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# 2013 Berkshire Hathaway Annual Meeting


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The 2013 annual meeting was an opportunity for shareholders and analysts to pose questions to these master investors, businessmen and philosophers in a five-hour session covering over 60 questions.

Warren Buffett and Charlie Munger are still going strong at 82 and 89 years young. They have an amazing ability to tackle difficult questions and communicate in clear-thinking ways that leave little doubt of their accumulated wisdom.

Since I started attending these meetings (this is my 27th meeting in 28 years), attendance has grown from several hundred to over 30,000 because Buffett and Munger are great thinkers, genuine personalities and entertaining teachers. They celebrate good business and investment practices, the potential for human achievement, high ethics and decency to one's fellow man. Studying Buffett and Munger, you get a course in business, investing and decision making with material reaching across eight decades of experience.

The meeting serves to ingrain the culture of Berkshire with shareholders and employees. An entertaining movie is shown each year that celebrates Berkshire's businesses, managers and employees. A recurring part of the movie is Buffett's testimony to Congress following the Salomon Brothers scandal in the 1990s. Buffett stepped in as Chairman after the resignation of Salomon management. Buffett says that employees should behave as though their actions will be reported by an informed and critical reporter on the front page of the newspaper for all their friends and family to read. Lose money for the company and Buffett will be understanding, but lose reputation and he will be ruthless.

These notes are highlights rather than a transcript. Related subjects and similar questions are grouped together. My thoughts and comments are within brackets to distinguish them from what was said at the meeting, though they may reflect what has been said at prior meetings. Hyperlinks to more information are included in blue. More information on Berkshire Hathaway is available at www.berkshirehathaway.com.

## Advantages of Berkshire Hathaway

Munger offered two points when asked for the two-minute version of Berkshire's sustainable advantages for the long term.

1. Rationality. Staying sane when other people go crazy is a competitive advantage [allowing Berkshire to allocate capital to attractive investment or insurance opportunities when others are handicapped by emotional or institutional limitations or previous, less-rational decisions].

2. Being a good partner to their business subsidiaries, that is, treating them the way they would like to be treated themselves. [This gets the best from the subsidiary companies and attracts owners of large attractive businesses to sell to Berkshire in a non-competitive process. Berkshire Hathaway is run in an extremely decentralized fashion in all aspects except capital allocation, which Buffett handles centrally.]

Buffett elaborated on the second point. Berkshire's practices put the minds of the sellers of businesses at ease when they sell to Berkshire. People who have built a business they care about have three choices when they sell: 1) sell to a competitor and likely see the employees who helped build the business get sacked; 2) sell to private equity investors who would likely load the business up with debt and then re-sell it again in a few years, often with the same result for employees; or 3) sell to Berkshire, where the business will be treated with respect and management can continue to run it without interference from Omaha. [The seller may get less money selling to Berkshire but has a better life and outcome for the employees.]

Such sellers count on Berkshire to keep its promises, and it does. A question was asked if Benjamin Moore Paint might change its distribution to sell through big-box retailers like Home Depot or replace its independent dealers with company-owned stores like Sherwin-Williams. Buffett answered no, that Berkshire pledged not to change the Benjamin Moore dealer distribution strategy at the time of purchase and they'll stick to that.

## Disadvantage of Berkshire Hathaway

Size is the disadvantage for Berkshire, such that it cannot grow its value at the same rate as in the past. [Berkshire's book value per share has grown at a 19.7% annual rate for the 47 years since Buffett took over in 1965, but this rate is 7.9% over the last five years in part due to Berkshire's size being a limitation on the rate of growth. Berkshire's relative rate of growth is still attractive, as the S&P 500 returned just 1.7% annually in the last five years.]

If 2013 continues as it has to date, the five-year period ending 2013 will be the first time that Berkshire's growth in book value has not kept pace with the increase in the S&P 500. For the four-years ending 2012, Berkshire has increased its book value by 61.9% against 72.4% for the S&P 500. To this observation from a shareholder, Buffett noted that Berkshire does relatively better in down years, as was the case in 2008. Munger interjected that Berkshire will do quite well over the long term, and he doesn't worry about the one-, three-, or five-year measurements. Of course, Berkshire's future growth will slow given its present size.

Munger offered that the aggregate record of the largest companies in the history of the world from the time they became large is not great. [Berkshire is now the fifth largest company by market capitalization after Apple, Exxon, Microsoft and Google.] However, Munger thinks Berkshire has a better system and will do better than the record of large companies that came before.

## Investing

Questions to understand the approach and process Buffett and Munger use in making investment decisions are frequent at the annual meetings. Asked for the top five quantitative factors he uses to make investment decisions, Buffett explained that he looks at data but the data and its importance are different in every situation. Different things he sees encourage him to look further or not.

His decisions are not driven by precise ratios of numbers but by developing a picture with high confidence of what a business will look like 5, 10 and 20 years down the road and seeing a big difference between the current price of the opportunity and its value based on the picture he sees. Buffett looks at buying shares of a business exactly like he looks at buying whole companies. Buffett explained that he has much higher confidence in his picture of a business like the Burlington Northern Railroad 15 years from now than he does with a business like Apple. [Among other factors, Burlington Northern has just one competitor and no threat of new entrants, whereas Apple is constantly challenged by new competitors and new products.]

Munger added that people with high IQs and strong math skills naturally gravitate to look at ratios and formulas in trying to divine investment success, but investing well isn't as easy as that—you have to understand the business, which takes a lot more than numbers. Buffett said he didn't know how he would do it if he only looked at numbers, to which Munger added Buffett would do it poorly if he did.

Doug Kass, the short seller Buffett invited to the analyst panel, asked if Buffett had lost his passion for investing. Kass noted that Buffett did extensive research when he first invested in American Express in 1963 [during the Salad Oil Scandal] but had decided to invest in Bank of America while taking a bath. Buffett joked that it's true the idea came to him in the bathtub, but the bathtub wasn't the key factor.

Munger explained that investing knowledge is cumulative. Buffett did extensive research in 1963 because he didn't know American Express then. The second time Buffett bought American Express in the 1990s, it required a lot less research since he knew it already. The second American Express investment resulted when Buffett learned from Frank Olson, CEO of Hertz at the time, how important American Express is to Hertz. Hertz couldn't do business without accepting the Amex card, nor could Hertz negotiate lower fees on it.

Asked about determining the right price for a negotiated transaction, Buffett said he usually feels he is paying too much but he goes ahead anyway when he has a good feel about the business and the people. You can pay a high price for a wonderful business that earns high returns on capital and has the opportunity to reinvest at high rates. In the Heinz deal, Buffett said he was willing to pay more because of the partnership with Jorge Paulo Lemann than he would have paid without Paulo and his associates. Paulo wanted a more leveraged investment in Heinz and only invested in common equity. Berkshire invested in common and preferred equity and expects to earn a good return on both. Buffett said the stock market offers prices from time to time that you'll never see in a negotiated transaction like Heinz.

Asked about stock buybacks and the importance of book value to Berkshire's buyback program, Buffett explained that book value is not important at most companies and it is not the same as intrinsic value which is what matters for buybacks. Buybacks at less than intrinsic value increase per share, while buybacks above destroy it. At Berkshire, book value, has been a useful proxy for intrinsic value though its intrinsic value is substantially higher than book value. Therefore, Berkshire has set its buyback parameter as less than 120% of book value. While it likely wouldn't happen, there are circumstances [and prices] at which Berkshire could buy back quite a lot of stock.

## Macroeconomic Questions

To a question that future investment returns might be low reflecting the "new normal" economy of low growth posited by some economists, Buffett replied that he doesn't spend a lot of time on macroeconomic analysis. He and Munger can't figure the macro view with any accuracy and they doubt anyone else can either. Instead they have a general view that America will continue to work well and prosper over time, and they focus on individual businesses that they can figure out. For example, almost no matter what happens in the economy, Buffett expects the Burlington Northern Railroad to carry more traffic in 10 years than it does today, and there will still be just two competitors in the western U.S. and two in the east, all of which have enormous replacement value.

Investors will do very well if they look for good businesses to own over five, 10 or 20 years as opposed to worrying about the outlook for the economy or stock market. Munger, generally less of an optimist than Buffett, offered that normal returns for the stock market may be less than Buffett and Munger experienced in their careers. Buffett countered, but less than the last 10 years? Munger answered, "Conceivably."

Buffett doesn't know what would happen if the U.S. dollar loses its position as the world's reserve currency. He doesn't think that will happen for decades, if ever. Munger added that the U.S. would lose the advantages that come with reserve currency status [such as being able to issue debt to foreigners in your own currency]. The nature of things is that we are all dead in the long run, including civilizations, but Munger would expect the dollar to remain a reserve currency for another 20 years anyway. To a separate question about an emerging digital currency, Munger said he had no confidence at all that Bitcoin would be a lasting currency.

A questioner asked Buffett to explain his thoughts on corporate profits running at 10% of GDP, noting that Buffett had suggested holding at 6% of GDP would be wildly optimistic in a 1999 Fortune magazine article. Buffett pointed out that corporate tax rates are about half of what they once were. American business has done very well at a time when the divergence between the haves and the have-nots has grown. He expects the divergence between business profits and unemployment to be a point of political friction. Munger noted that just because Buffett thought something 20 years ago doesn't make it a law of nature! There isn't an automatic correlation between corporate profits and economic disparity.

The zero interest rate policy (ZIRP) of the Federal Reserve has affected Berkshire positively. Buffett explained that interest rates are to asset prices like gravity is to an apple. Low interest rates allow asset prices to go higher, and that has increased the value of Berkshire's investments. Buffett cautioned that people behave differently at zero interest rates than at 15% rates. The longer interest rates stay down, the more permanent people believe low rates are and the more they will bid up asset prices. Buffett empathizes with people who have stayed in cash as interest rates have come down and sees them as victims of ZIRP. In the long run, owning a piece of a good business makes more sense than holding cash or a fixed rate investment.

ZIRP will be harder to reverse than it was to put in place. It is often much easier to buy something than to sell it. Easy money has the potential to be inflationary, but there has been very little inflation to date. Arguably, the Fed may have liked to see more inflation. When the Fed starts selling, or possibly just stops buying, things could get really interesting. Buffett likened this to a movie that he enjoys watching because he doesn't know how it will end. Munger noted that not too long ago, intelligent people would not have thought what has happened with interest rates was possible. In this environment, Berkshire doesn't reach for yield but keeps its cash in treasuries that it can access immediately when opportunities arise.

When asked about the biggest disadvantage that the U.S. faces in competition with other countries, Buffett focused on health care costs at 17% of GDP in the U.S. compared to 7% or 8% in the rest of the developed world. Munger singled out the "grossly swollen" derivative and investment markets that distort capital allocation and draw talent away from fields where the best minds could be more productive for society as a whole.

Buffett is disturbed by the growth in national debt relative to GDP, but he notes that the U.S. came out of World War II with a similar ratio to today and we've encountered far worse problems in the past than we face today. Buffett praised the Federal Reserve and both the Bush and Obama administrations for their actions during the financial crisis. He credited George Bush for the 10 most prophetic words in economics—"If money doesn't loosen up this sucker could go down!"—and taking action to prevent the worst from happening. Munger added that there isn't one fixed ratio that is correct for debt, particularly since some of our biggest debts aren't even recorded. All of our fiscal problems become trivial in time if we can grow our GDP per capita at 2% per year.

## Investing in Europe

Buffett said he would be happy to look at investment opportunities in Europe. Europe isn't going to go away despite the flaws of the European Monetary Union. Europe synchronized its currency without synchronizing much else. Munger expects Europe to muddle through as it has already, but he hopes Buffett will call him first if he is thinking of investing in some parts of it. Munger doesn't think Greece is much of a capitalist country.

## Succession and Successors

The short-seller Doug Kass asked if Buffett's son Howard Buffett is qualified to succeed Buffett. Buffett explained that Howard would succeed him as Chairman of the Board, not the CEO. The CEO will run Berkshire, not Howard, but Howard's job as Chairman will be to safeguard the culture of Berkshire and to facilitate the change of CEO if a change is needed. Berkshire's board and culture are likely to reject a bad CEO, but what if the CEO is just average when exceptional is expected or exceptional on many measures but extremely deficient on others? In that case, it will be easier to change the CEO if the CEO is not also Chairman.

Post Warren Buffett, Berkshire's businesses matter, but the keys to Berkshire's success will be the strength of its culture and having a CEO with brains, energy and passion for the job and for Berkshire. The board is solidly in agreement as to who that is. For the benefit of any of his heirs in the audience, Munger said he hoped they wouldn't be so stupid as to sell their Berkshire shares. He noted that the Mungers will be better off with Howard Buffett as the subsequent Chairman too.

Buffett's successor may organize things differently than Buffett in terms of reporting and supervising. Indeed, Buffett has done a small amount of that himself as Berkshire's size has increased. However, the basic structure of decentralized operating management and centralized capital allocation will continue. [In jest, Munger sometimes describes Berkshire as decentralized almost to the point of anarchy.]

Buffett's successor will have the aptitude and ability to get the preferred deals that Buffett has obtained for Berkshire in times of distress. Berkshire has the capital for sound deals and remains the 1-800 number for companies that need cash quick and can offer something good in return. This is one area where size is an advantage, as Berkshire will get the first call to make large attractive investments on very short notice, as happened during the financial crisis.

Munger praised Buffett's development as an investor over the decades. When Buffett's investment capital was small, he didn't have much investment competition. If he had kept to the same things, he would have eventually had to make bigger investments against more competition. Instead, Buffett moved Berkshire to fields of its own without much competition in making quick, private and often distressed deals or buying whole companies from sellers who only want to sell to Berkshire.

Buffett's two potential investment successors, Todd Combs and Ted Weschler, operate independently from Buffett with only limited restrictions, such as not buying American Express. Berkshire, which already owns 13.7% of American Express, is prohibited from buying more by Bank Holding Company regulations. When Buffett managed his investment partnership, he wanted complete freedom, and it's the same with Todd and Ted. Buffett generally sees what they have done in reports about a month later. They have bought some things Buffett would not have and that's OK.

## Insurance

Several questions touched on Berkshire's expansion in commercial insurance with recent hires of top executives from AIG. Berkshire has the capital, and with the right people, the profit opportunities are reasonable. Berkshire prefers to build its insurance operations from scratch so as not to pick up any bad underwriting or reserving habits. There aren't many insurance companies that Berkshire would be interested in buying, and price is an issue when Berkshire can build insurance from scratch at book value.

Munger added that insurance at Berkshire and under Ajit Jain's leadership is far different than at other companies. Ajit figures out how to underwrite insurance for all sorts of things profitably. When competitors copy him and shrink the profit, Ajit thinks of new ways to maintain profits. In praising Ajit, Buffett said that had Ajit come to Berkshire in 1965 instead of 1985, Berkshire might own the world!

Berkshire is rational and can be either large or small in insurance depending on price relative to risk of loss. Berkshire contracted its National Indemnity insurance by 80% when rates became unattractive. Berkshire was big in catastrophe reinsurance when rates were good and walked away when rates went down. Most other insurance companies don't do that, but they should. The standby cost in insurance isn't back-breaking like it is with a steel mill.

It is reasonable to assume that the climate change experts are right about global warming, but Buffett doesn't think that makes any difference to insurance rates from year to year.

Several questions about GEICO focused on whether competitor Progressive's Snapshot device is a threat. [Snapshot tracks customer driving habits (speed and braking) to assess the driver's risk of accidents.] Buffett explained that GEICO's growth in policies and underwriting profit to date would suggest that Snapshot isn't a threat, but that GEICO would adapt to market changes if needed.

## Railroads and Airlines

Asked about the effect on railroads of the crude-oil renaissance but declining coal demand in the U.S., Buffett explained that with coal a lot depends on the price for natural gas as an alternative fuel for electric power generation. He expects flat coal shipments or a gradual decline over time. Crude shipments by rail are big for Burlington Northern, with shipments of about 560,000 barrels per day and planning to go to 1 million. The significant investment by oil producers and refiners in oil by rail suggest it is more than a temporary blip until pipelines are built. Trains move oil faster than pipelines and with more flexibility in destination.

Fund manager Bill Miller inquired about the attractiveness of airlines as a potential investment for Berkshire given the recent consolidation in the industry. Buffett said there would be no benefit to Berkshire's NetJets business from owning an airline. Buffett, who once had a significant investment in U.S. Airways, is skeptical about the long-term profit prospects for airlines even with the consolidation of the industry. He explained that some industries do very well and others don't once they have consolidated. The trouble with airlines is they are intensive users of capital, labor and fuel. They have an enormous fixed cost for the first seat that flies and very low incremental cost for each additional seat. This leads to the temptation to cut prices to fill seats.

Munger added that he puts airlines in his "too hard pile" even with their consolidation. In contrast to railroads where you can't create another one, there are no barriers to entry with airlines and people just love to start new ones. Munger said Berkshire was slow to recognize the improvement in the railroad industry as it consolidated and changed practices, but they're still doing OK in it, even having figured it out late.

## IBM

Asked about the competitive advantages of IBM, its moat in Buffett parlance, where Berkshire has a $13 billion investment, Buffett explained that he would never understand IBM as well as he does Coca-Cola or Heinz. Yet, he is comfortable enough with the business to invest in it. He particularly likes IBM's financial policies and capital allocation, but cautioned that IBM has an $80 billion-plus pension plan that could be a big swing factor.

## Newspapers

Buffett expects to make at least a 10% rate of return on Berkshire's purchases of small-town newspapers. The purchase prices were quite low to allow for future decline in earnings. Munger called the newspaper purchases an exception but one which Buffett enjoys doing.

## Too Big to Fail, Berkshire, Banking and Housing

The Dodd-Frank legislation has not affected Berkshire's insurance business directly. However, the increased capital requirement at large banks reduces their return on equity, which affects some of Berkshire's investments.

Buffett doesn't worry about the banking system, or banks causing the next bubble. The banking system is stronger than at any time in the last 25 years due to more capital, more liquidity, more reserves and bad loans written down. Capitalism goes to excess from time to time because of the humans that operate it, but it doesn't go the same way each time.

The housing bubble resulted from the whole country getting caught in the illusion that prices could only go up, more so than evil intentions by any actor [not that some evil or clever actors didn't take advantage of the bubble]. Fannie Mae and Freddie Mac were encouraged by Congress to lower their standards and didn't resist that encouragement. The Federal Reserve or government could have reined the party in but instead of taking away the punch bowl they added to the proof. The subsequent overhang in housing has been a negative for the economy, but that is improving.

Munger is less optimistic about the banking system than Buffett. Munger doesn't like huge derivative books mixed up with and backed by insured deposits. He doesn't like when bankers want to act more like investment bankers.

## Book Recommendations

Buffett cites *The Intelligent Investor* by Benjamin Graham as the book that changed his investment life. It gave him the bedrock philosophy for investing of 1) thinking about stocks as businesses rather than ticker symbols and 2) recognizing that the price action in markets was there to serve the investor rather than to guide him. Philip Fisher's book *Common Stocks and Uncommon Profits* helped Buffett to see the logic of getting into fundamentally more attractive businesses than he was exposed to with Graham. Buffett and Munger find it fun to read biographies and mentioned one about Joseph Kennedy they are reading currently. There was an earlier mention of a biography of A.P. Giannini, the founder of Bank of America, which Buffett had read years ago.

## Opportunities for Women

Buffett is bullish on the abilities and prospects of women and hopes all doors are open for them. In addition to fairness, society suffers if it doesn't access the talents of all its citizens across all endeavors. He recently contributed an article in Fortune on this subject and cited Katharine Graham as a woman of extraordinary ability who influenced him.

## Life Advice

Looking back 50 years, what advice would Buffett and Munger give to their 30-year-old selves? The boring and trite advice of the old virtues still applies. Hard work and persistence in a field you enjoy pays off. Don't do things just because other people are doing them. Don't be envious. Envy is terrible for the soul, and it's the only sin that isn't any fun.

## Social Media

Buffett thinks the rise of social media may affect the ways that some of Berkshire's companies market to and connect with customers. Buffett himself recently posted to Twitter. Buffett isn't a fan of companies using Facebook or Twitter to communicate important news to shareholders though. Berkshire's Business Wire subsidiary does a better job of simultaneous distribution of corporate news to interested parties than social media or company websites. Munger isn't a fan of immortalizing for all time the dumbest things you've said and done by sharing them on social sites. Some stupidity should remain hidden. Nor is Munger a fan of multitasking with the result that none of the tasks are done well.

## Good Fortune

To a question about the importance of being born in 1930 to his accumulation of wealth, Buffett agreed that he had benefited from the effects of the Depression, which turned others off to investing and created the low-priced investment opportunities he found when he entered the field. For wealth accumulation, one could argue it might have been better to have been born five years earlier or harder if he came along 10 or 15 years later.

Munger noted that the competition for investments was weak in Buffett's early days but wasn't weak today. So far as competition, Buffett countered that there were plenty of smart investors in 2008 and 2009 who didn't take advantage of the opportunities before them then. Incredible opportunities still exist in markets from time to time if you have the ability, mindset and cash to act on them. So far as the timing of being born, Buffett says he envies the baby being born in the U.S. today for all the opportunities that lie ahead.

## Shorting Stocks and Identifying Fraud

Berkshire Hathaway doesn't short stocks because in Munger's words, "they don't like trading agony for money." Buffett and Munger aren't strangers to shorting stocks from their days managing their private funds, but they don't do it. Identifying over-priced securities, stock promotions and frauds can be done, but making money at it is hard.

To a separate question on identifying frauds, Buffett likened it to the "tells" of poker players. You can see it or suspect it in the way promoters act, but he can't give you a specific check list. With financial statements, you have to understand how the numbers can be used to mislead—for example, how the reserves of an insurance company can be off or progress accounting on contracts can misrepresent revenues and expenses. There are many ways for accounting to be off. It may not be deliberately fraudulent, just that management is deluded—they believe what they are reporting themselves! Financial companies with derivative contracts have a special problem with these hard-to-value assets and liabilities. Munger calls the values assigned to derivatives "good until reached for." [Buffett has joked before that with financial statements of some companies, he isn't sure about the assets but he knows the liabilities are real.]

## Miscellaneous Topics

Buffett and Munger don't have a particular system of prioritizing their activities. Rather they lead simple lives, know what they like to do and get to do it. Buffett isn't a list maker, for instance. Munger added that they had evolved to a system that works well for them. They don't make decisions when they are tired, and it turns out that making a lot of decisions is tiring. They are creatures of habit, which conserves their energy, but they consume a lot of caffeine and sugar (Coca-Cola and See's Candy) to keep them going and ready if something interesting comes along. Turns out that is a perfect way for them to operate.

Brains and passion are what have made Iscar, Berkshire's metal-cutting tool business, a leader in its industry. Iscar has no advantage in geography or raw materials, but it has Eitan Wertheimer, CEO of Iscar, and family, and that's all Iscar has needed.

Fruit of the Loom has given up some market share in T-shirts for the screen-print market to a competitor, as screen printers tend to buy on price. Buffett expects Fruit of the Loom's volume to hold up over time. Fruit doesn't have the brand strength of a Coca-Cola, but has enough brand attributes to do fine in its markets. Munger added that large enterprises can average out pretty well without winning every battle.

## Index Funds and Competency

Individuals have a choice in investing. They can spend an appreciable amount of time becoming an expert on businesses and valuing them or they can choose not to spend that time and buy an index fund instead. There's nothing wrong with being an amateur investor, but you must know your own competency. If you think you know a lot more than you do, you're in for a whole lot of trouble. [Buffett often speaks in terms of staying with what you know: "It doesn't matter how big or small your circle of competency is as long as you stay within it."]

## S&P 500 Index vs. Hedge Funds

Buffett has a wager with a hedge-fund fund-of-funds manager that the return of the S&P 500 stock index will exceed that of hedge funds over a 10-year period. The winner of the bet chooses which charity will receive the wager proceeds. [Buffett, who began his career as a hedge fund manager, sees two disadvantages with modern hedge funds: 1) the typical high fees of 2% of assets plus 20% of profits, and 2) hedge funds producing superior returns for a while would attract so much money that size would become a drag on performance.]

After falling behind in the bear market during the first year of the wager in 2008, Buffett's S&P 500 side of the wager moved ahead through 2012 as shown in the following table.

| | S&P 500 INDEX | HEDGE FUNDS |
|---|---|---|
| 2008 | -37% | -24% |
| 2009 | +26% | +16% |
| 2010 | +15% | +8% |
| 2011 | +2% | -2% |
| 2012 | +16% | +6% |
| Cumulative | 8.7% | 0.1% |

## 2014 Annual Shareholders Meeting

The 2014 meeting will occur on Saturday, May 3, 2014, in Omaha, Nebraska. Omaha makes a nice weekend getaway with a number of attractions in addition to the annual meeting events. Make your plans now if you would like to attend. Hotels and planes fill up early.