

**Omaha – 2012****Simon Denison-Smith & Jonathan Mills**

The Berkshire Hathaway shareholders meeting in 2012 was as good as any of the previous 11 we have attended. After 6 hours of listening to the Q&A the Chairman and CEO of Berkshire (81 years old) and his Vice Chairman (88 years old), seemed as fresh as when they began. With Berkshire representing our largest position in the fund, it is comforting to see them in what appears to be robust health.

This event was different in that a third of the questions came from a panel of analysts – who asked a number of quite detailed (and not always particularly good) questions about the business, particularly the insurance business. This did seem to have the effect of encouraging Buffett to provide more detail in some interesting areas of the Berkshire Hathaway, such as his approach to valuation, his incentive structure for the new investment managers he has hired as part of his succession strategy and the way he is thinking about capital allocation in some of his capital hungry business units such as Mid America and Burlington Northern. There was a lot more focus from the audience on the issue of the share price being undervalued; this was in part precipitated by the Board's decision in September 2011 to announce a buy-back of the shares at a price of not more than 110% of the book value.

**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 7 hour long Q&A (with a 1 hour lunch break) with Warren Buffett (WB) and Charlie Munger (CM), his Vice Chairman, on stage taking questions from the audience of over 30,000, from a panel of three journalists, who filter questions emailed in by the public and for the first time a panel of three analysts.

Questions alternate between one of 13 microphones around the audience, one of the 3 journalists and one of the analysts. WB generally answers the question first, with CM following up sometimes with a witty one liner or his trademark "I have nothing to add".

**Berkshire – questions about the company**

CM : "The first \$200 billion was hard, the next £200 billion will be a lot easier". WB agreed "the businesses are in place to take us to \$400 billion".

Berkshire currently has \$37bn in cash on which it earns nothing because the normal earning power of this money (through interest) had been depressed by the Fed.

**Uniqueness of the Berkshire model**

WB described the BRK model as "peculiar" and "very difficult to replicate". It takes a long-time to build the kind of brand that BRK has in the financial market place and during this period, you need the absolute consistency which comes from having a dominant shareholder. CM: "Warren would have a hell of a time starting out and trying to replicate this all over again at the age of 30". WB quipped "well I would like to try".

**Insurance**

"It's hard to think of many commercial insurance businesses which we like". CM

One theme which cropped up in a number of different answers was the decentralised structure of Berkshire Hathaway. Within the insurance business, WB was quite clear that they allowed the different insurance businesses to run themselves and did not attempt to influence any sharing of thoughts or drive any consistency with respect to reserve policy. The only guideline they provide the units is to instruct them to always ensure that the reserve policy is very conservative. Ultimately the importance of the culture of independence of each business is far more important to Berkshire than the benefits which may be derivable from trying to enforce the sharing of information or standards. Munger signed off on this question on imposing a consistent reserve policy across their 9 insurance businesses by saying “we are trying to fail at what you want us to succeed at”.

The key success driver of the Berkshire insurance businesses are to provide a “float”, i.e. the premiums which are collected are essentially investable assets, from which they will need to meet the future liabilities which they are underwriting. Berkshire’s aim from the insurance businesses is that they write profitable insurance business (at a minimum avoiding losses), which itself can be reinvested in Berkshire’s collection of private businesses and stakes in public companies. Essentially the insurance float is a cheap (in most years better than free) source of finance for the investment company – a form of leverage but without an interest rate or covenants. One message from this AGM was that Buffett was not convinced that the float was going to grow much in the next few years from its current level of \$70bn because it is difficult to replace the insurance policies which run off. However, he did point out that he had thought this when the float was \$40 billion. “When I mentioned it in the shareholders letter, Ajit told me that he regarded this as a personal challenge”. Munger added “I don’t think there is another insurance company in the world more cheerful about losing volume”.

Geico continues to prosper with profit margins at 9% in the last quarter and the float continuing to grow. Geico is valued at \$1bn over tangible book value in BRK’s books but according to Buffett “it should be worth \$15billion at least and we would not sell there either”. “All the metrics of retention and combined ratio are consistent. It is worth a lot of money now and will be worth a whole lot more in the future”. They would value Geico differently to GenRe. With Geico, it is rational to assume an underwriting profit for the next 10-20 years plus growth.

When they bought Gen Re it was doing a lot of “accommodation business” (business to help other companies out as part of a quid pro quo); there needed to be a cultural change there, but it is now doing very well and Buffett would bet that it will grow.

Buffett said that following the Japanese and New Zealand earthquakes, the market (prices) for catastrophe business was “significantly better than a year or two ago”.

When bidding for annuity business they won’t assume more than the risk free rate whereas others will pay 150bp more than risk free.

### **Their private business and investments: Power, Rail roads, holdings etc.**

“80% of our businesses (by market value) have increased their market position since we bought them. Where we have made mistakes, it’s because I have assessed a business’s competitive position wrongly”, WB.

MidAmerican is largely unaffected by the price of coal; changes are passed straight through to the customer. However electricity consumption in KWhours is down 4.7% and a reduction in the demand for coal will potentially impact the rail road company, Burlington Northern, which ships the product. Cash retained in MidAmerican earns 12%, which they are very happy with.

WB acknowledged that without the government subsidy, their wind and solar projects would be unviable. On solar, BRK has a particular advantage as they get the maximum benefit of the tax break, being full tax payers – he estimated that 80% of the competition pays little or no tax and would not have this benefit.

The rail road business continues to improve its asset quality and moat. To replicate this infrastructure would cost 5-6 times what BRK paid for it. The economics of this business are very solid – it's 3 times more efficient than trucks in terms of fuel usage per tonnage mile of freight hauled so as oil prices rise, its advantage increases. They started buying BNSF for \$34 / share in 1999 and now “appraise it” at over \$200 per share. BNSF now “makes over \$5bn pre tax”.

Buffett said that the 30% of BNSF that they paid for with BRK stock was a bad deal because BRK stock was so undervalued, but this was more than made up for by the excellent deal that they got for the 70% of BNSF that they paid for with cash. BRK will invest almost \$4bn in BNSF capex this year.

On Walmart, WB did not believe that the recent revelations of corruption in their Mexican division has had any material impact on the earning power of the business. There is nothing fundamentally dishonest about Walmart. It is very difficult to control such a large business. WB was certain that of their 270,000 employees in BRK, someone would be breaking the law right now.

When asked how Berkshire builds barriers to entry within his businesses, WB answered that this was tough – “we tend to buy barriers not build them”. They look to buy at a significant discount to replacement cost – “with \$30billion, I would not have the faintest idea of how to unseat Coke from its market position” – Richard Branson failed. CM however warned that “one competitor is frequently enough to ruin a business”.

On their derivatives book Munger feels that they will make at least \$10bn, maybe more.

### **The threat the Internet poses to different business models**

WB and CM acknowledged that some business models particularly retail were very challenged by the Internet. Amazon has a lot of very happy customers and this is sure to hurt a lot of businesses. “It will be terrible for many retailers not slightly terrible but really terrible, but it won't affect Nebraska Furniture Mart”. The Nebraska Furniture Mart is in very strong health – up 11% per annum this year selling a record \$6m of business on the Tuesday before the meeting.

Newspaper business: WB believes that there is still a local newspaper business based on a subscription or paid for model – he acknowledged that they are not as “bullet proof” as they used to be. The key ingredient is a “sense of community”; for this people are prepared to pay for local information. He mentioned that World Book which they owned had been “80% destroyed” but still made reasonable profits. He felt that some newspapers would now fall into that category.

GEICO initially missed the Internet as a distribution opportunity – WB admitted that he did not think people would shop around for quotes online as much as they do and this had helped GEICO's business because it was the lowest cost operator.

### **Acquisitions**

They would consider an acquisition of c\$20bn (they have recently been looking at one at \$22bn), the limit on size is that they want to hold \$20billion in cash however they would consider selling down

some of their listed securities if they had a compelling opportunity. If they have not done a deal by next year, they could look at doing a \$30 billion deal.

In terms of valuations, they would love to buy operating businesses with similar characteristics to the ones they already own at 9-10x pre tax profits.

When asked about whether they would look at forestry, given the number of businesses which they own which use the output, WB was quick to answer that synergy would never drive an acquisition decision and then added that the structure of BRK put them at a tax disadvantage to REITS in holding property assets.

Declining businesses: when asked how they value a declining business, CM responded “less than a growing business!”. They pointed out that they had made a lot of money from declining businesses which throw off a lot of cash but they did not look for these kind of businesses now. WB: “We were masochistic in the early days”; CM: “ignorant too”.

### **Buffett’s health (following his recent announcement of being diagnosed with stage 1 prostate cancer).**

He was asked a question on his health “I feel terrific was the response”; they have consulted with four Doctors “at least some of whom are shareholders” and believe he is statistically more likely to be “shot by a jealous husband” than die of prostate cancer. CM followed up by saying “I resent all the sympathy and attention that Warren is getting – I probably have more prostate cancer than him but I refuse to get tested”.

### **Succession**

Inevitably, WB had to answer a number of questions on the issue of succession. He confirmed that a key role of his successor would be to manage the risk of the business. He and Munger used the opportunity to castigate companies which delegate this function, stating that it was on a par with the other two key skills for running Berkshire: capital allocation and manager selection. CM pointed out that the delegation of risk management starts in the courses taught at University. “The Value at Risk approach is one of the dumbest ideas put forward” quipped Munger.

WB also stated that whilst his successor may not be doing the kind of deals which he has been doing with the likes of Goldman, GE and Bank of America, he pointed out that these deals have been far less important to the growth in BRK value than the investment decisions in the likes of Coke and the individual businesses they have bought.

CM: “we have been fortunate [referring to their managers]. What is interesting is that this good fortune will not go away if Warren happens to die...but it won’t help him”.

When asked whether a successor could result in managers leaving BRK, WB responded that the successor would not turn off the management team – he added that most can leave now but they love what they are doing.

### **Management**

Continuing the theme above, the key to their approach of management is to provide their managers with autonomy. Their managers do not work for money. “I am the compensation committee for 60-

70 people and I am not overworked”; CM: “prostitution is a step up for compensation consultants”. WB confirmed that CM was in charge of diplomacy at Berkshire!

WB provided interesting insight into the detail of the compensation package of the two new Investment managers who have been hired: Tod Combs and Ted Weschler:

- They started with \$1.75bn to manage and have each been topped up with another \$1bn at the end of March
- They receive a salary of \$1million + 10% of the outperformance of the S&P on a 3 year rolling basis.
- 1/3 of the gain in a particular year is paid in the first year, the rest is payable over the next 2 years but can be clawed back if there is no outperformance.
- 80% of the performance payment is driven by their individual performance and 20% by the performance of the other, so that they have an incentive to help each other.
- If they employ anyone, this cost is deducted from their performance measure.
- They can use their own brokers; the only oversight WB has is when they invest in a new name – because he needs to be sure that there is no insider issue.

CB commented: “Each could earn a lot more but in a less desirable environment” WB agreed “yes, we have a free coke machine”.

Buffett continues to personally manage the other \$150bn and pointed out that when a small purchase (under \$1bn) was announced this would normally be Tod or Ted, not Buffett. (A recent example is Intel which has been bought by BRK, but almost certainly not by Buffett.)

Apparently Tod did “substantially better” than the S&P in his first year.

### **Management – the lightest of touches**

WB used the question on what advice he would give to Chinese companies to make them more attractive to BRK, to make the point that it had almost always been a futile exercise to give advice to anyone. He pointed out that 4 of their investments are worth a combined \$50billion and yet he will only speak to CEOs of these businesses twice per year. “If we thought the success of the business was dependent on them taking our advice, we would pass”, suggested Munger. “Trying to change management is like marrying someone to change them, or trying to change your children”.

### **The Share Price / dividend policy**

A number of questions focused on the share price, why it was so low, whether the buy back was a drag on the price or whether a dividend might help to lift the price. There was a sense of exasperation (particularly from Charlie Munger) at the line of these questions, who at one point later in the meeting said directly to one member of the audience “if you are focused on 6-12 month share price performance, then you are not welcome in this room”. Buffett acknowledged again that the shares are very undervalued. He would be very happy buying 10% or more of the company back at levels below 110% of book value – indeed he would be happy buying at levels of 115% but they will stick to the 110% ceiling for now. Based on fundamentals, they both agreed that BRK shares were somewhat cheaper than they were a year ago and (by definition) the margin of safety higher.

He said that there have been 4 times when the share price of BRK has been "cut in half" since they have managed the business – the beauty of stocks is that they can trade at crazy prices from time to time which is when you make a lot of money. He reminded us that "Mr Market is there to serve you not advise you". The stock market which Munger described as a "psychotic drunk" who "makes lots of mistakes for a variety of reasons" is the most obliging money making place in the world – "the rules are stacked in your favour as long as you don't turn into a psychotic drunk yourself". "It is built into the system that stocks get mispriced".

On dividends, WB explained that with a dividend in place, individual shareholders would be worse off now than if they had personally sold the same percentage of their stock. He admitted that in due course there will be a dividend. WB was encouraged by the opportunities for him to deploy their spare cash; MidAmerican alone could deploy \$100billion in the next ten years. "We'll think about it when we are older" CM signed off on the subject of dividends.

A member of the audience pointed out that investing in gold in the last 10 years had been a much more successful trade than investing in BRK. WB was quick to point out that in 1970, gold was at \$20 per ounce and BRK traded at \$15 / share. Today gold is £1600 / ounce and BRK is \$120,000 per share. Over 50 years, WB was happy to predict that BRK will do better than gold. "It is very hard for a non productive asset to beat a productive one over a long period of time" - WB. CM: "I never had the slightest interest in owning gold. I can't imagine a worse crowd to deal with than gold bugs".

He was asked why their share price was not used as the performance benchmark in their investor letters. WB explained that the share price was subject to the vagaries of "Mr Market"; their growth in book value was a much more reliable indicator of progress. In any case the shares traded at a discount to book value at the start of the business and now trade at a premium so the picture would actually look a lot better if they did it that way.

### **The Market / Economy**

When asked the degree to which they take into considerations macro when making an investment decision, Buffett said that in 53 years they had never had a discussion about the macro economy on any investment decision – "there is always good and bad news out there" but "if we find a business we like and think we understand, we buy it".

#### **Future GDP Growth**

WB was not bullish about the US economy getting back to 4% growth. He told us that we should be happy with 2.5% long-run growth; both pointed out that the standard of living base was already high. CM felt that achieving 1% real growth per capita would be a "sensational result".

#### **Sovereign debt and stimulus**

"When a government is operating at a GDP deficit of 9%, this is effectively a huge stimulus, which we will have to be weaned off". WB and CM acknowledged that they did not know how this Keynesian experiment was going to end. CM described it as the "really intelligent question of the day and we are having trouble answering it". He cautioned that the US should not go too far with this. "Everyone wants fiscal virtue but not quite yet – this is like St Augustine, who was willing to give up sex but not quite yet".

## The banks

WB is upbeat about US banks – believes that they are in far better shape than they were 3-4 years ago and said that the “American banking system is in fine shape”. European banks are a different story. The European banks are more wholesale funded than the US banks – particularly in heavily property led economies like Spain and Ireland. There has been huge intervention by the ECB, providing them three year liquidity at 1%. “I would love to have these terms but I am not in trouble so I cannot get it”.

## General Musings

Buffett and Munger typically answer directly or indirectly with their thoughts on a number of subjects and this meeting was no exception.

Someone asked them which investments to avoid. They were categorical in their antipathy towards IPOs. They argued that it is a high probability that you are on the wrong side of the trade: “How can a new issue be attractive to the buyer when the seller is choosing the time to sell and the stock is being pushed by a broker earning 7% commission”. They said that they had never bought an IPO.

Later, they also cautioned on the investment attractiveness of medium term government bonds in the US or those of other countries.

Munger suggested that one should look at what other smart people are buying “Warren has made a lot of people rich he didn’t even know – because they copied him”.

Buffett was unusually positive on Apple and Google, stating that he thought there was a reasonable likelihood that these businesses would be bigger in ten years time “I certainly would not short them, however others will understand them better than us” CM: “we have the reverse of an edge”.

On business schools, they were encouraged by the improvement in the quality of the teaching although this praise was a little barbed in that they qualified it by stating that it was coming off a low base. For investment purposes, WB believes that there are fundamentally only two courses required: 1. Security valuation and 2. Markets. “Who needs option pricing in the investment business?” CM on Black Scholes: “the accounting profession wants some kind of solution that doesn’t require them to think too hard...and they have one”

“If you buy at a price less than intrinsic value and you can tell the difference between what you can and cannot value, you will make money.”

Munger quoted Sandy Gottesman (one of their early business partners, now on the Berkshire Board and worth several \$bns) who fired someone who worked for him and when the guy asked “how can you do this when I am such a big producer of business for you?” Sandy replied “Well, I am a rich old man and you make me nervous”.

“A lot of share repurchases are idiotic” – CM

“If you select your investments, neighbours or friends on the basis of political views, you would lead a very peculiar life” - WB

“We are never going to risk what we have and need for what we don’t have and don’t need” – WB

“We have always been more concerned about how our record was achieved, than the record itself”  
– WB

WB won't donate money to “super PACs” that lobby for particular candidates as “there is enough of a push towards a plutocracy without moving it into the voting system”.

“In a business without barriers to entry you have to run very fast” – WB

“It's always good to be a low cost producer in any business, but it is particularly nice in the insurance business” – WB

“I have the exact opposite view on QE to other people, and of course I think I am right” – CM

“The tape worm eating the inside of US industry is the cost of medical which is now running at 15% of GDP” -WB

CM argued on the issue of learning from mistakes that WB had learned more from learning about other people's mistakes “a much more pleasant way to learn”. WB expressed a fascination with reading about disasters, which has given them an edge over others with a lot of 'math'. They don't understand humans: “being the students of other's folly has served us well”.

...quite the opposite of what 30,000 people were doing in Omaha on the May bank holiday weekend!