing being produced in the way of value from the asset that you also have the problem that it draws in a lot of charlatans and that sort of thing who are trying to create various sorts of exchanges or whatever it may be.

You know, it's something where people who are of less than stellar character see an opportunity to clip people who are trying to get rich because their neighbor's getting rich buying this stuff that neither one of them understands. It will come to a bad ending.

Charlie?

CHARLIE MUNGER: Well, I like cryptocurrencies a lot less than you do. (Laughter)

And so to me it's just dementia. And I think the people who are professional traders that go into trading cryptocurrencies, it's just disgusting. It's like somebody else is trading turds and you decide, "I can't be left out." (Laughter and applause)

WARREN BUFFETT: To the extent that this — we are being webcast around the world, I hope some of our stuff doesn't translate very well, actually. (Laughter)

13. Shareholders will get a lot of the corporate tax cut benefit

WARREN BUFFETT: OK, Gary.

GARY RANSOM: Yes, I had a question on the corporate tax rate. And we have a debate in my investment world about where the benefits of that cut fall. And I'd say the consensus is going to the consumer as it gets competed away over time. But perhaps some of it sticks to shareholders.

And my question is, do you think, over the long run, some of the benefits sticks to shareholders? And maybe it's even beyond auto insurance? Maybe it's other businesses you have as well.

WARREN BUFFETT: Well, what people do generally with that is they take what they want to be the answer for them and then they hire — or they just attach themselves to some economist that gives them a more complicated way of saying it's all going to be wonderful because it's happened.

But the answer is that in the case of our regulated public utilities, the benefits are all supposed to go, and will go, to the utility customer, because we're entitled to a return on equity if we perform well. And we're not entitled to get excess returns because our tax rates changed. And similarly, if tax rates would go back up, we would expect to get compensated for that. So in that area — and that was 5 or $6 billion for us.

But in that area, absolutely, it goes to the user, the consumer. And it should.

Then the question is, with the remainder, does it get competed away or not? And the answer is sometimes it does, sometimes it gets competed very quickly and substantially. Sometimes it may be slow. And other times it probably won't.

The one thing to know is that the change in the corporate tax law was good for shareholders, generally, and Berkshire shareholders. I mean — and that's what Congress passed. And the intent had to be that if you were going to cut taxes that shareholders would get a particularly large portion this time. And some of you will agree with that politically and some of you won't agree with it politically. But you'll all benefit equally. (Laughs)

And I think it's human nature if you're getting a break to say it's going to work wonderfully for everybody else. And we'll find out whether it will or not.

It's very, very, very difficult in economics to measure the impact of single variables. You cannot just do one thing in economics. People kind of learn that in physics and talk about butterflies in China and all that sort of thing. But the — every question you get in economics the next, any statement, you should say "and then what?"

And when you get into the "and then whats" you get start favoring people who give an answer to that in political life that happens to usually help you in some way or another, including your pocketbook. And we've see that with this. And it's helped the shareholders at Berkshire Hathaway.

I would say that some will be competed away. Some (inaudible) utilities and some will benefit Berkshire shareholders. Charlie?

CHARLIE MUNGER: I have nothing to add.

14. Utilizing multicultural backgrounds to improve international economies, and the benefits of multiculturality

WARREN BUFFETT: OK. Station 3.

AUDIENCE MEMBER: Hi, Mr. Buffett and Mr. Munger. My name's Kevin and I'm from Shenzhen, China, currently studying finance and philosophy at Boston College.

I have a rather broad question. In this more and more globalized world, what do you think our younger generation can do to best leverage our background and experience of both China and U.S. to create values and for the benefit two countries' economy and relationship? And what do you see valuable in a person with a multicultural background? Thank you.

WARREN BUFFETT: Well, I think in answer to the last question, I think it's terrific to have a multicultural background. And I never was any good at languages. But if I were in college today, in either country, I'd be learning the language of the other country, because I think it would be a great advantage over time.

The first part of the question, I'd like to have that stated again to me. I want to make sure I'm answering your specific aspect there on the — I think it's going to be good for your future. But can we have the microphone on up there again?

AUDIENCE MEMBER: So the first part of the question is, like, what do you think our younger generation can do to best leverage our background and experience of both China and U.S.?

WARREN BUFFETT: Well, I'd start with being multilingual, I mean, certainly, in terms of, you know, I mean, obviously you want to be able to express yourself in both. And the better you can understand, obviously, the culture of another society, obviously, that's a benefit.

But I think the market system, modified as it may be, both in China and in the United States, in a way, it really does — there will be an invisible hand, to some extent, that does work to improve the lot of future generations by the fact that both China and the United States, and the rest of the world, is improving. I mean, it is much better, in my view, particularly in a nuclear world. But it's much better to have people prospering throughout the world, partly through their own efforts but partly through their interactions with the rest of the world.

And we've made a lot of progress in that respect particularly since World War II. I mean, it was a terrific idea to have the Marshall Plan, you know, instead of behaving like we did after World War I and getting the result that we got. I think we behaved much more intelligently after World War II.

So I'm bullish on the future of United States. But I'm bullish on the future of China, and to a significant extent, you know, the rest of the world.

People are going to be living better 10, 20, 50 years from now. And I don't think that's something that can be stopped even. Charlie? Absent weapons of mass destruction.

CHARLIE MUNGER: Yeah, well, the multicultural stuff, it wouldn't do you much good to be fluent in both English and Chinese if you were, say, a proctologist in China or a proctologist in Nebraska. (Laughter)

So if you’re going to use your multicultural background, you’ve got to work at some interface between the United States and China.

And you can raise money in the United States and invest it in China like Li Lu does or you can be some kind of an importer or a trade specialist. But you’ve got to get near that interface to benefit from being bilingual and so on.

WARREN BUFFETT: But you would bet that the interface will be substantially greater.

CHARLIE MUNGER: Huge.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: Huge.

WARREN BUFFETT: And that’s what you want to prepare for.

CHARLIE MUNGER: Yes. And I think that, generally speaking, that we get multicultural you can also be multidisciplinary. But generally I think people make more money if they’re very narrowly specialized, like the proctologist. (Laughter)

And it’s much harder to make a lot of money for most people if you try to imitate Warren and me.

WARREN BUFFETT: I’m glad I didn’t meet him earlier. I mean — (Laughter)

15. Subsidiaries encouraged to offer low-cost 401(k) options

WARREN BUFFETT: OK, Andrew.

ANDREW ROSS SORKIN: OK, this question comes from someone who says, “I am a Berkshire employee and shareholder.”

WARREN BUFFETT: Uh huh.

ANDREW ROSS SORKIN: “I read an investigative article from ProPublica and The Washington Post that many of Berkshire’s various units only offer 401(k) plans with high fees that are actively managed rather than the low-cost indexes you have advocated as the best path for savings for retirement.

“The article’s author said he contacted the company and nobody would comment.

"Will you do something to improve our 401(k) offerings to match your investment philosophy? And from an operational perspective, how did this happen, given your strong views on the topic?"

WARREN BUFFETT: Well, I've absolutely said what — many, many times through annual reports — and our managers know what I think about the attractiveness of having an index fund option. But they all have different plans, different histories. And they run their businesses.

And who knows, you know, which particular — if you go back to the older businesses, they have defined benefit pension plans, generally. Nobody puts them in anymore. And then the question is, you know, do you transition to something else.

In the end, we overwhelmingly thought our managers make those kind of decisions and others. And my guess is that a very high significant percentage of people who have — who work at a company that has a 401(k) plan will have an index fund option, but they may not, in some cases.

The only thing we — I think we have asked the companies to have a limit on the percentage, I think, that they might put in Berkshire's stock through the 401(k). We don't want people to lose jobs who are tied to Berkshire.

We certainly don't want to be in the position of encouraging to put 100 percent or something of their savings in Berkshire itself. I don't want to be in that position.

But I don't think even there we've insisted on any company doing that. I think we've probably made that, when we've been asked about it once or twice, I think we've given that suggestion.

But the managers will run the companies. The employees, if they feel — and some of our companies have human relations departments — if they feel that they'd like different options or something like that, you know, they should make those views known to the managers. And in some cases the managers, I think, will pay attention to them and in others they probably won't.

We've got a wide variety of managers that run our businesses. And we're not going to start trying to run them from Omaha.

Charlie?

CHARLIE MUNGER: Well, you're right. That has happened. That business of the high-fee choices, because we've delegated the whole subject to the managers of the subsidiaries. And so no attention at all is being given to the employee choices at headquarters.

And what you're pointing out is that a lot of the employees in the subsidiaries would do better if they indexed instead of choosing what they did choose. My guess is you're absolutely right about that. You know.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And if there are any people, managers, in the business today, I hope we'll do a little better at encouraging better choices.

WARREN BUFFETT: Yeah, although we don't want them to interfere too much in —

CHARLIE MUNGER: No.

WARREN BUFFETT: — directing what they, you know, we can take over human relations.

CHARLIE MUNGER: No, it's up to the managers. But we wouldn't object to a little different viewpoint.

WARREN BUFFETT: And we have made it very clear what we think. I mean, some of them don't listen to us. (Laughter)

16. Berkshire's culture will continue because "it works"

WARREN BUFFETT: OK, Gregg.

GREGG WARREN: Warren, you've noted time and again that there is a strong common culture shared across Berkshire subsidiaries built on a commitment to honesty and integrity, a focus on the long-term, and an emphasis on customer care. And it's also critical to find cultures that mesh well with Berkshire's when acquiring operating companies.

In most cases, the managers that are currently running these subsidiaries are the same individuals who are members of the families that originally sold their firms to Berkshire, leaving them with a vested interest in the businesses they are running and a strong connection to the culture they tend to share in common with Berkshire.

It seems to me that the greater challenge is in ensuring that the large publicly-traded firms that have been acquired and account for a meaningful and growing amount of Berkshire's overall value, stay the course. Could you comment on whether or not this is the case and what the greatest challenge is for you and Charlie when it comes to not only maintaining Berkshire's culture but in finding firms that would fit in well with what you've built?

WARREN BUFFETT: Yeah, I think the culture is very, very strong. And I think it gets reinforced — frankly, I think it gets reinforced by the shareholders we have. I mean, we have a different body of shareholders and we look at those shareholders, I think, in a somewhat different way than a good many other companies do.

I mean, I think there are a fair number of public companies that wish they didn't have, you know, public shareholders. We're happy to have public shareholders. And we like having individual shareholders. And we don't favor institutions. And we're not going to, you know, give guidance and talk especially to them on investor calls and all that sort of thing. We want our — we want it to be directly with — we want shareholders who are partners, basically.

And it begins with that. It goes to the directors. We have directors who are not — well, I've been on 19 boards, and I've never seen another board like ours. And I think it's terrific that we've got the people who represent, in many cases, lots of shares themselves. They didn't gets special deals. It's a group of owner-oriented, Berkshire-conscious, business-savvy owners.

And we don't have anybody on the board because they're a leading, you know, educator or whatever it may be. We want people who, basically, think about how to run a business well for themselves and for their partners. And we've got managers who fit into that culture, who have chosen that culture in coming with us.

And sometimes we have the second or the third or fourth generation, say at the Nebraska Furniture Mart, that share that. Is it perfect? No, it's far from perfect. I mean, you don't get everybody thinking the same way. We have people — we have people that are very independently minded running a lot of businesses. And some of them have different political beliefs, they have different — they see through different lenses than we do, to some degree.

But in terms of having a common, strong, positive culture, I don't think there's any big public company that has it any better than Berkshire. And I think that will continue because people opt into it to a great deal. Cultures get passed along. You do things that are consistent with the culture, so you do — what you talk about is what you do.

And you don't find people saying, you know, "We're a wonderful partnership," and then voting themselves, you know, huge options. And then a whole bunch of other people will say options beneath them because they can't look like they're taking it all for themselves, and arranging — I read about some deal where it could pay off with many, many, many billions of dollars, the other day. We won't name names.

But we've got as good a culture as you can get. And I would say, net, it grows stronger. We have a few people all of the time that really don't buy into it entirely. I mean, it is not 100 percent. But it's as close to it.

And I think it gets closer all the time as we go along. And we will keep — we will try to keep behaving in a way that reinforces it and doesn't dilute it. And I think that will not only work for Charlie and me but it will work for our successors very well. It won't be perfect.

Charlie?

CHARLIE MUNGER: Every time I come to one of these meetings and sit in the manager's luncheon, I feel more strongly at the end of the luncheon that the culture and values of Berkshire Hathaway will go on and on for a long time after the present management is gone.

In fact, I think it'll go on after all of the present managers are gone. I think we've started something here that will work well enough that it will last. And one of the reasons it will last is it's not that damned easy to duplicate.

So the one that is present is likely to just keep going and going. Think of how little direct copying of the Berkshire system there's been.

WARREN BUFFETT: But it won't produce the returns it's produced in the past even.

CHARLIE MUNGER: No, I think it's going to last a long time for a very simple reason. It's going to —

WARREN BUFFETT: It works.

CHARLIE MUNGER: — deserve to last a long time.

WARREN BUFFETT: It works.

CHARLIE MUNGER: And it's going to work.

17. Cash needed to support Berkshire insurance operations

WARREN BUFFETT: OK. (Applause) Station 4.

CHRISTIAN MAX: My name is Christian Max (PH). I'm a proud shareholder from Cologne, Germany. It is my pleasure to be here.

My question relates to the Berkshire insurance operations. When I look at the quarterly billing sheets of the last two decades, I noticed a pattern that I kindly ask you to discuss.

The sum of cash plus fixed income always hovers around 100 percent of the amount of insurance float. Therefore, my question is, is it fair to say that from the 128 billion of consolidated cash plus fixed income as of March, 116 billion are actually needed to support the insurance operations?

WARREN BUFFETT: No, I appreciate —

CHARLIE MUNGER: The answer is no. Yes.

WARREN BUFFETT: The answer is no. But he deserves an explanation of how this — maybe I haven't looked at it the way he's looked at it.

We would much rather have a number closer to 20 than to have 116. And we do not correlate or, in effect, measure the float and then decide how much to put or leave in cash, in fixed income.

The fact —our float keeps growing. And lately our — which is by design and has been terrific for us — and our cash and cash equivalents have has grown because the competition for acquisitions has become much stronger as — both as money has piled up with the buyers of businesses and because debt has been so cheap and a variety of factors.

But I don't think those are necessarily permanent. In fact, it would be reasonably true they aren't permanent. It's just a question of when they change.

We are not tying, as Charlie said, we're not tying the cash and cash equivalents at all to float. The float is (inaudible).

The float went up $2 billion in the first quarter. And there is no way that that that float can shrink a lot in any short period. It just structurally has been set up in such a way that it will not — it cannot shrink. And actually, I think it'll grow a little bit for a while.

I mean, I've always been amazed by how much it has grown. We've got so much more float than any property-causality company in the world. And it's pretty amazing that it all came from that little building that Jack Ringwalt built and picked the location because it was near the tennis courts. (Laughs)

OK, Carol.

Oh, and Charlie.

CHARLIE MUNGER: There are encouraging recent developments. Some of the cash has gone out recently for securities we vastly prefer over the cash. And we have a lot of cash that could be — remaining — that could be deployed in securities we might like a lot better than Treasury notes. So stay tuned.

WARREN BUFFETT: Yeah, to make it very simple, in the first quarter we earned five and — from operations we earned a little over $5 billion. Now, we only spent about our depreciation. Normally we would spend somewhat more than that. But that's 5-and-a-fraction billion. Two billion came, in net, from float. So that's $7 billion that — basically in the first quarter — that would have been added to our cash if we hadn't done something with it. And instead our cash and equivalents went down, because we, net, invested more in equities by some margin than the seven that came in.

But we do have this position where, even absent a change in float, about 400 million comes into Berkshire every week, which is very comfortable. (Laughs)

And we will — we want to get it so that more than 400 million is going out into productive assets. And we succeeded in doing that in the first quarter. And, net, net we improved our position in the first quarter.

18. "Amazing" earnings in the new "asset-light economy"

WARREN BUFFETT: Carol?

CAROL LOOMIS: In your 1999 article in Fortune magazine, you stated your belief that after-tax corporate profits were unlikely to hold much above 6 percent for any sustained period, due not only to competition but also to public policy.

You stated in the article, "If corporate investors, in aggregate, are going to eat an ever-growing portion of the economic pie, some other group will have to settle for a smaller portion. That would justifiably raise political problems."

Since 2008, after-tax corporate profits have been 8 to 10 percent of GDP. Do you believe that is a permanent shift in the U.S. economy? And of course, we have to think about the latest tax bill. Or will corporate profits revert back to the 4 percent to 6 percent of GDP range that was normal in the 20th century?

WARREN BUFFETT: Well, it's been an interesting development during that period. It goes back a little bit before that period. But you now have the four largest companies, by market value, in the United States — a $30 trillion market — you have four companies that essentially don't need any net tangible assets.

And if you go back many years, I mean, if you looked to the largest companies — Carol used to put out the Fortune 500 list. And you know, it would be AT&T and General Motors, and it was companies that — Exxon Mobil — it was companies that just required lots of capital in order to produce earnings.

So American industry has gotten incredibly more profitable, in aggregate, in the last 20 or 30 years. You look at the return on the S&P 500, the earnings as a percent of net tangible assets, and the rest is just, you know, if you buy a company that has a million dollars' worth of net worth and you pay a billion for it, it still only had the million dollars' of net worth. I mean you just paid more for it. So the basic profitability of the company is huge, even though your investment may be at a significantly higher price.

So that what has happened is that, I think if you look at the earnings on tangible net worth of the S&P 500 and compare it to 20 years ago, it is amazing. And that is really due to the fact that this has become somewhat, you could call it an asset-light economy.

And you know, those four companies that earn 10 percent of the — they comprise close to 10 percent of the market value of the entire publicly-traded corporate America, they don't — and they don't take any money, basically. And that is a changing world. And they will earn even more money with the tax rate going down.

And I don't think people have quite processed all that information in terms of what has gone on in the market.

You don't — you know, [Andrew] Carnegie built a steel mill, and then he paid it off. Or he borrowed a little money, and then he built another steel mill, and all of that sort of thing. But it was enormously capital-intensive.

And one industry after another. AT&T was enormously capital-intensive. And now the money is in the asset-light — I mean, huge money is in the — not only asset-light business — but the negative asset.

You know, IBM even, you know, had — it has no tangible — it has a net — minus tangible net worth. There's nothing wrong with that. It's terrific. But it is not the world we lived in 30 years ago.

And in that sense, I didn't see that coming in 1999 when I wrote whatever I wrote there. It hasn't changed the profitability of the asset-heavy companies particularly. I mean, it isn't like oil.

If you take the five most capital-intensive industries in the '90s, I don't think you'll find that their earnings on tangible asset have increased a lot. But you will find that this group has moved in that really doesn't — they don't need any net tangible assets at all, or they need very minor amounts.

Charlie?

CHARLIE MUNGER: There's also a lot of financial engineering that's raised leverage, even in the capital-intense businesses. And you know, while Warren may have predicted a little wrong when he wrote that very scholarly article, he didn't invest wrong. And so it just shows that it's hard to make these economic predictions.

WARREN BUFFETT: OK, Jon —

CHARLIE MUNGER: We weren't very right on that one, Warren.

WARREN BUFFETT: Yeah, actually, the performance of the stock market since then has been pretty accurate. (Laughs)

CHARLIE MUNGER: Yes. That's true.

WARREN BUFFETT: Yeah. Being right for the wrong reason or something. (Laughs) Or wrong for the right reasons.

19. "We still feel OK" about AIG's $10.2 retroactive premium

WARREN BUFFETT: Anyway, Jonathan? (Laughs)

JONATHAN BRANDT: Berkshire received a 10.2 billion retroactive premium from AIG early last year. If the upwardly revised estimate of 18.2 billion of ultimate claims proves to be correct, will the cost of float, adjusted for favorable tax attributes, likely be lower or higher than what Berkshire would have paid to borrow 10 billion for a similar duration?

WARREN BUFFETT: Well, we certainly go in with the idea that it will be — the cost will be lower. And it's an interesting situation.

We — essentially, AIG, which is one of the largest property-casualty, particularly commercial property-casualty companies in the world, said, "We want to give you all of the losses that we incurred in a very big percentage of our domestic business before December 31st of 2015, and we will pay the first 25 billion. And then after we pay 25 billion and AIG pays $25 billion, then you pay 80 percent of the next 25 billion." And they gave us $10 billion for doing that. And that's —

If we are correct about our estimates of how much money will be paid and when it will be paid, we should come out being better off than if we had borrowed a similar amount.

We have a history of doing 10 or so — maybe 12 — big deals like that. We hold the record. We did it for Lloyd's of London 10 or more years ago, and we did it now with AIG.

And sometimes we've been on the low side in our estimate, and sometimes we've been on the high side so far.

AIG just said that they — I think they paid 15-and-a-fraction billion on these pre-12/31/2015 losses. They paid 15-and-a-fraction billion. But the payments tend to trickle down over years as you get further away from when the losses occurred.

So I would say that we still feel OK about it, and we'll be wrong one way or the other. Everybody is when you estimate losses that may not get settled for 20 or 30 years. But so far, on the group as a whole of these deals we've done, we've been OK. And I think on the AIG thing, we think we'll be OK. And I think AIG thinks we'll be OK. I mean, they entered into it for good reasons of their own. So it looks OK.

Sorry to get into this technical stuff, but Jonathan always asks me questions like that, so I have to be ready to — I want to answer them.

20. “We really want products where people feel like kissing you”

WARREN BUFFETT: OK. Station 5.

AUDIENCE MEMBER: Good afternoon. My name’s Adam Bergman with Sterling Capital in Virginia Beach, Virginia. I’m here with my daughter Michelle from Cape Henry Collegiate in Virginia Beach.

AUDIENCE MEMNBER: Hi Warren, hi Charlie.

AUDIENCE MEMBER: Our question for you is how you go about attempting to forecast the degree of future success of one specific product in a good business versus another, such that you invest in American Express and Coca-Cola rather than Diners Club or RC Cola, for example. Thanks.

WARREN BUFFETT: Well, with American Express — (laughs) — it was an interesting situation, because Diners Club got there first. I think American Express, in a certain sense — I mean, they did it for a lot of reasons — but they went into the credit card business because they were worried about what was going to happen to traveler’s checks. And — although traveler’s checks are — still exist in a significant way.

But the interesting thing when American Express went into competition with Diners Club, and with Carte Blanche, as I remember that — which also existed at the time — was that instead of charging less than Diners Club and going in figuring they were going against the established guy and they’d come in at a lower price, they went in it at a higher price, as I remember.

And the American Express centurion was on that card. I’ve got one that I got in 1964, but they were in it before that. It had more value in time. I mean, it got better representation. And frankly, if you were a salesperson out with somebody, and you could pull out that American Express card with that centurion, you looked you were JP Morgan. And if you pulled out the Diners Club, it had a whole bunch of flashy symbols, you looked like a guy that was kiting his checks from one month to the next, and — (Laughter)

A fellow named Ralph Schneider — Ralph Schneider and Al Bloomingdale developed the Diners Club. And they were very smart about getting there first, but they weren’t smart about how they merchandised it subsequently.

RC Cola, you know, it did — there are all kinds of colas that came after Coke. I mean, you know, you go back to 1886 and come up with something at Jacobs’ Pharmacy that’s incredibly successful, you know, fairly soon you’re going to get lots of imitators. But Coke really is the real thing. And you know, you offer me RC Cola and say, “I’ll give it to you at half the price of Coca-Cola,” in terms of drinking it, I mean, just, this is a product that's 6 1/2 ounces, sold for a nickel in 1900, you know. And now if you buy it on the weekend and buy it in large quantities and everything, you're not paying that much more. This newspaper was three cents in 1942, you know. I mean, the amount of enjoyment per real — in terms of the real — of what you pay for this, has gone dramatically down in inflation-adjusted money. So it is a bargain product.

You know, you have to look at — See's Candy, you know, if you live in California and you were a teenage boy, and you went to your girlfriend's house and you gave the box of candy to her or to her mother or father and she kissed you, you know, you lose price sensitivity at that point. (Laughter)

So we really want products where people feel like kissing you, you know — (laughs) — rather than slapping you.

It's an interesting thing. I mean, you know, in effect we're betting on the ecosystem of Apple products, but — led by the iPhone. And I see characteristics in that that make me think that it's extraordinary. But I may be wrong.

And you know, so far we've been — I would say we've been right on American Express and Coca-Cola.

American Express had this huge salad oil scandal in 1960 happen — in '63, November, right around the time [President John] Kennedy was shot. And there was really worry about whether the company would survive.

But nobody quit using the card. Nobody quit using the traveler's checks. And they charged a premium price for their traveler's checks. So there are things you can see around consumer products that sometimes can give you a pretty good insight into the future. And then sometimes we make mistakes.

Charlie?

CHARLIE MUNGER: I've got nothing to add, except that if we'd been offered a chance to go into Coca-Cola right after it was invented, we probably would have said no.

WARREN BUFFETT: We'd have turned it down. Yeah.

CHARLIE MUNGER: It would've looked kind of silly to us.

WARREN BUFFETT: Well, unless we drank it, now, Charlie, listen. (Laughs)

No, he's right. I mean, we don't foresee things that we haven't got a lot of evidence in on. And —

CHARLIE MUNGER: No.

WARREN BUFFETT: We want to see a lot of — if we're talking about a consumer product — we want to see how a consumer product behaves under a lot of different circumstances, and then we want to use something — actually, there was a book by Phil Fisher written around 1960 called "Common Stocks and Uncommon Profits." It's one of the great books on investing.

And it talks about the "scuttlebutt method" of investing, which was quite a ways from what Ben Graham taught me in terms of figures. But it's a very, very good book. And you can learn a lot, you know, just by going out and using some shoe leather.

Now they call them channel checks now or something like that. But it's — you can get a feel for some products, and then there are others you can't. And then sometimes you're wrong. But it is a good technique. It's an important investing technique, I would say that. And Ted [Weschler] and Todd [Combs] do a lot of that. And they have people — some people that help them out on doing it, too.

Charlie's done it with Costco. I mean, he's — (Laughs)

I mean, all the time he is finding new virtues in Costco, you know, and then it — and he's right, incidentally. I mean, Costco has an enormous appeal to its constituency. They delight — they surprise and delight their customers. And there is nothing like that in business. You have delighted customers, you're a long way home.

21. Hostile bids aren't "evil" but Berkshire doesn't do them

WARREN BUFFETT: OK, Becky.

BECKY QUICK: This comes from John Hegarty (PH) at Brightstar Capital Partners, who writes, "Warren, you're stepping down from the Kraft Heinz board at a time when the company's looking to do a large acquisition: Unilever, for example. Do you fundamentally disagree with the combative nature of hostile bids, activist investing, and competitive proxy contests?"

WARREN BUFFETT: Well, we will not make hostile tenders ourselves. I do not believe that there's anything fundamentally wrong with the idea. I mean, if you take the Fortune 500 companies, I'm sure that all 500 are not managed by the best, or in some cases even the friendliest to investor managements in the world.

So I don't think it's evil or anything to conduct a hostile offer for a company. It's just we won't do it, and we don't want to get into that. We like being liked by the managements that we join, because we're counting on them to run the company, and we're not bringing in a whole bunch of people that know how to change businesses.

We seldom take a position opposite the management — very seldom — on anything involving a proxy, but — contest of sorts. But we don't rule it out. We don't think every management is entitled to be — you know, they don't have a lifetime hold on their business. But it's not our style at all to — well, we won't do it in terms of initiating it ourselves, and we'd be very, very, very unlikely to support a contest.

But we have voted against a couple of propositions over 50 years that managements have had — made — in relation to stocks options. We withheld a vote at Coca-Cola a few years ago to express our opinion.

But we don't think it's evil for the shareholders, in some cases, to have different opinions about who should run the company, or whether compensation's appropriate, or matters of that sort. The stockholders still own the company.

Charlie?

CHARLIE MUNGER: I've got nothing to add to that. I don't envy these people that are in these unfriendly uproars all the time. Imagine doing that after you're already rich. It's insane. (Laughter)

WARREN BUFFETT: Yeah. Yeah, we are definitely not looking for it. We don't —

There are certainly companies that deserve challenge. And they propose things that deserve challenge occasionally. But again, it's not our main activity.

And incidentally, this has — the question was asked in reference to Kraft Heinz.

The people at 3G are great, great managers. They've been wonderful partners. I had made a determination, before we got involved there, I was going to be on no more public boards. I'd been on 19 of them, and it takes a lot of time. And they asked me if I'd go on for a while, and I did.

But it really is, like, seven-and-a-half days or something. And if you're on a bank board, it may be quite a bit more than that. I mean, there just —

Being on a public board usually means quarterly meetings plus maybe an extra one. And, you know, at 87, I think I've now learned what happens, and it's fine, but I don't want to spend seven-and-a-half days a year when I — maybe I can call up people that I trust and admire who are on the board in five minutes, you know, and find out what's going on or whatever it may be, any questions that come up.

And so we are their partners, and delighted to be their partners. And now we have two people on the board of Kraft Heinz, and they can do the traveling and I can stay home.

Charlie, how many public — you're on Costco, of course, over the — your lifetime, how many public boards?

CHARLIE MUNGER: Oh, I — Costco — except for something —

WARREN BUFFETT: Kansas City Power.

CHARLIE MUNGER: — like The Daily Journal where I own part of it, Costco's the only public board —

WARREN BUFFETT: You were on Kansas City Power.

CHARLIE MUNGER: — if it wasn't Berkshire or something I owned personally.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: I was on Kansas City Power and Light. Boy, that goes way back. But basically it hasn't happened. I don't envy people who float around to a lot of different board meetings.

WARREN BUFFETT: No, generally speaking you have very little influence and spend a lot of time. And the trouble is, if you're going to a board meeting, particularly if you get to the international, and sometimes they feel they have to have one that's international, you know, they feel they have to take up a fair amount of your time or it wouldn't have been worth coming, you know, thousands of miles for.

So you get a lot of the show and tell stuff and — that — I find my mind drifting. OK. (Laughter)

22. Berkshire still not on radar screen of international business sellers

WARREN BUFFETT: Gary.

GARY RANSOM: Yes, you've said that you are looking for non-insurance large acquisitions to put that cash to work. And when you've said that, I've usually thought of the United States, because you're a big fan of the U.S. business.

And I just was wondering whether you're seeing more opportunities as the rest of the world opens up, grows, whether there's opportunities for some of those mega-transactions in other parts of the world, say Asia or Europe.

WARREN BUFFETT: Yeah, Gary, I would say that I've been disappointed in that, because we do see some outside the United States, and thank heavens we saw the one we saw in Israel some years ago [ISCAR] when Eitan [Wertheimer] wrote me a letter. But — and you know, we bought a business which is a very important part of Berkshire now.

But we are still not — they're certainly aware of Berkshire Hathaway outside the United States. But they don't sort of pick up the phone automatically.

In the United States, I think any large — particularly private — company that thinks — is thinking about doing something, they at least think about Berkshire. But that — in Europe or Asia, that — we are not embedded in the minds the same way.

They know about us, they know we've got a lot of money and they know we like to buy things. But we really, we're on the radar screen big-time in the United States, and we're not as — we don't — the immediate desire to be sure that they've thought about the Berkshire option does not occur the same way outside the United States. And we've tried to encourage it a few ways. But I would say that the results have not been great at all.

But I hope tomorrow, you know, I get a call from Germany or Britain or Italy or you name it, and Australia, wherever it may be. And I hope I get a call and we get an opportunity to do it.

There's a good many countries we'd be quite happy to put substantial money into it. And like I say, our experience in Israel has been just terrific.

Charlie?

CHARLIE MUNGER: Yeah, but the corporate acquisition game now is so driven by the leveraged buyout and the so-called, whatever they call them, strategic, yes, strategic. I usually translate that into barnyard language. (Buffett laughs)

And we're so — there's so much craziness in price from our viewpoint. Of course, it's very hard for us to do it.

The people in the leveraged buyout game, who love massive leverage and don't mind high prices, even they are getting nosebleeds. It's hard. And it's not an environment that means that — that allows Berkshire just to go out and buy a whole lot of companies.

WARREN BUFFETT: Have you ever made a strategic deal that you —

CHARLIE MUNGER: We have to wait.

WARREN BUFFETT: We've made a strategic deal that you can remember?

CHARLIE MUNGER: Hmm?

WARREN BUFFETT: Have we ever made a deal that we would have regarded as strategic?

CHARLIE MUNGER: We've never had a strategic plan unless you've hidden it from me. (Laughter)

WARREN BUFFETT: OK. That answers that.

23. Investing "doesn't require advanced learning"

WARREN BUFFETT: Station 6.

AUDIENCE MEMBER: Hi, I'm Brady Ritchie (PH) from St. Louis, Missouri. Shareholder since 1996.

WARREN BUFFETT: Terrific.

AUDIENCE MEMBER: Warren, you and Charlie have been critical of business schools in the past and what they teach. With respect to value investing, in "Superinvestors of Graham-and-Doddsville," you featured the returns of many great investors with different backgrounds' work in education, with the lesson being, "Following the philosophy is the key."

To be successful today, does it still just fall back to chapter eight of "The Intelligent Investor?" And what do you think of programs and designations such as CFA, CFP, et cetera, which purport high standards yet root it heavily into academia? And I'd like to challenge you to a round of bridge tomorrow. (Laughter)

WARREN BUFFETT: And what was the last part?

CHARLIE MUNGER: Well, he was talk — what do we think about —

WARREN BUFFETT: Yeah, business schools and all that.

CHARLIE MUNGER: — business schools and all that.

WARREN BUFFETT: I didn't catch the last —

CHARLIE MUNGER: They're better —

WARREN BUFFETT: Oh, he's challenged me to a round of bridge. OK. The — (Laughter)

I went to three business schools, and at each I found a teacher or two. I went to one specifically to get a given teacher. But at each one of them I found a teacher or two that I really got a lot out of. The — so we're not anti-business school here at all.

We do think that the priesthood, say, 30 years ago, for example, in terms of — or 40 years ago — in terms of efficient market theory and everything. They strayed pretty far, in our view, from the reality of investing. And I would rather have a person — if I could hire somebody among the top five graduates of number one, two or three of the business schools, and my choice was somebody that had — was bright — but had chapter eight of "The Intelligent Investor" absolutely — it just was natural to them — they had it in their bones, basically — I'd take the person from chapter eight.

This is not — what we do is not a complicated business. It's got to be a disciplined business, but it is — it does not require a super IQ or anything of the sort. And there are a few fundamentals that are incredibly important, and you do have to understand accounting. And it helps to get out and talk to consumers and start thinking like a consumer in many ways in certain — and all of that.

But it just doesn't require advanced learning. And — I — I certainly — you know, I didn't want to go to college, so I don't know whether I would have done better or worse if I'd just quit after high school, you know, and read the books I read and all of that.

I think that if you run into a few great teachers, and they really change the way you see the world to some degree, you know, you're lucky. And you can find them in — you can find them in academia and you can find them in ordinary life.

And I've been extraordinarily lucky in having great teachers, including Charlie. I mean, Charlie's been a wonderful teacher. And, you know —

Anyplace you can find somebody that gives you insights into things you didn't understand before, maybe makes you a better person than you would have been before, you know, you get — that's very lucky, and you want to make the most of it. If you can find it in academia, make the most of it. And if you can find it in the rest of your life, make the most of it.

Charlie?

CHARLIE MUNGER: Well, when you found Ben Graham he was unconventional, and he was very smart. And of course, that was very attractive to you. And then when you found out it worked and you could make a lot of money while you're sitting on your ass — (laughter) — of course you were an instant convert. And so —

WARREN BUFFETT: It still appeals to me, actually. I mean — (Laughter)

CHARLIE MUNGER: But the world changed. Before he died, Bill Graham — I mean, Ben Graham — recognized that the exact way he sought undervalued companies wouldn't necessarily work for all times under all conditions. And that's certainly the way it worked for us.

We gradually morphed into trying to buy the better companies when they were underpriced, instead of the lousy companies when they were underpriced. And of course, that worked pretty well for us.

And Ben Graham, he outlived the game that he played personally most of the time. He lived to see most of it fade away. I mean, just to find some company that's selling for one third of its working capital, and figure out it could easily be liquidated and distribute $3 for every dollar of market price. Lots of luck if you can find those in the present market. And if you can find them, they're so small that Berkshire wouldn't find them of any use anyway.

So we've had to learn a different game. And that's a lesson for all the young people in the room. If you're going to live a long time, you have to keep learning.

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: What you formerly knew is never enough. So if you don't learn to constantly revise your earlier conclusions and get better (inaudible), you are — I always use the same metaphor. You're like a one-legged man in an ass-kicking contest. (Laughter)

WARREN BUFFETT: If anybody has suggestions for another metaphor, send them to me. (Laughter)

Graham, incidentally, one point, important point. Graham was not scalable. I mean, you could not do with really big money. And when I worked for Graham-Newman Corp, here he was, the dean of all analysts. And you know, he was an intellect above all others around that time.

But our — the investment fund was $6 million, and the partnership that worked in tandem with the investment company also had about $6 million in it. So we had 12 million bucks we were working with. Now, you can make adjustments for inflation and everything. But it was just a tiny amount. It wasn't really scalable.

And the truth is that Graham didn't care, because he really wasn't interested in making a lot of money for himself. So he had no reason to want to find something that could go on and on, become larger and larger.

And so the utility of chapter eight, in terms of looking at stocks as a business, is of enormous value. The utility of chapter 20 about a margin of safety is of enormous value. But that's not complicated stuff.

CHARLIE MUNGER: I finally figured out why the teachers of corporate finance often teach a lot of stuff that's wrong. When I had some eye troubles very early in life, I consulted a very famous eye doctor. And I realized that his place of business was doing a totally obsolete cataract operation. They were still cutting with a knife after better procedures had been invented.

I said, "Why are you in a great medical school performing absolute obsolete operations?" And he said, "Charlie, it's such a wonderful operation to teach." (Laughter)

Well, that's what happens in corporate finance. They get these formulas, and it's a fine teaching experience. (Laughter)

You give them a formula, you present the problem, they use the formula. You get a real feeling of worthwhile activity. (Laughter)

There's only one there. It's all balderdash.

WARREN BUFFETT: Yeah, whenever you hear a theory described as elegant, watch out, you know. (Laughter)

CHARLIE MUNGER: Right.

24. Buffett "bullish on human race" as women enter the workforce"

WARREN BUFFETT: OK, Andrew.

ANDREW ROSS SORKIN: This question — we got a couple like this one — comes from Lauren Taylor Wolfe. She's a managing partner at Impactive Capital.

"Warren, you've recently said that one of the things that makes you optimistic about America is women entering the workforce and the quote 'doubling of the talent that's effectively employed in that workforce.' When it comes to positions of leadership, however, women make up less than 21 percent of boards of S&P 500 companies, and an even smaller 5 percent of the CEOs.

"What can Berkshire do, and what is Berkshire specifically doing, as a major investor in many of these large companies, to advance gender equality, both at the board level and among senior leadership?"

WARREN BUFFETT: Yeah. Well, again — (applause) — you know, as I've pointed out in the past, one of my sisters is here. And I have two sisters that are absolutely as smart as I am. And they have better personalities, as anybody that knows both of us — or all of us — can attest. And they didn't remotely have the same opportunities I had.

And you have this 1942, or — New York Times — and you know, women could be nurses or teachers or retail clerks or stenographers. And that actually worked enormously to my advantage when I was a kid in Omaha in the '30s, because I had way better teachers, because they were — that was a job open to women, I didn't have a single male teacher in grammar school, and Charlie didn't when he went to Dundee, I don't think, either.

And we had this huge talent pool that was being funneled into very few opportunities, and therefore we got better than we deserved in terms of a market system producing it. The —

Again, our managers run their companies. But I've probably named — before we made this management change — I probably named only six or seven CEOs in the last five or six years. We don’t change that much. But I would say that half of them that I’ve named have been women, which is about what you would — what should turn out to be the case in terms of ability.

Now, there is a certain pipeline problem, but that gets cured with time, and you can’t use that forever as an excuse.

And you know, I feel very good about the decisions we made for CEOs. I prefer all our CEOs to live forever. And one woman almost did that, that we hired. Mrs. B. [Nebraska Furniture Mart founder Rose Blumkin] lived to be 104. She retired at 103. And that’s a lesson to our other managers, that if you retire prematurely, you know — (laughter) — no telling what’ll happen.

But it is absolutely true. It does make me bullish. It makes me bullish on the human race. But it’s certainly on our country. Because if you look at what happened, you know, before the 19th Amendment, and then after the 19th Amendment for a long time, and continuing to this day, but it’s — that — there’s been significant improvement.

And I do feel more optimistic about the future, because I think there will be more selection by merit, rather than, you know, by gender or by race or by inheritance.

I think that if you had a system where all businesses got passed on to the eldest son or something, I think it — I think that society would make a lot less progress than one that’s merit-based.

Charlie?

CHARLIE MUNGER: Well, we did live in a different age. There’s an old saying that the past is a very strange country. People behave quite differently there. And it was just totally different. And it was ridiculous that — I cannot remember — I had one or two male teachers in my high school. But almost none. And the world has really changed.

And within Berkshire, I’ve never seen any overt discrimination anywhere on the grounds of gender.

WARREN BUFFETT: There probably has been some, though. I mean —

CHARLIE MUNGER: No, no, I’m sure that we have our —

WARREN BUFFETT: Oh, there has —

CHARLIE MUNGER: —share of all the peculiarities of human nature.

WARREN BUFFETT: Sure.

CHARLIE MUNGER: But it's generally, it's — everything has always improved, wouldn't you agree with that?

WARREN BUFFETT: Yeah.

CHARLIE MUNGER: And I think it'll keep improving.

25. Berkshire buybacks not limited by state insurance rules

WARREN BUFFETT: OK. Gregg?

GREGG WARREN: Warren, in this year's annual report it was noted, much as it is every year, that payments of dividends by the company's insurance subsidiaries are restricted by insurance statutes and other regulations, with Berkshire's insurance operations currently allowed to declare up to 16 billion as ordinary dividends during 2018.

My question here is, should we view this annual regulatory threshold for dividends as a benchmark for allowable share repurchases as well? And in the event that Berkshire wanted to buy back more stock than that, or pay out even more as dividends, would there be an issue with you using capital from operations that aren't held by the insurance operations to return additional capital?

With the side question here being, would the annual cash distribution from BNSF, which is held on National Indemnity's books, be excluded?

WARREN BUFFETT: Yeah. The — we will obviously follow the rules of the states in which we're domiciled, and all the rules, of course. But basically it's the state of domestication in the insurance companies, and they do restrict the amount of dividends in any given year. Although you could, if you wanted to, request some additional amount. But we don't ever consider that.

But repurchases — if repurchases were really attractive, we would do it in a very big way. And, you know, I wouldn't rule — there's all kinds of ways that we could arrange things to do either a very large acquisition, which is what I would prefer, or a very large repurchase, would I don't think is probably in the cards just because the way our stock trades, not because we wouldn't like it at a large discount.

So Charlie and I, we've got the appetite. And we would have — we've got a lot of cash — but we could have a lot more cash. We can make any deal of — even one of a very large size. We can make anything that came along — we could work out how to get it done.

We would — we would have — we're not going to be doing this, but we would have partners who would come in and give us a preferential part of a partnership. That's not going to happen, in all probability. But there's a lot of things that we could do. So don't rule out anything based on statutory limitations of distributions from insurance companies —

CHARLIE MUNGER: And that — we could get special permissions to —

WARREN BUFFETT: Oh, we can get —

CHARLIE MUNGER: — declare bigger dividends. We are not — you should not assume that we're constrained by the laws of nature to the amount that we can take out under the statutes now.

26. Munger: "I don't think the world is going to be changed that much by machine intelligence"

WARREN BUFFETT: OK, station 7.

AUDIENCE MEMBER: Hi, Warren and Charlie. Thank you for everything. I'm David (inaudible), an investment manager in Shanghai. I've been here for eight years.

If investment is a sport in the Olympics, you are our champion team. So my question is, facing the fast-growing machine challenges, how do you see the new competition impact the capital allocation productivity in the future?

For Charlie, what is the first principle of capital allocation from a general economic interest point of view? Thank you.

CHARLIE MUNGER: Well, two questions. Machine intelligence. I'm afraid the only intelligence I have is — is being provided by something that's not a machine. And I don't think I'm going to learn machine intelligence. Yeah. If you ask me how to beat the game of Go with my own intelligence, I couldn't do it. And I think it's too old for me to learn computer science.

Generally I'm — I think that the machine intelligence has worked. After all, a machine now can beat the best human player of Go. But I think there's more hype in that field than there is probable achievement.

So I don't think the world is going to be changed that much by machine intelligence. Some, but not hugely.

And what was the other question?

WARREN BUFFETT: Well —

CHARLIE MUNGER: One of them was machine intelligence.

WARREN BUFFETT: I think he was getting at capital allocation —

CHARLIE MUNGER: Oh yeah. That's such a general question. Generally speaking, we're always trying to get the best — to get something that's worth buying.

And the human mind rejects that if you're in academia, because you could come in and make one declaratory sentence at the opening of the semester and you wouldn't have anything to do for the rest of the — of your time. So people want to find some formula. It's what I call "physics envy." These people want the world to be like physics.

But the world isn't like physics, outside of physics. And that false precision just does nothing but get you in trouble.

So I would say you've got to master the general ideas, and you've got to work to improve your judgment slowly, the way all the rest of us had. And I don't think most individuals have much hope of individual gain from machine intelligence.

WARREN BUFFETT: No, I don't — I don't think that — I'm impressed when machines beat Go or something of the sort, or even win at chess or whatever it may be.

I don't really think they bring much to the table in terms of capital allocation or investing. And then I may be missing something entirely, you know, maybe I'm just blind to what's out there.

CHARLIE MUNGER: You're missing a lot of very remunerative, fee-earning twaddle. (Laughter)

WARREN BUFFETT: Yeah, well. Well, that takes care of that. So we'll go on to station 8. (Laughter)

27. Munger: "American investors are missing China"

AUDIENCE MEMBER: Dear Mr. Buffett and Mr. Munger, thank you very much for hosting the meeting. It's truly been remarkable. Thank you.

My name is Yen (PH), and I'm a partner at Tiger Brokers, a leading electronic brokerage firm from China.

Let me rephrase that. So, I and my colleagues flew half a way from the globe with (inaudible) to be here, and it is honor, just like everyone else in the stadium, we're honored to be here.

My question is, you mentioned earlier that investors don't really have to be struggling in picking the right stocks. They would do well in picking, probably, the right market and the right country.

China is the second-largest economy, and probably has the biggest growth potential. Just by passively weighting a portfolio — by passively valuating a portfolio — U.S. investors are significantly underweighting China. So in your opinion, what are stopping the investors from investing in China? Thank you.

CHARLIE MUNGER: Well, I think the answer is that you're absolutely right. That we are — American investors are missing China. And they're missing it because it's a long way away, it looks different, they're not used to it, it's complicated, the headlines confuse them.

In other words, it just looks too hard, sitting in Omaha, to outsmart the Chinese market. But I think you're absolutely right. It's where they should be looking.

WARREN BUFFETT: OK. (Laughter)

We've actually had a couple investments in China. We've done pretty well. But there were — well, if you go back a number of years, (inaudible).

In terms of getting a lot of money into something, you know, many billions, and we have to get billions into things in — to move any kind of a needle, that can be tougher in markets that you've got — you're unfamiliar working in. And it's difficult under any circumstances.

But accumulating a 6 or 8 or $10 billion position in investments outside the United States can be very difficult. For example, in U.K. and much of Europe we have to report when we own 3 percent of a company. In fact, we can be asked to report if we even have less than 3 percent. That really gets very tough when we get a bunch of followers and a lot of publicity that probably isn't deserved in terms of what we're doing in the markets and everything.

Some of the problems are, just by the nature of our size. It would be lot — it'd be a lot easier if we were running a smaller fund.

PetroChina, we managed to get a very big position. But the government owned 90 percent of it. So we bought 14 percent of what the government didn't own, but it was still only 1.4 percent of the company.

But Charlie, Charlie actually keeps pushing me to do more in China. And we've tried a couple of times, actually. And there was one operation that we got involved in —

CHARLIE MUNGER: Well, you did so poorly the first time, you put in 200,000 and got about 2 billion, so.

WARREN BUFFETT: Yeah. Yeah. Well.

CHARLIE MUNGER: Wasn't encouraging enough. (LAUGHTER)

28. "What Jeff Bezos has done is something close to a miracle"

WARREN BUFFETT: OK. Station 9.

AUDIENCE MEMBER: My name is Dr. Sherman Silber. I'm an infertility doctor from St. Louis. And I've been a shareholder and coming to this meeting for 23 years, and I want to thank you very much for making my grandchildren very rich. (Laughter and applause)

And they sometimes compare me in the medical world — infertility world — as the Berkshire Hathaway of infertility, because I'm so old and I come from a relatively small community.

But I'm wondering about your interests in not just Apple, but all of the tech stocks, like Amazon and Google. Because you've avoided them, you've stated in the past, because they're complicated, you should stick with something you understand.

On the other hand, Amazon and Google have what you call a very durable competitive advantage. They really hardly have any competitor. And that's true in China, too, of Alibaba and Tencent.

So it seems like it's a conflict, and I'm wondering if you're going to be turning the corner and going into these tech companies that seem to have no serious competition.

WARREN BUFFETT: Well, we certainly looked at them. And we don't think of whether we should be in tech companies or not, or that sort of thing. We are looking for things when we do get into the durability of the competitive advantage, and whether we think that our opinion might be better than other people's opinion in assessing the probability of the durability, so to speak.

But the truth is that I've watched Amazon from the start, and I think what Jeff Bezos has done is something close to a miracle. And the problem is, if I think something will be a miracle, I tend not to bet on it. (Laughs)

It would have been better — far better, obviously — if we — if I had some insights into certain businesses.

But you know, in fact, Bill told me early on — Bill Gates told me early on — you know, that I think I was on AltaVista and he suggested I turn to Google.

But the trouble is I saw that Google was skipping past AltaVista, and then I wondered if anybody could skip past Google. And I saw at GEICO that we were paying a lot of money for something that cost them nothing incrementally.

We've looked at it, and you know, I made a mistake in not being able to come to a conclusion where I really felt that at the present prices that the prospects were far better than the prices indicated.

And I didn't go into Apple because it was a tech stock in the least. I mean, I went into Apple because I made certain — came to certain conclusions about both the intelligence with which the capital would be employed, but more important, about the value of an ecosystem and how permanent that ecosystem could be, and what the threats were to it, and a whole bunch of things.

And that didn't — I don't think that required me to, you know, take apart an iPhone or something and figure out what all the components were or anything. It's much more the nature of consumer behavior. And some things strike me as having a lot more permanence than others.

But the answer is, we'll miss a lot of things that — or I'll miss a lot of things — that I don't feel I understand well enough.

And there is no penalty in investing if you don't swing at a ball that's in the strike zone, as long as you swing at something at some point, then you know, eventually that you find the pitches you like. And that's the way we'll continue to do it. We'll try to stay within our circle of competence.

And Charlie and I generally agree on sort of where that circle ends, and what kind of situations where we might have some kind of an edge in our reasoning or our experience or something that — where we might evaluate something differently than other people.

But the answer is, we're going to miss a lot of things.

Charlie?

CHARLIE MUNGER: Yeah, we have a wonderful system. If one of us is stupid in some area, so is the other. (Laughter)

And of course, we were not ideally located to be high-tech wizards. How many people of our age quickly mastered Google? I've been to Google headquarters. They look to me like they're — it looks like a kindergarten. (Laughter)

WARREN BUFFETT: A very rich kindergarten.

CHARLIE MUNGER: Yes. (Laughter)

WARREN BUFFETT: No, it's extraordinarily impressive, what they've done. And like I say, at GEICO we were paying them a lot of money at the time they went public. And all three of the main characters — Eric [Schmidt] and Larry [Page] and Sergey [Brin] — they actually came and saw me. But they were more interested in talking about going public and the mechanics of it and various things along that line.

But it wasn't like what they were doing was a mystery to me. The mystery was how much competition would come along, and how effective they would be, and whether it would be a game where four or five people were slugging it out without making as much money as they could if one company dominated.

Those are tough decisions to make. You can have industries where there's only two people in it, and they still don't (inaudible) very good because they beat each other's brains out. And that's one of the questions in the airline business. It's a better business now than it used to be, but it used to be suicide, so — (Laughs)

And you know that the competitive factors are extraordinary in airlines, and how much better business is it with four people operating at 85 percent capacity than it was at — with seven or eight operating in the mid-70s, and with more planes run. Those are tough decisions.

But I made the wrong decision on Google. And Amazon, I just — I really consider that a miracle, that you could be doing Amazon web services and changing retail at the same time, with — you know, without enormous amounts of capital, and with the speed and effectiveness of what Amazon has done.

I just — I underestimated — I had a very, very, very high opinion of Jeff's ability when I first met him. And I underestimated him. (Laughs)

Charlie?

CHARLIE MUNGER: Well, my comment would be that the shareholders have one thing to be thankful for.

Some of the age-related stupidity at headquarters has been ameliorated by Ted and Todd joining us. We are looking at the world with the aid of some younger eyes now. And they've had a contribution —

WARREN BUFFETT: Significant.

CHARLIE MUNGER: — beyond their own investments. And so you're very lucky to have them be shareholders. Because there's a lot of ignorance in the older generation that needs removal. (Applause)

29. "We already have a family office. It's sitting right here"

WARREN BUFFETT: OK, station 10.

AUDIENCE MEMBER: Hi, good afternoon. Good afternoon, Warren. Good afternoon, Charlie. And my name is Ujean (PH). I come from China, and I work for (foreign language) family office. And we are serving high-worth individual clients in China. And you two would be my dream customer.

I know your shareholder Bill Gates has a family office, which, helping his wealth. So my question is, do you have a family office, and what — can we know what they do, some — anything for you? And if not, are you planning to have a family office in the future?

CHARLIE MUNGER: We already have a family office. It's sitting right here. (Laughter)

WARREN BUFFETT: Yeah, we would be the last guys in the world to have a family office, actually. (Laughter)

There are a lot of them around, and — but it's not something that fits the Munger family or the Buffett family. (Laughs)

Charlie, you have anything?

CHARLIE MUNGER: No.

WARREN BUFFETT: OK.

30. No "precise formulas" on Berkshire's incentive plans

WARREN BUFFETT: Let's — we'll do one more. Station 11.

AUDIENCE MEMBER: Hi Warren, Charlie. My name is Adam Mead, Mead Capital Management from Derry, New Hampshire.

In the past you have touched on certain compensation arrangements with key executives. Could you please provide some specific examples of compensation arrangements within Berkshire that speak to incentivizing good behavior while not penalizing the manager for size or the relative ease or difficulty of the business or industry? Thank you.

WARREN BUFFETT: Well, that is a very, very good question, and a very, very tough question. Because some of our —

CHARLIE MUNGER: He really doesn't want to answer.

WARREN BUFFETT: Well, some of our managers — (Laughter)

No, some of our managers are in businesses that are just much easier. I mean, we bought into a variety of businesses. People are obviously influenced by what pay arrangements are elsewhere. They wouldn't be human if they weren't.

And trying to come to the right answer when you have different degrees of capital intensity, different degree — very different degrees — of basic profitability, and how much you scale up based on size, because there is an incentive to grow businesses. Usually if businesses get much larger, everybody from the CEO down expects to earn more money for something that — where they really bring the same amount of intensity and work and (inaudible) to it.

It is really a tough question. I think that if you engage compensation consultants at public companies, which they all do, they're going to recommend things that cause them to have CEOs recommend them to other companies. (Laughs)

It's just, you're working against human nature when you have an arrangement like that.

I would say that we have obviously kept a very, very, very high percentage of the managers that we hoped to have stay with us. In fact, just about a hundred percent. It's —

And I think people do like — they do like to make their own decisions. They do like recognition. You know, they — most people respond — they like doing a good job, and they like the fact that we understand it. And compensation's part of that. But it's not the whole thing.

And I wish I could give you some precise formulas, but there aren't any —

CHARLIE MUNGER: No, you really don't, Warren.

WARREN BUFFETT: What?

CHARLIE MUNGER: It's an advantage at Berkshire to keep our individual deals private. There would be no advantage to just publishing them all.

WARREN BUFFETT: No, we're not going to do that.

CHARLIE MUNGER: No, of course not. So what we're saying, he makes all those decisions personally. He's got every formula in the book. And he keeps them all private. That's our system. (Laughter)

WARREN BUFFETT: Well, we do — (Laughter)

We publish what the directors are paid.

CHARLIE MUNGER: We publish what we have to, yes.

WARREN BUFFETT: OK. It's 3:30 now. We're going to reconvene at 3:45.

Charlie and I, we love the fact that our partners basically turn out for this. So we thank you for coming. I hope you've had a good time, both at the meeting and in Omaha. And we look forward to seeing you again next year. Thanks. (Applause)

31. Formal business meeting

WARREN BUFFETT: We're going to move it right along, with a little (inaudible) copy here.

If you'll please take your seat, thank you.

This is the formal meeting, so the meeting will now come to order.

I'm Warren Buffett, chairman of the board of directors of the company, and I welcome you to this 2018 annual meeting of shareholders.

This morning, I introduced the Berkshire Hathaway directors that are present and also with today are partners in the firm of Deloitte & Touche, our auditors.

Jennifer Tselentis is the assistant secretary of Berkshire Hathaway. She will make a written record of the proceedings.

Becki Amick has been appointed inspector of elections at this meeting, and she will certify to the count of votes cast in the election for directors and the motions to be voted upon at the meeting.

The named proxy holders for this meeting are Walter Scott and Marc Hamburg. Does the assistant secretary have a report of the number of Berkshire shares outstanding entitled to vote and represented at the meeting?

VOICE: This is the important part.

VOICE: You sit there.

WARREN BUFFETT: We're building the suspense here. (Laughs)

JENNIFER TSELENTIS: Yes, I do. As indicated in the proxy statement that accompanied the notice of this meeting that was sent to all shareholders of record on March 7th, 2018, the record date for this meeting, there were 748,347 shares of Class A Berkshire Hathaway common stock outstanding with each share entitled to one vote on motions considered at the meeting, and 1,344,969,701 shares of Class B Berkshire Hathaway common stock outstanding with each share entitled to 1/10,000th of one vote on motions considered at the meeting.

Of that number, 537,524 Class A shares and 823,145,874 Class B shares are represented at this meeting by proxies returned through Thursday evening May 3rd.

WARREN BUFFETT: Thank you. That number represents a quorum. And we will therefore directly proceed with the meeting.

First order of business will be a reading of the minutes of the last meeting of shareholders. I recognize Mr. Walter Scott who will place a motion before the meeting.

WALTER SCOTT: I move that the reading of the minutes of the last meeting of shareholders be dispensed with and the minutes be approved.

WARREN BUFFETT: Do I hear a second?

RON OLSON: I second the motion.

WARREN BUFFETT: Motion has been moved and seconded. We will vote on this motion by voice vote. All those in favor say aye.

VOICES: Aye.

WARREN BUFFETT: Opposed. The motion is carried.

The next item of business is to elect directors. If a shareholder is present who did not send in a proxy or wishes to withdraw a proxy previously sent in, you may vote in person on the election of directors and other matters to be considered at this meeting. Please identify yourself to one of the meeting officials in the aisles so that you can receive a ballot.

I recognize Mr. Walter Scott to place a motion before the meeting with respect to the election of directors.

WALTER SCOTT: I move that Warren Buffett, Charles Munger, Greg Abel, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Ajit Jain, Thomas Murphy, Ron Olson, Walter Scott, and Meryl Witmer be elected as directors.

WARREN BUFFETT: Is there a second?

RON OLSON: I second the motion.

WARREN BUFFETT: It has been moved and seconded that Warren Buffett, Charles Munger, Gregory Abel, Howard Buffett, Stephen Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Ajit Jain, Thomas Murphy, Ronald Olson, Walter Scott, and Meryl Witmer be elected as directors. Are there any other nominations or any discussion?

The nominations are ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the election of directors and deliver their ballots to one of the meeting officials in the aisles. Miss Amick, when you are ready you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast not less than 605,906 votes for each nominee. That number exceeds a majority of the number of the total votes of all Class A and Class B shares outstanding. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. Warren Buffett, Charles Munger, Gregory Abel, Howard Buffett, Steve Burke, Susan Decker, William Gates, David Gottesman, Charlotte Guyman, Ajit Jain, Thomas Murphy, Ron Olson, Walter Scott, and Meryl Witmer have been elected as directors.

32. Shareholder motion on methane emissions

WARREN BUFFETT: The next item of business is a motion put forth by Freeda Cathcart on behalf of shareholder Marcia Sage. The motion is set forth in the proxy statement. The motion requests that the company provide a report revealing the company's policies, actions, plans, and reduction targets related to methane emissions from all operations.

The directors have recommended that the shareholders vote against the proposal.

I will now recognize Miss Cathcart to present the motion. To allow all interested shareholders their views, I ask that the representative of the Baldwin Brothers limit the presentation of the motion to five minutes.

FREEDA CATHCART: Good morning Chairman Buffett, Mr. Munger, members of the board and fellow shareholders. I am presenting this proposal on behalf of Baldwin Brothers on the issue of methane asset risk. This is the second year for this methane-focused proposal. Last year 10 percent of shareholders approved of it.

Methane asset risk is a serious financial safety and environmental issue across the entire natural gas supply chain. The failure of a gas injection well at Southern California Gas Aliso Canyon Storage facility in Los Angeles revealed major vulnerabilities in the maintenance and safety of natural gas facilities.

In that situation, cleanup and containment costs have soared to close to $1 billion. Governor Jerry Brown of California has threatened to shut down the facility.

Berkshire Hathaway owns the largest interstate natural gas pipeline system in the United States. It has natural gas storage distribution and transportation facilities that may face similar safety risks through the Northern Natural Gas Company, Kern River Gas, and Mid-American Energy Corporations.

On an environmental front, research indicates methane leaks could erase the climate benefits of reducing coal use to meet internationally agreed upon climate change targets. Methane emissions have an impact on global temperature of roughly 84 times that of CO_2 over a 20-year period.

Berkshire is a voluntary member of the EPA's Methane Challenge and ONE Future Emissions Intensity Commitment Framework and should be applauded for reducing its leakage rates to below the 1 percent target along its value chain.

Since this framework is a cost-effective versus prescriptive approach, shareholders would like to understand if this cost-effective approach employed at Berkshire is sufficient — maintenance and enhanced disclosure should help mitigate the potential for these financial and regulatory risks.

In closing, we think it prudent that Berkshire Hathaway issue a report revealing and disclosing the company's specific best practices, policies, and safety standards for methane assets and required upgrade costs to facilities to mitigate potential business risks.

The report would make it easier for investors, customers, and regulators to understand Berkshire's overall approach to managing methane emissions and risks. Thank you for your consideration.

WARREN BUFFETT: Miss Cathcart, could you help me out? Are there some other people that are there to speak? I can't quite see from here.

VOICE: No, there are no other shareholders who wish to speak on this issue.

FREEDA CATHCART: There's nobody behind me to speak.

WARREN BUFFETT: Did you get that, Charlie?

CHARLIE MUNGER: No.

WARREN BUFFETT: Greg — could we put up slide one and then if somebody will give Greg a microphone, that'd be helpful. He could elaborate some on this chart and knows what we're doing.

GREG ABEL: OK. Thanks, Warren and appreciate the comments there. What we've prepared here is in response to the proposal. It demonstrates the ONE Future Initiative goal as it was highlighted. They'd like to see our pipelines operating by 2025 at a 1 percent throughput — or a loss of throughput at 1 percent.

I'm happy to report, as this slide shows, that in 2017 our throughput loss was 0.046 percent, 20 times better than the request in 2025. (Applause)

Thank you. It's a great compliment to our operating team, obviously. They take the issue that has been highlighted very seriously. I would also add, as it was noted, we're part of the EPA program where we report on a voluntary basis. Our practices are disclosed and reviewed by the EPA and additionally added on our website.

Accordingly, I strongly feel we're getting the results and disclosing the appropriate information. Thank you.

WARREN BUFFETT: Yeah, and thanks Greg. And Miss Cathcart, we are on the same side you are on this basically. We just are not looking for ways to conduct more studies and prepare reports that may cost us money and generate more reports and all that. But I can tell you two things.

This is something that is reported to the board of directors of Berkshire Hathaway Energy quarterly. And I'm on that board. And we believe in achieving the same (inaudible) and we think Berkshire Hathaway Energy is both sensitive and effective — sensitive to and effective — in reducing methane emissions.

So if — I think we're now ready. The motion is now ready to be acted upon. If there are any shareholders voting in person, they should now mark their ballots on the motion and deliver their ballot to one of the meeting officials in the aisles. Miss Amick, when you're ready, you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast 48,040 votes for the motion and 558,640 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares properly cast on the matter, as well as all votes outstanding, the motion has failed. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. The proposal fails.

33. Shareholder proposal on sustainability reports

WARREN BUFFETT: The next item of business is a motion put forth by shareholder Freeda Cathcart. The motion is set forth in the proxy statement. The motion requests that Berkshire adopt a policy to encourage more Berkshire subsidiary companies to issue annual sustainability reports.

I will now recognize Freeda Cathcart to present the motion, and to all interested shareholders to present their views I ask her to limit her remarks to five minutes. You have the floor, Miss Cathcart.

FREEDA CATHCART: Thank you so much. It is a privilege to be here and a privilege I can give thanks to my grandfather James Cathcart, who started out in the mailroom of Gen Re and worked himself up through the company to become the chair of Gen Re. During that time he accumulated a lot of Gen Re stock, which he bestowed generously upon his family.

And when he did so, he encouraged the members of his family to do good and to pay it forward, to do something that would make a difference in the world and in our communities. For my father, he did so by being philanthropic with educational institutions with the theory that if you give a person a fish you feed them for a day, but if you teach them to fish, you feed them for a lifetime.

My focus has been on the environment with the thought that when people fish, it would be nice if they were able to eat the fish.

I want to take this opportunity to clarify my proposal about the sustainability reports and put the emphasis on the word encourage. It is evident that Berkshire Hathaway's management of allowing the subsidiaries to work without getting guidance — well, mandates from you is being very successful.

And I wouldn't recommend changing it. You're doing a great job. Please keep it up.

But I do think that there's something to be said to encourage them and support them, and in many ways you already are.

There is a high level of interest from investors and the public in corporate social responsibility. One-fifth of investments are based on socially responsible investment strategies. And back in 2012, I found an article by Planet Earth Herald where they wrote, "When Warren Buffett talks, people listen. He is now talking about the environment. He believes that companies need to have a triple bottom line. And respecting the environment is absolutely critical to a company's economic performance."

In times — and this is a direct quote from you, Mr. Buffett, "In times such as these a company must invest in the key ingredients of profitability: its people, communities, and the environment."

One-third of Berkshire Hathaway's subsidiaries already have a sustainability presence on the web. And one of them is Berkshire Energy that has the acronym respect, R-E-S-P-E-C-T, which stands for Responsibility, Efficiency, Stewardship, Performance, Communication, and Training.

And Berkshire Hathaway provides an annual sustainability summit to help bring the subsidiaries together so they can learn how to be more sustainable, how to share tips, and how to be profitable. And that's excellent.

But when I try to find a web presence about the sustainability summit, I wasn't able to find it. And that's where I think that we can do a better job in Berkshire Hathaway when it comes to communication with our shareholders and with the outside world about the good work that we're doing.

A simple solution to that would just be to create a link on the Berkshire Hathaway website to sustainability that people could click on and go and find out about initiatives like the sustainability summit. And from there, perhaps, they could click on to go to the subsidiaries that have a web presence about sustainability to see what they're doing.

In doing so, we give a window to the world where they can see what we're doing to make a difference that might inspire other corporations to follow the example. Or perhaps a college student working on a paper would read about it and think that that is a good business model, that that's something that he wants to bring forward when he goes into his career.

There is a Facebook page called "Berkshire Hathaway's Sustainability" that will be available for shareholders and the outside world to look at to see research and to encourage each other to learn how we can support sustainability practices. And that is available now.

I greatly appreciate this opportunity to speak with you today and to clarify what my proposal is. And I do greatly applaud and appreciate all the work that you're doing on behalf of our corporation and the world. Thank you so much.

WARREN BUFFETT: And thank you. (Applause)

Many of the managers — a great many of the managers — of Berkshire are here and are listening to you. And I suspect that a very high percentage of them agree with what you're saying. Whether they — what they do in terms of web pages and so on, in our view, is basically up to them.

But I can tell you that one leading proponent, as you mentioned, was Greg Abel, who until recently was running Berkshire Hathaway Energy and now is vice chairman. And Greg may want to say a few words on this, too. But I can assure you that the managers are listening to you.

GREG ABEL: Thanks, Warren. Yeah, we do everything that was touched on. I'll just maybe add a few points for our shareholders. Obviously, sustainability is a priority for Berkshire and each of our operating subsidiaries. It was highlighted that a number of them have sustainability reports. But I would go beyond that. If you go to our various companies' websites, you'll see specific actions they're taking relative to sustainability. So it may not be summarized in a specific report, but that type of information is available.

I can also add that when you think of the Berkshire Hathaway Energy Corporation, we're trying to lead by example with support from Warren, Charlie, Walter Scott. I'm happy to report, if you look at where our energy production is right now at the end of 2017, 50 percent of our energy that is produced and consumed by our customers comes from renewable energy.

That's something we're strongly communicating across the U.S. and globally as an example of what can be done in our industry. And I'm happy to report by the end of 2021, 100 percent of the energy utilized by our customers can be met through renewable energy in Iowa.

So I understand the concept of sustainability. We're working across our organizations to share best practices. But as Warren highlighted, it really resides in each of our companies. But it will be encouraged and you'll continue to see great results. Thank you.

WARREN BUFFETT: Thank you. (Applause)

The motion is now ready to be acted upon. If there are any shareholders voting in person they should now mark their ballot on the motion and deliver their ballot to one of the meeting officials in the aisles.

Miss Amick, when you're ready you may give your report.

BECKI AMICK: My report is ready. The ballot of the proxy holders in response to proxies that were received through last Thursday evening cast 67,282 votes for the motion and 544,256 votes against the motion.

As the number of votes against the motion exceeds a majority of the number of votes of all Class A and Class B shares properly cast on the matter, as well as all votes outstanding, the motion has failed. The certification required by Delaware law of the precise count of the votes will be given to the secretary to be placed with the minutes of this meeting.

WARREN BUFFETT: Thank you, Miss Amick. And I would say Miss Cathcart, our managers heard you. I mean, you have had an impact and I appreciate what you have done.

Walter, I guess we're now ready for a motion?

WALTER SCOTT: I move that this meeting be adjourned.

WARREN BUFFETT: Is there a second?

RON OLSON: I second the motion.