

2004 Berkshire Hathaway Annual Meeting Notes

The following notes were taken during the meeting by Dennis Blyly and Drew Wilson, and edited by fellow attendee Frank Martin, who added little beyond synthesizing his two partners' good work. The questions and answers below are not organized by topic but simply follow the random flow by which they were voiced. While somewhat disjointed, this will allow easy comparison with the transcript that the *Outstanding Investor Digest* ("OID") publishes in installments in the quarters ahead. The answers, as always, revealed the sagacity, humor, core ethics and brilliance of two of the finest thinkers and practitioners on the investment scene in more than half a century. Despite our repeated trips to the "Woodstock for Capitalists," each visit offers new insights as well as a current assessment of the investment world. The education is cumulative; the feeling is like a classroom where the professors' wisdom and knowledge seems boundless. Because of bathroom breaks, crunching on See's peanut brittle, exchanging ideas with our guests, this is far less than a complete account.

The release of the MCM annual report precedes Berkshire's as well as Berkshire's annual meeting, so there's some obvious interest around MCM world headquarters until the last words are spoken at the BRK meeting as to whether we and the Berkshire duo are on the same path or whether they have chosen a divergent course. While this is always open to question until the meeting concludes, Warren Buffett and Charlie Munger appear to be following our lead rather well! Keep it up, guys!

The meeting opened with Susie Buffett Jr. alone on the dais. Warren's daughter, named after her mother who died unexpectedly of a stroke earlier in the year, eulogized the life of a remarkable woman. Up-close and personal video clips extracted from a Charlie Rose interview pictured Susie as a bright, forthright, witty, perceptive and balanced woman, no more corrupted by wealth than Warren is.

Buffett on First Quarter 2005 Results

Buffett noted that he was quite satisfied with the first calendar quarter and reminded shareholders that the underwriting results have a large seasonal component due to hurricane exposure, as was apparent in the fall of 2004.

He said the acquisition of their long-standing holding in Gillette by Procter & Gamble was the most significant transaction. Because of GAAP accounting rules, a large capital gain will be booked that does no more than cause a gain in value, which has already been realized, to flow through the income statement. It is not, however, a taxable event. He expects to hold Procter & Gamble for a long time and actually purchased additional shares as part of the transaction. While not prepared to make a public disclosure, he hinted that Berkshire would soon purchase another insurance company for roughly \$1 billion. We later learned they agreed to purchase Medical Protective Corp., a medical malpractice insurer, from GE. The small size of the transaction speaks in part to the paucity of large acquisition opportunities.

What Buffett looks for in a manager of a Berkshire company

He (or she) must love the business more than the money. Since the manager of an acquired company no longer has an economic need to work, he must *want* to work. Managers must exemplify BRK's behavioral model:

- Intelligence
- Passion for the business
- Integrity (none of the above matters without the linchpin of integrity)

In response to a later question about management talent being "innate" (in reference to a comment in the BRK annual report) and whether there are tools Buffett uses to predict it, he responded that he does it the easy way—by observing it. He said he doesn't believe he could predict innate talent in a class of newly minted MBAs. Buffett's success in identifying talented managers is due to looking at their record and past behavior.

On the Anheuser-Busch stock purchase

He said it took him about 2 seconds to make up his mind. He has read 20 years' worth of annual reports. He understands the business and the consumer behavior that drives it. He noted the consolidation in the industry and the reasonable growth prospects outside the United States.

Within consumer products, BUD brand has the advantage of less private label competition [compared to the host of other consumer products we purchase where private label and generic substitutes pose a competitive threat]. Beer consumption per capita will likely remain flat and the trend toward substitution of wine/spirits for beer over the last year created an opportunity to buy while the company was out of favor. Purchases are often made possible by a little bad news. In previous meetings he said he would like to buy high quality companies when they are on the operating table, assuming the condition isn't terminal. BUD was an example. [He did forswear any inclination to substitute beer for the copious amount of Coca-Cola products he and Charlie consume during the course of the annual meeting!]

As an aside to the discussion on BUD, he indicated corporate profit as a percentage of GDP will likely

decline. Pricing power is one of their favorite indicators of a moat.

Current prospects for Berkshire: "Glum"

In response to a question regarding all the money being committed to hedge funds and private capital, and whether it made things more difficult for him, Buffett responded, to paraphrase in a word, "Indeed."

Proliferation in hedge funds [now numbering a record 7000 plus] and private equity funds has diminished opportunities to redeploy capital. This is reminiscent of when Warren closed his partnerships in 1969 in part because there was too much money chasing too few ideas. He and Charlie noted that they have never seen a time when more money and energy was being spent in the business of buying and selling companies. They said they must wait for a better environment; events can and will occur that can change things very quickly. Buffett believes we have reached a heightened state of potential rapid money movement ... what he called high "hair trigger" risk. With so much money in the hands of shortsighted investors and with the speed at which information flows, there is a high probability that an event will trigger massive dislocations somewhere in the global financial markets.

Warren and Charlie both pointed out that some business owners would always prefer to sell to Berkshire for reasons that are not exclusively economic. However, it is clearly a challenge to put their money to work prudently with all the money currently chasing deals.

This was the first time that Charlie referred to the "Apex of Civilization." Charlie mentioned this phrase again when he referenced the bad behavior of lawmakers, lawyers, and the waste of having so many smart people employed in the money management/securities business.

The current environment in which there is more intellectual capital dedicated to making money quickly by buying and selling little pieces of paper reminds Charlie of Sodom and Gomorrah. "Bad things can happen" in environments like this.

Pricing behavior and the quality of a business

Buffett said that the quality of a business has a direct correlation to the agony management experiences in putting through price increases. He referred to the changing nature of the newspaper business where managers used to regularly increase advertising and circulation rates without thinking about the competitive ramifications. He said that is no longer the case and that it is important to look at the pricing behavior in an industry.

Future dividend from Berkshire?

While the media made a big deal of this, he answered it as he always has. He will pay a dividend when he no longer believes he can create more than \$1 of intrinsic value for every \$1 retained. The only additional caveat was that with more than \$40 billion in cash, if it's not put to work over the next few years, the "burden of proof will shift rather dramatically."

International Economics

Buffett, in response to a question, made his case for a lower dollar. He thinks America's current account is akin to a farmer unwittingly, gradually selling pieces of a huge farm in exchange for living a little better today. He doesn't believe the current account deficit is sustainable and that a lower dollar is the inevitable result. He referenced the Paul Volker *Washington Post* editorial and said it made sense to him. If you would like to access it, call or e-mail us at mail@mcmadvisors.com. Volker isn't optimistic that this problem will be solved easily nor will it likely be accomplished by a soft landing.

Charlie doesn't completely buy into Buffett's argument in terms of the severity of consequences. In Charlie's point of view, there is nothing necessarily bad about foreigners owning perhaps as much as 10% more of the U.S. over time if the U.S. is 30% richer. Charlie believes that reversing the trend could involve unpleasant remedies that would require less consumption and more savings. [Dennis suspects they both think that lower consumption and higher savings will come from higher interest rates, although they didn't specifically say it. Frank agrees and adds that free and unfettered markets tend to be self-correcting. Allowing all major currencies, including China's, to trade without governmental

interference, and minimizing tariffs and other barriers to free trade, will enable the process to work as efficiently as possible. Since 1989, Japan has been an example of the ongoing damage inflicted by interventionism.] Buffett did reference the potential for the "electronic herd" to get spooked in the international currency markets—again pointing to the potential for higher interest rates if foreigners become more concerned about U.S. Treasury debt.

In the realm of economics, predicting what might happen is easy; predicting when it will happen is hard.

Housing Bubble?

Both Charlie and Warren believe that a housing bubble exists, although they agree that it is confined to the geographic areas where price increases have far exceeded the growth of construction costs. They said this could cause some problems at financial institutions heavily dependent on mortgages, not unlike the small rural banking institutions that were burned by the drop in farmland values in the mid-1980s. Farmland kept rising to sell at prices far beyond what they could support, based on income from economic rents (frequently a precursor of trouble). They also pointed out that the growth of securitization has effectively reduced the quality of the mortgage underwriting since the originator doesn't have to live with the loan once it's made. This would obviously apply to all asset-backed securities of all types. They believe that relaxed underwriting standards have clearly contributed to the continued growth of residential housing and the trend is unlikely to continue.

What will they do in the event that economic Armageddon actually occurs?

They believe that Berkshire will continue making money. They own good businesses with good managers, who have the right incentives. The answer was similar to last year's when Warren said, "Berkshire is built to last." He went on to talk about how they manage the reinsurance operation with definitive limits that now exclude large terrorism risks. They also work hard to identify and manage correlated risks throughout Berkshire. [Rarely do adverse events occur without the possibility of the "domino effect" or, in more contemporary chaos theory terms, the "butterfly effect." A small triggering event can have disproportionate consequences. Buffett and Munger

are acutely aware of this cascading risk phenomenon because of their insurance businesses.]

On General Motors' problems

Buffett said that GM's and Ford's problems stem from the inability of previous managers to take a stand against labor's ever-increasing demands for a larger slice of the corporate pie. [Munger went further to suggest complicity on the part of managers because future healthcare and retirement benefits were bargaining giveaways that didn't penalize current earnings, despite the reality that these benefits were real costs saddled on later generations. While not a perfect analogy, it smacks of Buffett's longer-term concerns about the foreign trade deficit.] Lax labor policies have resulted in U.S. automakers being less and less able to compete with foreign rivals that do not have such "legacy costs." He pointed out that the labor unions have \$90 billion in pension assets and shareholders have \$15 billion in equity at General Motors. "The score is labor 90; shareholders 15." He doesn't know how it can be fixed. Munger said fixing it would be a priority if he were a politician or manager of one of the companies. The longer they wait, the more difficult it becomes. Bankruptcy is not out of the question.

On the question of "general strategy" given the currency bets and \$40+ billion in cash

Warren says it's not really a question of "strategy." He said he and Charlie don't sit around thinking about what the market might do or macro factors that might lead to lower prices. He said he's known people that focus on one or two macro factors that keep them from buying stocks. Buffett says it's a big mistake and they have never done it. They would welcome an event, but they aren't predicting or waiting for one.

Bet against the dollar and U.S. long-term prosperity

In response to a question on the currency bet, he repeated what he said in the annual report. The international currency bet is NOT an investment made that reflects bearishness on the U.S. economy. He said he and Charlie are very bullish on the long-term prospects of the U.S. They acknowledged that the relative competitive position of the United States is likely to undergo gradual change,

but that is nothing to be overly concerned about. Growing prosperity around the world will be a net benefit to the U.S., even if its relative standing erodes. Buffett noted other countries have begun to adopt our "best practices."

In response to "What has been your best investment?"

Buffett: "The first purchase of half of Geico for \$40 million was pretty good." He also noted the purchase of See's Candy, not so much as an investment per se, but what it has taught them about investing in wonderful businesses. See's Candy has thrown off lots of cash that they have been able to redeploy in other businesses.

Munger: The purchase of the investment that brought us Ajit Jain was a wonderful investment. He said it was a life lesson. Get the right people and a lot of good follows after that.

On the subject of the NYSE going public

He said the NYSE should not be incented in any way to boost trading volume. Activity is the enemy of good performance. If the NYSE is public, it will find ways to suck more money out of the system. Warren and Charlie agreed it will be bad for society at large and they rather liked the NYSE being an exemplar of good behavior. This is unlikely to happen if it becomes a public company.

On Social Security reform

He is in favor of raising the cap (increase taxes) and not cutting the benefits. He argues that a country as rich as the U.S. can stand an additional 2-3% of GDP going to seniors over time. He noted that in a country of our wealth, the richest have an obligation to take care of the children (through improved education) and the elderly. Charlie called Social Security one of the best governmental programs, but didn't necessarily agree with Warren [the Democratic contingent on the podium!] on the fix.

On Public Education

Buffett is a big fan of public education, because it creates a more equal opportunity set for graduates. That there

are 8th-graders who can't read is "criminal." He believes in cultivating a love of reading at an early age.

Question: You got out of the market in 1969 and warned us in 1999. Given what you've said about the current account deficit and all the money sloshing around, why are you still substantially invested?

Buffett: It is true that they own some positions that they wouldn't buy today. Neither are they interested in selling them. He said they are in a zone where they are neither happy sellers nor buyers. Buffett declared that there is "not as much silliness, by far," as there was five years ago, but they still aren't finding much to purchase today.

Munger: He said Buffett was right, but the interesting thing is that they have done as well as they used to with much smaller investments (hundreds of millions rather than billions) that they have made over the last five years. Size, though, will be a continuing problem for BRK. [Size forges its own anchor.]

Question: Given the "Apex of Civilization" comment and the talk of bubbles, why not buy gold?

Buffett would far prefer to buy real estate (say, an apartment in Omaha) or an Index Fund as a store of value. Referring to his earlier comments on pricing power, Buffett endorsed great business like See's Candy as inflation hedges because people won't stop buying candy if the company raises prices. If worried about paper money, he'd prefer to buy "stuff" and things with earning power, rather than gold. Gold has not worked very well as a store of value. He repeated himself a little more emphatically later in the day on the question of gold.

Question: You gave us a long-term forecast for equities a few times over the years. Would you update your forecast?

Buffett said there are times when you can safely say intelligent things about markets and know you're going to be correct in time. When things are at an extreme, you know you will be right eventually. You can clearly get a lot more value per dollar in stocks than you could five

years ago. He definitely would prefer equities to long-term bonds [which are currently yielding less than 5% and would fall dramatically in price if interest rates were to rise]. He doesn't believe we are still in a bubble environment, nor does he believe we are in bargain purchase territory. Things are not at enough of an extreme to speak out definitively. He doesn't think his previous forecast (6-8% total annual compounded return from equities for the next decade or so) has dramatically changed. He hopes they will be able to do something more enterprising sometime down the road.

On the subject of real estate (REITS)

Five years ago REITS were almost 100% of his non-Berkshire holdings [which accounted for only 1% of his net worth]. They were quite cheap. Now they are unattractively priced. Real estate is generally an unattractive investment for Berkshire's corporate structure. Munger said most of his friends that are in the real estate business have been selling their least attractive properties and getting much more than they think they are worth.

On corporate governance

He said it is a very difficult dilemma. He said the best independent directors are independently wealthy and have no economic incentive to stay unless they find their role satisfying. Buffett would also look for good business experience and judgment. These types, however, are rarely sought. He said he has even found himself falling into line on some things that, as a board member, he didn't like. He rationalized, "Why cause a problem, when it's not going to make a difference anyway." He said some companies find ways to get disagreeable types off the compensation committee, for example. CEO's pretty much get what they want at most companies.

On drug stocks

Buffett says he believes that politics will play a large role in the future economics of the industry. Munger said they have looked at Pharma several times and ultimately threw it in the "too hard" pile. They noted that it is far better for an investment universe [their sphere of competence] to be too narrow than for it to be too broad.

On avoiding mental traps (heuristics)

Like alcoholism, the first step is being aware that traps exist. He said you needn't be perfect, but rather less prone than the average Joe. Later he gave a plug for *Poor Charlie's Almanac* in a question to Charlie on why he doesn't write a book that summarizes his "worldly wisdom." Buffett believes that he and Charlie are "wired" in a way that generally makes them less prone to such biases, notwithstanding the "anchoring" mistake they made on Wal-Mart several years ago. [Buffett stopped buying the stock when it moved up, in retrospect, a rather minor amount.]

On the Petro China investment

"We simply read the annual report, which was in English and fairly straightforward. There was a good description of the business." He noted that it was priced at 1/3 of the valuation of comparable Western companies and *that*, plain and simple, was the attraction. He didn't talk to management or anything of that sort. "It was very cheap." They were also looking at Yukos (the giant Russian oil company) but decided China was much more stable.

Discount Rates

He said if he and Charlie were convinced that the 10-year Treasury would stay around 4.2%, they would have to recalibrate everything they do and stocks would be much more attractive. He and Charlie don't understand why longer-term rates are staying this low.

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