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2016 BERKSHIRE HATHAWAY ANNUAL SHAREHOLDERS' MEETING

"We try to avoid the worst anchoring effect, which is your previous conclusion. We really try and destroy our previous ideas."

Charlie Munger, 30th April 2016

We made our annual pilgrimage to Omaha, Nebraska to attend the 2016 Berkshire Hathaway Annual Shareholders' Meeting. As usual the Q&A session with Warren Buffett (age 85) and Charlie Munger (age 92) lasted a marathon six hours and covered a range of topics from negative interest rates, business valuation as well as their recent $37.2 billion acquisition of Precision Castparts, a global manufacturer of components for the aerospace, power and general industrial markets.

An estimated 40,000 people attended the meeting this year at the Omaha CenturyLink Center.

Questions were submitted by the public and asked by a panel of journalists including Carol Loomis (former Fortune magazine editor), Becky Quick (CNBC reporter) and Andrew Ross Sorkin (New York Times journalist). Warren and Charlie were also quizzed by insurance analysts Adam Bergman (Sterling Capital Management LLC), Clifford Gallant (Nomura Securities), Greggory Warren (Morningstar Inc.) and Jonathan Brandt (Ruane Cunniff & Goldfarb).

We believe that the following notes present an accurate depiction of the key take-outs from 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 directed by John Landis (the director of Trading Places, Animal House, and Coming to America). This year the film was a parody of the 1983 Hollywood business movie Trading Places. The movie featured cartoon versions of Ajit Jain (President of Berkshire Hathaway Insurance Group) as a snobbish investor and the GEICO gecko as a sly street con artist, with the pair finding their positions reversed as part of a bet by two callous billionaires (Buffett and Munger).

The annual video also included appearances from Arnold Schwarzenegger, Jamie Lee Curtis and TV host Stephen Colbert promoting Kraft Mac & Cheese (now a Berkshire-owned product). The video finished with a clip of Schwarzenegger casting for the next Celebrity Apprentice, with significant doubts that Warren possesses the qualifications for the positon. Warren's response – "Arnie, I seem to remember telling you the same thing when you ran for Governor."

Q&A Session

Q: In your 1987 letter to shareholders you commented on the kinds of companies Berkshire liked to buy – those that required small amounts of capital. You said 'because so little capital is required to run these businesses they can grow while concurrently making all of their earnings available for deployment in new opportunities.' Wind forward to today, Berkshire appears to have changed its strategy and invests in companies that are highly capital intensive, regulated, and earn lower returns on equity capital. Why is this?

Buffett: Well, it's one of the problems of prosperity. An ideal business is one that takes no capital but grows. There are very few business like this and we own some. We would love to find one that we could buy for $10 billion or $20 billion that is not capital intensive. If you have a business that grows and gives you a lot of money every year, you get a double barrelled effect. See's Candy is a great example of this. Back when the newspaper business was good our Buffalo newspaper was another good example. The Buffalo newspaper was making a profit of $40 million a year and didn't require a lot of reinvestment so we could take this whole $40 million and buy other businesses.

Unfortunately, greater capital acts as an anchor on returns in many ways and one of the ways is that it drives us into businesses that are much more capital intensive.

You just saw a slide for example on Berkshire Hathaway Energy where we announced in the last couple of weeks a $3.6 billion investment in wind generation. We have pledged overall to have $30 billion invested in renewables. Anything that Berkshire Hathaway Energy or BNSF does takes lots of money. Fortunately we still generate decent returns on capital but we don't get the extraordinary returns like some of our other businesses.

As I mentioned in the Annual Report, we have some businesses that earn 100% on true invested capital and clearly that's a different sort of operation than something like Berkshire Hathaway Energy which may earn 11-12% on capital. That is a very decent return, but it's a different sort of animal than a business with very low capital intensity. Charlie?

Munger: Well, when our circumstances changed, we changed our minds.

Buffett: Slowly and reluctantly!

Munger: In the early days, quite a few times we bought a business that was soon producing 100% per annum on what we paid for it and didn't require much reinvestment. If we had been able to continue doing that we would've loved to do it. When we couldn't, we went to plan B and plan B is working pretty well. In many ways I sort of prefer it. How about you Warren?

Buffett: When something is forced upon you, you might as well prefer it.

[Laughter]

We knew that was going to happen. The question is, does it lead you from what was a sensational result to a satisfactory result? We are quite happy with a satisfactory result. The alternative would be to return to working with very tiny sums of money and that really hasn't got a lot of serious discussion between Charlie and me.

Q: What in particular did you like about Precision Castparts [a company Berkshire recently acquired]? Are there long term investments that Precision can make now that they couldn't as a public company?

Buffett: We made the deal last August and completed the acquisition in January. The most important asset is Mark Donegan who runs Precision Castparts. He is an extraordinary manager. Charlie and I have seen a lot of managers over the years. I would almost rank Mark as one of a kind. He is doing extremely important work, primarily making high precision aircraft parts.

I would say that there are no disadvantages for Precision to be a subsidiary of Berkshire. I think Mark would say, and Charlie and I would agree with him, that over time there could be significant advantages. For one thing he can spend 100% of his time figuring out better things to do with aircraft engines. This was his first love and he did spend most of his time on this. However, he also had to spend some time explaining quarterly earnings to analysts and perhaps negotiating bank lines and that sort of thing.

His time, like all of our managers, can be spent exactly on what makes the most sense for him. Mark does not ever have to come to Omaha to put on some show for me to justify a $1 billion acquisition or plant investment. He doesn't have to waste his time on anything that is unproductive. Running a public company you do waste quite a bit of time on stuff that isn't productive.

I would say we have taken the main asset of Precision Castparts and made him even more valuable to the company. In terms of acquisitions, Precision has always made a number of them but being a part of Berkshire there really is no limit on what can be done. There again, his canvas has been broadened following the acquisition by Berkshire. If he needs capital I've got a 1-800 number. He wasn't paying much of a dividend before and he doesn't have to pay any now. Precision Castparts will do better under Berkshire than it would have independently, although it would have done very, very well independently.

Munger: In the early days we used to make wise ass remarks and Warren would say 'We buy businesses that an idiot can manage because sooner or later an idiot will.' And we did buy some businesses like that in the early days when they were widely available. Of course we prefer to do that but the world has gotten harder. We had to learn new and more powerful ways of operating. A business like Precision Castparts requires superior management that is going to stay superior for a long time. We have gradually done more and more of that and it's simply amazing how well it works. I think that to some extent we have gotten almost as good at picking superior managers as we were in the old days at picking no brainer businesses.

Buffett: We won't be able to find them because they are very rare birds, but we would love to find another three or four businesses of a similar type to Precision Castparts where they are forever going to produce something where quality is important, where the customer depends very heavily on them, where there are contracts that extend over many years and where people don't just simply take the lowest bid. It's very important that you have somebody there that has enormous skill running the business and their reputation among aircraft engine manufacturers is absolutely unparalleled.

Q: Is GEICO losing share to Progressive due to their investment in technology? Does Progressive's faster growth in 2015 concern you?

Buffett: GEICO's growth rate in the first quarter was not as high as it was in the last few first quarters but it was satisfactory. The first quarter is by far the best quarter for growth but last year both frequency [how often people have accidents] and severity [cost per accident], went up quite suddenly and substantially. Progressive's figures show that less than GEICO and others but I don't think you will see those same trends this year.

It's an interesting thing, last year for the first time in I don't know how many years the number of deaths in auto accidents per 100 million miles went up. Now, if you go back to the mid-1930s, there were almost 15 people killed per 100 million miles driven. It got down to just slightly over 1. You had roughly as many people killed in auto accidents in the mid-1930s, 30,000 to 32,000 per year, as we had last year or the year before when people drove 15 times as many miles.

Cars have gotten far, far safer. It's a good thing because if we had the same rate of deaths from auto accidents as we had in the 1930s relative to miles driven we would have had over half a million people die last year from automobile accidents instead of a figure closer to 40,000.

Last year for the first time there was more driving and there was more distracted driving so you had this uptick in frequency and more importantly in severity. GEICO has adjusted its rates as I mentioned. My own prediction would be that underwriting margins at GEICO would be better this year than last year although you never know when catastrophes will come along. March and April have had a lot of catastrophic activity.

I made a bet a long time ago, a mental one, on the GEICO model versus the Progressive model. They were significantly ahead of us in volume a few years back and we passed them and Allstate. As I put in the Annual Report, I hope on my 100th birthday the GEICO people announce to me that they have passed State Farm but I have to do my share on that by getting to 100. So we'll have to see how I do on that particular one!

[Laughter]

Munger: Well I don't think it's a tragedy that some competitor got a little better ratio in one period. GEICO has quadrupled its market share since we bought all of it.

Buffett: Quintupled!

Munger: Quintupled, yeah, all right Warren.

[Laughter]

I don't think we should care about whether somebody else had a good 90 days.

Buffett: I think it's far more sure that GEICO will pass State Farm than I will make it to 100, that's for sure.

Q: With the rise of Amazon and others, we have seen a shift towards pull marketing away from push marketing – from millions of catalogues to now consumers searching for what they want. What is your take on how this shift from push to pull marketing will affect Berkshire?

[VGI Partners comment: In push marketing, the idea is to promote products by pushing them onto people. A "push" promotional strategy makes use of a company's sales force and trade promotion activities to create consumer demand for a product.

In pull marketing, the idea is to get the consumer to come to you. Common sales tactics include search engine optimisation, product placement, corporate sponsorship, social media marketing and word-of-mouth referrals.

Pull marketing attempts to create brand loyalty and keep customers coming back, whereas push marketing is generally more concerned with short-term sales.]

Buffett: This development is huge, really huge. It isn't just Amazon but Amazon is a big part of it. What they have accomplished in a fairly short period of time and continue to accomplish is remarkable, including the number of satisfied customers they have developed.

We don't make any decision, whether it's the manufacturing of goods, whether it's retailing, without thinking long and hard about what the world will look like in ten or twenty years with that hugely powerful trend that you just described. We don't look at that as something where we're going to try to beat them at their own game, they're better than we are at that so Charlie and I won't 'out-Bezos' Bezos by a long shot.

We think about push versus pull marketing but it does not worry us for Precision Castparts. It doesn't worry us about the overwhelming majority of our businesses but it is a huge economic trend that twenty years ago was not on anybody's radar and lately has been on everybody's radar screen. Many people, including us in a few areas, have not figured out how to either participate in it or counter it.

GEICO is a great example of a company in an industry that had to adjust to change. Some people made the change better than others. We were slow on the internet, the phone had worked so well for us. Traditional advertising had worked so well there was always a resistance to think about new possibilities. When we saw what was happening on the internet and now mobile we jumped in with both feet.

The nature of capitalism is that if you've got a good business somebody is always trying to figure out how to take it away from you and improve upon it. The effect from Amazon and others that are playing the same game has not yet been fully seen. It is a big, big force, it has already disrupted plenty of people, and it will disrupt more.

I think Berkshire is quite well positioned. One big advantage we have is we never saw ourselves as starting in one industry. I mean we went into department stores but we didn't think of ourselves as department store guys or steel guys or tire guys or anything of that sort. We've thought of ourselves as having capital to allocate.

If you start with a given industry focus and spend your whole time working on a way to make a better tire or whatever, it may be hard to have the flexibility of mind that you have if you just think you have a large and growing pile of capital. We are trying to figure out what is the best next move you can make with that capital. I think we do have a real advantage that way.

I think Amazon has a real advantage too in its intense focus on having hundreds of millions of generally very happy customers getting very quick delivery of something they want to get promptly. They want to shop how they want to shop. If I owned a bunch of shopping malls or something like that I would be thinking plenty hard what they would be looking like ten or twenty years from now. Charlie?

Munger: Well I would say we failed so thoroughly in retailing when we were young that we avoided the worst troubles when we were old.

[Laughter]

I think net-net Berkshire has been helped by the internet. The help at GEICO has been enormous and it has contributed greatly to the huge increase in market share. Our biggest retailers are so strong that they will be amongst the last to have trouble from Amazon.

Q: Removing your own beverage consumption from the question, please explain why Berkshire should be proud to own Coke?

Buffett: I think people confuse the amount of calories consumed. I happen to elect to consume 700 calories a day from Coca-Cola. I'm about one quarter Coca-Cola roughly but I'm not sure which quarter and I don't think we want to pursue the question.

[Laughter]

But, I think that you have to decide if sugar generally is something the human race shouldn't have. I think the average person consumes 125 pounds of sugar per year. I elect to get my 2,600 to 2,700 calories a day from things that make me feel good when I eat them. That's been my sole test. It wasn't a test that my mother or grandfather thought was great.

There are over 1.9 billion 8oz servings per day of some Coca-Cola drinks including Coke, Coke Zero and Diet Coke. That's 693.5 billion servings per year, but it's a leap year.

[Laughter]

That's almost 100 8oz servings per capita for 7 billion people living in the world every year. That has been going on since 1886. I would find quite spurious the fact that if somebody says you're eating 3,500 or so calories a day and some of it is Coca-Cola that you can blame any obesity related illnesses on the Coca-Cola you drink. You have the choice of consuming more than you use and I mean, I make a choice to get 700 calories from this. I also like fudge a lot and peanut brittle.

I am a very, very happy guy and I'm serious about this, if you're happy every day, it may be hard to measure but I think you're going to live longer. I think there may be a compensating factor.

[Applause]

I really wish I'd had a twin and that twin had eaten broccoli his entire life and we both consumed the same number of calories.

[Laughter]

I know I would have been happier and I think the odds are fairly good I would have lived longer. I think Coca-Cola is a marvellous product. If you consumed 3,500 or 4,000 calories a day and lived your life with a fairly normal metabolism something is going to go wrong with your body at some point. You have to balance out the calories so that you don't become obese. I have not seen evidence that convinces me that I will make it to 100 if I suddenly switch to water and broccoli.

Incidentally, a friend of mine, RJ Miller, a remarkable man, was born about 100 miles from here near Shelby, Nebraska. Shelby's population was only 598 and it never changed, every time some girl had a baby some guy had to leave town.

[Laughter]

It was a very stable place. Anyway, RJ went on to be President of Ford Motors, he had his 100th birthday on March 4th this year so I went out to see him. RJ told me that there were 10,000 men in the United States that had lived to 100 or greater and there were 45,000 women that were 100 or greater.

I came back and went on the internet to check that versus the census figures and sure enough, that is the ratio. There are 10,000 men and roughly 45,000 women over the age of 100. So if you really want to improve your longevity prospects, have a sex change.

[Laughter]

You are 4.5x more likely to get to 100, that sounds like one of those studies people put out! It's just a matter of fact folks. I think I will have Charlie go first on that one though.

[Laughter]

Charlie, any comments?

Munger: Well I like peanut brittle better than the Coca-Cola but I drink a lot of Diet Coke. People who ask questions like this always make one ghastly error that is really inexcusable. They measure the detriment without considering the advantage. Well that's really stupid. That's like saying we should give up air travel because 100 people die a year in air crashes. That would be crazy.

The benefit is worth the risk. Every person has to have about eight or ten glasses of water a day to stay alive and it's pretty cheap and sensible to add a little bit of flavour to your water to make it more enjoyable and add some stimulation and calories. There are huge benefits to humanity in that and it's worth having some disadvantage.

We ought to have a law, here I am sounding like Donald Trump, where people shouldn't be allowed to cite defects without citing the advantages. It's immature and stupid.

[Laughter]

Q: In your 2008 shareholder letter, you said 'derivatives are dangerous, they have made it almost impossible for investors to understand and analyse our largest commercial and investment banks'. How do you analyse and value companies like Bank of America Merrill Lynch and other banks that Berkshire has investments in relative to their significant derivative exposures?

Buffett: Yeah derivatives do complicate the problem dramatically. There is no question that if you ask me to describe the derivative position of Bank of America, I would know that they have done a conscientious job and worked hard to adjust their position.

The great danger in derivatives is if there is a market discontinuity. Without one, there is not much of a problem assuming the derivatives are marked to market and collateralised. But if the system stops for a while like after 9/11 there can be a problem.

If you have a major cyber, nuclear, chemical or biological attack on the country, which will certainly happen at some point, you have a major discontinuity, at which point you will have a lot of problems. I regard very large derivative positions as dangerous.

We inherited a modest size derivative position in Gen Re in a benign market and we lost about $400 million in just trying to unwind it with no pressure on us whatsoever. So I do think it continues to be a danger to the system.

Munger: By the way, the accountants blessed our big derivative positions as being worth a lot of money. They were only off by, what, a few hundred million?

[Laughter]

Buffett: Well Charlie found one position when he was on the Audit Committee at Salomon that was mismarked by $20 million. I actually know of a current position that staggers the mind to know the way that position is marked, it is so mismarked that it would blow your mind. And the auditors are not necessarily capable of holding that behaviour in check.

Derivatives are still dangerous in large quantities and we would not do them on a collateralised basis because if there was a discontinuity I don't know where we would end up. It does not entice me at all to do any derivative transaction, it is a potential time-bomb for a discontinuity, and by a discontinuity I mean anything that may cause trading to come to a halt and cause markets to stop functioning.

I am not in the least troubled by our Bank of America investment or Wells Fargo. On the other hand there are a large number of banks we would not invest in. If you take the 50 largest banks in the world, we would not even think about probably 45 of them, wouldn't you say that Charlie?

Munger: Well we are in the awkward position where we will probably make $20 billion in revenues from those contracts that you and I did a few years ago. All that said we are different from the banks, we would really prefer if those derivatives had been illegal for us to buy, it would have been better for our country.

[Applause]

Q: My question concerns the float generated by Berkshire's insurance companies. In your 2015 letter, you said that this float allows Berkshire to increase its investment income but what happens when interest rates decline? If the US were to implement negative interest rates the same way the Eurozone and Japan have done, how would Berkshire be affected?

Buffett: Yeah well some of our float actually exists in Europe where we have the problem of negative interest rates on very high grade short-term and even medium-term bonds. And obviously anything that reduces the value of having money is going to affect Berkshire because we have a lot of it.

Because we have so much capital and so many sources of earning power, we have the ability to use our float in ways that most insurance businesses can't. We have $50 billion of short-term government securities and we are going to get more in June so we will have almost $60 billion earning 0.25%. The difference between 0.25% and -0.25% is not that great – it is almost as painful to have $60 billion earning 0.25% as having it earning negative rates.

Float is not worth as much to insurance companies now as it was 10 years ago and that is true at Berkshire. I think it is worth considerably more to us than the typical insurance company because we have a broader range of options around what to do with it.

This is not just a problem for insurance companies but it is a problem for retirees and anybody that is stuck with fixed-dollar investments. We love the idea however of increasing our float, that money has been very useful to us over time and it is useful today even under present conditions and it is likely to be very useful in the future. It is shown as a liability but it is actually a huge asset. Charlie?

Munger: I've got nothing to add.

Buffett: Well, Charlie's now in full swing.

[Laughter]

Q: The railroad industry seems to be suffering from exposure to some of the weakest parts of the economy, with volume declines in coal, oil, metals and even intermodal, usually a steady source of growth. How much of this weakness is cyclical and how much is secular? In the last 15 months, the market cap of the other railroads is down by 35% – is your estimate of BSNF's intrinsic value down by a material amount or is your view unaffected by these short-term wiggles?

Buffett: Now there are many factors that may have caused the declines in coal. We had a mild winter and went into the winter with utilities carrying unusual amounts of coal. Because the weather was mild, electricity use was poor so they continue to this point to have more coal on hand than they would like.

Certainly the decline in coal, which is a very important commodity at about 20% of revenues, that's secular. At 20% of revenues, that's a significant factor. The market generally got very enthused by railroad stocks a few years ago, but now that people have seen that carloads and earnings are down, the equity valuations have also come down.

We love the fact that we own BNSF, we think we bought it at an attractive price, we'd love to be able to buy a second thing exactly like it at that price and we would even pay a little more. But we don't mark up or down our wholly owned businesses based on stock market valuations. Obviously stock market valuations are a factor in our thinking but we are not marking our wholly owned businesses because we are going to own them forever and BNSF is a very good business to hold forever. It will lose coal volume and gain in other areas. It is a terrific business with invaluable assets even though it may not earn as much money this year as it did last year. Charlie?

Munger: I've got nothing to add.

Q: For my children watching at home today, how should they look at stocks when every day in the media they see companies IPOing that have never been profitable, that are dilutive and with a 'short-term spin' as the investment cycle is getting shorter and shorter. How should they view stocks and what is your message for them?

Buffett: You don't really have to worry about what's going on with IPOs. People win lotteries every day but you shouldn't be jealous. If they want to do mathematically unsound things and one of them occasionally gets lucky, that's fine. What you ought to do is try to figure out what makes sense and get yourself in the frame of mind that when you are buying a stock you are buying a piece of a business.

If you don't look at a quote for five years, that's fine. You don't get a quote for your farm every day, week or month or on your apartment house or on a McDonald's franchise. You want to look at your stocks as businesses and think about their performance as businesses, think about what you pay for them as what you would pay for a business. Let the rest of the world go its own way, you don't want to get into a stupid game just because it's available.

Q: Berkshire's performance is influenced by oil markets, more so today than in the past. Recently, revenues at BNSF and Berkshire Energy companies have been negatively impacted partly due to the oil price. Yet during this year Berkshire invested in Phillips 66, Kinder Morgan and Precision Castparts, all of which are somewhat affected by oil prices. Although Berkshire would not make a bet on a commodity such as oil, is Berkshire making a statement about the outlook for oil?

Buffett: No, we don't have the faintest idea about what the long-term price of oil will be. We don't think we can predict commodity prices. We don't hedge cocoa or soy beans for this exact reason so any of our investments were not bought based on commodity price predictions. We are thinking about other things when we make those decisions. Charlie?

Munger: I'm even more ignorant than you are.

Buffett: I think that's the first time I've ever heard him say that. It has a nice ring to it.

[Laughter]

Q: If Donald Trump becomes President (and recognizing your public criticism of him and your support for Hilary Clinton) what specific risks (political, regulatory or others) do you foresee for Berkshire's portfolio?

Buffett: Government is a very big factor in all of our businesses. I will predict that whether Donald Trump or Hilary Clinton becomes President, Berkshire will continue to do fine. Charlie?

Munger: I'm afraid to get into this area.

[Laughter]

Buffett: We've operated under price controls, we've had 52% federal tax applied to our earnings, we've had regulation come along and in the end business in this country has done extraordinarily well for over 200 years and it has adapted to the society. This is a remarkably attractive place in which to conduct business.

In a world of zero interest rates, people with money in savings accounts have had their earnings destroyed. But owners of businesses, if you look at returns on tangible equity, they have not suffered even as people who own fixed-income instruments have suffered enormously. Businesses manage to take care of themselves, as they are the engine of the market economy that delivers output.

In my lifetime, the US GDP per capita in real terms has increased six-fold. Overall, people have six times the real output that they had at the beginning of their lifetime. The system works very well in terms of aggregate output, although the distribution of that output can sometimes fall very short. The system will keep working and in 20 years there will be more output per capita in real terms than today. No Presidential candidate or President is going to end that, they can only shape it in someway. Now, Charlie, give something pessimistic to balance it out.

[Laughter]

Munger: I think that the GDP figures greatly understate the real advantage that our system has given our citizens. It underweights some huge achievements because they don't translate into money but the real achievements over the last century are way higher than are indicated by GDP figures.

Buffett: There is no one I've met that would say 'with my talents, I wish I was born 50 years ago.' The majority of the American public think they would've been better off 50 years ago. They are wrong. You are making free choices that were not available to you 50 years ago.

Q: Do you believe that Berkshire Hathaway will eventually be targeted by activist investors? And if so what protections would you install to try and prevent future generations from breaking up Berkshire Hathaway?

Buffett: Yeah I used to worry about that more than I do now. Partly because size is one factor. I think the more important factor would be that Berkshire will always be in a position to repurchase very significant amounts of stock. And as long as it is willing to buy that stock at some price, and it should be, close to intrinsic value, and there should not be a large margin. In terms of anyone coming along I don't think there would be a lot of money in breaking it up. There would be money lost by breaking it up in terms of we would lose certain advantages.

MidAmerican Energy could not have done what it has done in renewables without Berkshire being the parent. I mean if it had been split off, the parts would have been worth less than the whole. I could give you many significant instances of that in other cases. So I don’t think there will be a spread that will be enticing to anyone. And beyond that I think the numbers that would be involved would be staggering.

And we have a shareholder base that recognises the advantages of both the Berkshire businesses and its culture. So I think it is very, very unlikely but there have been periods in business history where stocks sold at dramatic discounts from what you might call intrinsic value and it’s interesting that very little activity occurred.

In the 1974 period there were really good companies, one of which was Cap Cities for example that Tom Murphy ran. It was trading at a huge discount to what it was worth. But people did not come along – when the discounts are huge, money is hard to get. It’s not a huge worry with me. Because of the way my stock will get distributed to philanthropies after I die, it is very likely that my estate for some years will be by far the largest shareholder of Berkshire in terms of votes. So it is not something that I worry about now. I used to worry about it some but it’s not a factor now. Charlie?

Munger: Well I think we have almost no worries at all on this subject. Other people have a lot of justifiable worry and I think that helps us. So I look forward to this subject with optimism.

Buffett: Do you want to explain how it helps us Charlie?

Munger: Well if you’re being attacked by people that you regard as evil and destructive and so forth. And you want a strong ally. How many people would you pick in preference to Berkshire?

Buffett: My name is Warren Buffett and I approve that message.

[Laughter]

Q: My wife and I have the vast majority of our net worth invested in Berkshire and in shares of the Sequoia fund. Mr. Buffett, you have endorsed the Sequoia fund on more than a few occasions. Recently, the Sequoia fund has been in the news because of its large position in Valeant Pharmaceuticals. Mr. Munger has called Valeant's business model highly immoral. Mr. Buffett, do you agree with Mr. Munger's assessment? Have your views about the Sequoia fund changed?

Buffett: In a sense, I'm the father of Sequoia fund in that when I was closing up my partnership at the end of 1969, I was giving back a lot of money to partners, and these people trusted me and they wanted to know what they should do with their money.

And we said there were two people that we admired enormously in the investment business, not simply because they were terrific investors, but they were terrific people and they would be the kind of people that you'd make trustee of your will.

So those two, one of whom is in the room, Sandy Gottesman, a director, and one was Bill Ruane. They were friends themselves. So Sandy took on a number of our partners, and they became clients and very happy clients of his, and I'll bet some of them are still clients or their children or their grandchildren are to this day. A lot of my original partners went with both of them actually. In fact, I wouldn't be surprised if the majority of them who had a lot of money gave some to Sandy and gave some to Bill.

Bill ran Sequoia until roughly 2005 when he died, and did a fantastic job. Even now, if you take the record from inception, with the trouble they've had recently, I don't know of a mutual fund in the United States that has a better record. There probably is one maybe, or two. But it's far better than the S&P, and you won't find many records that go for 30 or 40 years that are better than the S&P.

So Bill did a great job for people. And though he died in 2005, the record continued to be good until a year or so ago. And at that time, the manager took an unusually large position in Valeant and despite the objection of some people on the board, not only maintained that position but actually increased it after a fair amount of people had doubted them.

The record, from when it started, is still significantly better than average. My understanding is that the manager who made the decision on Valeant is no longer running the operation. And I know that they're very smart, decent people who are good, probably way better than average analysts in terms of Wall Street. So I think it was a very unfortunate period when the manager got overly entrenched with a business model. I watched the Senate hearings a couple of days ago when Senator Collins and Senator McCaskill interrogated three people from Valeant, and it was not a pretty picture.

But in my view, the business model of Valeant was enormously flawed and had been touted to us. We had several people who urged us strongly to buy Valeant, one asked to meet in person, all that sort of thing, but it illustrated a principle that Graham I think said many, many years ago. He said if you're looking for a manager, find somebody that's intelligent, energetic and has integrity.

And he said that if they don't have the last one, be sure they don't have the first two. If they don’t have integrity, you want them to be dumb and lazy. And if you've got an intelligent, energetic guy or woman who is pursuing a course of action which you'd put on the front page and it would make you very unhappy, you can get in a lot of trouble.

Charlie and I have seen these patterns before. We get pattern recognition, which is very important in evaluating humans and businesses. There are certain things in business and securities markets that we have seen over and over and that frequently come to a bad end, but frequently look extremely good in the short run.

Many of the schemes on Wall Street that are designed to fool people have that particular aspect to it. And there were patterns at Valeant that I think – certainly, if you'll go and watch those Senate hearings, I think you could say that there were patterns there that really should have been picked up on. And it's been very painful to the people of Sequoia.

Munger: Well, I totally agree with you that Sequoia is a reputable investment fund, and the manager that reconstituted it is a reputable investment adviser. And I've got quite a few friends and clients that use Sequoia and I've advised them to stay with them. And I believe you've done the same thing, haven't you?

Buffett: Correct.

Munger: So we trust that the whole thing is fixed. Valeant, of course, was a sewer and those who created it deserve what they got.

Q: What can be done to reduce the risk of chemical, biological, nuclear, or cyber-attacks and why don't you spend more time telling the government what to do about it?

Buffett: In my view there is no problem remotely like the problem of what I call "CNBC" – chemical, nuclear, biological and cyber-attacks.

Either by rogue organisations, individuals, or rogue states. It will happen.

We've been both lucky, and frankly the people in government have done a very good job because government is the real protection on this, in not having anything since 1945.

We came very, very close during the Cuban Missile Crisis and I can think of many people that would have caused a very different result if they had been in the place of Kennedy or Khrushchev.

It's the ultimate problem. It's the only real external threat to Berkshire's economic well-being over time. I just hope that when it happens that it's minimised. But the desire of psychotics and megalomaniacs and religious fanatics to do harm on others is a lot more when you have seven billion people on Earth than when you had three billion when I was born.

If you were a psychotic back far enough you threw a stone at the guy in the next cave and it was a linear relationship of damage to psychosis. And that went along through bows and arrows and spears. And in 1945 we unleashed something like the world had never seen and that is a pop gun compared to what can be done now.

There are plenty of people who would like to cause us huge damage and I came to that view when I was in my 20s and it was one of the issues I thought should be the main issue of my philanthropic efforts. I got involved with the Concerned Scientists and the Nuclear Threat Initiative and efforts to build a reserve of uranium that would take away the excuse for other countries to build their own enriched uranium.

But it's overwhelmingly a governmental problem that you're dealing with. It should be and has been the top priority for President after President. It's not the thing they talk about because they don't want to scare the hell out of everybody and they also don't want to tip their hands to tell everybody what they are doing.

But you don't have to be in the insurance business to know that someday, somebody will pull off something on a very, very big scale that will be harmful. The United States is the most likely place for it to happen but it can happen in a lot of other places.

That's the one huge disadvantage to innovation.

Munger: Warren, he also asked why Berkshire doesn't spend a lot more time telling the government what it should be doing and thinking.

Buffett: Well, I've tried telling them and nobody disagrees with you on it. It just seems hopeless. They've done a lot of things and not all gets publicised.

I think Khrushchev shouldn't have been sending them over to Cuba but at least he had enough sense to turn the ships around when confronted by Kennedy. But you can't count on Kennedy's and Khrushchev's being in charge of things all the time.

I've seen mistakes in business and human behaviour where people act contrary to their own long-range self-interest. Humans have a lot of frailties.

Q: How does the flow of information such as knowing macroeconomic information affect your decision-making? What about the anchoring effect of knowing stock prices?

Buffett: Charlie and I read a lot and we are interested in economic and political matters, so we are familiar with a lot of macroeconomic factors. We do not know where they are going but we know where they currently stand.

In terms of the businesses and stocks we buy, we try to know all, or as many microeconomic factors as possible. I like looking at the details of a business, whether we buy it nor not, I mean I just find it interesting to study the species.

Charlie and I are the kind that find it interesting in any business to look at micro factors. When we bought See's Candies in 1972, there may have been 140 shops, we looked at the numbers of each and watched them over time.

We really like understanding businesses, it's interesting to us. Some of the information is very useful and some may look like it's not but who knows when some information stored at the back of your head pops up and becomes relevant.

We are fortunate in that we are doing what we love doing. Much like watching baseball games, which I love to do, every pitch is interesting and every moment, whatever it may be, is interesting.

Munger: There hardly could be anything more important than the microeconomics. And we are not anchored to our buy prices, we ignore them. We try to avoid the worst anchoring effect, which is your previous conclusion. We really try and destroy our previous ideas.

Buffett: Charlie says that if you disagree with somebody, you ought to be able to state their case better than they can. At that point you've earnt the right to disagree with them.

Munger: Otherwise you should just keep quiet. It would do wonders for politics if everyone followed my system.

[Laughter and applause]

Q: Most entities use large teams, outside consultants and lawyers to carry out due diligence over months while you and Charlie can often strike deals over a handshake. Does your diligence process put us at greater risk and if you are ever gone, how would you recommend Berkshire change how we approach deal-making?

Buffett: Yeah I get that question fairly often, often from lawyers. It's interesting, we have made plenty of mistakes in acquisitions. And we have made mistakes in not making acquisitions. The mistakes are always about making an improper assessment of the economic conditions in the future of the industry or of the company. They are not a bad lease or a specific labour contract, they are not the things that are on every checklist for every acquisition by every major corporation in America. Those are not the things that count.

The thing that counts is whether you are wrong about the basic economics and how the industry is likely to develop or whether Amazon is likely to kill them in a few years. We have not found a due diligence list that gets at what the real risks are when we buy a business.

We certainly have made at least half a dozen mistakes and probably a lot more. But none of those would've been cured by more due diligence, they might have been cured by us being a little smarter.

It just isn't the things that are on the checklist that count. Assessing whether a manager who I'm going to hand $1 billion to is going to behave differently in the future, that's incredibly important. There's no checklist in the world that is going to answer that.

If we thought there were things of importance that were missing in assessing the future economic prospects of the business, we would by all means drill down on those.

We bought Precision Castparts, and they have 170 plants. There are going to be pollution problems at some plants. That does not determine whether a $32 billion acquisition is going to be good five or ten years from now.

I have seen deals fall apart for arguing over small details and their egos get involved and they draw lines in the sand. When we start to make a deal, it usually gets done. Charlie?

Munger: The thing to think about is business quality usually counts more than whether you check some old lease. And the human quality of the management that are going to stay is very important. And how are you going to check that?

I don't know anybody that has generally had a better record than Berkshire in judging business quality and human quality. I don't think it would have improved at all by using some different method. For us at least, we are doing it the way we should.

Buffett: Negotiations that drag out have the tendency to blow up. People can get silly about very small points. I like to show a certain level of trust in the other person because usually trust comes back to you. The truth is that there are some bad apples out there and spotting them is not going to come by looking at documents. You really have to size up how the person who is getting cash from you is going to behave in the future.

You just don't try to win every point. If your negotiations are in bad faith, then you've got another problem and you are lucky if you find that out early. Charlie anymore?

Munger: How many people that are married in this room carefully checked their spouse's birth certificate and so on?

[Laughter]

My guess is our methods are not as uncommon as they appear.

Buffett: I'll need to think about that one.

[Laughter and applause]

Q: 3G has been very successful in cutting costs and increasing margins at Kraft Heinz. The company has seen volumes and revenues decline. As a long-term investor, how do you judge when a management is cutting muscle as well as fat? Can a business increase revenues while cutting costs?

Buffett: Well, the answer is yes – sometimes you can cut costs that are a mistake to cut, and sometimes you can keep costs that are a mistake to keep. Tom Murphy had the best approach – he never hired a person that he didn't need and therefore never had layoffs. And you might say that at headquarters at Berkshire we have followed a similar approach.

If you are in a cyclical business you may have to cut a workforce because there aren't as many carloads of freight moving or something like that, so you cut back on train crews. But the idea that you give up your staff because business has slowed down – if you don't need them now you didn't need them in the first place. You get a department going and they are always going to want to expand. The ideal method is not to do it in the first place.

But there are all kinds of American companies that are loaded with people that aren't really doing anything, or are doing the wrong thing and if you cut that out, it should not really have any significant effect on volume. On the other hand if you cut out the wrong things you could have a big effect.

My impression from everything I've seen is that 3G, in terms of the cost cuts they've made, have been extremely intelligent and have not cut things that would cut volume. It is true that in the packaged goods industry volume trends for everybody, whether they are fat or lean in their operation, are not good. The test will be over time, three to five years, for the operations which have had their costs cut, do they do poorer in terms of volume than the ones that look very fat. So far I have seen no evidence of that whatsoever.

I do think at Kraft Heinz for example, we have got certain lines that will decline in volume, we have certain lines that will increase, but overall I think that the packaged goods industry is not going to go any place in terms of physical volume, it may decline just a bit.

I have never seen anybody run anything more sensibly than 3G has in terms of taking over operations where costs were unnecessarily high and getting those costs under control in a hurry. And the volume question we will look at as we go along – but believe me I look at those figures every month, and I look at everybody else's figures every month. And I am always looking for any signs of underperformance because of decisions made and I have seen none. Charlie?

Munger: Sometimes when you reduce volume it is very intelligent because you are losing money on the volume that you're discarding. It's quite common for a business not only to have more employees than it needs but it sometimes has two or three customers that it would be better off without. So it is quite hard to judge from the outside whether things are good or bad just because volumes are going up or down a little.

Generally speaking, I think that the leanly-staffed companies do better at everything than the ones that are over-staffed. I think that over-staffing is like getting to weigh 400 pounds when you are a normal person – it is not a plus.

Buffett: Yes, sloppy thinking in one area probably indicates that there may well be sloppy thinking elsewhere. I have been a director of 19 public corporations and I've seen some very sloppy operations and I've seen a few really outstanding business operators and there is a huge, huge difference.

If you have a wonderful business, you can get away with being sloppy. We could be wasting $1 billion a year at Berkshire and maybe you wouldn't notice it, but…

Munger: I would.

[Laughter]

Buffett: Charlie would notice it. But it's the really prosperous companies that tend to waste money. The classic cases were the tobacco companies many years ago. They went off into this thing and that thing. And it was practically play money because it was so easy to make and it didn't require good management. And they took advantage of that fact. You can read about some of that in "Barbarians at the Gate."

Q: When interest rates go from 0% to negative in a country, how does that change the way that you value a company or a stock?

Buffett: Well, going from 0% to -0.5% is really no different than going from 4% to 3.5%. It has a different feel to it obviously if you have to pay 0.5% to somebody, but if you have your yield or your base rate reduced by 0.5%, it's of some significance but it isn't dramatic.

What's dramatic is interest rates being where they are generally. We are dealing with a situation of essentially very close to 0% interest rates and we have been for a long time and longer than I would have anticipated. The nature of it is that you will pay more for a business when interest rates are 0% than if they were 15% like when Volcker was around.

We don't get too exact about it, because it isn't that exact a science, but very cheap money makes me pay a little more for businesses than when money was at what we previously thought were normal rates. And very tight money would cause me to pay somewhat less. We had a rule for 2,600 years that "a bird in the hand is worth two in the bush". But a bird in the hand now is worth about 9/10ths of a bird in the bush in Europe.

If you ask me whether I paid a little more for Precision Castparts because interest rates are around 0% than if they'd been 6%, the answer is yes. I try not to pay too much more, but it has an effect. If interest rates continue at this rate for a long time, if people ever really start thinking something close to this is normal, it will have an enormous effect on asset values. It already has some effect. Charlie?

Munger: Yeah but I don't think that anybody really knows much about negative interest rates because we've never had them before. And we never had periods of stasis, except for the Great Depression. We didn't have things like what happened to Japan – a great modern nation playing all the monetary tricks, Keynesian tricks, stimulus tricks, mired in stasis for 25 years. And none of the great economists who've studied this and taught it to our children understand it either. So we just do the best we can.

Buffett: And they still don't understand it.

Munger: No, our advantage is that we know we don't understand it.

Buffett: It's really interesting though, it makes for an interesting movie. And it does modestly affect what we pay for businesses. I don't think anybody expected it to last this long, do you Charlie?

Munger: If you're not confused, you haven't thought about it correctly.

Buffett: I've thought about it correctly then.

[Laughter]

Q: You've talked in the past about the ability of American Express to reinvent itself over time. But today, it seems to be a company that doesn't have alternative businesses, and its brand doesn't seem to have the same kind of cache as it once did. Shouldn't Berkshire periodically reassess its reasons for owning an investment?

Buffett: Well, we reassess our reasons for owning all investments on almost a continuous basis. Both Charlie and I do that, and we're usually in a general range of agreement, but sometimes we are a fair distance apart. There is no question that payments are an area of intense interest to a lot of very smart people who've got a lot of resources.

Munger: And rapid change.

Buffett: Yes and rapid change. I personally feel okay about American Express and I'm happy to own it but their position has been under attack for decades and it will continue to be under attack. I mean it is too big a business and too interesting a business and it could be too attractive a business for people to ignore it. And it plays to the talents of some very smart people.

Munger: A lot of great businesses aren't quite as great as they used to be. The packaged goods business of Proctor & Gamble and General Mills and so forth are all weaker than they used to be at their peak.

Buffett: And the auto companies.

Munger: And the auto companies, oh my God, when I think about the power of General Motors when I was young and what happened! When I was young, General Motors loomed over the economy like a colossus. It looked totally invincible.

Buffett: Trying to hold down market share.

Munger: Yes, because they were afraid they'd be too monopolistic. So the world changes, and we can't make a portfolio change every time something is a little less advantaged than it used to be.

Buffett: But you have to be alert, and thinking all the time about whether there has been something that really changes the game in a big way. And that's not only true for American Express, that's true for other things we own, including things we own 100% of. And we'll be wrong sometimes. We'll be late sometimes. But we will be right sometimes too.

It's not that we're not cognisant of threats. It is about assessing the probabilities of those threats being a minor problem or a major problem or a life threatening problem. It's a tough game, but that's what makes our job interesting.

Munger: I think anybody in payments who is an established long-time player with an old method has more danger than used to exist. It's just, there's more fluidity in it.

Q: Charlie, you clearly understand the power of incentives. How do you apply this at Berkshire when designing compensation formulas?

Munger: Our incentive systems are different, and what they try to adapt to is the reality of each situation. And the basic rule of incentives is that you get what you reward for. So if you have a dumb incentive system you get dumb outcomes.

One of our really interesting incentive systems is at GEICO, and I'll let Warren explain it to you because we don't have a normal profits-type incentive system for the people at GEICO.

Buffett: Well at GEICO we have two variables, and they apply to well over 20,000 people. And as you go up the ladder, it is still the same two variables, but it gets to be larger and larger in terms of bonus compensation as a percentage of your base. But it is always significant.

Those two variables are very simple. I care about growing the business, but I care about growing it with profitable business. So we have a grid which consists of growth in policies in force on one axis and profitability of seasoned business on the other.

It costs a lot of money to put business on the books. We spend a lot of money on advertising. So in the first year, any business that we put on the books is going to reduce profit significantly. And I don't want people to be worried about the profit that might be impaired by growing the business fast. So profit of seasoned business, growth of policies in force. Very simple.

We've used it since 1995, we've put a tiny little tweak or two in for new businesses or something of the sort. But it is overwhelmingly a simple system. Everybody understands it.

In February or so, it is a very big day when the two variables are announced and people figure out where they come out on it. It totally aligns the goals of the organisation in terms of compensation with the goals of the owner. And that's a simple one.

Munger: It's simple, but other people might reward something like just profits, so the people don't take on new business they should take on because it hurts profits. So you've got to think these things through and of course Warren's good at that, and so is Tony Nicely [GEICO's CEO].

Buffett: I don't want to reward profits alone. It would be the dumbest thing you could do – you'd just quit advertising and shrink the business a little.

And like I said, people there know that the very top person is getting paid based on the very same two variables, so they don't think that the guys at the top have got a cushy deal compared to them. It's just a very logical system.

The interesting thing is that if we brought in a compensation consultant they would start coming up with plans that would be designed for all of Berkshire and get us all pulling together. The idea of having a coordinated arrangement for incentive compensation across 70 or 80 businesses is just totally nuts. But I can almost guarantee you that if we brought in somebody they would be thinking in terms of some master plan with sub-plans, and explain it with all kinds of objectives. We try to figure out what makes sense in each business we're in. There are some businesses where the top person is enormously important, and some businesses here the business itself dominates the nature of the result. We try to design plans that make sense.

Munger: A lot of the bad examples of incentives come from banking and investment banking. And if you reward somebody with some share of the profit, and the profits are being reported using accounting practices that cause profits to exist on paper that aren’t really happening in terms of underlying economics, then people are doing the wrong thing and it’s endangering the bank and hurting the country and everything else. And that was a major part of the cause of the great financial crisis – that the banks were reporting a lot of income that they weren’t making, and investment banks were too.

The accounting allowed, for a long time, a lender to use as his bad debt provision his previous historical loss rate. So an idiot could make a lot of money by just making way gamier loans and accruing a lot of interest, and saying “I’m not going to lose any more money on these because I didn’t lose money on different loans in the past.” That was insane for the accountants to allow that. Literally insane, that’s not too strong a word. And yet nobody is ashamed of it. I’ve never met an accountant that’s ashamed of it.

Q: Most American corporations separate out supposedly one-time restructuring costs, whereas Berkshire doesn't. Berkshire's reported operating earnings are, therefore, in my opinion, of higher quality. Have you ever calculated how much higher operating earnings on average would be if Berkshire separated out one-off costs?

Munger: Let me take that one. That's a question like asking, why don't you kill your mother to get the insurance money. We don't do it. We're not interested in manipulating those numbers, and we haven't had a restructuring charge ever, and I don't think we're about to start.

Buffett: Yes, I would say this too. We don't do that. The numbers would not be huge. There could be a year, I suppose, when they might be for some reason, but they are more conservatively stated than most companies, and I think they're of higher quality.

But I'd point it out, also, that I think that our depreciation expense at the railroad, which is standard and which all the other railroads use, is inadequate as a measure of true operating earnings.

Munger: We like to advertise our defects.

[Laughter]

Q: Warren, in 2012, you told Becky Quick that if you had a way to easily manage them, you'd buy 100,000 houses and rent them out. How do you feel about the real estate market today?

Buffett: It's not as attractive as it was in 2012.

We're not particularly better at predicting real estate markets than we are at stock markets or interest rate markets. But there are certainly properties that are being sold at very, very low cap rates that strike me as having more potential for loss than gain. But again, if you can borrow money for very, very little and you think you're getting into some very safe asset 100 basis points or 150 basis points higher, there's a great temptation to do it. I think it's a mistake to do that, but I could be wrong.

I don't see a nationwide bubble in residential real estate now at all. I think in a place like Omaha or most of the country, you are not paying bubble prices for residential real estate. But it's quite different than it was in 2012, and I don't think the next time around the problem is going to be a real estate bubble. I think that it certainly was the cause in a very large part what happened in 2008 and 2009. Charlie?

Munger: Nothing to add.

Q: I just have a simple question for you. How would you explain IBM's moat?

Buffett: I'm not sure that's a simple question.

Munger: No, I am not either.

Buffett: Well, it has certain strengths and certain weaknesses, and I don't think we want to get into giving an investment analysis of any of the portfolio of companies that we own. I think I probably better leave it there. Charlie?

Munger: Yes. It's obviously coping with considerable change in the computing world and it's attempting something that's big and interesting and God knows whether it's going to work modestly or very well.

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