

A weekend in Omaha – 2011

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This was my 7th trip out to the Berkshire Hathaway Annual Shareholder Meeting. I am often asked what is the attraction of going year after year to listen to Warren and Charlie crack jokes and share their simple (but profound) anecdotes on business, investing and life. Attending this event and reading about the success of this great investor and company has been the inspiration behind our new fund - the next 30 years of my life. This in itself would be sufficient but there is more. Some of the anecdotes are repeated but there is always something new, some new angle and this year was no exception. In addition, the whole weekend has grown from the original “Woodstock for capitalists” to become the central annual gathering of the global Value Investing community. We attended many additional events and met many new and old faces. In addition to a fascination with Warren Buffett’s remarkable and continuing success, there is a common thread which binds the attendees of this meeting: most of us share a belief that the free market and capitalism is a force for good and that it is possible to be successful in that environment without being dishonest – this last point was in sharper focus this year than in any of the previous years I have attended.

Berkshire – questions about the company

The key issue to be addressed in this meeting was the actions and subsequent resignation of David Sokol, a trusted Manager and widely speculated successor to the non investment responsibilities of running Berkshire. This has been well covered in the press but was the first time in which WB had really commented on the events and taken questions on the subject.

David Sokol: “Inexcusable and Inexplicable”

WB opened the proceedings by addressing this set of events head-on. He explained that he found Sokol’s actions “both inexcusable and inexplicable”. Dwelling on the latter, he commented that Sokol had not at any point attempted to conceal his ownership of the shares. He also shared an anecdote from early days of Sokol’s employment with Berkshire in which Sokol elected unilaterally to split 50:50 a very significant incentive package offered to him and his second-in-command, which had been originally proposed by WB to be 2:1 in Sokol’s favour, thereby “giving up \$12m for nothing”. It was clear that WB could not reconcile this behaviour with that of the Lubrizol share purchase.

The first question to WB asked why he had not been more forthright and critical in his memo published on the announcement of Sokol’s resignation. WB explained that at this time, the full facts of Sokol’s meetings with Citi had not fully come to light. WB however recognised that he had

The Q&A

The Berkshire Shareholders meeting is like no other AGM. The formal part of the event (i.e. where shareholders can vote) is a 5 minute after-thought with the main attraction being a 5 hour long Q&A with Warren Buffett (WB) and Charlie Munger (CM), his Vice Chairman, on stage taking questions from the audience of over 30,000 and from a panel of three journalists, who filter questions emailed in by the public.

Questions alternate between one of 13 microphones around the audience and the 3 journalists. WB generally answers the question first, with CM following up with either a witty one liner or his trademark “I have nothing to add”. This latter expression has in past meetings made up 30% of Charlie’s responses. This year was different: less than a handful of times out of the 53 questions, which is testament to the quality of the questions and therefore the quality of the event.

Overview of the David Sokol / Lubrizol share purchase

In brief, David Sokol made a £10m investment in shares of Lubrizol this year, a company which was subsequently acquired by Berkshire for a 20-30% premium. The act of owning shares in the business and then introducing the business as a potential acquisition target was not necessarily a breach of Berkshire's code of ethics; Sokol had declared himself as an investor when he introduced the idea to WB. What Sokol failed to mention was he had only recently become a shareholder after Investment bankers from Citi had approached him directly about the possibility of Berkshire acquiring the company. WB was completely unaware of this meeting with Citi until after the transaction took place

handled the press release poorly. In WB's defence on this point, CM commented "you can always tell a man to go to hell tomorrow, if it's such a good idea".

Given the importance Buffett places on reputation and integrity in annual shareholders letters, considerable time was devoted to these event,. There was a sense of catharsis in the open and confessional nature of the way that it was addressed. Buffett's discussion about this were transcribed word-for-word and were posted on the Berkshire website: <http://www.berkshirehathaway.com/dlsokol/TranscriptSokolQuestions.pdf>

The insurance business: an underwriting loss for 2011?

As a major insurer of large catastrophe risk, Berkshire was not immune to the earthquakes in Japan and New Zealand and extensive flooding in Australia. WB explained that whilst they aim to be at a minimum break even on the insurance business (making money for shareholders through the wise investment of the premiums), they generally do a bit better than that and then every 5 or 10 years, have a bad year in which they make an underwriting loss. This first quarter suggested that 2011 was going to be one of those years.

However, when asked whether book value was a fair reflection of the value of the insurance business, WB acknowledged that over the long-term, the business has done better than break-even and that this is not reflected in the book value (the bench mark by which WB has always measured his success). Both CM and WB believe that they have the best insurance business in the world. Central to this success was hiring Ajit Jain – "my best deal was hiring Ajit; every year, Ajit and I meet to discuss his compensation and he always thanks me; I am always thinking that I left off a zero".

Succession – the ever larger question

The Sokol affair brought into sharper focus this year the issue of succession and a number of questions attempted to tease out more insight into this issue. WB gave the impression that Sokol was not, as had been widely speculated, the guy they

Berkshire - simplified

The Berkshire business can be split into 3 parts:

1. a large very high quality insurance business, which collects premiums and underwrites a wide range of risks,
2. a portfolio of holdings in listed companies like Coke and American Express and
3. a large and growing collection of fully or majority owned private businesses that range from utilities in the UK to one of the biggest US railroads.

Berkshire has used the cash which is collected from the premiums of the insurance businesses to invest in the public holdings and private investments, ensuring that there is always sufficient liquidity to meet any significant payouts on its insurance risk

had identified for the operational management role. He said that the successor in this role is a current manager of one of the operating businesses and that he was prepared to bet a lot of money that there was no integrity risk with this individual. Howard Buffett his son is the likely successor as Chairman. WB explained that he struggles to think of anyone better suited to ensure that the interests of the shareholders are protected. CM's comment on the challenge: "the bible tells us that the meek shall inherit the earth, but the question remains whether they stay meek once this has happened".

On the subject of succession, it is worth noting that Buffett appeared to be in excellent physical and mental health and shows no sign whatsoever of wanting to reduce his commitment to the company.

Berkshire share price: undervalued

Their unwillingness to complete any transactions with stock instead of cash indicates Buffett's own view that the share price of BRK is currently undervalued compared to investments he is considering. "the businesses we own are so good that it's a poor idea to give up any part of them [the effect of using stock] to buy another business".

Listed Investments: on his banks, The Washington Post and J&J

WB's stepping down from the board of the Washington Post was not an indication that they were a seller but simply that at 80 years of age he does not want to attend any other Board meetings than Berkshire's. WB reconfirmed that the Washington Post remained "a permanent holding" in their portfolio.

On the question of J&J's very recently announced acquisition of Synthes, unlike Kraft and Cadbury, in which he was very vocal about Kraft over-paying, WB said that he could not comment on the 21 times PE being paid for the business but again returned to the theme of paying with stock. "I would like the deal better if it was all in cash, and they can [do this]. When they trade away the present business for something new, you can draw inference that J&J is not valuing its own businesses as attractively as you think it should be valued"

WB commented that his banking investments (Wells Fargo and US Bankcorp) are very good operations but not as attractive investments as they were when leverage levels were higher. However, he is convinced that the worst is in the past in this sector and he has been increasing the investment in Well Fargo.

Their private business: struggling with retailing, defending an investment in BYD, the attraction of cyclical businesses, favours nuclear power and extols the virtues of Lubrizol.

In response to a question on which are the worst performing businesses in the Berkshire portfolio, WB acknowledged that they have had the most trouble with the retailing businesses they have bought. "Despite being in several businesses for a long time, we have not created major earning power in retail. We did generate a lot of capital from Sees. But that may have convinced us to go into more retail...like the duck on a pond when it is raining, we think we are rising in a world because of merit". CM: "That has been the hardest game for us; if we were a little smarter we could have figured it out".

On BYD, the Chinese battery and electric car company, which is a personal favourite of CM, the business has faltered and the share price is down 65% from its peak. CM commented "I am very happy with this investment. The price is still way higher than when Berkshire bought it. By definition, it is not quite as cheap as it was then. They tried to double auto sales every year for 6 yrs,

and it worked the first five times. I am quite optimistic". WB quipped in a parody of his partner "I have nothing to add".

On their cyclical businesses, "the advantage is that people don't like them very much, which means that no one is bidding for them". WB compared the cyclical businesses to seasonal businesses. "See's Candy loses money for 8 months in the year; the only difference is that with cyclical, we have to look over a longer period; we expect 3-4 years to be bad in every 20". This puts off other purchasers but not Berkshire which takes the long view. To emphasise this he mentioned that they had just bought a brick producer in Arkansas and CM commented that they would be ready with bricks when some customers turned up.

When asked whether the returns justified the risks for Mid American to build a nuclear power plant in Iowa, Buffett came out strongly in favour of nuclear power, pointing out that it reduced emissions and was a lot less dangerous than other forms of energy "more people die in accidents in coal mining every year than ever in the nuclear industry in the US". CM added: "if a Tsunami gets to Iowa, that will be one hell of a Tsunami".

On the Lubrizol acquisition, they were asked whether by forcing the Lubrizol board to go exclusive on the deal so early on, the Lubrizol board was in breach of its duty to get the maximum value for their shareholders. Uncharacteristically, Charlie broke in "Let me do this one. No, the board did not breach its duty. We would not have participated in the transaction if they didn't do it our way so this was the only way they could get the deal done with us" and then mocking the "prominent investor in the audience" who asked the question he asked "anyone else have any easy questions?"

With respect to the attractiveness of Lubrizol as an investment CM commented: "Iscar and Lubrizol are sisters under the skin. Each has small markets – which are not attractive to anyone with sense to enter. And they are both fanatics on service. If you have more like that, give Warren a call."

A lucrative money spinner for Berkshire

Alongside this event sits a large exhibition of the Berkshire companies; the consumer facing companies take the opportunity to capitalise on the event and the shareholders open their wallets willingly. Indeed Berkshire shareholders are strongly encouraged over the weekend to shop at the two major retail businesses owned by Berkshire in Omaha – Borsheims the jeweller and the Nebraska Furniture Mart, a massive warehouse shop which sells anything from Ipods to lamp shades. Inevitably, escaping the UK over a long weekend (particularly the Royal Wedding weekend) is never popular with Mrs Denison-Smith and a trip to Borsheims has become the annual penance. A sales woman there confided that 70% of her annual commission was generated from the two weeks around the Berkshire meeting – only Buffett could turn his company's AGM into a massive money spinner.

The Market / Economy

Bullish on the long-term future of American capitalism

WB remains very bullish on the long-term resilience of the US capitalist system. "If I had a choice, I would prefer to be born in the US today than any other country in the world or any other time".

"I don't see how anyone can be anything but enthused about this country. I was born in 1930, and if someone had come to me in the womb, and told me the Dow was 381 and is going to 42, we are closing 4,000 banks, having a dustbowl, and grasshoppers are taking over -- it's like the Woody Allen movie where he says, 'go back, go back!'

But since 1930, the average standard of living has increased 6-fold. When I was a child, we sat around the dinner table hearing about how things were going to hell. I went over to talk to Susie's dad before I proposed, and Doc Thompson told me "Warren you are going to fail but it is not your fault. If you starve, she would have starved anyway. It is not your fault, it is because the Democrats are in and taking the world to communism". Then he blessed me and we got married. When I got out of school in 1951, my Dad and Ben Graham both told me don't start in stocks, the Dow was over 200 and had never been that high. There are always negatives. We've had 15 recessions since this country started. It doesn't do it in a straight line. The power of capitalism is incredible. That is what is bringing us out of recession. The resuscitative powers of capitalism re-sets and re-starts. The game is not up. The rest of the world has caught up, and state capitalism in places like China are turning dormant economies loose. In the next 100 years, there will probably be fifteen or twenty lousy years but we'll be so far ahead of where we are now, it will be unrecognizable"

On inflation, yes he was confident that the \$ along with all other currencies would continue to buy less in the future than it does today. He pointed out that a dollar in 1930 would be worth 6c now and yet the US standard of living is six times higher.

Consistent in avoiding commodities including Gold and Oil

"If you owned all the gold in the world, you would have a cube measuring 67 feet on all sides. You could sit on it and polish it but it would earn you nothing. All the gold in the world is worth about eight trillion dollars. Compare that to America which has about 1 billion acres of farmland, worth about \$2 trillion. Ten Exxon Mobils is \$4 trillion. So you could own all the farmland in US, ten Exxon Mobils, and still have a couple of \$trillion of change for spending money. Or you could have a 67 foot cube of gold that you could fondle. That might seem like a difficult decision to some, but not to me. Essentially buying gold is a bet on how scared people will be in the future; we prefer assets, where its success is based on what it delivers not what someone quotes you for it. When we buy a security, we do so on the basis that we don't care if the exchanges close for five years. CM finished up by saying "it's a strange asset – you dig it out of the ground in Africa and ship it to the Federal Reserve in the US, who put it back in the ground".

One self promoting questioner from the audience gave us a blow by blow account of her (apparently successful) 3 year trading performance in oil and then asked for WB's advice on the future direction of the oil price. "I should obviously be asking you that question" came back WB. "If I could predict the price of oil, then it would be much easier for me to trade the stuff than run businesses like the rail roads which use it". CM added "what we are doing is a lot easier than what you are doing; I don't know what edge you can have in commodities".

At an event after the meeting, one 20 year veteran of these meetings pointed out that this meeting had similarities to the meeting in 1999, when everyone was asking WB why he was not investing in Internet and tech stocks, only this time the focus was on commodities and oil. Further to this, a shop-keeper in a local grocery store, recognising that we were in Omaha for the BRK shareholders meeting, launched into an investment thesis on why we needed to pile into commodities... "its all going to China!"

Housing in a terrible state...but it will get better...

Looking at the various businesses, which are exposed to housing, gives WB an insight into the market. "Housing is in a terrible state, flat lining at very low levels; we expected that we would see an upswing before the end of 2011 but there is nothing to suggest that this will happen yet so we may not see this for another year. However, we are creating households faster than we are creating housing units. That problem will get cured."

And finally

They were asked how they would like to be remembered. Initially, WB quipped “At my funeral, I would like them to say, “That is the oldest looking corpse I ever saw.” CM answered “a fortune fairly won and wisely used”. Warren Buffett finally answered the question “I would like to be remembered as a teacher”. I am sure that 30,000 people in the stadium felt that this was one ambition which was well on its way to being achieved.