

Meeting with Warren Buffett 28Jan05 – synthesized notes by topic

On investing...

How Warren spends his day:

- Wakes up at 6:45, reads paper at home, often doesn't make it into the office until after the market opens
- No set schedule, WB hates having a full calendar
- Always takes reading material home
- Spends 80% of the day reading, 20% talking on the phone (he then said it might be more like 90/10)
- Phone conversations are generally short

Investment process:

- In the past some things were cheap enough WB could decide in a day (this was somewhat a function of a time period where companies would sell at 2-3x earnings)
- Decisions should be obvious to onlookers. You should be able to explain why you bought something in a paragraph.
- "I don't do DCF" (WB says he does a rough approximation in his mind)
- Finding ideas is a function of cumulative knowledge over time. Something just comes along – usually an event takes place, like a good management team screwing up – that creates the opportunity (WB seems to imply here that his reading isn't specifically targeted at finding ideas, but rather that ideas jump out at him as a natural consequence of voracious reading)
- You must be patient...good ideas tend to be clustered together, and may not come at even time intervals...when you don't find anything for a while it can be irritating
- WB isn't bothered by missing something outside his circle of competence
- Missing things inside the circle is nerve racking...examples include WMT, FNM

Advice for new investors:

- Don't worry too much about your mistakes
- Don't learn too much from your mistakes
 - o Don't become Mark Twain's frog that never sat again on a stove after being burned
 - o BUT...never be willing to play a "fatal" game
- Don't confuse social progress with the chance to make money – look at airlines and autos for examples
- Law degree is not essential, but good if you think it will help in your specific career
- Learning to think like a lawyer is a valuable trait
- Allocate even more of your day to reading than he does
- Read lots of K's and Q's – there are no good substitutes for these
- Read every page
- Ask business managers the following question: "If you could buy the stock of one of your competitors, which one would you buy? If you could short, which one would you short?"
- Always read source (primary) data rather than secondary data
- If you are interested in one company, get reports for competitors. "You must act like you are actually going into that business, and if you were, you'd want to know what your competitors were doing."

Why more people don't follow his advice:

- The advice doesn't promise enough...it's not a "get rich quick" scheme, which is what a lot of other philosophies promise
- WB mentioned that when he was really young he started investing using technical analysis, but found that he never could make any money with it
- "I realized that technical analysis didn't work when I turned the chart upside down and didn't get a different answer."
- After seeing that charting didn't work, he switched to Graham...it made sense and it worked

What Warren reads:

- Most of reading includes K's, Q's and 5 newspapers daily
- Hasn't found much worthwhile book reading outside of Graham and Fisher

Advice to non-professional investors:

- If you like spending 6-8 hours per week working on investments, do it
- If you don't, then dollar cost average into index funds. This accomplishes diversification across assets and time, two very important things.
- "There is nothing wrong with a 'know nothing' investor who realizes it. The problem is when you are a 'know nothing' investor but you think you know something."
 - o NOTE: this is analogous to the concept of 'metaknowledge' that Mauboussin talked about...there's also a Confucius quote on this

Avoiding human misjudgment:

- WB said repeatedly that it doesn't take above a 125 IQ to do this...in fact, IQ over this amount is pretty much wasted. It's not really about IQ.
- Staying within circle of competence is paramount
- When you are within the circle, keep these things in mind:
 - o Don't get in a hurry
 - o You are better off not talking to others
 - o Just keep looking until you find something (don't give up)
 - o Good ideas come in clumps – by time, by sector, by asset class

Discount rates used for valuation:

- Use a long term normalized interest rate for Treasuries...e.g. 6%
- Don't use different discount rates for different businesses...it doesn't really matter what rate you use as long as you are being intellectually honest and conservative about future cash flows.
- Only want one variable to compare in order to assess the viability of an investment – price versus value. If we allowed discount rates to change it would lead to more than one variable.
- WB's assessment of the risk of a company is baked into the probabilities for future cash flow scenarios of the company
- "I don't know what the true cost of capital is for a business unless we own it"

Starting a fund from scratch today:

- Probably would do the same thing he did before

On Berkshire...

Managing Berkshire:

- Focused hard on creating a company over time that he would like today...built the company around the way he likes to work
- Hates meetings, managing people, and company rituals
- BRK has no general counsel or IR
- Directors meet in person only once per year
- 17 people employed at HQ
- "I don't call managers of my businesses, they call me"

Buying businesses:

- The first question I ask is: "Does the owner love the business or does he/she love the money?" It's very easy to tell the difference.
- I am proud to be able to provide a good home for many businesses. It is like finding a home for a painting. Business owners who are looking to sell can either sell their businesses to Berkshire (like putting painting in the Metropolitan Museum of Art) or sell to an LBO and let them tear it up, dress up the accounting, and resell it (like selling a painting to a porn shop).

Why he has a large cash position:

- Can't find things to buy
- In the past there were times it was like shooting fish in a barrel...sometimes even like shooting idle fish in a barrel...it's not like that now, but there will be times in the future when it will be like that again
- Berkshire is currently putting a few billion to work buying a stock, but it wouldn't trouble him deeply if they were not able to take the position

On specific industries or companies...

Subprime mortgage industry:

- There are similarities between subprime and manufactured housing financing
- The most important factor for the subprime industry is the health of the economy, which has been good of late
- Securitization moves the ultimate lender farther away from borrower, which is what causes problems
- A shock will probably not occur unless we see materially higher long interest rates...200-300bps
- As long as participants in that industry are charging a high enough interest rate to account for the inherent credit risk, it should be okay.
- As far as housing prices go, there won't be a problem until the collateral value falls below the value of the loan
- "We haven't played in that [the subprime industry] yet, but we do own H&R Block, which does some of those loans, although they don't keep the paper."
- REIT structures in the subprime industry aren't necessarily a bad thing
- The economy is going to be far more important than the structure used

Competitive advantage and business model in banking:

- Banking is a good business - many banks earn high returns on tangible equity
- “Charlie and I have been surprised at how much profitability banks have, given that it seems like a commodity business.”
- Underestimated how sticky customers are and how unaware they are of fees banks charge them
- WFC - \$4.00 per share after full taxes on \$15 of tangible equity
- If you have a well run bank, you don't need to be the #1 bank in an area
- Bank ROA is not highly correlated to size
- You may have to pay 3x tangible equity to buy a bank
- Only problem with banks is that sometimes they get crazy and do dumb things... '91 was a good example
- If a bank doesn't do dumb things on the asset side, it will make good money

Auto industry outlook (especially GM):

- GM bonds are currently selling at B spreads
- Auto industry is a very tough business
- In the '60's GM had over 50% of the US car market...people thought they were impenetrable
- GM did dumb labor deals when the accounting didn't require accruals for costs
- GM is now a terrible life/health benefits company with an auto business attached
 - o Auto business is well managed, but labor issues are just killer
- 2000 auto companies were started after Henry Ford – there are now 3 left in the US – no money has been really made over time

Musings on Coke:

- The chance that Coke is not the leader in the carbonated beverage business in the future is very small
- Candy bars become very entrenched in their markets and are hard to unseat...they don't travel well into new markets
- Coke travels well into new markets
- One of the most important thing about Coke as a consumer product is that Coke does not have a “taste memory.” In other words, the taste of Coke doesn't accumulate in your mouth. This is what makes it easy for some people to have 3,4,5+ Cokes each day. They never tire of it because there is no taste residue. Orange or grape soda accumulates and you get sick of it. Same thing with chocolate. There is no diminishing marginal utility of taste for Coke. WB doesn't believe there has ever been a word written about this phenomenon.

On currencies...

Bet against the dollar / currency hedging:

- Currently owns over \$20B in foreign currency
- No strong feeling on which currencies will do best against the dollar
- Increasing interest rates will also add to debt service burden to foreigners

- Every day US consumes 5% more than we produce...US is like an enormously wealthy family with a very large farm, and we keep mortgaging larger and larger pieces of it to foreigners
- Foreigners own net \$3T of US securities...goes up \$2B per day
- This is no a “doom and gloom” bet on the US – still a great country with great infrastructure
- Formulated thesis after reading Bureau of Economic Analysis data
- In November trade imbalance with China was \$16B (\$190B annualized)
- This is not a short term bet...don’t know where the dollar is going over the next year...this is a five year bet
- Typical investor should not make the same bet unless one found a foreign stock that was attractive...could buy the stock and leave the currency risk unhedged
- WB never hedges currency risk when he buys a foreign security because he likes the extra diversification it provides

Impacts of the potential revaluation of the Yuan:

- If it revalues 10-20% it probably won’t have a material impact because the discrepancy between labor costs in China and US is so large
- It is unlikely that China will remove the peg
- Wal-Mart is opening up big in China

The future of the Euro:

- There will be strains, but it should be fine over the long term
- WB believes it has been a good thing for Europe and the world

On inflation...

Inflation and the CPI:

- CPI is flawed as a measure of inflation
- Average person’s CPI has a very different composition than the weighted CPI used to calculate inflation
- CPI understates human consumption
- Businesses often have contracts that range from 90 to 360 days, therefore inflation lags substantially
- Eventually higher raw material costs will get passed through to the consumer
- Health care is 6% of CPI, but 14% of GDP
- Home ownership was taken out of the CPI 20 years ago and replaced by an imputed rent amount
 - o Rental rates have not risen since then but home prices have...the increased burden of higher home prices has been fortunately offset for a while by lower interest rates

On commodities...

Oil and natural gas:

- Everyone thinks oil has moved a lot...you have to consider the weakening of the dollar...if you look at oil priced in Euros it has not moved a lot...same situation with gold

- We have seen a real increase in many raw materials...coal is a good example; very scarce right now
- WB doesn't play the game of betting on the price of oil or commodities often
- Natty – MidAmerican is looking at an Alaskan pipeline
- Alaska has 80T-90T cubic feet of natural gas (a lot)
- Trouble with Alaska opportunity:
 - o \$2/mcf transport costs
 - o Takes 6-7 years to build pipeline – hard to make 6-7 year commitment with uncertain future price outlook
 - o Same issue with LNG terminal build-out
- Most commodity companies don't trust current prices because they've been burned too many times on price
- Oil exploration in the US is tough
- Today our onshore production is 6MM barrels/day
- We used to be self-sufficient in oil production, to the point where we had to periodically shut down because we were producing too much
- US is the most explored oil province in the world – haven't found a real elephant in the lower 48 states in 30-40 years
- BRK is not tempted to bet in the oil exploration business in any material way

Aluminum:

- No real opinion on it
- The problem with raw materials businesses is that there's no brand identity...no one ever says, "I want a Coke only if it comes in an Alcoa aluminum can"
- Aluminum, to a large degree, is just stored up electricity, because power is such a huge component of its production cost

On public policy...

Privatizing social security:

- We must remember that social security is not for you or me
- 10-20 million people will not be able to support themselves when they are old
- A rich society like the US should provide that support for its citizens (before one is productive a society should provide good schools, and after one is productive, a society should provide financial support).
- Don't think it's good to let less competent investors do it on their own...they need help, they are not "wired" to be good investors, and it's our responsibility to help provide them with the highest SS base possible
- Privatization plan would lower the base and require you to invest to make up the difference

Miscellaneous...

Impact of emerging economies on US:

- Don't think it will be anything dramatic

Social activities:

- Spends 1-2 hours 4-5 times per week playing bridge

Charity:

- Doing charity work is the opposite of investing – with charity, we look for the most difficult problem to solve and the ones that have the lowest probability of success
- WB is giving guidelines to trustees (see above), but he's not dictating exactly where he wants to give. WB realizes that he will have no idea what the big problems will be in the distant future after he's gone

Warren's success:

- "I was born wired to allocate capital well." If I was born in Bangladesh and I walked down the street explaining that "I allocate capital well", the townspeople would say "get a job".
- Bill Gates says that if I was born 1000 years ago, I wouldn't survive because I am not fast or strong. I would find myself running from a lion screaming "I allocate capital well!!"