

perspective

2005 Berkshire Hathaway Annual Meeting Notes

This summary is based on notes taken by the entire MCM research team and a rough transcript provided by Whitney Tilson, author of Value Investor Insight, a monthly publication (www.valueinvestorinsight.com). Comments attributable to Warren Buffett and Charlie Munger will appear in quotation marks, even though they may not be verbatim.

Opening remarks ☺

Like hymns to create the mood during the Sunday morning church service, the early Saturday morning matinee at the Berkshire annual meeting is an admixture of humor, sometimes bordering on the hilarious, and Warren's never-miss-an-opportunity-to-hawk-products. This year we found 82-year-old bespectacled Charlie Munger the victim (thanks to his devious partner and co-star Warren Buffett) of the affections of two beautiful women, Jamie Lee Curtis and Nicollette Sheridan, the latter of "Desperate Housewives."

Chairman Buffett opened the 2005 Berkshire Hathaway annual meeting, which is unlike any other in America! Looking over the crowd of 24,000 shareholders and others, Warren's first words were: "Some of you may be wondering why in the movie Charlie always gets the girl. I think it has to do with the Anna Nicole Smith rule: When choosing between two old rich guys, choose the older of the two." So much for parliamentary procedure!

First-quarter 2006 results

Warren Buffett was quite pleased with the first-quarter results. He once again reminded shareholders that underwriting results have a large seasonal aspect to them (this can easily be seen in the hurricane experiences in the fall of 2004 and 2005).

The big event for the quarter was the announcement of the acquisition of Iscar, an Israeli metalworking company.

Warren [in introducing the acquisition of Iscar]: "... [B]ut what's really important is we acquired a large, extremely well-managed company called Iscar. Last October, I'd never heard of this company, but then I got a 1½-page letter from Eitan Wertheimer. Sometimes I get a letter and a person's character and intellect jump off the page at me. So I met Eitan and his top managers in Omaha. They subsequently met Charlie. This all came to fruition yesterday when we signed the deal. As hard as this is to believe, Charlie is as enthusiastic about this as I am."

Munger: "This Company rose from very modest beginnings to be the best company in its field ... in the world. It's not the largest, but that leaves them something to do. [Laughter] The quality of the people in this company is off the chart—and they're young. This is a real quality enterprise, and we can learn a lot from them."

The \$4 billion transaction was completed on May 5 for 80% of the Company's stock, with

management retaining the other 20%. Warren and Charlie are always enthusiastic about working with the best people in the world. It was noted that the Iscar transaction was a negotiated transaction, and they could not remember buying a business in an auction process.

This is the first acquisition of a company based outside the U.S. Warren made it a point to state that we will look back on this in 5–10 years as a significant event for Berkshire Hathaway.

Warren and Charlie's thoughts on acquisitions

Warren: "It's important to note that in this world where many businesses get dressed up and auctioned off, we occasionally hear from people who consider their business too important to auction off. We don't participate in auctions. I can't recall buying a business at auction, can you Charlie?"

Munger: "I can't remember one."

Buffett: "People who won't put their business up for auction like a piece of meat and care about the home in which their business resides are the type of people we want to be partners with. It says something very important about how much they care about their business, their customers, and their employees. We've acquired a number of businesses like this in the past couple of years and the crowning one is Iscar. I'm going to Israel in September to see if there are any more girls like Iscar there."

On Social Security reform

Every society faces the challenge of caring for both their young and old. Customarily those who are capable of production turn out the products and services needed by those citizens incapable of caring for themselves. Franklin Delano Roosevelt formalized this process in 1935, coining it Social Security—the system that distributes benefits to those facing retirement, disability, and death. It has been one of the most successful programs in the history of this country and is the largest government program in the world.

When asked about the fate of Social Security, Warren and Charlie echoed last year's response by saying that the United States can easily handle the Social Security question. It astounded Warren that a government that is

now running \$300–\$400 billion in deficits is worried about \$100 billion deficits from Social Security decades from now. The GDP per capita is approximately \$40,000 today, and we produce more every year. Both men agreed that there will always be discussions about how to cut the pie, yet they urged the audience to remember that the U.S. has a huge and growing pie, thus ensuring that we *can* take care of the elderly. Charlie went on to say that if the system remains unchanged, then it would be logical to assume that Social Security would have problems. But if the country grows and the system is tinkered with, then it's "child's play" to divert more to the people who are older.

On designing compensation systems in cyclical industries

Running a copper company, the village idiot can coin money with copper selling at \$3.50/lb. It can be much harder at 80–90 cents/lb., however, where it has been most of Warren's life. If Berkshire owned a copper mining company, the compensation system would be based on the cost of production. In such a system, the copper mine manager may get paid handsomely even if the profit of the mine declines due to declining copper prices. There is really no standardized system that works for everything, but the general idea is to compensate management on what it has control over, such as the operating conditions, not the market prices. For compensation at Geico, by comparison, (1) unit growth and (2) profitability of seasoned business are measured.

Charlie stated that it's easy to have a fair compensation system; Warren agreed, saying it wasn't "rocket science." It may not be rocket science, but an estimated 50 % of public companies still don't have fair compensation systems. While those at Berkshire know how to handle compensation, their ability to influence the rest of corporate America has been close to zero.

Pinpointing the inducement behind unfair compensation systems, Charlie went on to observe that envy is a bigger motivator than greed. Warren agreed and sagely noted that "Our experience is that envy is what really drives people. You can give someone a \$2 million bonus, and they're happy until they see the next guy got \$2.1 million, and then they're miserable." He went on to say that envy, while being one of the worst of the deadly sins, is also the only one that makes you feel miserable. He joked that

gluttony is at least enjoyable, and others have told him that lust has some upside too. ©

On training successors/succession planning

Charlie rhetorically asked the audience, "If Warren has kept the faith until he's 75 years old, do you really think he'll blow the job of passing that culture along?" What could be more important in terms of his duties in life? Neither Warren nor Charlie is in the business of training executives; they're tracking down the best so they don't have to. After all, if a mountain stands up like Everest, you don't have to be a genius to find it.

So what will happen when Warren is gone? The new CEO may be tested by investment bankers for awhile, but as Warren says, "The nice thing about it is that our culture [Berkshire's] is so well-defined that there are rarely mismatches." The culture at Berkshire is too strong to be dismantled, and people will learn that not much is going to change. Great people looking to sell great businesses will still want to find a home at Berkshire.

Method for electing the board of directors—asked by Frank Martin

Question: "Will the recent shareholder movement that is pushing to use majority voting instead of plurality voting help raise the ethical standards in corporate boardrooms?" [Note: *With majority voting 51% of votes must be cast "for," while under plurality voting the candidate with the most votes wins, but for board elections there is only one candidate, so one "for" vote elects a board member. With directors' fees commonly exceeding \$50,000, buying a share and voting "for" would be a pretty good investment for a board member elected by a plurality!*]

Warren has observed that there is a big difference between board members who act like (or preferably are) owners and those who don't—especially since the board of directors is responsible for hiring the CEO and keeping him or her focused on increasing the owners' value. Unfortunately, changing the voting method will probably not have much of an effect on a board member who does not think like an owner. In response to Frank's question, Warren thought that the only way to really bring about change is for very large (typically institutional) shareholders to *directly* vote proxy issues actively in the best interest of shareholders. Many large institution

owners neglect to act like owners by outsourcing proxy voting to consultants. [The MCM challenge to the CEO of Emmis Communications regarding his proposed "going private" offer points out (1) the scarcity of institutional investors willing to take a stand and (2) the incredible investment of time necessary to take a stand.]

Warren graciously interrupted the question to say that Frank had just finished a great book, *Speculative Contagion*, which is a compilation of annual reports to his firm's clients that Warren has read over the years. He dubbed it a "must read." [The writer laments: With an endorsement like that—which money simply can't buy—you'd think the book would be flying off the shelves ... Based on royalties to date, he has no plans of giving up his day job!]

On circle of competence

When evaluating businesses for acquisition, Berkshire always uses three boxes: in, out, and too hard. It doesn't bother Warren or Charlie to put an idea in the too-hard pile, as both men are acutely aware of the fact that one doesn't have to do *everything* well. Warren emphasized the importance of knowing one's strengths. To back his point he quoted Tom Watson Sr., the founder of IBM, who used to say "I'm no genius, but I'm smart in spots, and I stick to those spots." What "spots" does Berkshire "stick to"? Well, while it's hard to predict what some businesses will look like in five years, Berkshire believes that it's important to find companies that are unlikely to change a great deal over the next 5–10 years, as change is rarely a positive development. Both men are cognizant of their aptitude in assessing a business's future, which helps them play to their strengths. A foreign correspondent once said to Charlie that "you guys don't seem smart enough to do as well as you are doing; what is your explanation?" Charlie responded by saying that they knew the edge of their competency better than most people. It's not a competency if you don't know the edge of it. Pete Liegl was cited as an example as someone you should not compete against. If you do, he'll beat you—at least when it comes to RVs, which is precisely why he doesn't run insurance. He sticks with what he knows.

Are we in a commodity bubble?

Agriculture commodities have not done anything. The most extreme move has been copper. As the saying goes, what the wise man does in the beginning, the fool does in

the end. The beginning is driven by fundamentals, but once a price history develops, speculation can become the main driver. Warren's guess is that there is some speculation in the commodity area currently. He compared copper to the Internet stocks in 1998–99.

Berkshire's history in commodities has not been impressive. Warren likened it to being at Cinderella's Ball. For the most part, everyone knows that it's all going to fall apart at midnight, but each person also thinks he or she will make a little money and slip out the door at 11:58 p.m. The problem is there are no clocks, and when midnight does come everyone is going to stampede to the exits.

Charlie did mention that at one time Warren made a good deal of money on oil, but, overall, Berkshire didn't get where it is today by owning non-interest-bearing assets. Commodities are not like stocks that pile up earnings while you wait. If an asset doesn't bear interest, you must hope that its price will go up. They recently failed to profit from one of the biggest commodity booms in history. It's a good habit to trumpet your failures and be quiet about your successes.

Outlook for manufactured housing/real estate

One must go back 40 years to find the manufactured homes volume as low as it is today. There were years when manufactured housing accounted for 20% of the housing market. Today it's in the 6–7% range. Manufactured housing can offer considerable value, but stick-built is getting more efficient through the use of engineered systems. Warren pointed out that there were two houses on display at the meeting that were \$45/square foot. The lax financing of the past has led to the current industry troubles. Sales probably won't improve much this year or next, but at some point the volume will get back up to 200,000. Clayton has done considerably better than the rest of the industry. So much so, in fact, that Warren said it's hard to find a company that has performed in second place. In the future, Clayton could become the largest homebuilder in the country.

Why are manufactured homes experiencing such a dramatic decline in the market? There are several contributing factors. For starters, manufactured housing is having problems because of the easy financing and excess demand of the past. There are some of the same signs with stick-built housing today. Dumb lending

always has consequences. Charlie likened it to a disease that takes a week to show itself: By the time you see any problems the epidemic is well on its way. Things are starting to slow now. High-end markets or properties that were bought for investments could be problematic. Not all areas of the country are the same, however, and there are many areas that will remain for the most part unaffected.

Use of cash at Berkshire Hathaway

Warren always wants Berkshire to have adequate cash but not excessive cash. The \$40 billion they currently have is probably excessive and a more normal number would be in the \$10 billion range. While the Company is likely to have less cash in the future, they can't guarantee it. Warren admitted that there are, however, more unfavorable circumstances than having excess cash. He stated: "While we [Berkshire] don't like having excess cash, we like doing dumb deals even less because we're stuck with them forever. You're right that we should be uncomfortable that we have this cash, but [the alternative of doing bad deals is far worse]." They were currently looking at a \$15 billion deal but qualified it by saying it's a low-probability event. As always, Berkshire will issue a dividend when they come to a point where they can no longer get an adequate return on reinvested capital.

Charlie pointed out that despite having difficulty they have put a lot of wonderful businesses into Berkshire in the last 10 years. They're not pessimistic about the future; in fact, it appeared to be quite the opposite. Warren went on to observe that throughout his career, with patience, new opportunities tended to present themselves without much notice.

Share repurchases

Share buybacks in the past were mostly motivated by buying the stock back at below its intrinsic value. Today, that motivation has been swamped by simply propping up the stock. In Berkshire's case, they are unlikely to be able to complete a share-buyback program because of the lack of liquidity. Berkshire has one of the lowest turnover rates of any large public company in America. This is not just a function of concentrated holdings, as even Wal-Mart has a turnover rate of 79% compared with Berkshires' 14%.

Hyper-helpers? (investment managers)

There are more “helpers” [parasites might be a better word] in the economy than there used to be. Charlie noted that they get the best of them coming to Berkshire but then went on, in his rational but brutally honest style, to say, “As to what you ought to do to become like Warren Buffett, I would say reduce your expectations.”

The activities of all the professionals are self-neutralizing. In aggregate, the investment profession does not add value, and Warren estimated the overall cost at \$140 billion a year. The investment business is an interesting one in that the more you charge, the more money you can bring in, temporarily. It is somewhat like a business school. No one wants to go to the school that charges \$20,000 for tuition, but everyone wants to go to the school that charges \$50,000. There are large portions of investment management that are charging fees that cannot work out for investors in the aggregate, in particular the “2&20” fee—2% of portfolio and 20% of investment returns annually—that is so popular now with hedge funds.

[See page 18 of the 2005 Berkshire Annual Report for further discussion on “Helpers” and tips on “How to minimize investment returns.”]

Media and entertainment businesses

It's unlikely that the need to be entertained and/or informed will ever be satiated, yet the manner by which people go about spending their leisure time is sure to vary. There's a plethora of new products geared toward entertainment/information, and this number will only increase as technology improves. As is usually the case, any time you get more competition in an area, the economics deteriorate. While newspapers and television are still highly profitable businesses, their future is far from rosy. Warren lamented the future of newspaper readership, stating, “When they take people to the cemetery, they're losing readers, but when they graduate from college, they're not gaining any readers.” Both men loved newspapers and used to consider them bulletproof. They were wrong. They do, however, have a method for coping. As Charlie stated, “We just put it in the ‘too hard’ basket. If something is too hard, we move on to something that's not too hard. What could be more simple?”

Views on U.S. currency

Warren stated that his views are as strong as ever and perhaps a bit stronger. It's almost certain that the U.S. dollar will weaken over time as a result of the fiscal and monetary policies the United States is currently following. Berkshire is doing less in the direct-currency markets, however, as the cost of the carry has gone from positive to quite negative. Buying companies whose earnings are in non-dollar currencies is a better way for them to protect against a falling dollar in the future. The earning power of Iscar, for instance, is largely in non-dollar currencies. While most of Berkshire's money will be in U.S. dollars, they are likely to increase the activity of acquisition of non-U.S. companies. In order to offset the higher risk level (political, regulatory, cultural understanding, etc.) in emerging markets, *Warren requires a larger margin of safety for international investments.* [Given the flood of capital flowing into comparatively small foreign markets, if anything, the margin of safety has inverted.]

Great civilizations might be able to withstand more than you would have thought at the outset. The longer it goes, however, the more likely it will be dealt with painfully. Economists talk about the benign concept of a “soft landing,” but Warren doesn't know how that comes about and is not really even sure what that means. One possible result is significantly higher inflation. If you owe a lot, it can be very tempting to pay in a deflated currency.

Accuracy of Consumer Price Index (CPI)

Warren and Charlie believe that the publicized numbers understate inflation. It's curious how inflation is showing up in very specific places. In certain areas, like VCRs and DVDs, there has been considerable deflation. In other areas, there has obviously been considerable inflation. Overall, if you're old, own your house, and drink Coke all day, your CPI is probably accurate. If you're young, buying a new house, and driving to work every day, your CPI has gone up considerably. [Kate Welling did a superb piece on the systematic dismantling of the CPI over many political cycles. Call if you'd like more information.]

Effective decision-making skills in order to avoid swimming naked

Warren turned to Ben Graham when offering the audience more keys to investment success. Ben Graham

said you're not right because people agree or disagree with you; you're right because your facts and reasoning are right. Once you have the facts, *you* need to think about what they mean. You don't take a survey. The focus should be on what's important and knowable. If it's important but unknowable, forget it. Decide if you have enough valuable information to act and then know that the market is there to serve you and not to instruct you. Neither Warren nor Charlie plays big trends like demographics. They agree that there are more important things to think about than the macro stuff.

On terrorism

Warren and Charlie reiterated their concern about terrorism and stated that it is humankind's ultimate problem. It's irrefutable that there have always been people who want to do harm to others; this is not new to humanity. In the past, however, the tools to do so ranged only from rocks to rifles. It's a fairly recent development that such a small number of people have the capability and technology to cause harm to such a large number. They, unfortunately, put the odds of a nuclear device going off in a U.S. city in the next 60 years at near 100%. What can we do? As Warren suggested, "You can elect leaders who are very aware of the problem and devote efforts to mitigate it. The genie is out of the bottle, but you'd like to have leaders who focus on this."

Buffet on philanthropy

Subsequent to the annual meeting, Warren proved once again that his genius is only exceeded by his humility. The proposed systematic transfer of his wealth to the Bill and Melinda Gates Foundation says volumes about the man and dispels any myths about Buffett and money. He is this generation's Andrew Carnegie ...

- Aaron Kindig, CFA
- Tom Dugan

MARTIN
CAPITAL MANAGEMENT, LLP
Registered Investment Advisor

300 Junior Achievement Dr. / Suite 301 / Elkhart, IN 46516 / Phone 574.293.2077 / Fax 574.293.2153
www.mcmadvisors.com

