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2012 BERKSHIRE HATHAWAY ANNUAL SHAREHOLDERS' MEETING

"We are never going to risk what we have and need for what we don't have and don't need."

- **Warren Buffett, 5 May 2012**

Three of us made the annual pilgrimage to Omaha, Nebraska to attend the 2012 Berkshire Hathaway Annual Shareholders' Meeting. As usual the Q&A session with Warren Buffett (age 81) and Charlie Munger (age 88) lasted a marathon six hours and covered a range of topics from business valuation to Warren's health condition.

An estimated 35,000 people attended the meeting this year at the Omaha Century Link Centre. We feel that the overall quality of the questions continues to improve significantly with filtering from the experienced media panel of Carol Loomis (Fortune Editor), Becky Quick (CNBC reporter) and Andrew Sorkin (New York Times journalist and author of Too Big To Fail).

We believe that the following notes are an accurate depiction of the meeting, however we have omitted discussions on topics unrelated to investing and business success.

We hope that you enjoy reading these notes as much as we enjoyed attending the meeting and putting them together!

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The meeting began with the annual Berkshire Hathaway film produced by Susan Buffett Jr (Warren's daughter) featuring former Republican Presidential candidate Herman Cain, talk show host Charlie Rose, the entire cast of the US TV series *Glee* and of course Warren and Charlie to name a few.

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Q&A Session

After the introduction Warren and Charlie got down to business taking their positions on stage for the Q&A session.

Q: Warren, does your successor have the necessary knowledge and temperament to be the Chief Risk Officer of Berkshire as well as the CEO?

Buffett: I believe that the CEO of any large financially related company should be its Chief Risk Officer as well. It's not something to be delegated. Unfortunately Charlie and I have seen this function delegated at a number of major financial institutions. The risk committee would report every month to the Board of Directors and have a lot of nice figures lined up and talk in terms of how many sigmas were involved. These places were just ripe for trouble.

I am the Chief Risk Officer at Berkshire and it's up to me to understand anything that could really hit us in any catastrophic way. My successor will have this same responsibility and we would not select anybody who we did not think had that ability. This is a very important attribute which is up there with allocation of capital and the selection of managers.

We have people in charge of our insurance businesses who very much worry about the risks in their own unit and therefore the person at the top really has to understand whether the three or four people running those big insurance units are correctly assessing their risks. They also have to be able to aggregate and think how these risks cumulate over the years. I don't worry too much about financial leverage as my successor engaging in excessive leverage just isn't going to happen.

Charlie, would you like to comment on that?

Munger: Not only was this great responsibility delegated in America, it was delegated to people who were using very silly ways to assess risk which is being taught in business schools today.

Buffett: So-called value at risk (VAR) and other theories that financial markets follow. It involves a lot of use of the Gaussian curve (bell curve).

Munger: The dumbest ideas ever recorded.

Sandy Gottesman created one of my favourite risk control examples – one day he fired an associate and the man said how can you be firing me, I'm such an important person? And Sandy says **"I'm a rich old man and you make me nervous."**

[Laughter]

Q: Warren do you believe that Berkshire would have been able to gain the favourable terms on the General Electric, Bank of America and Goldman Sachs warrant deals without your involvement as CEO? If not what implications does this have for Berkshire's future returns?

Buffett: There is no question that partly through an ability to commit a lot of capital and partly because Berkshire has speed and finality - which is quite unique among large American corporations – we get the rare chance to do large transactions like these. But it does take a willing party on the other side.

Regardless, those mentioned deals have not been key to Berkshire's success. If you look at what we did with General Electric and Goldman Sachs they are not as remotely as important as buying Coca-Cola stock or buying IBM stock over a six to eight month period. The value in Berkshire that has been accumulated by the warrants mentioned is really peanuts when compared to the value created by buying Iscar or Burlington Northern or other such deals. It's not key to Berkshire's future.

Q: Over the last few years you have made some investments in China, Petro China and BYD to name a couple. What advice would you give to Chinese corporate and political leadership such that you would make more investments in the country?

Munger: We're not spending too much time giving advice to China.

[Laughter]

If you think about it China has been doing very very well. To some extent we ought to be seeking advice from China.

Buffett: I would say that we have found it useless in almost 60 years of investing to give advice to anyone in business. If we look at our four largest investments which together are worth around $50 billion dollars, the number of times that we talk to the CEOs at those companies doesn't average more than twice a year. We're not in the business of giving people advice.

If the success of an investment was dependent on advice from Charlie and I we would move onto something else.

Q: Warren, you have stated repeatedly in the past that it is just as bad for Berkshire's stock to be overvalued as to be undervalued. I have bought Berkshire stock over the last few years at two times book value versus your recent announcement to buy back the stock at 1.1x book value.

Why didn't you warn us previously that the stock was overvalued?

Buffett: We prefer not to see our shares sell at the highest price possible. We have a very different view on that compared to other managers. If we could have our way we would have the stock trade once a year and Charlie and I would try and come up with a fair business value and it would trade at this price. That's how some private businesses trade, however you are not allowed that luxury on the public markets.

The public markets do very strange things. We certainly have never done anything consciously to encourage people to buy our stock at a price that we thought was above intrinsic value.

One time we sold stock back in the mid-1990s and we thought that the price was on the high side. So we put on the cover of the prospectus something that I don't believe has ever been seen and something that I don't think you will see again from any company. We put on the cover that neither Charlie or I would buy the stock at the current price nor would we recommend the stock to any of our family members.

We think that if we are going to repurchase shares from people we should let them know that we think we are buying from them too cheap.

Charlie?

Munger: Some people buy their own stock back regardless of price. That's not our system.

Buffett: We think a lot of stock repurchases are idiotic.

Munger: Yes, but I was trying to say it more gently.

Buffett: Why start now Charlie? You've never done that before.

[Laughter]

It's for ego. I've been in a lot of Board meetings where share repurchase authorizations have been approved and I will guarantee you it's not because the CEO is thinking the way we are thinking. They like buying their stock at ever higher prices. We will only do it for one reason and that is to increase the value of Berkshire the day after we have done it. If we get a chance to do that in a big way we will do it in a big way.

Q: What's your view on the state of European and US banks?

Buffett: I have a very different view on the US and European banks. The American banks are in a far better position than they were three to four years ago. They have taken most of the losses that were manifesting themselves on their balance sheets. They built up their capital in a very big way and they now have liquidity coming out their ears – the American banking system is in fine shape.

On the other hand the European banking system was gasping for air just a few months back which is why Mr. Draghi opened his wallet at the ECB and came up with a trillion Euros (equivalent to ~$US1.3tn) of liquidity for those banks. To put it in context $1.3 trillion is about one sixth of all the banking deposits in the United States. It was a huge act by the ECB and it was designed to replace funding that was running off for European banks. On average European banks have more wholesale funding than American banks. And compared to deposit funding wholesale funding can run pretty fast.

The European banks need more capital. They have done very little in the way of capital raisings. Basically they have not wanted to raise capital because they didn't like the prices that they would have had to of done so. So they were losing their funding base but the funding problem was solved by this extraordinary act from the ECB, providing the banks with three year funding at 1%. I'd like to have a lot of money for three years at 1% - however I'm not in trouble so I can't get it!

[Laughter]

Looking at the American banking system it is really remarkable what has been accomplished. I thought at the time that the Treasury and the Fed may have been over doing it when they bought those CEOs to the Fed and banged their heads together and told them they were taking this capital injection whether they liked it or not. Overall I think that policy was very sound for this country's economy and our society benefitted enormously because of those actions. I think that the Fed handled things quite sensibly and if they hadn't done so the world today would be very different.

Charlie?

Munger: Europe have their own problems. In the United States we've got this whole Federal Union. A country with its own central bank can print its own money, have its own debt and so on. In Europe they don't have a full Federal Union and that makes it very, very difficult. We are more comfortable with the risk profile in the United States.

Buffett: In the fall of 2008 when Bernanke and Paulson, and implicitly the Government of the United States said that they would do whatever it takes you knew they had the power and the will to do whatever it took. But when you have 17 countries that have surrendered their sovereignty as far as the currency is concerned you have these types of problems.

Henry Kissinger put it best – “if I want to call Europe what number do I dial?”

Just imagine if in the Fall of 2008 we had 17 States and we had to have the Governors of all those States meet in Washington to take a course of action when there was widespread panic. We would have had a very different outcome.

I would put European banks and American banks in very different categories.

Q: Could you discuss the current low cost of natural gas and coal in America?

Buffett: Natural gas is currently trading under $2 versus oil up around $100. If you had told Charlie and me five years ago that you would have a 50:1 ratio between oil and natural gas I think we would have asked you what you were drinking.

Did you ever think that was possible Charlie?

Munger: I think what is happening now is idiotic. In America we are using up very precious resources (being natural gas) and sparing resources that are not as precious (such as coal). If I were running the United States I would use every ounce of thermal coal before I would touch a drop of natural gas. I think those natural gas reserves they just found are the most precious things we could leave our descendants.

[Applause]

Buffett: it is going to be very interesting to see how the oil to gas ratio plays out. It has changed very dramatically in a very short period. Three years ago people wouldn’t have thought it was possible.

Q: In recent years Business Schools have taken some of the blame for the State of the Economy. What changes would you suggest Business Schools make to their Curriculum?

Buffett: I think that business schools have taught students a lot of nonsense about investments. However I don’t think it’s been the great cause of recent economic events.

Charlie what do you think?

Munger: No but it didn’t help.

Buffett: You want to elaborate on that Charlie?

Munger: I think business school educations are improving.

Buffett: Is your implication that it is from a low base?

Munger: Yes

[Laughter]

Buffett: I'd agree with that.

I would say that the some of the silliest stuff we have seen being taught in business schools is in the investment area. It's astounding to me how these schools continue to focus on one finance theory fad after another. It's usually been very mathematical based.

We think investing is not that complicated. I would have a couple of courses. I would have a course on how to value a business and I would have a course on how to think about markets. I think if people grasp the basic principles of those two courses they would be far better off than if they were to indulge in modern portfolio theory or option pricing models.

You look at some of the books they are using in business schools these days and there is really nothing in there about valuing businesses. That's really what investing is all about. If you buy businesses for less than they are worth you are going to make money. If you know the difference between the businesses you can value and the ones you can't value, which is key, you are going to make money.

Charlie?

Munger: The best way to price an option is not by using Black Scholes. People who try to value an option using Black Scholes want a formula that doesn't require them to think. And they have found one.

Buffett: Is there anyone he forgot to offend?

[Laughter]

Q: Could you discuss your thoughts on the Buffett Rule[1] that is in front of Congress and implications for America?

Buffett: If you look at the most recent year and aggregate both payroll and income tax and you take the 400 largest incomes in the United States, they averaged around $270 million each. 131 of that 400 pay tax rates that were below 15%. In other words they are paying a rate that is less than the standard payroll tax rate.

Back in 1992 when the average income of the top 400 was only $45 million there was only 16 of the 400 that paid a rate less than 15%, now it's 31.

[Applause]

I don't have any tax planning or any special Swiss bank accounts when I do my tax. And over 2004, 2006 and 2010, in which my income was anywhere from $25 to $65 million I came in with the lowest tax rate in our office. We have had 15 to 22 people at any one of those times. Everyone in the office was surprised as they were all in the 30%+ range. Whereas I was around 17% each time. That's because the tax laws have been moved over the years in a way to favour people that make huge amounts of money. I think it is time to take a closer look at that.

[Applause]

Q: You are clearly entitled to speak your mind on any subject as an individual but recent publicity around the Buffett tax has become quite loud and as a shareholder I fear it is to a degree limiting interest in the Berkshire stock.

For example my 84 year old father is not interested in investing in Berkshire because of his opposition to your tax position. Do you think perhaps some of the political dialogue should be muted?

Buffett: This has been raised quite a lot lately. In the end I don't think that any employee of Berkshire should have their citizenship restricted. When Charlie and I took this job we did not decide to put our citizenship in a blind trust. But of course people are obviously entitled to disagree with us.

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[1] The Buffett Rule is named after Warren Buffett who publicly stated in early 2011 that he disagreed with wealthy people, like himself, paying less in federal taxes, as a portion of income, than the middle class, and voiced support for increased income taxes on the wealthy

I don't know the politics of Muhtar Kent (CEO of Coca-Cola) but it doesn't make any difference as long as he continues to run the business well. I really think that the 84-year old man making a decision on what he invests in based on political preference is crazy. Sounds to me like he ought to own Fox *[we assume Buffett is referring to NewsCorp].*

[Laughter]

If you start selecting your investments based on people who agree with you you're going to be very disappointed.

Q: Would you consider an acquisition over $20 billion and if so how would you fund it?

Buffett: We considered one a month or so ago which was in the range of around $22 billion. About $20 billion is the point where we get stretched because we won't use our stock to finance the transaction at all. We used stock in the Burlington Northern acquisition and we felt that it was a mistake. We used stock in that case for what ended up being around 30% of the deal. However we would not use stock for an acquisition now.

Charlie?

Munger: It could happen.

Buffett: Yes it could happen . . . but it won't happen.

[Laughter]

We looked at this $22 billion deal and we would have done it if we could have made it work. It would have stretched us but it wouldn't have taken us to a point where cash fell below $20 billion. We would have sold some securities and done whatever was necessary to have a $20 billion cash balance when we got done with the deal. Now if that had been at $30 billion no matter how much I liked the company I don't think I would have been able to pull the deal off. You've hit the point where we start squirming a little bit. On the other hand the money is building up month by month.

If you do have a $20 billion deal for us I have a toll free number you can call.

Q: [In reference to Warren's recent announcement that he has been diagnosed with early stage prostate cancer]

How are you feeling Warren?

Buffett: I feel terrific. I love what I do, I work with people I love, it's more fun every day. I have four Doctors and my wife and my daughter and I listened to the four of them for about an hour and a half about two weeks ago. They described various alternatives and none of the ones they recommended involves a day of hospitalisation and they don't require me to take off even one day of work. The survival numbers are way up in the 99.5% range for ten years.

So maybe I'll get shot by a jealous husband but this really is a minor event.

[Laughter]

Charlie will tell you how minor it is.

Munger: Well as a matter of fact I resent all this attention and sympathy that Warren is getting.

[Laughter]

I probably have more prostate cancer than he does. They don't know because I don't let them test for it.

[Laughter]

Q: I'm a 26 year old working for a private equity firm in Chicago. If you were me and had a chance to start over what areas would you look to get into and do you think my generation will have the same level of opportunities as yours?

Buffett: You will have all kinds of opportunities. I would probably do very much what I have done in my life but I would try and do it a little earlier. I would have tried to aggregate the money a little faster. I would try to develop an audited record of performances as early as I could and I would try to attract some money. When I had built up a fair amount of money from investing I would try to get into something much more interesting which would be buying businesses to keep. You mentioned private equity which very often is buying businesses to sell. I don't want to be buying and selling businesses. When people come to me and want to sell their businesses I want it to be for keeps. That's been enormously satisfying but it takes some capital to get into that business.

I didn't have any capital when I started out so I built it through managing money for myself and other people combined. Like I say I would get through that process as fast as I could and get into a game where I could buy businesses of significance and interest to me. Then I would spend the rest of my life just as I have done.

Charlie?

Munger: Well I have nothing to add to that.

Q: At least 95% of the people in the arena believe that Berkshire stock is undervalued – why do you think it is undervalued?

Buffett: We've run Berkshire now for 47 years. There have been four or five times when we have thought that the stock was significantly undervalued. We saw the price get cut in half at least four times in fairly short periods of time. I will say this – if you run any business for a long period of time there are going to be instances when the stock is overvalued and times when it is undervalued. Tom Murphy ran one of the most successful companies the world has ever seen and in the early 1970s the stock was selling for about a third of what you could have sold the properties for. *[Buffett is referring to Capital Cities Communication which in 1985 acquired the US Broadcast station ABC. The Walt Disney Company subsequently brought Capital Cities/ABC which included ESPN in February 1996.]*

The beauty of stocks is that they do sell at silly prices from time to time. That's how Charlie and I have gotten rich.

Reading chapters eight and chapters twenty of the *Intelligent Investor* is really all you need to do to get rich in this world. Chapter eight says that in the market you are going to have a partner by the name of Mr. Market. And the beauty of him as your partner is that he's kind of a psychotic drunk. He will do very weird things over time and your job is to remember that he is there to serve you, not to advise you. You have to keep that balanced state as Mr. Market offers you thousands of prices every day on practically every major business in the world. He makes lots of mistakes for all kinds of weird reasons. And all you have to do is occasionally oblige him when he offers you some crazy price on any given day.

Essentially stocks get mispriced. And Berkshire has been no exception to that. Over the next twenty years Berkshire will be significantly undervalued at some point and it will be significantly overvalued at some point. That will be true for Coca-Cola and all of the other securities we own. I just don't know in which order and at what times.

The important thing is that you make your decisions based on what you think the business is worth. And you stick with businesses that you have good reason to think you can value. If you do this you simply have to do well in stocks.

Stock markets are the most obliging money making places in the world because you don't have to do anything. You've got lots of information on thousands of businesses and you don't have to do anything. Compare that to any other investment alternatives. For example you can't do that with farms. If you want to buy the guys farm next door he's not going to quote you a price every day at which you can buy his farm. But you can do that with Berkshire Hathaway and IBM. It's a marvelous game and the rules are stacked in your favour. That's if you don't turn those rules upside down and start behaving like the drunken psychotic instead of the guy who takes advantage of him.

Charlie?

Munger: We've had a lot of fun doing what we do. It's an enormously constructive way of investing. So the faster you can work yourself into our position the better off you'll be.

[Laughter]

Q: Have macroeconomic factors and events ever caused you to pause when buying equities?

Buffett: In my memory, throughout our 53 years of investing together, Charlie and I have never had a discussion about buying or selling a stock or a business where we have talked about macro affairs. If we find a business that we think we understand and we like the price at which it is being offered to us we buy it. It doesn't make any difference what the headlines are we will simply buy it.

There's always going to be good and bad news out there which not surprisingly gets emphasized depending on the mood of people. I bought my first stock in June of 1942 when we were losing the war. At that time America wasn't a place that was going to produce anything that the world wanted. But stocks were cheap. You can read all sorts of bad news but so what, America is not going to go away.

We look at value, we don't look at headlines at all. Everyone thinks that we sit around and talk about the macro but the reality is we don't have any discussions about macro factors.

Charlie?

Munger: Yeah but we did keep liquid reserves at the bottom of the panic. Had we known it wasn't going to get any worse we would have spent more.

Buffett: We know we don't want to go broke and we start with that. And you can't go broke with a fair amount of liquid reserves around and you don't have any near term debts. Our first rule is always be able to fight tomorrow no matter what happens!

Q: Of the businesses you own which business has greatly improved its competitive position over the last five years? Additionally what has been the most disappointing?

Buffett: There is no question that the railroad business for very fundamental reasons, which I should have figured out earlier, has improved its position dramatically over the last 15 or 20 years. It's an extremely efficient and environmentally friendly way of moving around a whole lot of things. It's an asset that couldn't be duplicated for three, four, five, or even six times what it is selling for. It's a whole lot better business than it was five or ten years ago.

The mistakes have been in the buying. It's been where I have misgauged the competitive positioning of the business and it's not because of the faults of Management. It's because either I had too much money around or I'd been drinking too much Cherry Coke. I assessed the future competitive positioning in a way that was really inappropriate. *[We believe Buffett is referring to his investments in textile, clothing and footwear including Dexter Shoes[2]]*

Q: In recent times Berkshire stock has barely moved whereas gold has gone up multiple times over the last few years. What happened?

Buffett: When we took over Berkshire gold was trading at $20 an ounce and Berkshire was at $15 a share. Gold is now at $1,600 whereas Berkshire is at $120,000. So you can pick different starting periods. Obviously if you pick something that has gone up a lot in the last month or year it will beat 95% of other investments. I can bet my life that over a fifty year period Berkshire will do considerably better than gold.

Common stocks as a group will do much better than gold. If you own an ounce of gold now and you caress it for the next hundred years you'll have an ounce of gold a hundred years from now. If you own a hundred acres of farmland you'll also have a hundred acres of farmland a hundred years from now but you'll also have taken crops from a hundred years and sold them and presumably bought more farmland. It's very hard for an unproductive investment to beat a productive investment over any long period of time.

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[2] Harold Alfond and Peter Lunder sold Dexter Shoes to Berkshire Hathaway in 1993 for $433 million in stock; eight years later Warren Buffett decided to fold Dexter into another business, admitting in 2008 that it was "the worst deal that I've made." As Buffett puts it himself – "that move made the cost to Berkshire shareholders not $400 million, but rather $3.5 billion. In essence, I gave away 1.6% of a wonderful business...to buy a worthless business."

If you say anything negative about gold it arouses passions in people which is fascinating because usually when you think through something intellectually it shouldn't really matter what other people say. What should only matter is if your facts are right and if your reasoning is right.

Charlie?

Munger: I have never had the slightest interest in owning gold. It's much better in life to work with people in businesses and engage with people interested in business. I can't imagine what it's like trying to deal with a bunch of gold bugs.

Q: You said in an interview on CNBC that you had bought shares in JPMorgan for your personal account. Could you explain how you make a personal investment versus as a fiduciary for shareholders at Berkshire?

Buffett: The truth is I like Wells Fargo better than I like JPMorgan. We bought Wells Fargo stock and that takes me out of the business of buying Wells Fargo for my personal account. Therefore I go into something that I don't like quite as much. I can't be buying what Berkshire is buying. So when I have some money around I go onto my second choices. My best ideas are all in Berkshire, that I can assure you.

Charlie?

Munger: Basically the Munger family is in two or three things only. Diversification is something that I have absolutely no interest in. I rejoiced the day I got rid of the stock quoting machine.

Buffett: If you have 98.5% of your money in Berkshire like I do and you are really thinking about what's best for the remaining 1.5% then you are crazy. You should be thinking about Berkshire which I assure you I do.

Q: You have described the newspaper business in the past as chopping down trees, buying expensive printing presses and having a fleet of delivery trucks all to get pieces of paper to people to read about what happened yesterday. With the newspaper business in structural decline why buy the Omaha Herald? Was there some self-indulgence in this?

Buffett: No. I would say this about newspapers though. Everything that you have read about the industry decline is true and it's even worse than that.

News is what you want to know that you don't already know. Everyone in this room has a whole bunch of things that they want to be kept informed on. If you go back fifty years the newspaper contained dozens and dozens and dozens of areas of interest to people where it was the primary source of information. If you wanted to rent an apartment or you wanted to find a job you could learn more about it by looking at a newspaper. If you wanted to learn how your favourite team performed or if you wanted to learn the price of your stocks you went to the newspaper. All of those things that are of interest to many people have found other means and other venues where that information is available on a more timely and often cost free basis.

However newspapers still are primary in a great many areas. The Omaha World Herald tells me every day a lot of things that I want to know that I can't find other places. They don't tell me as many things as twenty or thirty years ago but they still tell me some things I can't find elsewhere. Overwhelmingly those items are going to be local. They tell me a lot of things about my city, about local sports, about my neighbours, about a lot of things that I want to know. As long as they stay primary in that arena they've got an item of interest to me.

I think there is a future for newspapers that exist in an area where there is a sense of community and people actually care about what's going on in their geographic area. There is a market for that but it's not as bullet proof as the old method. I'm interested in Omaha in knowing who is getting married, or who dies or who is having children. When I lived in White Plains, New York I really wasn't that interested as I did not feel a sense of community there.

We bought a paper in Buffalo for this same reason and we have made decent money there. Based on the economics we paid we may buy more newspapers but it will be where there is a strong sense of community. It's nothing like the old days but it still fulfills an important function.

Charlie?

Munger: We had a similar position when we owned World Books which was 80% destroyed by Bill Gates [as a Director of Berkshire Bill Gates was sitting in the front row]. But we are still selling encyclopedias and we are still making reasonable money.

Q: Are there other businesses where you are concerned that Amazon and other internet companies will displace some of your retail operations?

Buffett: Amazon is a tough one to figure out as it could affect a lot of businesses that don't think they are going to be affected today. It's huge and it's powerful. I don't think it's going to affect the Nebraska Furniture Mart but it may affect some of the other retailing operations that we have.

GEICO was very affected by the internet and at first we missed that. GEICO used mail originally in the late thirties and early forties and it was very successful. And then it moved to television. Then the internet came along and I thought originally that only young people would look for insurance quotes on the internet but things have changed dramatically.

It's very hard to find people who have done business with Amazon that are unhappy about the transaction. They have happy customers and a business that has millions and millions of happy customers is going to be a powerhouse. I think it could affect a lot of businesses but it's hard for me to figure out.

Which ones do you think it will hurt the most Charlie?

Munger: Anything that can be easily bought by using a home computer or an iPad for that matter.

Buffett: Which of our businesses do you think it can hurt?

Munger: I think it will hugely affect a lot of people and I think it is terrible for most retailers. Not slightly terrible . . . really terrible.

Buffett: With that cheerful assessment we'll go to the next question.

Q: One of Berkshire's largest listed investments is Wal-Mart. Has your opinion of the company changed following the Mexican bribery scandal?

Buffett: No, not at all. It looks like they may have made a mistake in how that was handled but I do not think it changes the fundamental dynamics of the business. Wal-Mart does operate on low gross margins because it uses it all to offer low prices and that works in retailing. It's a huge diversion of Management's time that's costly but I don't think that the earnings power of Wal-Mart five years from now will be materially affected by the outcome of this situation. Charlie?

Munger: Well we have so many employees that it's not inconceivable that someone is doing something illegal somewhere. When you are as big as Wal-Mart you are going to have an occasional glitch. I don't think there is something fundamentally dishonest about Wal-Mart.

Buffett: We have 270,000 people today interacting with customers and Government officials and all kinds of people. I will guarantee you that someone is doing something wrong. In fact I would guarantee you that at least 20 people are doing something wrong. You can't have a city of 270,000 people and not have something going on.

It is a worry if you are running a business like this. You don't worry about someone doing something wrong because you know that will always happen. What you worry about is that someone is doing something materially wrong and nothing is getting done about it. We've got hotlines and all sorts of communications set up and we try to convey to the managers that if you find something wrong act now on it. We can handle bad news as long as we get it promptly. I am very sympathetic to anyone running hundreds of thousands of people.

Q: You are interested in businesses that throw off lots of cash like See's Candies. But you also buy capital consuming business like Burlington Northern Railroads?

Buffett: Cash consuming business are by their nature unattractive unless the cash that they consume earns a respectable return. Our first preference is cash generating businesses that do not require you to invest substantial capital back into the business in order to just stay in business. There are also cash consuming businesses like the railroads that generate an acceptable return on the cash that you invest and this is fine for us.

If we had an investment that required a large amount of capital each and every year just to stay in business for another year and we did not generate an acceptable return on that capital, then this would be a bad situation – thankfully we do not own any such businesses.

In the case of Burlington we think we can generate a 12% return on capital invested over time and this is a good outcome.

Charlie?

Munger: Oh, I think we'll do just fine.

[Laughter]

Q: How do you value a declining business?

Munger: They're not worth nearly as much as a growing business.

[Laughter]

Buffett: Generally speaking, it pays to stay away from declining businesses. They are very difficult to value.

We have several declining businesses - the newspaper business is a declining business. We will pay a price to be in that business but that is not where we are going to make a lot of money. All the money at Berkshire is going to be made from investing in growing businesses.

I would never spend a lot of time trying to value a declining business that I call a cigar butt (one last free puff out of the business). I can spend the same amount of energy and intelligence analysing a growing business and I am going to get a better outcome.

At Berkshire, we have some declining businesses. We started with declining businesses, textiles, US made shoes, Blue Chip Stamps - We have one business that did $120 million in sales in 1968 and last year did about $20,000 in sales. We'd like to bring the sales chart out and put it upside down.

Munger: I presided over that one myself.

[Laughter]

Buffett: Oh, I think I helped there too Charlie. We were sort of masochistic back in those days.

Munger: Ignorant too.

[Laughter]

Q: You won't talk about what investments you are buying right now so I will invert the question and ask what investments you are avoiding today. What investments today strike you as folly, fad, unsustainable, crazy, or dumb?

Munger: Quite a lot.

[Laughter]

Buffett: I think I would rather stay away from businesses that I don't understand. When I say don't understand I mean I do understand what a certain business does and how it makes money, but I don't understand what it will look like in the next five to ten years.

When I say that I understand a business I mean that I have a reasonable fix on about the earning power of the business in five or ten years – so I've got some notion of how the industry will evolve and where the company will sit in the industry in the future.

I stay away from IPOs. I don't believe that an IPO that is being sold by an informed seller at the timing of their choice is the best opportunity over the 10,000 other stocks to invest in on that day.

I would guarantee that you have thousands of stocks around the world and most of them are not being promoted that day.

Stay away from any investment that is paying a large commission to someone else. It makes no sense that an investment would need to pay away a large commission in order to offer you to be able to invest in it.

Charlie and I have a number of filters that an investment needs to get through very quickly in order for us to spend any time on it. Some people think we are very rude because people would call us and I would save them time and politely say we are not interested very quickly.

In this business you do not need to be able to spell 500 words to get to the end of the spelling B and beat everybody else – you just have to do one or two things right. I just try to do one or two things right each day.

Munger: Start looking at what other people that you know and respect are buying. This is far from a silly filtering device.

Buffett: I used to wait for the Graham Newman newsletter to come out each week so I could see what they were buying and it would be a good place to start to look for investments. If Graham Newman was looking at something it was definitely worth my while to look into it.

Munger: Warren has made a number of people rich who have just copied his investments.

Buffett: Don't go into things with big commissions.

Q: How long will it take China to have some great companies like Coca-Cola?

Munger: China already has great companies. I can't think of any branded goods companies like Coca-Cola but China does have some great companies. I just can't pronounce the names.

[Laughter]

Buffett: Not many Chinese fast food companies have been exported to the United States but there are many American fast food companies in China – we seem to be good at exporting fast food brands.

Q: IBM is, to use one of your terms, inevitable in that customers need to use them. Is Google inevitable? Is Apple inevitable?

Buffett: Both Google & Apple are extraordinary companies, both with huge returns on capital and heaps of cash flow. They both look very tough to dislodge.

I would not be at all surprised if they made a lot more money in ten years from now. But I cannot get to the level of conviction that would make me able to buy them. But I wouldn't short them either. I just don't know how to value these companies. People are out there working in big companies and also garages trying to come up with products that change the world just like these companies did and I don't know how this will turn out.

Munger: In understanding Google and Apple we have the reverse of an edge.

[Laughter]

Buffett: The chances of us being way wrong in IBM are very limited. But I could never get the same level of conviction in IBM as I could in Coca-Cola.

Q: Could you please discuss the economic advantages of railroads over other forms of goods transport?

Buffett: On the railroad industry we have very favourable economics. We can move heavy material 500 miles more efficiently than any other form of transport. Maybe even three times cheaper than trucking.

America's railroads cannot be replicated and this makes them wonderful assets.

The railroad industry had something like 1,700,000 employees in the United States right after World War II. Today there are less than 200,000 employees. Railroads have become so much more efficient by a huge factor. It's a very good way to move heavy stuff a long distance.

Q: Why do you compare Berkshire's book value return against the S&P 500 including dividends? This seems like an unfair comparison of apples and oranges as an investor can easily get the S&P 500 return but is unable to get the return implied by Berkshire's book value.

Buffett: We could show this in a number of ways. If we compared the share price performance of Berkshire with the S&P 500 our comparative returns would be higher as Berkshire began trading below book value and is now trading above book value. So we feel that we are presenting returns in the most conservative way.

Charlie?

Munger: Long-term the stock price has tracked very well to book value.

Warren, I think you've actually just been criticised for making yourself look worse.

[Laughter]

Q: What control do you exercise over your operating businesses?

Buffett: Virtually none. We don't make any attempt to have our operating businesses talk with each other. We do not make Clayton Homes buy their carpet from Shaw or buy their paint from Benjamin Moore. We just don't do that. You can say that's kind of silly but anything we would gain would be far offset by the change in the feeling of the management.

We want our business managers to feel that they are running their own businesses.

We have managers who have handed us ownership of their business and we have handed them billions of dollars. In many cases they have run these businesses for decades and we want them to feel exactly the same about the business the day they hand us ownership and we hand them billions of dollars as they did the day before when we had the billions of dollars and they had ownership. The moment we change the way a manager operates they would think differently about their business.

Q: How do you think about risk?

Buffett: Charlie and I both think about worst case scenarios a lot. As a kid I made a living from throwing papers at doorsteps and I don't want to go back to that. We've got a number of family members with 80-90% of their net worth in Berkshire stock and I am just not that interested in explain to them that we went broke because there was a 1/100th percent chance that we would go broke and the remaining probability that we would double our money, and I decided that this was a good gamble.

<u>We are never going to risk what we have and need for what we don't have and don't need.</u>

[Applause]

We will still find things to do where we can make money but we don't have to stretch to do it. It's my job to figure out what can really go wrong in this place. We've seen September 2001 and we've seen September 2008 and we will see these events again in the future and we want to be able to sleep well at night.

Charlie?

Munger: How do these super smart people with all these degrees in higher mathematics end up doing these dumb things?

I think it's explainable by the old proverb, to a man with a hammer every problem looks like a nail.

They've learned these techniques and they just twist the problem to fit the solution. This is not the way to live.

Buffett: In 1962 when I set up my office in Kiewit Plaza where we still are I put seven items on the walls. Our art budget was $7, so I took photocopies of newspaper front pages from historically significant financial events.

One of these cases was May of 1901 when Edward Harriman was trying to get control of Northern Pacific and another party was also trying to get control of Northern Pacific. Unknown to each other they both bought more than 50% of the stock. Two people owning more than 50% of the stock each. In that paper of May 1901 the whole rest of the market was totally collapsing but Northern Pacific went from $170 per share to $1,000 per share in one day because the shorts needed to buy the stock to cover their short positions. There was a little item at the top of that paper where a brewer in Troy New York committed suicide by diving into a big vat of hot beer as he was short the stock and had received a margin call that day.

To me the lesson was that that fellow probably understood sigmas and statistical measures of risk but did not anticipate that it was ever possible for the stock to go from $170 to $1,000 in one day and receive margin calls. **I've never wanted to end up in a vat of hot beer!**

Life in financial markets has got no relation to standard deviation. *[Standard deviation of return is commonly used as a measure of risk in financial markets]*

Charlie?

Munger: I've got nothing to add.

Q: [A number of very long-winded questions about Fannie Mae & Freddie Mac, the two Government-sponsored enterprises that played a large role in securitizing mortgage-backed securities and are now defunct]

Buffett: I got through college answering fewer questions than that!

[Laughter]

Munger: Canada to the North kept a more responsible lending system then we did. The United States lending system was irresponsible and Allan Greenspan was the architect of the problem. It's the duty of the government to stamp out crazy behaviour. Greenspan made a big mistake here.

[Applause]

Many years ago we met a US regulator in relation to our savings and loans business. He told us that we are using the Government's credit in the savings and loans business and therefore you have to make more loans because we are telling you to. And I said to him, we're not using the Government's credit, the Government is using Berkshire's credit, we're taking insurance premiums and you're using our credit.

[Laughter]

Buffett: This regulator then asked, well what type of people do you lend money to? And Charlie responded, we don't lend money to people like you!

[Laughter]

Buffett: We've always had a problem with these regulators since.

[Laughter]

Q: A question on executive compensation and how you motivate Berkshire managers.

Buffett: Charlie and I are often asked why we do what we do when we don't need the money at all. The answer is that we get the opportunity to paint our own painting every day, and we love painting our own painting and it is a painting that will never be finished. And if we had someone over us telling us we should use more red paint than blue paint and offered us all the money in the world we would go and tell them what to do with the paint brush.

[Laughter]

Charlie and I have more fun doing it together than doing it by ourselves.

So, if this works with us, then why shouldn't it work for a bunch of other people who have loved what they do for a long time and in many cases do not need the money. We let them keep the paint brush and we leave them to it and applaud.

We do pay large sums of money to our managers, sometimes eight digit figures, nobody likes to feel that they are being taken advantage of. I come up with all the compensation programs for senior Berkshire managers myself.

I can't put passion into somebody about their jobs, but I can certainly take it away and I do everything I can to ensure that doesn't happen.

Charlie?

Munger: We don't have any standard formulas like you see in other big companies.

Buffett: Our businesses are all different so we can't use the same compensation metrics for each business. They need to be tailored to the individual businesses. Some businesses don't need any capital and some use heaps of capital. It is very important to tie the compensation to metrics in each individual business that the manager can directly control.

I am the compensation committee for about 60 people, and I am not overworked. We don't use any compensation consultants.

Munger: Prostitution would be a step up for them. [compensation consultants]

[Laughter]

Buffett: Charlie is also in charge of diplomacy at Berkshire. We told you we would get to offending everyone by the end of today.

Q: What would it take to get American GDP to start growing by 4% again?

Buffett: Charlie, that's too easy for me, you take this one.

[Laughter]

Munger: A lot. It's not going to be easy.

Buffett: If population grows 1% pa and GDP in real terms grows 2.5% pa it would be a quadrupling of per capital GDP every century. 2.5% may be slow in getting us out but it is a remarkable rate of growth for a country that already enjoys a very high standard of living.

In my lifetime the real GDP per capita has increased 6 for 1. We have US$48,000 GDP per capita in the United States today.

Charlie, if you had to guess the real GDP growth per capita over the next 50 years what would you say?

Munger: I think 1% per capita in real terms would be sensational. From this high base it would be sensational – that's 25% real growth in 20 years.

Q: How do you minimise mistakes?

Buffett: We make mistakes, we will make more mistakes. We try to not expose ourselves to the potential to make mistakes that will put us out of business.

I don't worry much about my mistakes, as my next mistake will be different.

Munger: I try to learn from other people's mistakes. That is really a much more pleasant way to learn.

Q: How do you build barriers to entry in a business?

Munger: Very difficult, we *buy* barriers we don't *build* them. Some industries simply don't have barriers to entry and never will so we avoid them.

We find that one competitor is enough to ruin a business.

Buffett: I used to have a gas station down the road here in Omaha and there was another gas station down the road. Whatever he charged for gas was my price. You don't want to be in a business like that.

Q: When are you going to pay a dividend?

Buffett: Not now. We think we can add more value by investing in new businesses. We'll think about it when we're older.

[Laughter]

Q: What percentage of cars in this country will be electric in 2030?

Munger: Not many.

[Laughter]

Q: There has been recent political discussion around the United States becoming energy independent. How do you think this might affect the country's trade deficit?

Buffett: Well if our production increases substantially and we have to import less oil then this will obviously factor into the deficit. I don't see us getting self-sufficient in oil. Charlie and I might argue that over time we are better off using someone else's oil and keeping our own reserves in this country for a longer time.

Munger: I think those oil reserves are the single most valuable assets in the United States. I want to use all the foreign reserves before we touch a drop. And I think we should suffer now so our children can do better. Because that's the way I think grownups should behave.

[Applause]

So I'm for using up all the other stuff and conserving your own.

I think that energy independence is the stupidest idea that I have ever heard grown people talk about. Think of the terrible shape we would be in if we had achieved total energy independence years ago. We wouldn't have any oil and gas left at all. That would be a wonderful condition. We don't want energy independence; we want to conserve this stuff. Thank God we have some of this precious stuff at all. I have the exact opposite idea of most people on this subject and of course I think I'm right.

[Laughter]

Buffett: It's Charlie's version of saving up sex for old age!

[Laughter]

Q: What do you feel is the right corporate tax rate to get the economy started?

Buffett: Last year the actual taxes paid were about 13% versus the corporate rate which is 35%. But corporate profits are not the problem. Corporate balance sheets and corporate liquidity is not the problem with this economy. There are huge amounts of money available in the corporate world.

I don't think it's a lack of available capital or tax rates that is holding back investment in this country. This country prospered in the fifties and sixties when the corporate rate was 52% and when it was cut to 48% we all rejoiced. In fact corporate tax rates last year were 1.2% of GDP. Medical costs were more than 17% of GDP and there we have at least a seven percentage point disadvantage against the rest of the world. If you ask me about the tapeworm of American industry I would point to our medical costs. We've got a huge cost disadvantage against the rest of the world. That's unbelievably tough to address. But as you would say that's where the money is.

You could play around with the corporate tax rates but I don't think that's going to have any big effect on the economy. I think both political parties agree that they would like to see lower corporate tax rates. A flat corporate tax rate. However it is very hard to put that into practice because to get equal rates across all corporations someone's tax rates are going up and those people will fight with intensity against that Bill that far outstrips the intensity on the other side. It's a really complex problem in that way.

Munger: With so much money involved it's not where the game change will come from.

Q: Berkshire's multiple of price to book value has been coming down over the past 6 to 12 months as the stock price has not done much. Could you please explain why this is happening?

Munger: It is too short term to look at one twelve month period. I don't think you're really welcome in this room if you are that short-term in your view.

[Laughter]

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