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Outstanding Investor Digest

THE FOLLOWING IS A SPECIAL REPRINT FOR BERKSHIRE SHAREHOLDERS
WITH THE COMPLIMENTS OF BERKSHIRE HATHAWAY

PERSPECTIVES AND ACTIVITIES OF THE NATION'S MOST SUCCESSFUL MONEY MANAGERS.

Investors featured in this Edition:

Other Investors in this Edition:

Companies & Investments in this Edition:

Volume XV Numbers 3 & 4 December 18, 2000

OID MAILBAG:
FPA CAPITAL FUND'S BOB RODRIGUEZ
"MANY VALUE STOCKS ARE BEING NEGLECTED — AN OPPORTUNITY WE WISH TO SHARE WITH INVESTORS."

After closing FPA Capital Fund to new investors in 1995, Bob Rodriguez said two criteria would have to be met before he would reopen it: (1) There would have to be a plethora of investment opportunties. And (2) there would have be very little interest in value investing. In his latest letter to shareholders, he says both requirements have been met.

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OAKMARK FUNDS'
BILL NYGREN & HENRY BERGHOEF
"EVERYONE'S BECOME A MOMENTUM INVESTOR — A TREMENDOUS OPPORTUNITY FOR VALUE INVESTORS"

Bill Nygren started managing Oakmark Select Fund in November of 1996. He told his partners at Harris Associates that his goal was to run a concentrated value portfolio and achieve an excellent track record over time. He told them that if the firm's past track record was any indication, somewhere in the first five years, there'd probably be an exceptional year; hopefully, there wouldn't be a horrible year; and the rest would probably be mediocre.

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BERKSHIRE HATHAWAY'S WARREN BUFFETT &
WESCO FINANCIAL'S CHARLIE MUNGER
"WE USE THE PHRASE 'WRETCHED EXCESS' BECAUSE THERE ARE WRETCHED CONSEQUENCES."

As we've said before, introducing Berkshire Hathaway's Warren Buffett and Charlie Munger in the pages of *OID* is akin to introducing the Pope at the Vatican — unnecessary at best. But $10,000 invested in Buffett Partnership in 1956 and reinvested in the stock of Berkshire Hathaway at the partnership's termination in 1969 would today be worth more than $270 million — *after all taxes, fees and expenses.*

Incredibly, even those figures understate Buffett's feat

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THIRD AVENUE VALUE FUND'S
MARTY WHITMAN
"USG'S FINANCIAL STRENGTH IS CLEAR. WE'RE FOCUSING ON ITS LIABILITIES."

If anyone is more qualified to assess a company in the midst of legal uncertainty than Marty Whitman, we don't know who it would be. Besides knocking the cover off the ball year after year at Third Avenue Value Fund and being a recognized expert in the field of bankruptcy, he's invested in distressed securities for more than 40 years and even taught graduate level courses on the subject for most of that time.

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WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from page 1)

— because, believe it or not, before fees, but after all taxes, that $10,000 would have grown to more like *$500* million.

Of course, the manner in which they've achieved those returns is no less remarkable. (However, we won't utilize scarce space to re-tell you about it here.)...

The following excerpt was the Wesco Financial segment of this edition's 27-page feature on the annual meetings of Berkshire Hathaway and Wesco.

We're very pleased to bring you excerpts ... from Munger's answers to questions from shareholders at Wesco Financial's meeting. And as always, we highly recommend a careful reading (re-reading, etc.).

WE'VE VERY RARELY HAD TO REMOVE ANYONE. AND IT'S NOT BECAUSE WE'RE SOFT OR FOOLISH.

We're the least "people-removing place" I've ever seen.

Shareholder: One of your most important jobs is to judge people — and you guys have done a fabulous job over the years. But occasionally, you decide that somebody doesn't fit. And I know that every situation is idiosyncratic and specific to that set of facts. But have you learned anything over the years that helps you decide whether it's the wrong person as opposed to someone running into bad luck or making a single bad decision?

Charlie Munger: It's *amazing* how few times over the decades we've had to remove a person. Compared to any other company I know, we're the "least people-removing" place I've ever seen. And I don't think that's because we're soft or foolish. I think it's because we're either wiser or luckier in the people that come to power in the first place.

We all tend to be too slow in doing the obvious people-wise.

Munger: However, *anybody* who makes a lot of personnel decisions makes mistakes that have to be corrected. And if you ask 100 intelligent executives looking back on their careers what their worst mistakes were, a high percentage of them will say, "I was way too slow to make some personnel change after it became obvious."

I'd guess that if you were to ask Deloitte & Touche what the big mistakes were that they made, they would say, "I was way too slow to cashier some client or partner." The human condition is such that we all tend to be too slow in doing the obvious.

But we've tended to be right about people time after time.

Munger: But our record is *fabulous* on that. It may be partly because we're so old-fashioned. Whatever it is, it's been working very well.

When Cort Business Systems came into Wesco, Warren said, "You're going to love Paul." And he was right. Paul has been working at Cort since he was in law school and he's been running it for many years. He really understands it. And he *likes* it. And he's *good* at it. He wouldn't have fabulous numbers from what looks like a mundane business without very excellent management.

We're guessing when a person like Paul Arnold comes aboard that he'll be here long after we're gone. And so far, we've been right on that kind of thing time after time.

The guy who ran Precision Steel for us finally retired after 50-odd years with the business. And he's been succeeded by a veteran of a mere *40* years or thereabouts.

THERE ARE CERTAIN VIRTUES IN OUR SUBSIDIARIES, BUT WE DIDN'T CREATE THEM. THEY WERE THERE.

We didn't create our subsidiaries' virtues. They were there.

Alice Schroeder: I've spent a lot of time in the last year travelling around meeting the managers of the different Berkshire operations. And Berkshire's portrayed as not having a unified culture, a centralized management or anything that really characterizes it — that the different operations are run completely individualistically.

Yet one of the things that struck me — one of the first things I noticed — is that there is, in fact, an *extremely* unified culture. The different companies have things in common. If I had to boil it down, I'd say every one of these people knows their own circle of competence with great intensity, has *no* desire to venture beyond it and really understands the promise they're making to their customers and that keeping that promise is the single most important thing.

Are all these companies in that identical state when you buy them or is some of this instilled afterwards?

Munger: You're right. Certain common virtues *are* observed in the Berkshire subsidiaries. That's because we *love* those virtues and we tend to select companies that display those virtues. But we haven't created the virtues. They were there in the culture before we ever came along. What we do is not screw it up.

That's not to say their virtues haven't been reinforced....

Munger: I do think that when those managers come to the annual meeting or bump into one another at other times and mix socially with other managers running other businesses and they find people very much like themselves with very unusual success stories, there's reinforcement — to use the psychological term — of the existing strength of the Berkshire subsidiaries' individualistic cultures.

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I hope there will be some spread of desirable practice, say, in furniture retailing where we've got different practices that work in different places. For instance, in Utah, they've been way better at building a wonderful credit business than, say, we have in Omaha. Yet in Omaha, we've been way better at doing certain things than they have in Utah. And there are some distinct differences. For example, in furniture retailing, some subsidiaries are way more promotional than others. Well, we'd hope that we'd each learn from one another.

But we don't *force* those changes on subsidiaries. That's where we're different from other people. And we don't try and have a bunch of culture vultures at headquarters that are haranguing the troops to be more like us. We get a common culture because we've *selected* for it....

WE HAVE WAY LESS RISK OF A RUINOUS SURPRISE THAN ALMOST ANY INSURANCE COMPANY AROUND.

Do we think about catastrophe risk? Only with each breath.

Shareholder: A bunch of theologians and I were having lunch before the meeting and we were considering the risk of the super-cat business on Berkshire Hathaway's balance sheet. Capitalization in relation to premiums seems extraordinarily low. But given an enormous catastrophe and all of the super-cat hitting their top lines, what is the real ratio of potential loss to capital? Have you ever done that on the back of the envelope?

Munger: Well, I'd say it's done every *time* at the top on the back of an envelope. No important policy is written without the concurrence of Ajit Jain and Warren. So you've got two minds that think in terms of maximum loss the way you breathe — namely, automatically.

We don't *write* contracts where there's no upper limit. We do write *little* contracts like on an individual auto [where] we don't pay much attention to limits. However, for big super-cat exposures, every policy has a limit of maximum exposure.

Now, sometimes there's an automatic reinstatement... — so that the worst thing that could really happen would be a big earthquake followed by a big earthquake. But to me, it's inconceivable that we would lose 6% or 7% of the net worth of the company after taxes on one event.

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We have way less catastrophe risk than almost anyone.

Munger: We *like* writing [contracts] where we take risks on that scale. The big risks of super-catastrophe, by and large, aren't in super-cat policies. They're in [the companies that] write ordinary policies against storms or something who haven't laid off the risk in any way by effective reinsurance. If big enough storms came through developed-enough swaths of the country, some insurers could suffer losses way beyond their total capital.

Roughly, that happened to 20th Century right here in California. That earthquake basically took 100% of their capital. And it happened because they had a lot of little policies concentrated [geographically] — and an earthquake, of course, had concentrated effects.

No, I would say that we have *way* less chance of a ruinous surprise than almost any insurance company that you could name. On the other hand, we have a way *greater* chance than most people of having an occasional year where we take a whack like 6% of capital after taxes.

We're buying less reinsurance and selling more everywhere.

Shareholder: ...If I read the annual report right, Wesco lays off some of the risk that Kansas Banker's Surety takes on to others. Maybe it's to Berkshire. Why doesn't Wesco carry the whole thing?

Munger: Well, that's a very intelligent question. We do carry miles more of the risks at Kansas Banker's Surety than the company carried for itself without reinsurance before we bought it. But we haven't gone to zero reinsurance — we've gone to immensely *reduced* reinsurance. But you raise a very good question.

Shareholder: Will you carry the whole risk at some time?

Munger: That's certainly conceivable. We tend to do less reinsurance everywhere where we're the purchaser and more where we're the reinsurer.

We can handle lumpy results.

Shareholder: It seems that Wesco is getting bits and pieces of reinsurance. Do you worry about the lack of diversification and whether your results will be quite different from the parent company when you're not getting a pro-rata share of everything?

Munger: ...The nature of the reinsurance business of Wesco is odd bits and pieces, sometimes big chunks. And am I worried about the fact that that's unconventional and that it will cause lumpy results? No, I'm not worried about it causing lumpy results. We're rich enough that we can handle lumpy results.

After all, we've had lumpy results on the *good* side for a long, long time. And we're so rich that we can handle an occasional lumpy result on the *bad* side. And we think it'll work out OK over a long time.

And that's not a *defect*. It's an *advantage*.

Munger: That is one of our *advantages* as an insurer.

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We don't give a damn about the results being lumpy — whereas everybody else is trying to please Wall Street by having smooth results. And that is not a small advantage.

So what your question may cause some people to view as a *defect*, I think of as the shining face of an advantage.

Low premiums to surplus = Greater investment flexibility.

Shareholder: I believe that Wesco writes at about 10% of its surplus. I just wondered if you could tell us how much Berkshire writes as a percentage of its surplus?

Munger: Both Wesco and Berkshire write amazingly low amounts of insurance in relation to surplus. And that practice gives us way more investment flexibility than companies that write a lot of volume in relation to surplus — and we *like* it that way. That's part of the reason.

The other part of it is that we just don't find enough opportunities to write insurance to use the capacity that we have. We would *cheerfully* write a lot more insurance than we do if we could conveniently find policies that were attractive to us....

Decline in GEICO's float growth not necessarily a negative.

Shareholder: The ratio of float to premium growth at GEICO has declined steadily since Berkshire acquired it — so that the growth in float hasn't matched the growth in premiums. Can you tell us whether you think that ratio will bottom out at some point and float will then grow at a faster rate or give us your thoughts about that?

Munger: Here, I can give you an answer in which I have total confidence. I didn't know that it was going down. And now that I do, I could only guess why it's happened.

Here in California, the ratio of float went down because we squeezed a lot more fraud out of the auto accident settlement business. It was fraud that increased that float. If every little fender-bender is turned into phony chiropractic testimony, phony economic testimony, etc., etc., etc., float goes up.

In California, they changed the laws to some extent and the defense practices were changed to some extent. As a result, an enormous amount of fraud was squeezed out of the auto liability business in California. And that reduced the ratio you're talking about.

However, whether or not that's been the case at GEICO, I'm ashamed to say I do not know....

ACCOUNTING FOR DERIVATIVES IS A *DISGRACE*,
BUT GEN RE AND BERKSHIRE WILL DO IT RIGHT.

Accounting for derivatives is a *disgrace*....

Shareholder: Can you talk a little bit about Berkshire's substantially increased use of leverage through its General Re derivatives operation? I think it's increased about 50% from the time it was purchased. Is that a proper use of capital — to invest over $2 billion [in derivatives]? And isn't the downside risk much greater than the upside potential?

Munger: I have not followed in detail the nature of the General Re derivatives business. I *did* follow a very, very similar business at Salomon very closely over many years when I was a director and on the audit committee.

And I hate with a *passion* Generally Accepted Accounting Principles as applied to derivatives — in particular, interest rate swaps. The accountants sold out. J.P. Morgan was the last holdout among the reputable banks. But it sold out to a type of accounting that front-ends into income revenues that should not be recognized as income until very much later. So that is my opinion. I regard it as a *disgrace*.

And it's very stupid to have disgraceful accounting and then reward all the people doing the trading based on profits which are displayed in that disgraceful accounting. So I have that general feeling on derivatives.

But General Re does it better than most, if not all....

Munger: I am sure that General Re has a more conservative operation and better accounting than most, if not all, of the other players in the field. It's a naturally risk-averse place. It may have had some misfortune — even a mistake — lately. But basically, it's a very intelligent place with a very good culture. And its business instincts are right.

I don't like the basic business of being a derivatives dealer.

Munger: However, I do not like derivatives trading in interest rate swaps as the world has developed. It's a field with shoddy accounting and other irresponsible aspects.

Bob Denham is here. He was CEO of Salomon and sat sadly scratching his head through some of those hard days. I don't think I'll put Bob on the spot on that one with so many old colleagues and what have you. But I'm so old, I'm willing to just call 'em the way I see 'em.... The basic business of being a derivatives dealer with the kind of accounting that we now have, I don't like.

But it's quite possible, even necessary, to use derivatives.

Munger: Still, I never wanted its total elimination from Salomon — because I thought we *had* to be in it. And it may well be that at some level a little of it has to exist in General Re or even at Berkshire. And I never minded the derivatives trades that were done by the Meriwether group at Salomon. What I minded was the derivatives business conducted on a market-making business by *other* groups within Salomon.

I think it's quite possible to *use* the derivatives market. Indeed, Berkshire's quite capable of doing that in the future. But basically, I think there's a lot that's irresponsible in the derivatives business. And General Re has already

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announced that they plan to, one way or another, do *less* of it....

THERE'S PRACTICALLY NOTHING IN ACCOUNTING TO KEEP THE SKILLED FROM SHUCKING THE SUCKER.

Accounting abuse is regrettable now and will be *more* so....

Shareholder: My question is about accounting ... specifically the recent proliferation of accounting fraud as well as abuse of accepted GAAP accounting and the implications for an outside passive minority investor in public securities evaluating businesses even when one finds a superior business at an attractive price. Could you please comment on that as it relates to its implications for the markets and how one might go about correcting it?

Munger: Where so much money turns on numbers that happen to be reported, the human temptation to manipulate the numbers is bound to be pretty substantial. And then, when everybody's doing it, you get what I call "Serpico Effects" — you know, everybody else is doing it and you're a sucker if you don't go along and so on and so on. So I do think we get tons of promotional accounting, *particularly* in a period like this — which is regrettable now and will look even *more* regrettable when we look back on it a few years hence.

Defrauding suckers is hardly a new activity for the species.

Munger: I think it's *always* been thus. You can see what human nature will do unobstructed if you go back to the days of the early Irish ruffians who ran the Comstock Lode. Those guys were not satisfied with having the heart of the Comstock Lode where they could mine silver more efficiently than it had ever been mined before in the history of the world. After all, you can only make so much money digging out all the silver and turning it into currency.

So they decided since they controlled the companies, they would turn a *one*-handled pump for making money into a *two*-handled pump. Mining companies in those days declared monthly dividends. So they'd run the dividends way up, put out a lot of wonderful rumors — and then they'd sell short heavily. Then they'd fill the mine with water, cut the dividends to zero and buy the shares back. And you could do that over and over again. They turned a mine into something that would make money in two ways — mining silver and defrauding suckers.

It's not so *crude* today, but it's still being done in *spades*.

Munger: If it were *legal*, it would be done enormously to this very day. People get pretty close to it in some ways by crowding in to take advantage of unsound accounting conventions. The standard way of doing it today is not so crude as the one devised by Fair, Flood, Mackay & O'Brien — the gentlemen who figured out the two-handled pump system for handling the Comstock Lode.

Today, it's chain letter mechanics that people use to shuck the suckers. And since they're mixing the mechanics of a chain letter with legitimate activities like venture capital, improving commerce and what have you, it gets respectable. That's what caused great hostility from my wife when I said, "When you mix turds with raisins, they're still turds." I think we're mixing those respectable activities with *un*-respectable activities.

And that's being done in *spades* in the current era. There's practically *nothing* in accounting that is carefully designed to limit what some sophisticated entrepreneur can do with chain letter principles skillfully worked into a legitimate enterprise.

AND DARWIN DOESN'T JUST APPLY TO BIOLOGY. EVOLUTION IS AT WORK IN BUSINESS, TOO.

The New New Thing describes an appalling culture.

Shareholder: Have you read *The New New Thing* by Michael Lewis? If you have, may I ask your opinion of it?

Munger: Yes, I did. And I found it interesting enough so I didn't put it down until I'd finished. In some respects, it describes an appalling culture. It's had some creativity and made some large contribution to the wider civilization. But some of what's developed in that culture is not pretty.

In England, in the days of the asset-strippers — remember Slater? — one of the prime ministers called him "the unacceptable face of capitalism". And I would say that there were things described in *The New New Thing* that come pretty close to the unacceptable face of capitalism....

It's hard to isolate the five most valuable books I've read.

Shareholder: This year, [at Berkshire Hathaway's annual meeting,] you did not recommend any books. Could you name three to five important books you've read in your life that you might suggest to people who are interested in your field?

Munger: Well, I have trouble doing that because I've *blended* so many books in my own mind. If you have a very interdisciplinary mindset — which I've had for decades — you're just going through books like a scavenger slotting things out of the book into your own internal system. Therefore, you can't point to one book and say, "There is the source of all Truth" the way that the people at the Fuller Theological Seminary do right across the street.

But *The Selfish Gene* is one fabulous book.

Munger: I have had *enormous* pleasure at picking up this modern Darwinian synthesis — you know, Dawkins' *The Selfish Gene*. If you've never been introduced to that book and the way of thinking that's contained in that book — if you have any intellectual curiosity about the human condition — that is one fabulous book. The truth of the

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matter is without that insight, the basic Dawkins insight, you don't properly understand one of the most important theories ever found.

And by the way, he didn't *invent* the insight. He just popularized it better than anyone else has ever popularized a difficult insight.

But I would say that that is one fabulous book. So if any of you haven't ever read Dawkins' *The Selfish Gene*... That is one wonderful book.

Everything isn't invented. Sometimes it just evolves....

Shareholder: Are there lessons from the field of evolution that we can apply to evaluating businesses and industries? In other words, are there parallels in biology and business in terms of the functions and structures and the performance and the development of things?

Munger: Well, the answer to that is, "*Yes*." All *kinds* of things that work in business have been discovered by what I call "*practice* evolution". And just as evolution has gradually developed the eyes and wings and claws and behavior patterns that work so well to feed the animal, human enterprises have developed behavior patterns winnowed by their successes and failures.

So a lot of what you see that works like crazy, nobody thought it through *ab initio* the way that you would derive some theorem of geometry from axioms. They just blundered through a lot of things, repeated what worked and avoided what didn't. And in time, the result was a very elaborate practice evolution.

Darwin in business — the origin of ~~species~~ businesses.

Munger: Take something like Cort which has been in business for such a very long period. It has a lot of practice evolution in its personnel system and its practices of a million different things. When you evaluate businesses as a common stock investor, you're betting to some extent on the outcomes of practice evolution. And some people have developed better systems.

Take a mundane business like the car rental business — the equivalent of what Cort is doing with furniture — the short-term rental of automobiles: Both Hertz and Enterprise have through practice evolution created personnel systems, leasing systems, location systems and reward systems that work very well for them and that are different. It's very much like biology. In other words, Enterprise Rent-A-Car and Hertz are like two different species in ecological niches that are close together. Through practice evolution, they're just like two different butterflies. And each system *works*.

So yes, I think a lot of money can be made by common stock investors by identifying the outcome of practice evolution which really works.

There wouldn't be Tupperware parties if they didn't *work*....

Munger: One of the most extreme examples in modern capitalistic history was Tupperware. It developed what I regard as a corrupt system of psychological manipulation in order to sell a better class of plastic dishes. Well, when Justin Dart brought that to his board of directors for purchase, a couple of directors *resigned*. They thought it was so schlock, they didn't want to be identified with it.

But Justin Dart figured, "Well, nobody would have invented all that crazy shouting of Tupperware and bugging one friend to entertain other friends etc., etc. unless the practice evolution *worked*."

And Tupperware had enormous — what they call in show business — "legs". *Billions* of dollars were made out of Tupperware parties. And it went on for *decades*, although I think it's groaning in the traces now — as it probably should.

But my point is that somebody who *never* would have invented that system, like Justin Dart, saw it was working. And even though it came out of practice evolution, he predicted that it would *keep* working and the fact that it looked so *schlock* would keep a lot of other people *out* of it. At any rate, his decision made him a lot of money.

A *lot* of money can be made by thinking biologically.

Munger: So I do think biological reasoning actually can help you in investing because I think you will frequently find the outcomes of practice evolution in companies that will point to money-making opportunities that you can't recognize by deriving them from fundamental principles or something like that. Therefore, you've got to think *biologically* — as I think Justin Dart did with respect to Tupperware. I think a *lot* of money can be made that way.

We wouldn't have bought Cort Systems if we didn't like the culture that has evolved there — which, again, is practice evolution.

In most messy human problems, you need *all* the models.

Shareholder: You've talked about carrying a lot of models to improve your life. With your life experience and your knowledge about notions and models, do you have some special kind of general framework for reasoning when you apply those notions and models so that there are some generic questions you ask yourself when you approach different types of issues?

Munger: Well, that's a good question. My notion is so simple that I wonder that everybody doesn't immediately adopt it. I think you have to know the big ideas in all the big disciplines. Then, in most messy human problems, you have to be able to use *all* the big ideas and not just a few of them.

What happens is that people are trained in economics or engineering or marketing or investment management or something else. So they learn a few models and then they run around trying to solve all their problems with a limited number of models. And they don't really understand how their models intermix with other people's models.

So my system, such as it is, is just to learn all of the

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big models and use them *routinely* instead of just the models in which you happen to have the training. I've always loved that old saying, "To a man with a hammer, every problem will tend to look pretty much like a nail." That is a very dumb way of handling problems.

The core of EVA makes sense, but it wouldn't sell that way.

Shareholder: In Stewart's book, *The Quest for Value*, where he talks about Economic Value Added, he references Mr. Buffett in terms of the creation of shareholder value. I just wondered to what extent you and Mr. Buffett embrace the EVA principle and if you use that in your analysis?

Munger: Well, EVA, of course, is very popular because at least it talks about how you get a high return on capital and points out that shareholders are enormously benefited if you manage to get a high return on capital and if you can reinvest at that high return for a very long time.

But if you stated it the way that I've just stated it, you couldn't sell any books.

I don't think it's an admirable human system.

Munger: So you have to dress up the elementary idea with a lot of twaddle, copyright the twaddle and sell it to various people at high prices per hour — making it *worse* by introducing fuzzy concepts that don't really *work*, like a cost of capital concept that makes no true economic sense.

I don't want to talk any more about it. You can see that I... I think it's succeeding because there's some underlying truth that it is consonant with. But I don't think that it's an admirable human system. In its totality — what should I say? — it's like psychoanalysis.

WHAT WE'RE DOING SHOULD SPREAD — BUT WHAT'S SPREADING IS SOMETHING ELSE.

Why aren't we copied more? Partly because we're different.

Shareholder: I'd like to pick up on your thread with regard to economics and psychology. Why do you find that no one else seems to be trying to emulate Berkshire today? You have fund managers who run funds and people who run companies, but Berkshire seems to be rather unique. Why isn't anybody else trying this formula?

Munger: Well, I think that's a very good question — and, of course, we've asked that of ourselves. Look at how it's worked for us and the obvious fun we're both having doing it. Look at the fun our managers are having running their businesses. And look at the fun, by and large, that the shareholders are having which you can see at the annual meetings — even at crazy gatherings like this one. Why don't more people copy it? I think more *should*.

I don't think what we're doing is that difficult. I think it *looks* difficult from the outside — partly because it's unconventional. I think the unconventionality of it makes it get rejected. It isn't the way things are normally done. We don't have all these budgets, goals, quarterly reviews and all *kinds* of things in terms of dealing with subsidiaries that are standard in American management. We don't have personnel systems that are standard. And our investments are way more concentrated than is conventional in portfolio management.

Everything we do just strikes me as simplicity itself and to make nothing but sense. Yet it is very little copied.

People do copy us some — sort of....

Munger: It *does* get copied some. People invent something — or at least they invent a new *name* for it. They call it "Focus Investing." And they say, "We're going to be like Berkshire. We're going to have 10 securities instead of 40" — or 10 instead of 400 or whatever. I think there is more of that. I think so-called "Focus Investing" is growing somewhat, but only slightly.

What's *really* growing is exactly what I criticized in my speech to the Foundation Financial Officers [Group] — just unlimited consultants on allocation strategies and consultants on the monitoring of other consultants. *That's* what's growing. It's being *taught* in the business schools.

I was with Jack McDonald the other day at Berkshire's annual meeting. He teaches sort of a Berkshire mindset in terms of portfolio management at Stanford Business School. And I'll tell you what *he* feels. He feels lonely like the Maytag repairman. And I'm afraid that that's just the way it is.

We know why our compensation system isn't copied.

Munger: The world's *always* had crazy conventions. I was in Army ROTC for six years in high school and college. And that was a limited culture with certain standard constructs. It did not have a lot of new ideas. And I think there's a lot of that kind of ROTC thinking at very high falutin' places where people have Ph.D.'s and other advanced degrees. That's just the human condition.

But I don't know *why* our example isn't copied more. You'd think having overhead as low as we have it would attract people. Of course, part of how we *keep* it so low is not assaulting corporate compensation systems *ourselves*. And Berkshire's system for paying its top executives is a nonstarter at most places.

I'm not answering questions at this meeting for the money.

Shareholder: Which question should I ask of you today to highlight any specific area that might be fascinating to you?

Munger: I'm more fascinated with effective rationality as a lifelong quest than I am with any detailed activity like golf, accounting, bridge or what have you. And I'm quite confident my mindset will spread because it *works* better. In other words, a more basic, multidisciplinary approach to messy human problem-solving will spread. It *is* spreading.

And to the extent that I can contribute a tiny mite to

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that by answering questions here for a long time, that's why I'm doing it. It isn't that I like being a paid entertainer — or, even worse, an *unpaid* entertainer.

There are lessons in this little meeting for a reason....

Munger: I do think these ideas that come out in response to your questions either *are* or *should* be of utility generally — and in activities far removed from investing in common stocks. I'm talking about *lifes*manship.

I think Berkshire is about lifesmanship. I think the lives of the people that run the Furniture Mart or the two subsidiaries we have here in Wesco are good lives. I think the people around headquarters at Wesco have had pretty good lives even though they have had a basic business shot out from under them. And I'm talking about the savings and loan business.

So to the extent there are lessons in this little meeting, all I can say is, it's *intentional.*

IS COCA-COLA EXPENSIVE? SURE.
BUT THEN AGAIN, IT *SHOULD* BE.

If I'm right, if you own Coke long enough, you'll do all right.

Shareholder: What long-term growth rate in both unit case volume and EPS growth do you think that Coke will be able to achieve? Recently, *Beverage Digest*, a respected trade magazine, polled a number of bottlers who believe Coke cannot achieve its current unit case growth goals of 5-6% in the U.S. and 7-8% in the rest of the world without a price war.

And in my humble assessment, the bottlers have a little more credibility than Coke's management team at the moment in terms of their assessment of the business. So could you help me with that?...

Munger: Well, I don't think my view as to the exact probable percentages for future growth at Coke should get any special weight. I would be willing to bet a lot of money — in fact, you can say that indirectly I *am* betting a lot of money — that over the next 20 or 30 years, Coke will be selling materially more soft drink and other drink products. And I think they'll also be able to raise prices moderately during the same period and, if anything, increase margins.

Now if I'm right in that long-term view, if you own Coke and hold it long enough, you'll do all right. However, I don't think I want to get into arguing with the experts about the correct target for Coke.

Some believe in setting unreasonably high goals....

Munger: There are two lines of thought.... A whole bunch of management gurus say you need B-HAGs — bold, hairy, audacious goals. That's a technique of management — to give the troops a goal that looks unattainable and flog them heavily. And according to that line of thought, you will do better chasing a B-HAG than you will a reasonable objective.

And there's some *logic* in that — because if you tell your kid A-minuses are fine and he likes partying around the beer keg and can easily get A-minuses, you may *well* get a lower result than you would if you gave him a different goal.

[Editor's note: That reminds us of John Templeton's experience as a youth. After young Templeton brought home straight A's on one of his first report cards, his father, Harvey Templeton, decided that he would reinforce his son's drive for excellence by wagering him a bale of cotton that he could not achieve straight A's on his subsequent report cards. The result? Templeton earned straight A's in each and every grading period during elementary school, junior high school and high school (and 22 bales of cotton).]

Unfortunately, unreasonably high goals cause cheating....

Munger: Then there's another group that says that if you make the goals unreasonable enough, human nature being what it is, people will cheat. And you see that in the public schools — where they say you've got to have the reading scores better so we're going to pay the teachers based on the reading scores getting better. So the teachers start helping students cheat to pass the reading tests. So human nature being what it is, if the goals are unreasonable enough, you will cause some cheating in your corporation — or even within your top management.

Each organization has to find its own way.

Munger: I can't *solve* that problem. There are two factors that are at war. You don't want the cheating — which is bad long term and bad for the people who are doing the cheating. However, you *do* want to maximize the real performance. And the two techniques are at *war.*

What people generally do is give people the unreasonable goal and tell 'em, "You can't cheat." That's basically the goal at General Electric. They say, "We don't want any excuses.... But don't cheat.... If you can't handle those two messages, why, perhaps you'd be happier flourishing somewhere else." That is the American system in many places.

I've got no answer to that tension. Low goals do cause lower performance and high goals increase the percentage of cheating. Each organization has to find its own way.

Is Coke expensive? Yes. But it *should* be....

Shareholder: I understand your point — that stretch goals have certainly worked out great at General Electric.

If you could then help me think about my intrinsic value calculation. When I play around with the numbers and I take the highest earnings that Coke's had over the last several years and try to grow that out at fairly aggressive numbers — perhaps 9% for 10 years, 7% for 10 years after that, etc., permanently settling out at 3% or 4%

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— and then use an 8% discount rate, I still have a hard time seeing how the stock is anything but slightly overpriced. What might I be missing?

Munger: Well, you're pointing out a basic element of human securities valuation: If growth is *sure* enough, at practically any slight advantage over standard returns — say, interest rates — and if you project it far enough, the present values get very *high*. So when you get stocks like Coke where a lot of people have a lot of confidence that if they're coloring and flavoring 2% of the world's water now and it'll be 4% 20 years from now or something like that and they'll be charging higher prices, then people start giving it these higher valuations based on what you might consider a moderate advantage projected a long time.

But moderate advantages projected ahead a long time cause very high real values now. That's just the way the math works out. So what you're seeing in Coke is a residual prediction in spite of the stumbles of recent years that the underlying strength is still there — and that if you blank out these blips up and down, 20 years from now they'll be coloring and flavoring a lot more water and earning more per serving, which is the way that I tend to think personally.

SOMETIMES I'M IN THE DARK INVESTMENT-WISE,
BUT I KNOW WHAT WE'RE DOING WITH NET-JETS.

We don't even *look* at what Lou Simpson's doing.

Shareholder: You guys took two positions — one in Great Lakes Chemical and the other in the furniture area. Could you comment on both industries?

Munger: Well, I don't want to comment on the chemical industry. And by the way, when you say "you"... Frequently Lou Simpson will do something. And I don't even *look* at what he's buying or selling. So people will sometimes come up to me and say, "Why did you do that?" And if Lou isn't there, I haven't got the faintest idea why "we" did it.

Cort is an anomaly. But it's been an anomaly for *decades*.

Munger: As to the furniture industry, it's interesting. You can call that an accident. Berkshire now owns the leading furniture retailer in something like six different states. And the companies have somewhat different operating personalities. Now if you add Cort, which is in the so-called "rent-to-rent" end of the furniture business, we're a pretty substantial operator in furniture distribution — I mean, *really* substantial in that trade.

And that happened by accident. Furniture retailing is not generally a good business. But if you get into the very *best* of it — in terms of market share, practices, institutional personality — it's a very fine business for us.

And Cort has had *very* respectable operating numbers for *decades*. It seems like renting furniture couldn't produce such numbers — but it has and does. And that's why we own it.

NetJets is experiencing explosive growth in the U.S.

Shareholder: We came here on NetJets. The pilots told us that you have 700 pilots now and expect to have 1,000 pilots by the end of the year. That strikes me as rather explosive growth. Could you go into that a little bit?

Munger: I *did* go into it. I bought a sixteenth of the cheapest jet. [Munger laughs.]

Europe will be a perfect bitch of a place for us with NetJets.

Shareholder: They also said that they thought the inability to find good pilots in Europe seemed to be a constraining factor there....

Munger: Yeah. Europe will be a perfect *bitch* of a place in which to get up to speed — going into a lot of different countries with a lot of different rules and with the labor and other climates in Europe. We will lose money — we *are* losing money — going into Europe.

But short-term pain will lead to long-term gain.

Munger: But the nature of it is that if you get in there first and do it right and you've been *through* all the indignities, the latecomer is going to have *all* the indignities and trouble plus he'll have NetJets there. And if you think *we're* having troubles, boy is *he* going to have troubles.

So that's what encourages people to suffer like that. And Coca-Cola's done that all over the world — they've suffered like *hell* to go into difficult places. And look how well it worked in the end. That's what NetJets is doing in Europe. We're suffering for the long-term future....

IF HISTORY IS A GUIDE, EXPECT THE UNEXPECTED.
WE TRY TO BE PREPARED FOR THE EXTREMES.

We haven't made big profits with our interest rate insights.

Shareholder: Warren's said that if Alan Greenspan were to whisper in his ear exactly what he was going to do with interest rates, it wouldn't change a thing he does. But do *you* have an opinion about Fed policy? Do you care? Has the higher interest rate environment affected any of your companies?

Munger: Neither Warren nor I has any record of making large profits by guessing what the Federal Reserve is going to do or in which direction interest rates are going.

But if history is any guide, expect the unexpected....

Munger: That said, all intelligent citizens of a modern republic think some about interest rates. In my lifetime, I've seen interest rates at 1% and I've seen them at 20%.

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Now that's one hell of a range. As you sit here, 1% seems *inconceivable*. However, in Japan, short-term interest rates are *under* 1%.

When I was in law school, I think interest rates were about 1-1/2% for a long, long time. Common stocks yielded 6% or 7% and the Dow was a few hundred points. And those low interest rates lasted a long, long time.

And *nobody* really thought we'd ever get a prime rate of 20-21% and government bonds yielding 15-16%. But we *had* those conditions and they lasted a long time.

We try to be prepared for the extremes.

Munger: We try and operate so that it wouldn't be too awful for us if something really extreme happened — like interest rates at 1% or interest rates at 20%. But when they're in some intermediate-type range, we tend to be agnostic about interest rates. We tend to operate as if we just can't guess which direction they're going — and even what the long-term trends are going to be.

Prolonged Japanese downturn contradicts Keynes....

Munger: *Anyone* with any intellectual curiosity has to be flabbergasted by Japan being in this heavy recession for 10 years in spite of taking interest rates down near zero and running a huge government deficit. In other words, they're playing all of the monetary tricks and all of the Keynesian tricks — and yet they still have a recession that has now been about as long as our recession in the '30s, although it's not as severe, of course.

If you'd taken economics at Harvard during the postwar years, you would have been taught basically that that was impossible — that with these modern macroeconomic tricks that wise governments have learned how to play led by Keynes and others, what happened in Japan *can't* happen. But it *has* happened.

Economics by itself isn't enough....

Munger: So I think that interest rates get interesting — what they can do and what they can't do. For example, why does a crazy asset bubble in Hong Kong with a collapse that's met with massive government intervention in the stock market result in a pretty temporary downblip in the economic performance of Hong Kong whereas an asset bubble collapse in Japan results in a 10-year recession?

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I don't think economics by itself, as traditionally done, will give you the right answer.

Factoring in psychology, Japan is very understandable.

Munger: I think that you've got to mix economics with other disciplines. And when you mix economics with psychology, you can begin to understand the difference.

The truth of the matter is that people in Japan went *catatonic* risk-averse. You could ease up money all you wanted. But the banks who'd lost so heavily and were being criticized so much in a nation where people hate criticism and loss of face, just didn't want to make loans — period — that might cause them more trouble.

Warren always cites the case of Mark Twain's cat that, after a bad experience on a hot stove, never again sat on a hot stove — or a cold stove either. That's what's happened in Japanese banking. They just don't want to make loans because it hurt 'em so much *last* time. And the Japanese consumer is behaving the same way.

Psychology explains the Hong Kong experience, too.

Munger: In Hong Kong, you have a bunch of Chinese. That is a different ethnic group. The love of gambling and the love of action among the Chinese compared to the Japanese — that's just two entirely different conditions.

Taking into account things like that is not in the economics books. But that's because the economics books are wrong. Economics will make better predictions when it learns to take in more and more from the other disciplines.

By the way, it's been pretty good at that over the years. Of all the crazy, self-centered social science disciplines, economics has been the best at being a kleptomaniac — just running out and stealing anything that works from some nearby discipline. And that's very much to the credit of economics, but they haven't carried it far enough. And when they do, they'll be able to make better explanations — or so it seems to this assistant headmaster of a cult.

Interest rates are important, but they're also unknowable.

Munger: At any rate, interest rates are a *very* interesting subject. And for you people that are thinking about what common stocks are going to do for yourselves and your clients, interest rates matter *terribly*.

If interest rates go to 3% and stay there, you could say our better stocks are too *cheap*. But if, like us, you figure you can't really predict interest rates, then you've got to be making investment decisions in some other way. Similarly, of course, if interest rates are going to go to 9% or 10% and stay there, that's a very different world for common stocks.

But I think that *predicting* interest rates is very tough. I'm not saying somebody might not be able to predict some short-term blips here or there by being either exceptionally shrewd or well-connected. But if you ask people to predict

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what interest rates are going to be a year or two in advance — or five years in advance — I think their predictive power gets down pretty close to zero.

I think you can predict a *range*. I think it's quite unlikely that they'll go below 1% or above 20%. However, once you get outside of a big range like that, I think it gets a lot tougher.... That may be more about interest rates than you want to hear.

With the proper tools, Japan is no great puzzle.

Munger: And I'm not kidding when I say that the economics profession has been horribly surprised by what's happened in Japan — the fact that their recession has just gone on and on and on.

I'm not surprised. And that's just because I'm using a *slightly* different model. Can you imagine standing up at an economics convention and saying that that happens in part because the Chinese are so different from the Japanese? My *God*, it wouldn't even be politically correct.

I WORRY ABOUT PROSPERITY BASED ON CREDIT. THERE *MUST* BE A MORE SOUND WAY OF DOING IT.

Recent economic nirvana was aided by credit expansion.

Shareholder: Do you believe the Fed *needs* to slow things down? Also, do you see inflation?

Munger: It's hard to imagine a mature, unionized, civil-service-pervaded economy like that of the United States performing much better than it has over the last few years. It has to be something pretty close to optimal given the natural constraints of the system.

And that, of course, has involved a fair amount of credit expansion. We've pushed credit card lending and we've pushed asset lending. Everybody leases automobiles instead of buying them. I don't think that's necessarily true in this room, but it's generally true in the civilization.

And it's hard for me to imagine it getting much *better*. I can conceive of various ways in which it could get *worse*.

I think Greenspan's right to be worried.

Munger: So you'd have to say based on the record to date, Greenspan and his crew have a remarkable record. And I think he's right to be worried about asset bubbles.

In fact, the relation of national policy to asset bubbles is a very interesting subject. You had a huge asset bubble in Kuwait that amounted to a vast chain letter scheme of speculation with some crazy ... check-kiting scheme. Basically, the government came in and bailed 'em out. Otherwise, the whole *country* would have been broke. It was a mass mania. However, they have a lot of oil — and they were able to kind of bail people out.

Then you got the Hong Kong bubble where you had massive intervention in the stock market directly by the government of Hong Kong. And the enterprising Chinese, who don't go into a catatonic state of fear with the first reverse — or the second or third — quickly bounced back.

Where else did we have an asset bubble? Well, Warren cited the farmland bubble, where people basically bid the price of farmland up to three times what could be justified by the natural income from owning a farm. And that bubble broke many banks and caused a lot of trouble. But it went away and it didn't sink the economy.

There *has* to be a more sound way of doing it.

Munger: I worry a little about prosperity that comes from constant pushing of the envelope of credit expansion. Some of the world's great growth periods — such as Germany after World War II — occurred without any assistance from that kind of massive credit expansion. There *has* to be a more sound way of doing it than what we're doing now.

The credit system's been pushed about as far as it can go.

Munger: You'd think that eventually we'd get to a place where we pay a price for constantly getting next year's expansion by pushing the credit system a little further. For example, how much farther can you push credit in automobiles when you're already leasing them guaranteeing a residual value with no down-payment? And of course, some of the venture capital financing is getting very gamey. So we've pushed [the credit system] pretty hard in a lot of places already.

I think all intelligent people that have been here for a long time tend to worry a little about asset bubbles and credit expansions. And Greenspan's plainly correct to be making clucking noises and warnings on those subjects.

HIGH HOUSING PRICES DO CAUSE PROBLEMS. BUT I DON'T THINK WAITING IS THE SOLUTION.

If you think there was a rally in technology *stocks*....

Shareholder: Silicon Valley's housing prices are exorbitant and interest rates are not doing anything to help lower the prices because people are buying based on stock options.

I'm wondering what your opinion is on salaries in general in Silicon Valley — inclusive of stock options — and how wage-earners might migrate away from the Valley and create a generalized recession in that area?

Munger: Well, I think you're right to call attention to Silicon Valley housing prices. There has been nothing that extreme in my long life — not even Florida prices in the '20s. The Munger Professor of Business at Stanford Law School bought a moderate kind of a house when he started teaching at Stanford for $400,000. Well, that house is worth $4-1/2 *million* now. And it's not that big a house. So there's never been anything quite like it in the previous history of the world.

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And booms in housing prices cause all kinds of problems.

Munger: And it does cause problems when housing prices get so high. If you're going to have a servant class, they're going to have to migrate in from a long way off — which causes all kinds of envy effects. The accident of who bought a house five years ago and who didn't causes an enormous change in life outcomes. It causes all kinds of envy. It's *disruptive* to have a boom in housing prices on the scale that you're right in the middle of. It's a *very* extreme condition.

But if you wait for the old prices, you'll be living elsewhere.

Munger: But whether it will get *more* extreme or have a big bust is an interesting question. I'd bet a lot of money that it will not be a total long-term bust. I don't think Silicon Valley is going back to the desert. In other words, Palo Alto's a wonderful place to live, educate your children, be surrounded by a lot of brilliant people and enjoy a wonderful climate.

So if you wait for the real old time prices and you want to live in Palo Alto, I think you're going to spend your life somewhere else.

IF THE INTERNET IS THE PROBLEM,
THERE MAY BE NO SOLUTION....

Internet will change things significantly. Even at See's....

Shareholder: At Berkshire's last two annual meetings, Warren opined that brands are going to become even more important over the internet. Would See's ever consider paying slotting fees to AOL or Yahoo so that when someone searches for "chocolate" or "candy", the first company that it pulls up is See's Candy?

Munger: We don't have any absolute rules about which kinds of sales promotion techniques we use at See's. See's is already selling through the internet the equivalent of about three or four stores' annual sales. And it's some of the best business we have — because we get the same price with a fairly low-cost system of distribution.

I wouldn't regard See's as *the* most ideal candy to sell over the internet because there's a problem of maintaining quality when you send it out into the August heat no matter what delivery system you use. Nonetheless, See's is changing its delivery system somewhat based on the existence of the internet.

Everywhere in Berkshire, we encourage people to adapt to the new reality — which is that the internet is going to be a big thing and it's going to significantly change the way things are done from how they were done before.

But what's good for consumers *won't* be good for investors.

Munger: But from *your* point of view — you investors — there's a *very* interesting aspect of the internet that gets little attention from the people promoting stocks in the new order of things. And that is that high profits on capital in corporations with passive shareholders are made possible in many cases by information inefficiencies.

Take the Berkshire subsidiary, Precision Steel, that sells steel in minor quantities cut to order — sometimes fabricated a bit to order. The information disadvantage many of our customers are at makes us the best solution. "I need a small, specialized quantity of steel — and I need it fast. So I'll call Precision. They're always reliable. They'll deliver it."

But if you create an internet system where every damn piece of steel in America similar to what they need can be punched up on a computer and there's an easy way to punch in whoever has the piece of steel, maybe that will make it better for the buyers and worse for the sellers. Maybe the seller's economic advantage, which is real, will be reduced.

The wealth of the world goes way *up* when we squeeze inefficiencies out of distribution and inefficiencies out of market effects. But in that squeezing, there may be an averaged-out, general compression *downward* of returns on capital in corporate America — just as better textile machinery didn't really help the textile companies. The profits from better textile machinery came to you people when you put on your pajamas and when you wipe yourself after a shower. On the other hand, they didn't come to the textile companies at *all*.

If the internet is the problem, there is no solution....

Munger: All kinds of technical interventions that are wonderful for the civilization are not necessarily wonderful for the passive owners of the common stocks. A really efficient system that gets closer to an auction and makes it very easy for anybody wanting anything to know all the people who have it available for sale may well compress profit margins, on *average*, throughout America — and, indeed, throughout the *world*.

So everybody talks about the internet as if it has to be wonderful.... But on average, it may be very bad for you people to the extent that you want to live passively on common stocks — and bad for me, too.

I consider it quite *likely* that margins will be compressed by this greater bandwidth. Why *wouldn't* they be? If so, then there's no great general antidote for it. It's just one more limitation in life — much like getting old. You can *adapt* to it, but you can't *fix* it....

A FALLING TIDE DROPS MOST BOATS.
WE CAN SHOW YOU THE SCARS....

We've seen high margin businesses become commodities....

Munger: When IBM was forced to give up its tab card monopoly, Warren invested in one of the little companies

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that was created to use the IBM tab card machinery and so forth and sell tab cards in competition with IBM. And they sold big clumps of tab cards — *everything* was tab cards — to the telephone company, department stores, etc.

But the tab card orders were so big that they were put out to competitive bidding after there were several sellers of IBM tab cards. And the prices got horribly *lower*. After all, a tab card is a *commodity*. One tab card properly made is very much like another. And when IBM had a monopoly on the damn things, they made 25% or more of the profit of the whole company out of the tab cards alone.

By the way, they had no patent on the tab card or its structure. They had a patent on the press that made the tab card that enabled their presses to go faster than other presses. That was a monopolistic situation that arose out of practice evolution and accident and God knows what. But it was no impregnable patent or intellectual property position that gave IBM its enormous advantage.

It's just that the tab card cost so little in reference to the cost of the total computing operation that people didn't like compromising with the possible quality of the tab card. Whatever it was, once there were a bunch of companies out there using IBM's presses and there was competitive bidding, the price of tab cards went way the hell down — especially on the big orders to the government and so forth that involved competitive bidding.

<u>There will be some big winners. But *average* returns....</u>

Munger: Why isn't that going to happen in product after product after product? It's only fair to turn [your question] around. Does anybody have an explanation of why that's *not* going to happen with the increased efficiency of the internet? So that *I* get some instruction instead of just giving it all the time, would somebody please rise and tell me?

Shareholder: I could take a shot at that. What I care about as an investor more than the actual profit margin is return on capital. So when I look at the very high returns on capital being generated by very low margin businesses — like <u>Costco</u>, <u>Staples</u>, <u>Home Depot</u> and <u>Dell</u> — the efficiencies squeezing margins at one end are also allowing companies to get rid of massive amounts of inventory and vastly increase their productivity.

And I think PC manufacturing is a sector where pricing's come under *immense* pressure, but as a sector, there have been such vast gains in productivity and all that the returns on *capital* [haven't been hurt]. Obviously, Dell and <u>Gateway</u> have been the biggest beneficiaries because of a superior economic model. But I would argue that throughout the entire industry, efficiencies have increased dramatically and enhanced shareholder value.

So isn't it possible that those efficiencies could actually squeeze margins, increase capital efficiency and reward shareholders?

Munger: Well, that's why I so carefully talked about *average* returns on capital. Obviously, somebody that seizes on a wonderful position aided by a new technology could worm his way into an economic niche that's ungodly profitable like <u>Costco</u>'s. But that does not mean that the development of Costco is wonderful for the profits of retailing *generally*.

I would argue that the Costco model is wonderful for *Costco* and it's wonderful for the *consumer*. But as another retailer, I would not look with joy at the coming of Costco to my town — or <u>Wal-Mart</u> either, for that matter.

<u>If we're all going to excel, average returns may not matter</u>.

Munger: I'm talking about average results. Sure — if they send you on 50 missions over Germany to go into the flak and so forth and if you're the one that ... doesn't get shot down, you're going to have a very entertaining 50 missions and it isn't going to hurt you much. But averaged out, it's not a very wonderful activity to be in. I was talking about *average* results in capitalism.

It's quite clear that there will be many big winners in new models of distribution. I think you're totally right on that. But I suspect that averaged out, it's going to squeeze. And I was talking about averaged-out returns for [investors in common stocks].

If everybody in this room could be in the top 10%, then we wouldn't have to worry about average returns, right? But if we *can't*, why then, we face a development which may be squeezing us all.

THE INTERNET WON'T HURT EVERY BUSINESS. AND FOR SOME, THE JURY'S STILL OUT.

<u>Newspapers have more downside today</u>.

Shareholder: Looking out, what do you see as the future of the newspaper industry?

Munger: Well, it's way less certain to be wonderful than it was 20 years ago. And what threatens it, of course, is alternative mediums for delivering information. And they threaten it in two ways: For the person that wants information and the person who wants to buy something.

Every newspaper is trying to arrange to be a big winner in the age of the internet by parlaying its advantage in the area of print and paper into an advantage in a world that's mixed print and paper and internet commerce.

But because that is way less sure than the continued growth of print and paper was 20 years ago, I think the enterprises have more *downside* today. Some people think they have more upside. That's what makes life interesting. But I am less convinced of that.

Shareholder: Do you foresee the demise of the printed paper?

Munger: No, I don't think they'll ever disappear. But

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the fabulous economics could be grievously impaired.

Internet won't be as big a deal for trading of electricity....

Shareholder: You and Warren have said you expect decent returns from MidAmerican. But in thinking about the application of the internet to commodity businesses, it's a little hard to see why that would happen since Warren said at the annual meeting that MidAmerican has no cost advantage.

Munger: Where I grew up in the old days, there was a flour broker named A. Horace Erickson who traded flour out of one office. All of these flour mills, which were the equivalent of electric plants in some respects, would need to balance out flour. So they'd all do these elaborate trades with A. Horace Erickson. It was a very efficient system for flour milling — and it also made A. Horace Erickson rich even though he got a tiny little percentage of each trade.

My point is that the world was capable of doing that with flour back in 1937 with nothing but telephones. And I don't think electricity trading will be *helped* as much by the internet as a lot of other things....

Generation/delivery are more important in this business.

Munger: But the business of generating and delivering massive amounts of electricity — that is the ultimate business requiring a big tangible system as distinguished from just a little information going over wires. So I wouldn't expect the internet to have fabulous changes on a business like that.

Obviously, *anything* can be made more efficient with more bandwidth and more computing power. But I think the delivery and generation is a bigger part of the business. And I just don't think that that is one where the internet's going to have huge incremental effects....

TODAY, WE FACE A *DOUBLE* DISADVANTAGE. FORTUNATELY, WE HAVE ADVANTAGES, TOO.

Being bigger makes it much harder. It limits our options.

Shareholder: You've spoken about how much harder it is to make a large return on capital with the capital base that Berkshire has now than it would be if it were smaller.

Munger: Yes, although we have no desire to go back to that easier time.

Shareholder: Is that something that in your mind and Warren's mind needs to be reconciled either via buybacks [or dividends]? I know Warren says he must have been on the toilet the last time he thought of paying a dividend. However, with all your cash, whether there are earnings per share now or not, I think it's clear to most observant minds that Berkshire is generating a lot of cash — or will generate a lot of future cash.... So I'm wondering what your thinking is as you look forward. Or is it simply, "We'll have a lot of cash and we'll produce smaller returns."

Munger: There are *two* things that make it harder now for us in terms of operating in marketable securities. First, we're so big we can only look at pretty big companies. That makes it *much* harder. Our options are limited — and we're going into more competitive areas that are more closely examined by very smart people like Alice Schroeder. [Munger laughs]. People like Alice make it more difficult for us when we get into these bigger companies.

We actually face a *double* disadvantage....

Munger: Plus, I totally agree with Warren's article in *Fortune* which we sent out to Berkshire shareholders. I think the current climate offers probable prospects for the ordinary investor in common stocks that are *way* lower over the next 15 or 20 years than we've been used to over the last 15 or 20 years.

So we face a *double* disadvantage. We've got kind of an irritatingly limited climate in terms of potentiality. And we have restrictions on our own options because we've gotten so rich. Now this isn't my idea of the worst tragedy I've heard of in the history of Western civilization. And you will find us quite *contented* with our disadvantages. Nonetheless, they do affect what we can do.

But we have advantages, too.

Munger: There are also some *good* things in our present position. We have *enormous* flexibility. You're right — Berkshire will be accumulating *billions* of dollars of cash every year. Wesco will be accumulating cash. And we have a structure that allows us enormous flexibility.

Also, unlike a lot of portfolio managers, while we can't buy stock in small companies with any realistic prospects for us because of the size considerations, we get whole companies offered to us now by people who like and are good at running them. And that is not happening at most investment counseling operations. So we have a string to our bow that other people *don't* have. And who *knows* how big that string may eventually get to be.

So we've got great flexibility and a certain discipline in terms of not doing some foolish thing just to be active — discipline in avoiding just doing any damn thing just because you can't stand inactivity. And that's a very advantageous position.

What was it Mr. McCawber used to say? "Something will turn up." And something always *has* turned up for us.

And we are, in a slow kind of way, finding things to do.

Munger: You can say, "Well, but you do odd things — like buying a company that distributes electricity in Iowa and England." You can say, "What the hell is happening at Berkshire Hathaway?"

Well, I think that is a perfectly decent investment.

(continued on next page)

WESCO FINANCIAL'S
CHARLIE MUNGER
(cont'd from preceding page)

Not only that, it gives us a window into a field where a lot of craziness is going on. And we've been good at dealing with some kinds of craziness. Get us into a field where a lot of craziness is going on and we may find something *else* intelligent to do.

So we are, in a slow kind of way, finding things to do. And we do have a flexibility which is very welcome in terms of our overall position.

But don't expect the magic of the *last* 15 years in the *next*.

Munger: So I'm not discouraged. I just don't think it's going to be *anything* like, for you shareholders, in the *next* 15 years — and I'm not talking about what you do with your money elsewhere — what you're used to....

But I think I know many of you well enough to know you don't have that many other wonderful ideas either. In other words, *you* have some of the problem that *we* have.

NOT GETTING RICH FASTEST IS NO TRAGEDY.
BUT TRYING TO DO SO CAN *LEAD* TO ONE....

Someone getting richer faster than you is no great tragedy.

Shareholder: The last couple of years have certainly been different than anything I've ever experienced in my lifetime. And I'd just love to hear your frank observations on the silliness that appears to be going on with maybe some psychology mixed in with the answer.

Munger: Well, I think there's one big truth that the typical investment *counselor* will have difficulty recognizing, but the guy who's investing his own money ought to have no trouble recognizing: If you're comfortably rich and you've got a way of investing your money that is overwhelmingly likely to *keep* you comfortably rich and someone else finds some rapidly growing something-or-other and is getting richer a lot faster than you are, that is not a big tragedy.

Don't let the inevitable make you miserable.

Munger: And if you're not comfortable and don't understand the fact that somebody else is getting rich faster, so *what*? How crazy it would be to be made miserable by the fact that someone else is doing better — because someone else is *always* going to be doing better at any human activity you can name. Even Tiger Woods loses a lot of the time.

Look at the trouble Stanley Druckenmiller got into. He thought he was absolutely *required* to always beat everybody else. And even when it seemed kind of silly to him, he thought, "Well, I can't be *out* of it."

Just avoid the *really* big trouble....

Munger: A lot of success in life and success in business comes from knowing what you really want to avoid — like early death and a bad marriage.... There are a lot of things that are *really* big troubles. And if you give them a wide berth, your life works a lot better.

And if somebody else is having a lot of fun with Zsa Zsa Gabor, why, you can say, "Pass this cup from me."

WE WERE LUCKY TO START WHEN WE DID.
IT'S LIKELY TO TAKE YOU LONGER....

We were lucky to come into the business when we did....

Shareholder: What would you buy today, if you were 30 years younger, with the capital you had then — which you won't answer, I'm sure.

Munger: I think having a little capital now and being young gives one lower opportunities than, in retrospect, were available to me. I was lucky that I came in in the aftermath of the '30s when people were demoralized, when whole generations didn't want to buy common stocks and trust departments didn't want to hold common stocks. There'd been a lot of bad financial practice in the '20s that made people morally revolted at capitalism. I'm talking about the Insull utility holding companies, etc., etc. and Goldman Sachs' trading company.

As Eddie Cantor said, "They told me to buy this stock for my old age and it worked perfectly. Within six months, I felt like an old man." Coming into investing in that aftermath when there'd been a lot of failure and disgrace was a great advantage to people like Warren and me.

You may be able to *do* it. It's just likely to take *longer*.

Munger: Now a young person starting out today when you've had roughly 20 years of 15% returns from common stocks, way less disgrace, more achievement and so on, I'd say in the nature of things it's somewhat tougher for you for the reasons that Warren outlined in that article that appeared in *Fortune*....

That doesn't mean if you adopt the same catechism — the same mindset that we did, the same patience, the same decisiveness and willingness to bet on the few occasions when you get the wonderful opportunity to bet that you can recognize as such — that you won't do very well. It just means that it's likely to take *longer* in your case.

But what the hell, you will *live* a lot longer.... And it will fill in the years.

—OID

The preceeding excerpt
was the Wesco Financial segment
of this edition's 27-page feature
on the annual meetings
of Berkshire Hathaway and Wesco.

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