COVE STREET CAPITAL

The following are my notes from the 2012 Berkshire Annual Meeting. As usual, these were taken in real time without the use of a recording device. As such, what is written includes my personal interpretation of what was said and I apologize for any errors or omissions. I hope you enjoy the notes and please feel free to forward them to anyone who would enjoy them.

Sincerely,

Ben Claremon
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The Inoculated Investor

Notes from the 2012 Berkshire Hathaway Annual Meeting

Moderators

1) Andrew Ross Sorkin (AS)
2) Becky Quick (BQ)
3) Carol Loomis (CL)

Insurance Analysts:

1) Cliff Gallant (CG)- KBW
2) Jay Gelb (JG)- Barclays
3) Gary Ransom (GR)- Dowling & Partners

Buffett: Comments on the first quarter of 2012: all of the companies except for the ones tied to residential construction pretty much have shown good earnings. In the case of the biggest ones, the 5 largest non-reinsurance companies had their highest earnings ever last year. He thinks these 5 could earn over $10B pre-tax this year.

If you read the 10-Q and turn to the insurance section, you will see that there was an accounting change mandated for all property and casualty (P&C) companies that changed the treatment of deferred policy acquisitions costs (DPAC) but had no effect on the operations or cash generated. But this change did push GEICO's earnings downward by $250M (pre-tax). GEICO still had a great quarter. It had a 9% profit margin and the book value grew. However, the underlying figures are actually better than the presented figures due to the accounting change. In general he feels good about Q1 and the full year.

Question 1: CL- What about the heavy responsibilities of Warren's successor? Does the leading CEO candidate have the knowledge and temperament to be the chief risk officer? In terms of the recent Goldman Sachs (GS) and Bank of America (BAC) investments, could such favorable deals have been done without Warren's involvement and is his successor not going to have access to such deals?

Buffett: The CEO of any large financially-related company (and companies outside of the financial world as well) should be the chief risk officer (CRO). Risk should not be delegated. When it has been, the risk committee generally just reported to the Directors but that often meant the place was ripe for real trouble. He is the CRO at BRK and it is up to him to understand things that could turn into catastrophes. The successor will have the same responsibility for risk management and they would not accept someone for the job who did not have that ability. This skill ranks up there with allocation of capital and picking managers. It is not that hard a job though. There are already people in the insurance business who are very risk focused. The person at the top needs to aggregate the risk embedded in the units and monitor the risk managers in the insurance divisions.

Munger: In general, risk decision was delegated in America and people were using risk metrics they learned in business school. Things like Gaussian curves and Value at Risk (VAR) were some of the dumbest ideas ever put forward.

Buffett: He is not kidding. These were very smart people with great math degrees. It was easy to work with the Gaussian curve but that curve is not applicable to markets' behavior. Having said that, they are not going to have an arts major in charge of BRK.

Buffett: In terms of the second question there is no question that given his age, BRK's capital position, all the people he knows, and BRK's ability to act with rare speed, they get a change to make large transactions. But, we have to remember it takes a willing party on the other side as well. When they got in touch with BAC he had a deal in mind that would make sense for both companies. BAC's CEO Brian Moynihan knew that Warren would do what he said. He knew BRK had the money. So, the ability to commit and for the other person to know you can commit to large sums is a plus. BRK will have that ability even after he leaves.

Having said that, he does not think that every deal he has made will be available to his successors. But the successor the board has agreed on can do a lot of things well that he can't. So, even if you lose something in terms of transactions that no one else can get, BRK may gain that back by the new CEO being more energetic about sourcing deals. At the end of the day, the deals like the ones with GS and General Electric (GE) were not that important to BRK. The total value that has been accumulated as a result of special security transactions is very small in comparison to the value gained by buying GEICO or Burlington North (BNSF). But the ingredients that allowed them to do deals like the one with GS will still be available and unique to BRK. With BRK, people know it can get done.

Munger: Some of the BRK Directors are great risk analysts. Just think of the Kiewit Company. Kiewit and Walter Scott have been great at risk control. Sandy Gottesman provided Munger with one of the greatest risk mitigation examples ever. He fired a guy who made him nervous even though he was a great producer. He said: "I am a rich, old man and you make me nervous."

Question 2: CG- In the 2011 annual report, BRK adjusted higher its mortality rates for the Swiss Re contract. But, in terms of General Re, BRK reported lower mortality assumptions. What was the surprise and are there different trends in the assumptions?

Buffett: BRK wrote a large reinsurance contract in the case of Swiss Re and it applied to business written in 2004 and earlier. BRK started seeing mortality figures coming in higher than what they had expected and what looked like should be the case compared to earlier figures. At the end of last year—recall that they have a stop loss arrangement—they estimated a reserve that assumes the worst case and took the present value of that.

They will keep the reserve at the worst case estimate until they can figure out what to do with that contract. There is an ability to re-price the business as they go along but the varying degrees to which BRK and Swiss Re might want to re-price it could lead to controversy.

He would say that the one overriding principle is that they hope to and plan to reserve conservatively. Reserving is a lot different in the auto business and other short tail lines because you find out quickly how you are doing. General Re was under-reserved when they bought it and back in the 1998-99 time period those reserves were developing poorly. But, there is no risk coordination between people like Tad Montross of General Re and Tony Nicely of GEICO. They have the same mindset but they operate independently.

Munger: There are always going to be some insurance contracts where the results were worse than expected. Why else would anyone buy insurance if that were not the case?

Buffett: After 9/11 it was really hard to reserve, especially in terms of business interruption coverage. BRK turned out to be over-reserved for 9/11. Now you have the same situation in Thailand and Japan due to the supply chain disruptions. If you are a car manufacturer in the US and you cannot get parts, does your business interruption insurance cover that? That stuff can take years to work itself out. Generally, their reserves develop favorably though.

Question 3: Audience- What advice would you give the new Chinese leadership so that the Chinese could encourage companies like BRK to make investments in China?

Munger: They are not spending much time giving advice to China. China has been doing well from a tough start. He suggested that we ought to seek advice from China instead of giving it.

Buffett: In general, they have found it useless in 60 years to give advice to anyone, especially the companies they own stakes in.

Munger: In many cases they have had little influence even though they owned a large percentage of the stock. The beauty of the system at BRK is that they don't need control the companies they are invested in from Omaha.

Buffett: If you look at BRK's 4 largest investments, they have owned some for 20-25 years. The number of times they have talked to the CEOs of those companies hasn't averaged more than 2 times per year. They are not in the business of giving advice. If they thought that the success of the investment would be due to their advice, they would move onto something else.

Question 4: BQ- Given that the BRK is willing to buy back shares at 1.1x book value, the questioner feels like a chump for buying shares at 2x book. Why have they not warned investors when they thought that BRK's stock was too expensive before?

Buffett: Generally, they prefer to see shares not trade at the highest possible price. If they could have their way the stock would trade once a year and Charlie and Warren would pick a value for that day. But that is not possible in public markets. If they thought the stock was overvalued, it would be interesting to announce that. They have never consciously tried to encourage people to buy the stock at a price above intrinsic value. The only time they sold stock they the mentioned in the offering that neither Charlie nor Warren would buy the stock at that price. You may never see that disclosure again in corporate America.

If they are going to buy back shares from people they ought to let them know if BRK is buying the stock too cheaply. If they only had 2 or 3 partners they would come together to arrive at a fair price. But if the price was established by a market and they thought it was too cheap, they would tell people it was too cheap. Currently, they know the intrinsic value is significantly above 110% of book value. But, they will never announce if the stock is above intrinsic value.

Munger: I have nothing to add.

Question 5: JG- What is the capacity for buybacks? How attractive are buybacks versus acquisitions?

Buffett: Buying shares back at 1.1x book value is something they feel very comfortable with. They want the stock to be very undervalued but they might be content buying shares at a price higher than 1.1x. They want shareholders to know they think the stock is undervalued. They have a wonderful group of business and some of them are worth far more than they are carried at. In fact, none of them are worth a discount to carrying value. They would love to buy billions of dollars of stock back at 1.1x book value. You never know if that will happen, but they could buy shares as long as they didn't fall below $20B in cash. He believes that the value per share goes up when they buy at 1.1x book value. That fact is so obvious to them that they would do it at a large scale.

Munger: Some people buy their stock back regardless of price. But that is not BRK's system.

Buffett: He thinks a lot of buybacks are stupid and are done for ego. He has been in board rooms when people have voted on buybacks. Those CEOs were never thinking the way BRK thinks. They like buying shares at high prices and issuing options at lower prices. He and Charlie want to increase the value of BRK's shares by doing buybacks. He hopes they have a chance to do it—as a financial guy—but as a fiduciary he hopes it never happens.

Question 6: Audience- What is your view on the European and US-based banks?

Buffett: He has very different views on the banks. US banks are in far better positions. They have taken most of the abnormal losses that were going to come about from the crisis 3-4 years ago. They have built capital and have liquidity coming out of their ears. The US banking system is in fine shape.

The EU banking system was gasping for air, which is why Mario Draghi opened up the ECB's wallet and came up with 1 trillion Euros. Incidentally, that amount represents about 1/6th of all the bank deposits in the US. It was designed to replace funding that was rolling off. The problem with the European banks is they relied more on wholesale funding. Most US banks such as Wells Fargo (WFC) and BAC have a stable deposit base. EU banks need more capital and many have not wanted to raise capital because they didn't like the price. They were losing their funding base but the ECB solved that for 3 years by lending money at 1%. Buffett would love to borrow money at 1% but he is not in trouble so he can't get it. He thinks what has happened in the US is remarkable. Overall the TARP policy was very sound for the country. Even though banks were forced to raise capital—even if they didn't want it—that action was great for the society. As a result, he thinks the Fed and Treasury have acted sensibly.

Munger: The EU has a lot of problems that we don't. They don't have a federal union and it makes it very difficult to handle these stresses.

Buffett: The difference between the two is night and day. When Bernanke and Paulson said that they would do whatever it took to stem the crisis, they had the power and the will to do whatever it took. That is hard to do when you have 17 countries that don't have their own currencies. As Henry Kissinger said, you never know what country to call if you want to call Europe. If the governors of 17 states had gone to D.C. to try to agree on how to quash the panic in money markets, we would have had a different outcome.

Question 7: AS- Can you describe your views on coal and natural gas as investments? How do the low costs of coal and natural gas impact BRK?

Buffett: MidAmerican will never really be hurt by or benefit from coal prices. It is a regulated utility and is basically a pass through organization. Clearly, it needs to be operated efficiently to achieve a good return. But, what happens to coal prices affects its customers more.

In terms of BNSF, coal traffic is important to all US railroads and traffic is down. In fact, the number of kilowatt hours used in the US went down 4.7% last year. That is a very large decrease and that affected the demand for coal. The other thing that is affecting coal is the price of gas being under $2. If you had told Warren and Charlie 5 years ago that there would be a 50x multiple between gas and oil they would have thought you were crazy.

Munger: We are using up a precious resource we need to use for the future. He thinks we should use up every ounce of coal before we use a drop of natural gas. He thinks the gas we have found is the most precious thing we could leave to our children. We should use the coal up first. It is crazy to use up gas at this price.

Buffett: You cannot change the percentage of energy used for coal versus gas that quickly but there has been some shift. In the future we will see less energy generated by coal. But, it won't be dramatic because it can't be—the megawatt numbers are just too huge.

Question 8: GR- Telematics is the new pricing tool in the auto insurance industry. What is GEICO doing in that arena?

Buffett: Progressive has been the leader in that space but they have not done that at GEICO. But, if they ever think there is a better way to evaluate accident probabilities they will look at it. There are 51 questions on the GEICO website that are used to assess the propensity for someone to get into an accident. He does not think this move to telematics is a big change but if it does make sense to take it on, they will.

They are always looking for more data that will tell them the likelihood of having an accident. We know that youth is factor. 16 year old males have more accidents than a guy like him who drives 3500 miles per year and isn't trying to impress a girl. He doesn't see anything in this new experiment that threatens GEICO though. In fact, the company added a large number of policies at GEICO in Q1 2012. The marketing is working well and the risk selection is working well. GEICO is quite a machine. BRK carries the business at $1B over TBV. But GEICO is worth a while lot more than it is carried at—probably $15B more.

Munger: I have nothing to add.

Question 9: Audience- How would they suggest we change the way leaders are taught and developed?

Buffett: Business schools have taught a lot of nonsense about investing.

Munger: What was taught was a big sin but he thinks business school educations are improving from a low base.

Buffett: When it comes to business education, he would say that the silliest stuff they have seen has been in the area around investing. It is astounding to him how the schools have focused on one fad after another in finance theory and the fads have usually been very math heavy. When an idea becomes popular it becomes hard to resist if a professor want to advance within a faculty. Going against the wisdom of elders can be a danger to peoples' career paths.

He would simply have one course on how value a business and one on how to look at markets. This would be far more valuable than option pricing and Modern Portfolio Theory. When Ray Crock started McDonald's (MCD), the option value of MCD's stock was not important to him. He needed to know how to make hamburgers and fries. He sometimes looks at the books that are used in business schools and there is nothing in them about valuing businesses, which is what investing is all about. If you know the difference between business you can and can't value, you can make money.

Munger: What is taught at these schools creeps into accounting as well. A long-term option on a stock or index should not be priced by Black-Scholes but the accounting profession decides to use that formula because the people in the industry don't want to think too hard.

Question 10: CL- Is the Buffett Rule as it is being discussed in the media different from what he actually had in mind?

Buffett: The idea has been used in different ways because it was more fun to attack things he didn't say than what actually he did say. People who make very large incomes should pay a rate that is commensurate to what people think those people pay. If you make $30M per year, people think you are paying a 30% rate. But, if you look at the most recent years and you aggregate the payroll and income data, you will see that the people with the 400 largest incomes in the US made $270M each, on average. Amazingly, 131 of those people paid rates below 15%. That amount is less than what the standard payroll tax was—15.3%—f or most of the last decade. Under the Buffett Rule there would be a minimum tax on high earners and the rate would be restored to what it used to be. There are still wealthy people paying in the 30% range, but if you are asking for shared sacrifice he would at least make sure that people with huge incomes got taxed at a rate similar to how they used to be taxed and how the other 2/3rds of people are being taxed. It would affect very few people and raise a lot of money.

Munger: Isn't there also a suggestion that people should be able to give 50% to charity and not to the government?

Buffett: In his mind if you want to give 50% to charity to avoid a high tax rate, it has to be all cash. But if you give securities you get are subject to a 20% rate. There was a bill in the Senate that only got 51 votes that got to that proposition. He just thinks that people like him who have large incomes shouldn't pay such low taxes (even though he doesn't even have a Swiss banks account). For example, even though his income was $20-$65M over the last few years, he came to have the lowest tax rate in the office—out of between 15 and 22 people. All of them were paying in the 30% range and he was in the 17% range. The tax law has been changed to favor the largest earners. In fact, there were 31 people within the top 400 earners who were paying below 10%. That means the cleaning lady at the office has been paying 15.3% on her Social Security taxes when people who make hundreds of millions are paying less than 15%. It is time to look at that discrepancy.

Question 11: CG- The world has seen a lot of catastrophes. Is there a trend towards more catastrophes? What do you expect the impact to be?

Buffett: The trend is hard to predict, based on the unpredictable nature of catastrophes. It is hard to see if there is a trend. It is hard to separate randomness from new trends. They tend to assume you can't really see a trend. So, if they see more earthquakes in a place than there used to be, they won't extrapolate that trend but they also won't look at the 100 year figures as much.

As a consequence of these views, they have written more business in Asia than they wrote a few years ago. There have been huge losses in Asia as the previous premium rates were obviously inadequate. In Asia, companies are looking for large amount of capacity to underwrite risks and BRK is there to do that. But they don't know if there is a trend toward more catastrophes. How much does past data tell you about the next 50 years? Last year, there were 2-3 quakes in New Zealand and just the 2nd one caused something like $12B in damage. If you think of that amount relative to a country with 4-5M people, it would be like 10 Katrinas in the US. When that happens, everyone re-evaluates and right now BRK is willing to take on large risks if they are getting the right price. They are even offering $10B of coverage at the right price. The market for the catastrophe business is better in certain parts of the world than it was 2 years ago. But that is not true everywhere.

Question 12: Audience- MidAmerican has a large investment in wind and solar power. Can you talk about subsidies and how important those are to MidAmerican?

Buffett: He believes when it comes to wind they receive a 2.2 cent subsidy per kilowatt hour for 10 full years. That makes wind projects work where they wouldn't work without it. The subsidy has encouraged a lot of wind development. He thinks if there had been no subsidy there would have been no wind projects built.

Recall that there are 2 solar projects that MidAmerican owns half of. In the case of solar, the projects they are involved with have a commitment from Pacific Gas and Energy—a long term commitment. He doesn't know much about the subsidy they get. But, neither wind nor solar projects would be working without the subsidy. Remember, you can't count on wind for the base load. It works and it is clean but if the wind isn't blowing, people don't want to risk having their lights go off. As such, it is only a supplementary type of generation.

Munger: Eventually we are going to have to take power from renewable sources. It is wise to use subsidies to get that started.

Buffett: The future is subsidizing oil and natural gas in some sense.

Greg Able of MidAmerican: Just to touch on wind and solar, Warren is right. The subsidy has allowed MidAmerican to build 3000 MW of capacity and they would not have moved forward without the subsidy. In solar, you get a large incentive—30% of the cost—for construction. Additionally, there is a huge advantage there for BRK since it is a full tax payer while some competitors don't have the same tax appetite.

Buffett: People don't understand that BRK has a distinct competitive advantage in that BRK pays lots of income tax. As such, when there are programs that involve tax credits they can use them. They get a $1 for $1 benefit. He would guess 80% of utilities in the in US cannot reap the full or any benefits from doing those things because they do not pay income taxes. BRK uses the bonus depreciation to wipe out taxable income. Thus, BRK can have the appetite for wind projects where they get a credit. By being part of BRK, MidAmerican has an extra ability to do projects without worrying about tax capacity.

Question 13: BQ- Some shareholders are concerned that the recent publicity around the Buffett Rule may be limiting the interest in the stock. Should Buffett's public involvement be more limited?

Buffett: He does not think that any employee at BRK or any of the CEOs who run the companies BRK owns have had their citizenship restricted. When he and Charlie started this business, they decided to put their citizenship in a blind trust. He does not know the politics of some of the other major CEOs of BRK companies. He doesn't know their politics or religions. All he cares about is how they run their businesses. If a man invests in a company based on whether or he agrees with management team's politics, it sounds like he ought to own Fox.

Munger: Warren's views have led to a diminution of Charlie's popularity at the country clubs. He is ok with it though.

Buffett: He and Charlie have not had an argument in 50+ years. Roughly half of the country is going to feel one way in November and half the people will think the other way.

Question 14: JG- Would you consider a $20B+ acquisition? How would it be funded?

Buffett: They considered a $22B deal recently that they would have liked to do. They will not use stock anymore after the BNSF acquisition. Above $20B, a deal gets tough. They would not use stock now, likely even to fund 30-40% of a deal. He just does not think that will happen. They looked at a $23B deal and they would have done it if they could have made the deal. They would not have pushed it to a point where cash fell below $20B though. They would have needed to sell securities that they usually don't want to sell but he would have done it in this case.

However, if it had been a $40B deal, he would not have sold $25B in marketable securities to get it done. He would not want to be in limbo and then suffer a shock in a market where he wouldn't know where the money would come from. In general, money builds up month by month and he would make the right $20B deal. But, next year that number might be $30B.

Question 15: Audience- There are reports that jobs are coming back to the US as companies that have outsourced jobs are hiring in the US again. Could BRK do that?

Buffett: Of the 270K employees they have, probably only about 15K work outside of the US. Last year they invested over $8B in plant and equipment and 95% of that was invested in the US. The Iscar operation operates throughout the world, for example in Japan, Korea, and India. The US is an important market but it does not represent a majority of Iscar's revenue. That company has 11K employees but only a few of them are going to be located in the US. In reality, he would rather Iscar do business in Korea and Japan.

BRK also has a utility business in the UK and they bought a business in Australia. They also bought an operation based in the Netherlands just the other day. But, he thinks that 10 years from now most of the BRK employees will work in the US. There is no shortage of opportunity in the US. They loved putting out $8B+ last year and would love to put out more this year.

Munger: You can't bring a lot back if it never left.

Buffett: That's the long version of my answer.

Question 16: AS- How are you feeling?

Buffett: I feel terrific and I always feel terrific. He loves what he does and he loves the people he works with. He has more fun every day. He has a good immune system. His diet is such—well, people can see that he is eating properly (alluding to the See's candy on the table in front of him). Whatever it is, it works. He has 4 doctors, a few of whom own the stock. He has listened to the doctors' recommendations and none of them has suggested that he go to the hospital or take a day off. Maybe he will be shot by a jealous husband but he doesn't think the cancer is a major threat.

Munger: Said he resents all the sympathy Warren is getting. He probably has more prostate cancer than Warren does. He doesn't know because he won't let them test for it. So, he wants the sympathy Warren gets.

Buffett: Charlie's not kidding! In reality, Warren's secretary Debbie was getting too much attention so he decided to put the spotlight back on him. It is a non-event. He may have less energy but that might actually stop him from doing stupid things.

Question 17: GR-Would they look at buying an annuity business or writing more annuities?

Buffett: They would accept annuities but they will not assume a rate much higher than the risk free rate. They want to get money at attractive rates of return. They would think about doing annuities and they have done some in the UK. But, he would rather write P&C insurance policies.

Question 18: Audience- If Warren had a chance to start over, what would he be looking at and what would he do differently?

Buffett: He thinks he would have a lot of opportunities. He would do things the same way but do it a little better. He would try to aggregate money a little faster. He would try to get an audited record as fast as possible and try to raise money quickly. Then he would get into the buying to keep business. This is different from private equity firms that buy to sell. He wants to buy to keep but it takes a lot of capital to get into that business. In his early career, he built capital through managing money for other people. In hindsight, he would get through managing money for others as fast as possible. Then he would get to buying whole businesses as fast as possible. Of course we would do all of that with Charlie.

Munger: I have nothing to add to that either.

Question 19: CL-A shareholder wants to know why the stock trades at what looks like a pretty cheap level.

Buffett: There have been 4-5 times when the stock was really undervalued. They have seen the price get cut in half at least 4 times and in a really short time frame. If you run a business you will see that business both over- and under-valued. Tom Murphy ran one of the most successful businesses ever and at one point the stock was selling 1/3rd of what the properties were worth.

In 2001, Buffett said the stock was undervalued and that he would buy shares. He never got to buy shares but stocks do sometimes get crazy and Mr. Market gives you opportunities. Mr. Market will do weird things over time and you have to remember that he is there to serve you, not to advise you. All you need to know is contained in chapters 8 and 20 of Ben Graham's *The Intelligent Investor*. It is built into the system that stocks get mispriced.

Generally speaking he thinks BRK's stock has traded closer to intrinsic (over 47 years) than that of most companies. If you look at the high-low range versus that of 100 stocks you would see less fluctuation than with most. This is a good sign. In the next 20 years BRK will be both over- and under-valued. This will be true for WFC, IBM and Coca Cola (KO).

The important thing is that you make a buy decision based on what the business is worth. Stick with businesses that you think you can value and you will make money in stocks. The market is a very obliging place because you don't have to do anything. Prices change every day and you don't have to do anything. That is not true of farms—people don't price their farms each day. Investing in public markets is a great game and the rules are stacked in your favor if you don't act like a drunken psychotic.

Munger: He thinks they have had a lot more fun and have gotten rich enough to buy stocks that they could hold. The faster you get into their position, the better off you are going to be.

Question 20: CG- Have systemic risk fears ever caused them to be afraid to buy stocks?

Buffett: Charlie and Warren in 53 years have never had a discussion about buying or selling in which they talked about macro affairs. If they find a business they like and can understand, they buy it. It doesn't matter what the Fed is doing or what is going on in Europe. There is always going to be bad news. He bought his first stock in June of 1942 when the US was losing the war. Stocks were also cheap and he wrote that article that said so in October of 2008. He knew that the panic would flow into the economy but that the US would not go away. They look at value and not the macro.

Munger: They did keep liquid reserves just in case things got worse though.

Buffett: Yes, they did not want to go broke. They kept liquid reserves. You can't go bankrupt if you have liquid reserves. Charlie has a company called the Daily Journal Corporation (DJCO) and in 2009 he went out and bought stocks. That was the time to use the money.

Question 21: Audience- What businesses have gotten better and which have gotten worse over the last 5 years?

Buffett: The big ones have done well. There is no question that BNSF has improved dramatically over the last 15-20 years. This trend continues to this day and he really should have figured this out earlier. Railroads are an extremely efficient and environmentally friendly way to move things. The infrastructure could not be duplicated for 3-6x what it cost them to buy it. Also, GEICO is a much better business than it was 10 years ago. It is approaching 10% market share now versus 2% in 1995. Tony Nicely maximized what was there to be done. GEICO is worth billions more than what they bought it for. He thinks that BNSF and MidAmerican are worth billions more than they were worth when they were bought as well. The same is true for Iscar—that business just does not stop. He sure wouldn't want to compete with Iscar.

Munger: At least 80% of their businesses add to their values each year.

Buffett: The mistakes were made in purchasing—when he misjudged the competitive position of a company. It was either due to having too much money or too much Cherry Coke. It was not the management teams' faults. The big deals have worked out—even General Re. Ajit Jain has created something from nothing and now it is worth billions of dollars. All he had was brains, energy and character and he has created a business like no one has ever seen.

Munger: They have been fortunate and the success will not go away because Warren happens to die.

Question 22: BQ- Who will manage the derivatives book when Warren is gone?

Buffett: He doesn't think there will be much of a derivatives book when he is gone. There will be some derivatives in the utility businesses—they are basically required to hedge by the regulators. BRK companies also engage in swaps and a number of activities. The railroad formerly hedged diesel fuel and it may do that again in the future. Lastly, some operating business will have minor positions.

However, he thinks it is unlikely that the people who follow him—there will be at least 2 with Todd Combs and Ted Weschler—will do anything in derivatives. He won't restrict them but it will never be a big factor. He thinks they will do well with the derivative positions they have. They have done well with the ones they have expired. Now, he does not like the new rules for collateralizing of derivative positions. He and Charlie always think about the worst case all of the time. They are never going to expose themselves to a worse case and collateralization means you could have to come up with cash tomorrow morning.

Munger: The derivatives they have on the books are not normal contracts. They got better terms so he thinks they will make at least $10B on them and be lucky they did them.

Question 23: JG- How should we think about valuing the operating businesses, the insurance companies and the float?

Buffett: First off, he would value GEICO differently than he would value General Re. Basically, GEICO has an intrinsic value that is much greater than the sum of its net worth and float. But, that it not true of all of their businesses. With GEICO, it is rational to assume a large underwriting profit and that it will grow. This adds to the present float value. He cannot say that about all of the other businesses.

Different operating businesses have different characteristics. He would love to buy operating businesses that have similar characteristics at 9-10x pre-tax earnings. In fact, if the target had similar characteristics to some of BRK's current operating businesses, he might pay more.

Munger: When the questioner used the word EBITDA, he was unhappy to hear the word. There is a lot of nonsense surrounding EBITDA: earnings before everything that matters.

Buffett: EBITDA works for people who want to sell businesses but EBITDA is ridiculous.

Question 24: Audience- Since 1999, the stock has not gone up much while gold has gone up. What happened?

Buffett: Well, when they took over Berkshire Hathaway gold was $20 an ounce and BRK was $15. Now gold is at $1600 and BRK is over $120K. So, the return depends on your time period. The one thing he would bet his life on is that, over time, BRK will do better than gold; as will farmland and common stocks. If you own an ounce of gold now you will still own only an ounce in 100 years. But, if you own farmland, in 100 years you will still have the land but also will have benefitted from all the earnings made from the land. It is hard for unproductive assets to beat productive assets over long periods.

He can say bad things about US Treasury bonds and Bernanke just smiles at him. But, when he says bad things about gold, it gets people riled up. This means that people have an emotional attachment to gold he never understood. He even came from a family where his dad loved gold.

Munger: He has never wanted to own gold. He loves working with businesses and he sure would not want to have to work with gold bugs.

Question 25: AS- After hearing that Buffett bought shares of JP Morgan (JPM), a shareholder wanted to know how Buffett makes different share purchases for his account versus for BRK.

Buffett: He likes WFC more than JPM. But, since BRK buys WFC, he can't buy WFC. So, he bought JPM as a second choice. Without any question, his best ideas are all held by BRK.

Munger: Basically, diversification is not something he has any interest in, aside from the diversification within BRK. He likes to buy and hold business and thinks it has worked well over time. So, we should not care about Warren's personal investments. If that is the worst problem this questioner has in his life, he has a great life.

Buffett: He likes JPM fine but he knows WFC better and thinks it is easier to understand. BRK bought WFC last quarter, last year and during a lot of years. Even if he wasn't managing BRK he would have money with WFC and JPM too.

Question 26: GR- The whole BRK organization chart is challenging and has a lot of pieces. Are there any parts that provide a hindrance to making use of capital in the best way?

Buffett: Well, money held in their life insurance companies has less utility. He would rather have it in the P&C businesses but he has to hold some due to life company restrictions. Unfortunately, that money cannot be used as effectively and thus doing so is a disadvantage. The best place to have money is in the holding company and they have $10B now. That gives them the ultimate flexibility and also most of the operating businesses keep more than cash they need. As a company, he wants to have $20B around so he will not lose sleep. It is probably more than they need but it allows them to be aggressive and be more comfortable.

Having the railroad in National Indemnity is certainly not a disadvantage. They thought the rating agencies would like the idea of having a cash-generating operating business tied to National Indemnity. So, there is a fair amount of logic to where things are placed. If they were going to make a big acquisition it might lead to having to move some pieces around. Of course, he would like to find a big acquisition to make.

Munger: The casualty business has a ton of capital when you include the earnings power of BNSF. This is a combination that is better for policyholders and puts the casualty businesses in a unique position.

Buffett: BNSF is a business that has nothing to do with insurance and that can make $5B in profit. It is like having a royalty stream. No one else has something like that. The agencies and the regulators wouldn't let them have a structure like that if BRK was not so strong.

Question 27: Audience-Wouldn't a dividend help the stock go up and get it closer to intrinsic value?

Buffett: They would prefer the stock to trade at intrinsic value if it could. If it did and they could use stock to buy part or all of something else, they would like that situation. That is likely to occur at some point in the future. Over the last 35 years, without paying a dividend the stock has traded at or above intrinsic value at times and has traded below intrinsic value as well. He doesn't think a dividend would help it trade above intrinsic value.

They are willing to pay 110% of book value to buy back stock. Their goal is to have the stock trade as close to intrinsic value as it can. But markets operate in a way that causes the stock to bob up and down. Thus, they try to point out what they think is going on. When it trades at intrinsic value or higher they would consider using stock for acquisitions but they would rather use cash. They hate giving out shares—they don't want to trade shares of GEICO or BNSF because of acquisition ambitions.

Munger: What the questioner suggested was a conventional approach to investing and he believes that what they are doing is better approach.

Buffett: Buffett is giving away stock each year and those gifts will do more for charity if the stock trades at a higher price. So, he receives a lot to benefit if the stock is higher. He would rather it buy more vaccines than fewer. On the other hand, he does not want the stock to sell cheaply and they will buy it if it does. If they perform well, tell the truth and explain the situation to shareholders, over time it will average out. But, if people get excited enough about internet stocks they will forget about BRK temporarily. There are times when people have been depressed and excited about BRK.

Question 28: CL- With all of the new options in social media and the impact the internet has had on newspapers, why would BRK buy the Omaha World Herald? Was that a form of self-indulgence?

Buffett: Everything negative people say about the newspapers business is true. They have 3 problems—2 of which are difficult to overcome and the third is so severe that if they don't overcome it, they will have major problems. News is what you don't know but want to know. If you go back 50 years the paper contained dozens of areas of interest that weren't available anywhere else. If you needed a job or an apartment rental, you went to newspapers. Now these things can be found on other venues and the information is available on a more timely and free basis. To survive, newspapers need to be timely and create content of interest.

There are so many areas where newspapers were the primary source but aren't anymore. Stock prices are a good example. Clearly, they have lost primacy in important areas. They are still primary in a great many areas though. The World Herald tells him a lot of things he wants to know that he can't get in other places. Most of those items are local items—it is not going to tell him about the war in Afghanistan. He has to get that somewhere else. He learns about the city and the local sports that he wants to know about.

As long as newspapers stay primary in some areas, they remain interesting. But they are expensive to distribute. Also, in a great many cases content is given away free on the web at the same time people are being charged for delivery. There are very few businesses that can successfully charge for one version and give another away free. That business model just does not work.

Accordingly, many newspapers have been trying to get people to pay for content on the web. There is a future for newspapers that exist in an area where there is sense of community and where people care about schools and what is going on in their geographic area. The model is not as bulletproof as it was before. But, if you don't give the product away and generate content that people are interested in—for example, you can't get obituaries on the internet—then newspapers can survive.

They own a paper in Buffalo where there is a strong sense of community. Obviously, it has to develop an internet presence that people will pay for. They may buy more newspapers and they like the economics based on the prices they have paid. They own papers in towns where people have strong local interests.

Munger: They own an encyclopedia business that has been destroyed by Bill Gates. They still make money by selling encyclopedias but not as much as they used to. Similarly, newspapers will not occupy the same space they used to.

Buffett: They will do more in newspapers in places where people care about their communities. When people have strong ties to a specific region, they care about things that can't be found on the net. They believe that people will pay for newspapers and advertisers will pay to access those people.

Question 29: CG-Are there other BRK businesses that could be really impacted by technological change? What about Amazon's impact?

Buffett: Amazon is a tough one. It could affect a lot of businesses that aren't expecting it. As such, he thinks it could affect some of BRK's retailing operations. But it won't affect the Nebraska Furniture Mart, which did over

$6M of business just this past Tuesday. Those are huge volumes. That business will expand to Dallas in a few years and will have a store that will break all records.

GECIO was affected by the net and at first they missed it. GEICO was mail-based originally in the 1930s-40s and then it moved to TV. Then the net came along and he thought only young people would look for quotes online. That was when Warren was still using a rotary phone. Things change fast and if the consumers find something they like to do better, BRK will have to move to it. People love Amazon and it has millions of happy customers. It will be a powerhouse and it could affect a lot of business.

Munger: He thinks Amazon is almost sure to affect a lot of businesses. Anything that can be bought on a computer or an iPad will be affected. He won't be buying on Amazon. But he thinks it will hugely affect a lot of people. He thinks it is REALLY terrible for a lot of retailers.

Question 30: Audience-Question was about BRK's unique model and the free float.

Munger: BRK has a very peculiar model and it works for them.

Buffett: It has taken a long time to build what they have and the consistency has come from Warren and Charlie being controlling shareholders. They have not had to listen to Wall Street. This is very hard to do for most US companies. This is hard to do when managers come and go and have small share holdings. It took a long time to get to the point to where people with large private businesses would be willing to sell to BRK first. Now, if these sellers think of BRK first they don't think of anyone second. BRK does not do well buying businesses at auctions. They did buy a Dutch company recently at an auction. That will happen with small deals but large deals will not come together that way.

Munger: If Warren went back to being 30 years of age again it would be hard for even him to replicate what they have done. BRK is that unique.

Question 31: BQ- What goes into their thinking on how they vote BRK's shares in their owned companies?

Buffett: They have almost never voted against management but there have been a couple of examples, especially when stock option expensing was on the ballot. The general feeling is that they are a large shareholder of companies they like. The leaders of these companies may not subscribe to Buffett's view but he and Charlie are OK with that. They like them even though they don't think the same way. This does not rule out them owning a big share of the business. They are not trying to change people when they buy a business. They accept people the way they come. They don't expect everyone to be clones of the two of them. If they were to see a dumb merger or an egregious stock option plan they would vote against it. But, they wouldn't start a campaign against it and the measure would probably pass anyway. They have seen some dumb deals approved.

Munger: I think you have said it all.

Question 32: JG—Would they want to expand their commercial insurance operations if they had the chance?

Buffett: They could expand by buying a great company. They had a chance to get into medical malpractice when they bought a division from GE. In that case, they had a chance to get in with a first class manager and they jumped on it. It is hard to think of very many companies they would get excited about buying. There might be a couple though. They love the businesses they have. If they could find a quality company in commercial lines with good management they would buy it in an instant.

Question 33: Audience- Has the buyback announcement (at 1.1x book value or below) essentially put a ceiling and a floor on the stock? Would they be more flexible?

Buffett: He does not think the announcement puts a ceiling on the stock. Also, it does not put a floor on it as floors disappear when things get chaotic. There are circumstances in which they would buy a lot of stock but they are unlikely. If the stock were at 1.15x book value, they wouldn't buy that much stock, even though that is not a high price. He doesn't think there is a ceiling though. If he thought they would buy a lot more stock at a higher price he would adjust the multiple up.

Munger: He has nothing to add to that either.

Question 34: AS- Has their opinion of Wal-Mart (WMT) changed since the recent allegations about the Mexican division were released?

Buffett: If you read the New York Times story it looks like WMT mishandled the Mexico issue. It may lead to a large fine. He doesn't think it changes the fundamental dynamic of the company though. WMT operates on low gross margins and low prices and that works in retailing. Dealing with the legal issues is a huge diversion of time for the management but he doesn't think it will change the earnings power of WMT.

Munger: These are interesting issues but we have to remember that BRK could have some slippage somewhere, given how many employees they have. When you are as big as WMT you will have a glitch. He doesn't think there is something wrong there.

Buffett: When you are as big as BRK, you are going to have glitch somewhere as well. He guarantees that there are at least 20 people at BRK doing something wrong. People don't always get the message and Warren and Charlie are layers removed from their employees. It is a real worry. What you worry about is that the wrong doing is material and that you are not doing enough about it. Nothing stops the fact that someone right now is doing something wrong at BRK. He tries to convey to managers that they need to act on any bad news. He is sympathetic to people running hundreds of thousands of people.

Comments Prior to Lunch

Buffett: He made a million dollar bet with some hedge fund managers at Protégé Partners about which would win over a 10 year period—an index that tracks hedge funds or one that tracks the S&P 500. The S&P is slightly behind the hedge funds right now. Ironically, they bought a zero coupon bond to make sure the money $1M would be there at the end of the period and that zero coupon bond would have been the best performer. So, people should have ignored both the funds and the S&P and bought the zero coupon bond.

Question 35: GR- In terms of General RE, will you talk about the personnel adjustments that were necessary and will you talk about its room to grow?

Buffett: General Re was off the track when they bought it. The people there got more concerned with growth than they were with profitability. It took BRK a while to figure that out. But, when Joe Brandon came in he focused 100% on profits instead of premium volume. Tad Montross followed up on that and it required General Re to get a rid of a lot of business. The life business kept growing during that period while the P&C business shrank. But they will not miss the business they lost.

General Re is right-sized in terms of people and now has the right underwriting culture. That change doesn't happen overnight and it requires you to lose business. He thinks it is a great business that will grow, but only if it can do so properly.

Munger: It was a major fix up but they got it done.

Buffett: By the way, we don't go looking for those.

Question 36: Audience—Questioner has 2 concerns about the post Buffett BRK. Will its great people leave and will a large investor acquire enough of a stake to try to force a change?

Buffett: The successor they have in mind will not turn off BRK's managers. This successor really has the culture deeply embedded. People would probably not leave for more lucrative jobs but if the culture at BRK no longer existed, it is possible they could leave. Many could retire—they do not need to work at all. They only work because they love it. They work for the same reason Buffett works—he has fun and gets to paint his own painting. Managers get to paint their own paintings as well. There are a lot of people who manage other companies who would lose managers if they were in his position.

A takeover would be very hard given the size and the share structure. Even 10 years from now either Buffett or his estate will probably still own 20% of the company. So, the Buffett family will have 10x the voting power of anyone else. Also, the longer BRK operates, the larger it will get and the size will be more of an inhibitor.

We don't need to worry about Buffett's successor though. He will be even better than Buffett in many ways and will be completely in tune with the culture.

Munger: The first $200B was hard (referencing the market cap). The second $200B—with the current momentum in place—will be comparatively easier. He does not think anything will make people leave. The culture is loved by the people in it and no one wants to change it. The people who sold to Buffett and BRK will continue to do so no matter who is in charge.

Buffett: They have the businesses to take the market cap to $400B.

Question 37: CL- What about capital intensive businesses allows them to get comfortable buying one?

Buffett: Cash consuming business are unattractive unless they earn a certain return. In the electric utility business, if they can earn 12% they are OK with that. They will invest a lot of capital in the railroad and the prospect of earning reasonable returns will be good. They do not have any capital consuming businesses that earn poor returns. However, if you go back to a world where they thought they could earn 20% on equity, there are very few businesses that could earn 20% if they are capital consuming. But, BRK's size means they will not earn a 20% ROE and they will be happy with 12%.

Munger: I think it is all going to work pretty well.

Question 38: CG- Regarding the float, Buffett suggested in the annual report that the float will stop growing. But could it actually shrink?

Buffett: It could shrink due to the nature of some retroactive contracts. The float of GEICO and the smaller companies will grow. In Ajit's operation there is a lot of stuff that runs off. Remember though, when the float was $40B he was concerned that the float would not grow and it is now at $70B. The desire to grow the float is there and they have been imaginative about it. The numbers are huge but there is a natural runoff. So, he thought it was fair to tell shareholders not to expect a lot of growth. It is possible that the float will shrink or grow slowly.

Ajit took what was written in the annual report about the float as a challenge to him. He wants to make Warren look like an idiot. But, if he had to bet on where the float is 5 years from now, he would bet it will be only slightly higher.

Munger: In general, the casualty business is not a great business and you have to be in the top 10% to be good. He thinks they have the best casualty business in the world. Just because it came from nothing, doesn't mean it is nothing. It doesn't have to grow wildly. Ajit and Tony Nicely have done a great job in helping the float grow.

Question 39: Audience- How do you value declining businesses such as the encyclopedia businesses?

Buffett: Generally it pays to stay away from declining businesses. If you really think a business is declining, most of the time you should stay away. The newspaper business is a declining business. They will pay a price to be in that business but it will not be where they make the big money. He will not spend a lot of time to value a declining business just to get one last puff on that cigar. The same amount of energy and intelligence brought to other businesses will work out better.

We need to remember that they started with US-made shoes and textiles in New England as well as a trading stamp company. So, they are specialists in declining businesses. They have a business that did millions in revenue in the 1960s and did only $20K this year. Luckily, Charlie is still in charge of this business. He can't get Charlie to sell it. They were masochistic and ignorant in those days.

In 1966 Charlie, Warren and Sandy Gottesman bought a department store. There were 4 stores on that corner. They are all gone now. That $6M has turned into about $30B—all of that stemming from a failed business. Blue Chip stamps and Berkshire have had similar results.

Munger: Declining businesses are not worth nearly as much as growing businesses but they can be worth a lot if they are throwing off cash. So, many billions can come out of those declining businesses. Clearly, they are not looking to do it again.

Question 40: BQ—Can you give us some advice on the kinds of assets we stay away from in the investment world?

Buffett: He thinks that we should stay away from things that we don't understand. This includes situations in which we understand the business but we don't have a reasonable fix on the earnings power or what the competitive position will look like in 5-10 years. Buffett always wants to know where the industry will stand. Beyond that, if the price is crazy, that eliminates another whole group of potential investments. Next, with all of the money they are running, company size also eliminates other investments. Finally, they haven't bought a new issue in the last 30 years. The idea that a new issue is going to be the cheapest thing to buy is crazy.

Munger: Especially when it carries a 7% commission.

Buffett: If you have opportunities to buy things that are not coming to market precisely when the seller wants to sell, you are going to do much better. It doesn't make sense to spend 5 seconds on new issues.

In general, things need to get through a number of filters before they will look at them. People often call them and pitch ideas and they politely say that they have no interest. They really don't have to do many things that work. In investing, you don't have to be able to spell 500 words in a row to win the spelling be. You just need to have some investments that do really well and don't turn into huge disasters.

Munger: There are a few rules of thumb: if you receive material that includes a large commission, don't read it. As a place to look, trying to find things that other people are not buying is as good a place to start as any.

Question 41: JG- What are the implications if BRK were to become subject to the Investment Act of 1940?

Munger: The chances of that are very remote. It is not going to happen.

Buffett: He sees no way that they come close to that status (being considered an investment company). But they have steered clear in any case. They own 8 companies that would be part of the Fortune 500 if they were stand alone companies. They also have 275K employees.

Munger: They need the financial heft they have to make the business work. They are certainly not an investment company.

Question 42: Audience- How long do you think it will take China to create great companies like those in the US?

Munger: China has great companies but there aren't many great branded companies there. He can't pronounce the names but there are great companies.

Buffett: So far it has not been Chinese fast food companies coming to the US. The US tends to export certain businesses well, such as fast food.

Question 43: AS- Are there entrenched leaders in technology that are inevitable? What about Google and Apple, for example?

Buffett: Those are extraordinary companies: Apple and Google. They are huge, make money and achieve high returns on capital. They look tough to dislodge. He would not be surprised to see them worth a lot more 10 years from now but he will not buy either. He would not short them though.

Munger: They know that other people will understand those companies better than they do. They have the reverse of an edge.

Munger: How are those companies different from IBM?

Buffett: The chances of being way wrong in IBM are way lower. They think they understand IBM better but that doesn't mean Google and Apple will not do better than IBM. It will be hard to know how successful Apple will be over the next 10 years. There are a lot of people trying to compete with them.

Question 44: GR- Can you talk about coal plant shut downs and other political issue facing BNSF?

Buffett: BNSF runs its own business. There is no question that railroads, utilities and insurance companies are affected by the political process. In terms of the railroad industry, BRK has economics on its side and economics usually win out. Railroads are much more efficient than trucking and that is why railroads move 42% of intercity freight. They have a wonderful product and there will always be struggles between the competitors and customers of railroads.

Overall they like their position. All 4 railroads have to be involved in the political process as their customers and competitors will inevitably be involved. It appears that there will always be lobbyists and everyone will be forced to play a political game. He likes their position though because it would be dumb for the country to discourage railroad spending, given the transportation needs of the country. If you think of the congestion and emission problems the country has, we all have a strong interest in the railroad industry continuing to invest. They will spend $3.9B this year and a lot of that will go to improve the present system and some will go toward expansion. The government will not have to write a check and the country will be better off.

Munger: In the past, BNSF was helped by being able to double the container capacity as bridges were made stronger and when oil was found in North Dakota. Those were lucky breaks. There will be bad breaks as well but overall it is a great business with good management

Buffett: The railroad industry, after World War 2, had as many as 1.7M employees. Now there are less than 200K as railroads have become so much more efficient. They are fundamentally a very good way to move heavy stuff a long distance. It is nice to have barge traffic but there are only a few rivers that can handle large barge volumes. Trains are pretty darn good.

Question 45: CL- A shareholder made the statement that the chart that BRK includes in its filings that compares the S&P's return to the book value of BRK is unfair since the market price of the BRK's shares does not track book value perfectly. How would Warren respond to that?

Buffett: You can make the calculation differently as well. You could look at BRK's market value versus that of the S&P. In that scenario BRK would still perform better even though it would bounce around more. The gain would be about 35% higher in aggregate over the time period as compared to the book value gain. You could also show the book value of the S&P versus the book value of BRK but that relative outperformance would be a wash with the previous metric. So, they could show calculations that are more favorable to BRK but there aren't any calculations that make it look worse.

Munger: Over the long-term, the stock returns have tracked book value growth. But the stock has outperformed slightly over time.

Question 46: CG- In terms of risk management, how do you share info across insurance units?

Munger: If there is any sharing, the heads of the insurance units are doing it; not Warren and Charlie.

Buffett: He and Charlie are just about as uncoordinated as any managers you will ever meet. There is nothing in the way of an organized way of sharing information. Tad Montross, Tony Nicely and Ajit Jain are friends and see each other sometimes. But, they don't make an attempt to compare and there is no system that enables coordination. Warren and Charlie want the businesses to run autonomously and want the managers to feel they have freedom. They don't tell people at Clayton to buy carpets from Shaw. Any gains they would receive by doing that would be offset by the negative feelings of the mangers.

When they buy companies, they hand people billions of dollars and in return BRK receives the stock certificates. They want people to act the same way the next day after they have received those billions. They don't want to change anyone.

Munger: The irony is that they are intentionally trying to fail at what the questioner wants them to succeed at.

Question 47: Audience- Would a well run forest products firm fit with BRK, given the potential synergies between the segments?

Buffett: The question touches on the last answer. They don't look at the synergies between the businesses to decide whether they would buy a new business. They have looked at several businesses in the forest product industry but they have never found any that met the hurdle rate for returns. It is an easy busy to understand but the math has escaped them.

Munger: Additionally, a lot of forest products companies convert themselves into flow-through partnerships to avoid taxes. Thus, BRK would be at a tax disadvantage owning a forest company.

Question 48: BQ- Could you talk about their views on risk? Why is $20B in cash the magic number?

Buffett: There is no magic number. He would worry if someone walked in every morning and calculated how much cash they needed. They don't like companies that express their risk in terms of sigmas. Warren and Charlie are both of the same mind in that they think of the worse case and then they add in a big margin of safety. He enjoyed tossing papers but he doesn't want to do it for a living again. They build in layers of safety that others think of as foolish. But they have a lot of shareholders and they don't want to go broke because they took a remote chance. They are never going to risk what they have and need for what they don't have and don't need.

Further, they don't need to stretch to make money. It is their job to figure out what can go really wrong. They went through 9/11 and September 2008 and they expect to see more periods like those. They want to sleep well at night and have excess money for new opportunities. Some really great organizations have dozens of people with great mathematical training but they can't get at the true problem. At BRK, risk is top of mind all the time and, accordingly, their returns 99 out of 100 years will be less than they would otherwise have been. But they will survive that 1 year when no one else does.

He also thinks that people don't have a sense of financial history. In 1901 the Northern Pacific Corner occurred. Both guys tried to buy controlling stakes in the company and each bought more than 50% of the stock. What you can read in the newspaper from May of 1901 is the rest of the market was collapsing because the shorts got crushed. A brewer in New York committed suicide by diving into a hot vat of beer because he got a margin call. Warren never wanted to end up in a vat of beer. Life in financial markets has nothing to do with sigmas and standard errors.

Munger: To a man with a hammer, everything looks like a nail. In other words, people twist the problem based on the desired solution. These mathematical techniques have created a lot of false confidence. Now, even people on Wall Street have thrown away the Gaussian curve but have only shifted the curve. In reality they don't know what curve is right. They know about fat tails but they don't know how to quantify them.

Question 49: JG- Does BRK plan to replace Swiss Re premium volume that runs off in 2012?

Buffett: What they do will have nothing to do with the expiration. They won't do anything to "fill" those billions. They would love to write new business but they are not going to write dumb business. It is a non-event in terms of future strategy. They regard every decision as independent. He believes that some opportunities will come along that will be terrific.

Munger: There is not an insurance company in the world that enjoys losing volume as much as they do. They are happy to lose bad business.

Buffett: They don't measure themselves on size.

Question 50: Audience-What about the housing market, especially relating to Fannie Mae (FNM) and Freddie Mac (FRE)? Have they become too big? How many years can they stay in conservatorship?

Buffett: He would say that FRE and FNM are a mess because we haven't figured out yet what the best structure—going forward—to generally finance mortgages. There is no question that a government guarantee program lowers the cost of financing mortgages. These institutions were half trying to serve a housing mission and half adhering to a profit mission. Eventually the profit mission won out. This is a huge problem that Congress has not yet figured out. It is important that you have a market that minimizes costs for the right borrowers. They will stay in conservatorship until we get a resolution that both parties can go along with. It is going to be a long runoff. Just about everyone did their share in making this mess, except for Berkshire of course.

Munger: The interesting thing is that Canada kept a more responsible system and had almost no problems. We departed from soundness and morality and the government was a part of this. It was wrong not to step on a boom that was full of fraud and folly. Apparently, Alan Greenspan overdosed on Ayn Rand when he was young. There is a lot of bad behavior we have to regret. It has caused a lot of damage by allowing craziness to go unchecked. It is the duty of the government to step on crazy booms. The questioner put her finger on a disgraceful episode in US history. But we had no choice but to nationalize FRE and FNM.

Question 51: AS- Tell us more about the experience with Todd Combs and Ted Weschler this year. How are they compensated?

Buffett: In terms of Todd and Ted, he has been more concerned with how their records were achieved than the records themselves. He and Charlie care about integrity and the quality of character. They were looking for a lifelong commitment to BRK. They have seen hundreds of great records but few people they actually wanted to work with. Todd and Ted get a few million dollars in salary and then get 10% of how much they beat the S&P by. This is measured on a rolling, 3 year basis. Also, they get paid 80% based their own success and 20% on the success of the other. So, they have the incentive to work together. If they employ people underneath them it comes out of their performance record.

This structure has worked better than they had ever hoped. Each person had $1.75B at year end and now each has an extra $1B more to manage. He doesn't look at what they do because they operate through their own brokers. He has told them that he only wants to know if they are getting into a new name so he can make sure he has no inside information on it. They operate in different stocks and have a much larger stock universe than Warren has. They can look at a lot more things. They have also pitched in for other duties that they don't get compensated for. They will do a great job.

Munger: At least 90% of the investment management business would starve to death on that formula but he thinks these two guys will do well over the long run. He thinks they will be great for BRK. They could earn more money elsewhere but they wouldn't enjoy the same lifestyle.

Buffett: They are doing what they did before but now they are getting taxed at 35% as opposed to the 15% rate they were subject to when they were running hedge funds.

Question 52: GR- The GEICO combined ratio went over 100% in a recent quarter. What is going on there?

Buffet: The issue involved Florida and some interpretation of PIP rules that had to do with setting up one time higher reserves. In Q1 of this this year the combined ratio was only 91%. The basic business was good but a poor decision in Florida cost them a lot of money by changing potentially liability related to some claims that were already outstanding. However, every metric for GEICO this year is quite consistent with the general record.

Question 53: Audience—Warren mentioned that he likes BNSF because railroads offer an environmentally friendly way to move goods. What financial statement or other data do you use to see if a company represents an environmentally friendly investment?

Buffett: They look at every aspect of a company to decipher how the world is going to develop. They think they know a lot about what the world will look like for KO over the next 5-10 years. But, with a retail business, they will not have the same conviction

He mentioned the environmental thing when he referenced the railroads because it takes fewer resources to move goods by rail than by trucking. There is no magazine they go to in order to see that. They are just looking at the dynamics of the industry.

Munger: Even though Warren is an unseasoned young man he was able to figure out that the railroads generate less pollution.

Question 54: Audience- In terms of executive compensation, how do you incentivize managers?

Buffett: Warren and Charlie have thought a lot about why they do what they do when they don't need the money at all. They have the opportunity to paint their own painting and they love that. The painting will never be finished though. They have more fun doing it together than they would apart. They also like applause.

If that combination of factors works for them, they believe it should work for the BRK managers as well. In many cases these people have as much money as they need but they like what they are doing and that may be why they are good at it. They get to keep the paint brush, they receive applause, they are compensated fairly and Warren and Charlie don't tell them how to paint. As such, they have not had compensation problems at BRK.

Todd Combs and Ted Weschler are making below hedge fund and private equity standards and are getting less favorable tax treatment. But, they will make a ton of money and he hopes they will have a good time. He thinks they will have more fun over the years when they don't have to explain to investors why they are worth 2 and 20. Charlie and Warren want to have their managers enjoying their lives—both business and personal. Many managers have to spend a lot of time talking to lawyers and investors and bankers and he wants to take that burden off of BRK's people. He wants them to focus on their passion. He wants to not mess up something that is really good. As a result of this system, BRK has managers that no one else can hire. He thinks they will retain that advantage for decades because it works. There is nothing like getting proof that what you have designed works.

The businesses are so different it would be crazy to have the same metric for all the managers. For example, return on capital as a measure doesn't make sense for a lot of businesses. Alternatively, they could hire consultants to come in and make recommendations but they would never do that. People at BRK have made a lot of money—numbers in the 8 figures. There will be more of those people over time but the amount they are paid will relate to logical measures of performance in most cases.

In any case, the amount of time they spend thinking about compensation is very little. Warren is the compensation committee for BRK and he is not overworked.

Munger: They don't have a standard formula. They don't have a big HR department. Every arrangement between executives is different. In past years he has made the comment that prostitution would be a step up for most compensation consultants.

Question 55: Audience-How do we get America to grow GDP at 4% again?

Buffett: If the US population grows at 1% per year and GDP grows at 2.5% per year, that would be remarkable. Over a 5000 year time period, it would lead to a 4x multiple of GDP per capita every century. Unfortunately, 2.5% growth may be slow in getting the US out of a slump but it is a great rate of growth for a country that has a high standard of living. In his life real GDP per capita has gone up 6x. We are unbelievably rich even though a lot of people are not feeling that way—for good reason in many cases. We have a tremendous country to work with. It has a lot of strengths and a huge abundance of wealth. His parents would never have imagined that he would live to see 6x GDP per capita growth.

Charlie, what would you think the real growth rate will be for the next 20 years?

Munger: It will be really hard to get to 4%. If God would make a guarantee he would accept a low figure. With a mature country, new competition and a large social safety net, 1% would be enough. If the questioner wants 4%, it is a foolish dream. You would do foolish things to achieve that rate.

A 1% growth rate in GDP per capita over 20 years would lead to a 25% improvement over the previous generation's quality of life. The growth won't come that evenly but the system still works. Even after the incredible crash we have just witnessed, the US has seen a lot of resilience, especially compared to Europe. It is true that the rebound has been better for businesses than employment. Business profits as a percentage of GDP are as high as they ever have been. But the unequal recovery produces a lot of strains in the political system.

Question 56: Audience—Have they thought about giving money to a Super PAC?

Buffett: He wishes Super PACs had never been created and he won't invest in them. He has heard people saying that BRK has to be involved because the other side is doing it. But, the whole idea of huge sums of money controlled by a few people influencing politics is very bad. In terms of a guy such as Sheldon Adelson—who recently put in $12M—he is just playing the system. Warren understands that desire but he doesn't want to be a part of it. You have to take a stand at some point. The idea that he should spend $10M to fund a Super PAC that will spend the money misleading people is not a good one.

Munger: He is ordinarily very negative and he is very negative about the parties' gerrymandering and letting crazies on each side having so much power. He likes the Marshall Plan world, in which important legislation was passed on a bipartisan basis.

He thinks the two candidates we have are as good as we have had. If he thought you could reduce legalized gambling in the US by giving money to a Super PAC, he would definitely invest. He thinks gambling is very bad. This is true of capital markets acting like a casino as well.

Question 57: Audience—Since the beginning of last year the portfolio has gone up and the stock price hasn't budged. Is the market manic?

Munger: The market is not going to do what you want, when you want it. If short-term orientation is what turns you on, then you are not welcome in this room. He does feel better about the margin of safety in the stock now though.

Question 58: Audience—Why not pay a dividend when the stock is too high to buy back shares?

Buffett: By and large, they feel as through they can create more than $1 in present value by investing in BRK's businesses. Even if buying shares is not possible, every $1 they retain can be turned into more than $1 in present value. This has worked for 47 years. If an investor had wanted to create an income stream he or she could have sold a little stock each year. This person would have had more money working per share if they had sold as opposed to receiving a dividend. The math is compelling and it remains to be seen if it will continue to be in the future. If they had paid out a dividend then their shareholders worth would have been less.

Munger: Over time he thinks the dividends will come because they will have more trouble multiplying the rabbits. But, he hopes that day does not come soon.

Buffett: He thinks that during the last few years they have been able deploy capital at attractive rates.

Munger: He thinks that MidAmerican will have the ability to deploy a lot of capital at very great returns over the next 20 years. That is why they are not excited about dividends.

Question 59: Audience—If they started over, how could they improve on the performance based on what they know now?

Munger: They can't do with the amount of money they have now, things that they used to do. BRK's record would have been terrible if Warren hadn't kept learning. He had to learn new tricks each decade. But he is getting old and Charlie worries about him a lot.

Buffett: They have learned things since they were managing $1M and could probably earn a better return than they did when they were younger. In the course of 50 or so years they have learned lessons that they would be able to leverage if they were using less money.

Question 60: Audience—What are the most effective ways to minimize mistakes?

Buffett: They have made mistakes and they will make more. They think in terms of trying to not make mistakes that stop them from being able to play the market. They are always thinking of avoiding the worst case, but they have the instinct to do things in a big way. He doesn't worry much about mistakes. The next mistake will often be something different.

You may get some advantage by learning about people though. He will make mistakes with people but he thinks he will also make more good judgments about people. He thinks he can recognize the great ones better now. That skill improves but not through conscious thoughts about mistakes.

Munger: He would argue that what they have done is learned from the mistakes of others. That is a much more pleasant way to learn lessons. They are very interested in other people's errors.

Buffett: In terms of reading financial history, he has always loved to read about disasters. The financial arena will give you a lot of folly to observe. Warren and Charlie have had an advantage over people with IQs of 180 and fancy math skills. Those people just didn't understand how people work.

Question 61: Audience—How do you build barriers to entry?

Buffett: It is tough.

Munger: They buy barriers to entry; they don't build them.

Buffett: There are some industries that will never have them. You better run fast in those industries because everyone else will be running fast too. A great barrier to entry is something like this: if you gave him $20B and asked him how to knock of Coca Cola with a new drink, he wouldn't know how to do it. People have ideas in their minds about Coke that can't be changed. Years ago, Richard Branson came in with Virgin Cola but it never worked. KO really benefits from barriers to entry.

They have a number of businesses that can't be rebuilt—the railroad for example. BNSF will always have competitors but if you buy something at a huge discount to replacement cost and it is essential, you will have a huge barrier to entry.

Munger: They have found in life that one competitor is often enough to destroy an industry.

Question 62: Audience—What about the BYD and the potential for its electric cars?

Munger: Well, the car market in China is a huge market and BYD is located in China. This is their focus. The 1st cars they will try to bring to the US will be for fleets in California due to the environmental restrictions there. There are subsidies that come to electric cars as well. Generally speaking, he thinks BYD is an interesting company. Here is 1 of 8 children of a peasant who became a professor and won what is the Nobel Prize of China. They have 100M square feet of buildings. It is a very interesting start up.

Buffett: What percentage of cars in 2020 will be electric?

Munger: Not many. Like with wind power, he thinks we should subsidize electric cars in various ways to get the technology going and then wean ourselves from oil. He drove the BYD electric car and he was flabbergasted at how much it had been improved. The people in China are quickly learning what it took the US companies many years to learn.

Question 63: Audience—How do we value the insurance business, especially in terms of float and economic goodwill?

Buffett: The economic value comes from the ability to use float obtained at a bargain rate. At GEICO, it is reasonable to expect an underwriting profit as well as growth as far as the eye can see, coupled with a growing float. That is a very attractive combination of factors that comes from GEICO's low cost and scale characteristics. It is always good to own the low cost producer.

But GEICO's dynamic is different from that of Ajit's business. At GEICO they have thousands of policies and it is a statistically-based business. That, combined with low cost, is great. When it comes to Ajit's business, he needs to be smart in each deal because people come to him for huge deals in which you don't know much about the odds before entering each deal. Before Tony Nicely got to GEICO, it had gone along with 2% market share and Tony has quintupled that share while producing positive underwriting profit.

In the end it comes down to growing a large and low cost float. In their case the float has been very positive—people are paying them to hold $70B and that is really fun. The chances of that continuing are high but he is not sure if the $70B will grow much. He thinks he will be able to keep the float at low cost even if the rates go up to 4-5%.

They are getting nothing on like $36B in cash they have due to Fed policies. Thus, BRK's earnings power is being depressed by Bernanke—maybe for good reason.

Munger: We are currently in a low return environment but it won't last forever. There are times in the past when Ajit would generate a lot of float but we don't know if it will come again at that huge scale.

Question 64: Audience-What about the current account deficit and how it relates to oil and natural gas imports and exports?

Buffett: It would be a huge plus if the US's total energy production goes up a lot and if what we have to import costs a lot less. He doesn't see us becoming self-sufficient in oil but gas supplies are great. He thinks the energy situation has changed a lot in the last few years. He thinks we should use someone else's resources up rather than ours though. We used to be an oil exporter but it probably would have been better to use the Saudi's oil instead of ours. The energy picture has changed for the better and he thinks the deficit picture has changed for the better as well

Munger: It is a very complex interaction. The single most precious resource we have is the reserves in the US. He is a puritan—he wants to suffer so that the future can be better. He is all for using up other people's oil and saving ours. He thinks energy independence is retarded. We don't want to be independent; we want to conserve. Thank god there are other people who want to sell us oil. He knows this is opposite of what other people think but he thinks he is right.

Question 65: Audience—The questioner listed a recent example of excessive compensation at a mutual insurance company. What good does it do America if the economy improves without the people feeling it?

Buffett: You would hope that the 1% growth in GDP per capita would not concentrate in the top 1% of society. But, the tax code has encouraged just that. We have a tax code that has become more favorable the ultra rich. The tax code decides who pays for the government and we have moved away from the rich paying their share. He thinks that democracies have a trend that moves more toward plutocracies. We need countervailing measures to stop that.

The tax code issues are coupled with what has happened in terms of the ratio between CEO pay and that of the average worker. There has been much more poor behavior in the corporate world than the mutual insurance company space, for example.

Munger: Most of the great mutual insurance companies do not have really skewed compensation, State Farm for example. This is an egregious example.

Question 66: Audience-Sovereign debt levels seem to be a risk. How do large debts get balanced and is he concerned?

Buffett: The nice thing is that governments don't actually have to pay you and creditors can't grab anything from them; unlike other debts. Sovereigns have defaulted over history and what happens then is that you get a big reallocation of wealth. Luckily, you don't lose farms and plants and workers' skills.

Warren does not know how it all will play out in Europe. We have seen the ECB give 1 trillion Euros to banks that are loaded with questionable sovereign debt. He would not be surprised if the banks are using these borrowings to buy more sovereign debt. He thinks that might have a bad ending.

He would much prefer a world that was getting its fiscal house in order, especially in the US. The counterargument is that when you are in a recession, if you don't run deficits you risk a destruction that leads to a 1930s-like situation. When the government is operating a deficit of 8-9% of GDP, this is huge stimulus to the US economy. We will have to wean ourselves off of that pretty soon. Leaders of both parties know that we need to get revenues up to 19% of GDP and spending down to 21%. But, both sides are worried about being seen as weak. Also, the leaders of one party can't even speak for their party. In general, he would avoid all medium-term and long-term government bonds.

Munger: This is a great question. So, of course they are having trouble answering it. It is hard to know how much the Keynesian stuff will work after you have lost your fiscal virtue. At some point, money printing does not work anymore. It is very dangerous to go low on fiscal virtue. It is very important that we don't go too far in that direction. We want to have enough fiscal virtue so that in a calamity we have enough firepower to avoid a 1930s-like situation.

Warren, could we get a very poor result in the US?

Buffett: We could have problems but he thinks the result will be good over time.

Munger: He said he is less optimistic than is Buffett. He thinks the reason people disagree so much about this is because it is so hard. Everyone wants fiscal virtue; but not yet. The one thing he is sure of is that the safer way to spend the money is on things a country will need as opposed to giving it to crooked lawyers. We need our tricks to be used intelligently. He would spend on infrastructure that he knows we are going to need. He would have people pay much more cheerfully like the Romans during the Punic Wars. We do need more sacrifice and more sensible ways of spending money, along with more civilized politics.

Question 67: Audience—What do you think is the ideal tax rate?

Buffett: Last year the actual corporate tax rate paid was 13% versus the standard corporate rate of 35%. This was due to the immediate write-off of fixed asset purchases. Corporate liquidity, profits and balance sheets are not the problem in the US economy. The corporations have a lot of money available. For example, BRK is spending money where it is seeing opportunities—in the railroad business for example. The problem is not a lack of capital or the tax rates. The country prospered in the 1950s when rates were in the 50% range and people actually paid it.

The issue is that medical costs were 17% of GDP versus corporate profits of 1.2% of GDP. The tapeworm of American industry is medical costs, which are 7% higher as a percentage of GDP than those of other countries. He does not think the tax rate is the issue and it appears that both parties agree that there should be a lower rate but a more equal one across companies. However, this is going to be really hard to implement because the people whose tax rate will go up will fight very intensely.

Munger: He used to say that he expected to live to see a value added tax. He is not sure he will but he thinks we will see one sometime soon. He thinks it makes sense to tax consumption. He thinks it is a bad idea to give people money and then come in and try to take it back (as the current tax system is structured). It is easier to take money off of the top. We have a lot of problems and he does not think a 52% tax rate is a good idea now. That may have been OK when the US led the world but right now so many countries have lower rates that if we raised the rate to that level, it would cause us a lot of problems.