BERKSHIRE HATHAWAY 2014 ANNUAL MEETING NOTES

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We attended the Berkshire Hathaway annual meeting held on May 3, 2014 in Omaha along with a record crowd of about 40,000 other folks from around the globe who gathered once again for the Woodstock for Capitalists. Warren Buffett, Chairman of Berkshire Hathaway, and Charlie Munger, Vice-Chairman, answered questions from shareholders, analysts and the media. The meeting opened once again with an entertaining movie that provided a preview to the future in 2034 with Berkshire trading for $19 million a share (tongue-in-cheek) and a 103-year old Warren Buffett promising to retire in five years. Here are my notes from the meeting.

FIRST QUARTER RESULTS

Warren Buffett began the meeting with a brief recap of Berkshire Hathaway's first quarter financial results with operating earnings down 7% and net income down 4% (see our detailed first quarter analysis for Berkshire Hathaway on our website). Book value increased 2.6% from year end to $138,426 per A share. Insurance float as of 3/31/14 was approximately $78 billion. Operating profits were down a bit due to a drop in insurance earnings, which was impacted by the run-off of a large Swiss RE quota contract and changes in foreign exchange, which doesn't mean much quarter to quarter. Buffett noted that the $78 billion in float was his to invest and that the underwriting profits were satisfactory in the first quarter. He exclaimed, "The insurance business is marvelous!" While the $78 billion in float shows up as a liability on the balance sheet, it really is as valuable as equity since Berkshire has the use of the float cost-free. Buffett advised shareholders that they don't need to pay much attention to realized investment/derivative gains during any specific quarter as he doesn't try to time the markets by recognizing gains from quarter to quarter.

DIVIDEND PROPOSAL

The proxy this year included a shareholder proposal for Berkshire to pay a "meaningful" dividend. "Whereas the corporation has more money than it needs, and since the owners [unlike Warren Buffett] are not multibillionaires, the board shall consider paying a meaningful annual dividend on the shares," the proposal stated. The proposal was soundly defeated by shareholders with only 1.1% of the Class A shareholders voting for a dividend with 97.1% voting against it and 1.8% abstaining. If Buffett excluded himself from the voting, only 2.5% of Class A shareholders voted for the proposal with 93.4% voting against it and 4.2% abstaining. Buffett joked that he didn't want folks to think he "stuffed the ballot box." In addition, only 2.0% of the Class B shareholders voted for the dividend, while 97% voted against it and 1.1% abstained. Buffett marveled that by a vote of 45 to 1, Berkshire shareholders said, "Don't pay us a dividend." Shareholders apparently believe Buffett can create much more value by reinvesting the bountiful cash Berkshire generates than by distributing it as a dividend. For shareholders that "need" a dividend, Buffett has written in past annual reports on how they can "create" one by partially selling some of their shares. Buffett also joked that 3% of shareholders voted against reelecting him as a Director of Berkshire, noting that more shareholders did not want him as a Director than wanted a dividend.

COCA-COLA COMPENSATION

Berkshire Hathaway is one of Coca-Cola's largest shareholders, owning 9% of the shares, and Buffett had noted that the new stock option program Coca-Cola had proposed appeared to be "excessive" compensation. Buffett was questioned why he only abstained from voting for Coke's compensation program rather than voting against the plan as it appeared to be strange and "un-Buffett-like" behavior.

Buffett chuckled that "strange" is frequently Buffett-like. He then discussed that the 16% dilution calculation used by David Winters, a mutual fund manager who publicly criticized Buffett for not voting against the plan, was "widely-off" the mark.

Buffett noted that he privately spoke with Muhtar Kent, the CEO of Coca-Cola, and told him he would be abstaining from the vote as he believed the compensation was excessive. Buffett believes this was the most effective way for Berkshire to make a statement on the excessive plan and the effects of compensation practices at Coke.

Buffett said he "did not want to go to war" with Coke or endorse wildly inaccurate calculations of the potential dilution, although he did note that Winters had taken some of the potential dilution numbers directly from the proxy. However, Coke repurchases shares on a regular basis which offsets much of the dilution. Buffett went through a detailed analysis of the potential dilution of the current plan taking into consideration potential share repurchases and tax savings, which would result in dilution of 2.5% versus 16.0% that Winters quoted. He said Coca-Cola could help reduce the dilution by stretching the compensation plan over more years than the four years specified in the proxy.

Charlie dryly remarked that he thought Buffett handled the whole situation very well.

In response, Buffett exclaimed, "Charlie Munger remains Vice Chairman!" Buffett then noted that he had discussed the matter with Charlie, and they both agreed on Berkshire's course of action in regard to the vote.

DIFFERENCE IN ACQUISITON STRATEGY OF BERKSHIRE AND 3G

Berkshire went into partnership with 3G in their joint acquisition of Heinz last year. Berkshire basically provided the financing, and 3G took over the management of the company, which included significant layoffs as 3G restructured the company. In contrast, Berkshire's strategy on wholly-owned acquisitions is basically hands-off, allowing management to continue to run their own businesses as they had before. Buffett proclaimed Berkshires strategy was a "large corporate asset" as it attracted good business to want to sell their firms to Berkshire.

Buffett replied that the two strategies do not blend very well. He remarked that "3G does a magnificent job of running businesses." However, he noted that they used a different style than Berkshire, and it would not pay to try and blend the two strategies. Buffett noted that there was a good opportunity for Berkshire to do more deals with 3G in the future and called them "marvelous partners." He added that it was very likely that Berkshire would partner with them again on "things very large."

Charlie added that Berkshire never has had a policy that “loved overstaffing.” Buffett quipped, “Especially not at the home office!” Buffett then added that Berkshire does not enforce a discipline on subsidiaries to cut people. Instead Berkshire encourages by example, not by edict, for lean operations. Charlie concurred, “We don’t need the last nickel out of staffing costs.”

DIRECTION OF THE ECONOMY

A shareholder noted that Buffett has the ear of the President and asked him to communicate with the President on the direction of the economy, which he described as a “train going in the wrong direction.”

Buffett responded, “I will let you communicate with President Obama directly.” At the same time, Buffett said he did not agree with the shareholder about the direction of the economy. Buffett noted that American business is doing “exceedingly well.” “Just look at corporate profits,” he pointed out if you do not think the economy is doing well. He added that U.S. earnings on tangible net assets are the envy of the world with extraordinary returns. Corporate taxes, as a percentage of GDP, have come down from 4% to 2%. The corporate tax rate is far lower than it has been in the past, when it topped 50%.

In response to the question, Charlie muttered, “I’m going to avoid this one.”

BERKSHIRE’S BOOK VALUE PERFORMANCE COMPARED TO THE S&P 500 OVER THE LAST FIVE YEARS

Buffett was asked about Berkshire’s book value growth lagging the S&P 500 index over the last five years. Buffett responded that he did not change the yardstick in measuring Berkshire’s performance and had noted in the 2012 annual report that if the market continued to be strong the following year that 2013 would likely be the first time that Berkshire’s book value performance would lag the S&P 500’s performance over a rolling five-year period, which it did. Berkshire Hathaway will do worse in relative performance during strong stock market years and will do better in down years for the stock market. If there is a period when the stock market is strong five years in a row, Berkshire will not beat the S&P 500 index. Buffett repeated that Berkshire will likely underperform in very strong years for the stock market, match the S&P 500 in moderate years and will outperform in down years. Over any market cycle, Buffett expects Berkshire will continue to outperform the S&P 500 index.

Charlie noted that Berkshire’s book value performance is after full corporate taxes while the S&P 500 index performance is without taxes. He said Buffett has set a “ridiculously difficult standard” and still beat it over time. Charlie concluded, “If this is failure, I want more of it!”

NARROWING THE GAP BETWEEN BOOK VALUE AND INTRINSIC VALUE

A shareholder asked if Buffett would consider spinning off units to help narrow the discount between Berkshire’s intrinsic value and stock price. Buffett said the simple answer is an emphatic “NO!”

Buffett admitted that there is a significant discrepancy between the company’s intrinsic value and book value. As a specific example, he noted that GEICO is carried on their books at approximately $1 billion when he believes the intrinsic value is closer to $20 billion, which will grow larger in the future. Buffett said one way to narrow the gap is to buy back shares when they are trading at 1.2 time book value or less, which he considers a “bargain.” He added that calculating intrinsic value is not a science and said that he and Charlie would likely come up with different answers that would be within 5% of each other, but not 1%. Buffett will continue to provide shareholders with information on the important units in the company so that they can determine their own estimates of intrinsic value. He noted that the smaller units do not have a big impact on intrinsic value. The big difference in book value and intrinsic value comes from the insurance, railroad and utility operations. When Berkshire trades at 1.2 times book value or less, it is trading significantly below the intrinsic value of the company, according to Buffett. On the other hand, he noted that when other companies like Coca-Cola buy back stock just to offset stock option dilution, that may not be a good reason to buy back the stock if they are buying $1.00 for $1.10.

Charlie commented that they never have wanted to get Berkshire’s stock to trade way over intrinsic value, so that they had an advantage over other shareholders to balloon their assets. He added that folks that want the stock to trade over intrinsic value want “egg in their beer.” He remarked that “Berkshire’s stock will trade above intrinsic value over the long term whether we like it or not.”

Buffett noted that he has seen other companies talk their stock up as high as possible so they could use the overpriced stock to acquire other companies. However, he noted that managements that cheat on that game will often also cheat on their earnings. Buffett said he does not want to play that game. He then joked, “We better quickly move on to the next question before Charlie starts naming names. “

TRUST

Buffett was asked how Berkshire gains the trust of managers of companies that they acquire.

Buffett simply said, “We keep our word to them!” When he acquires a company, he promises the management team that he will not sell their business down the road as long as the business does not have significant losses or labor problems. He said he has put that promise into Berkshire’s Owner Principles so owners know they can count on it. While Berkshire cannot make a promise that they will never change employment at the firm, they can promise that they will keep the business. Over the decades, Berkshire has only had to get rid of a few businesses, including their original textile business.

Berkshire has been gaining trust of managers for 49 years and is in a class that few others can compete with, especially private equity firms which are different. If a management team cares where their business is going, they don’t want others (MBA’s at a private equity firm) to tear it apart. Trust that Berkshire will maintain and/or grow the business is a unique asset that provides Berkshire with a competitive advantage when it comes to doing deals. Buffett concluded, “Frankly, this is the way we want to operate, and it will continue to work well.”

Charlie succinctly agreed, “It has worked well and is unlikely to stop.” Buffett chuckled, “He doesn’t get paid by the word.”

HOWARD BUFFETT SUPPORTING BERKSHIRE'S CULTURE

A shareholder noted that Howard Buffett served on Coca-Cola's Board of Directors and supported the excessive compensation plan. Given that, it was asked how shareholders could count on Howard to support Berkshire's culture when Warren Buffett was no longer there.

Warren Buffett recounted how he had served on various Boards of Directors over the years, where he also voted for compensation plans and acquisitions that he did not agree with. He said Boards are part social structures and part business, so sometimes it is difficult for Directors to vote against management. The Compensation Committee reports to the full Board of Directors, with the Board delegating the compensation activity to the committee. As a result, the full Board almost never votes against the committee. With Board members often getting paid $200,000 a year for working 4-6 times a year with pleasant company and the prestige of the position, they really are not independent. Of the 19 Boards Buffett served on, he observed that they are not looking for Dobermans but instead seek out Cocker Spaniels with wagging tails. The social dynamics are important on the Board. Warren Buffett noted that Howard will be a non-executive chairman of Berkshire and will not set compensation or select the CEO of Berkshire. He will be there to facilitate change in the CEO if the Board of Directors determines that it is necessary. In essence, Howard will provide the "extra safety belt" the Board needs, and Buffett predicted, "Howie will be perfect!"

Charlie recounted how Warren Buffett had been totally voted down at Salomon, Inc. over compensation when he served on that Board for "shouting disapproval all day." Charlie advised shareholders they need not worry about Howie.

Buffett chimed in by saying that if you are always belching at the dinner table, you will soon find yourself eating alone in the kitchen. Charlie added, "I offend more people than you do, and I'm satisfied with the level of disapproval."

COST OF CAPITAL

Buffett was asked what Berkshire's cost of capital is, especially now that they have capital-intensive businesses.

With Berkshire's market capitalization north of $300 billion, Buffett acknowledged that there is no question that size is an anchor to performance. Berkshire cannot earn as high a return on capital as they have in the past. Buffett said the way they look at cost of capital is what can be produced by their second best idea, and then the first idea has to beat it in terms of performance.

Charlie grumbled that he has never heard an intelligent cost of capital discussion.

Buffett said the real test over time is whether the capital Berkshire retains will produce more than $1 of market value. He noted that if Berkshire puts billions of dollars to work, and it is worth more than what they put in over time, then they will keep doing it. He discussed how they recently put $3 billion to work by acquiring a Canadian transmission company, which was the best opportunity that they had available at the time. He believes the company will be worth more financially in the future. He added that cost of capital calculations are a game for most CEO's.

Charlie added that cost of capital often means silly things to business school professors. He bluntly said, "We are right, and they are wrong." Buffett chuckled, "I look good next to him."

NEBRASKA FURNITURE MART

A shareholder asked Buffett to comment on the wonderful price (2 times earnings and 85% of book value) that he paid for a wonderful business, the Nebraska Furniture Mart (NFM).

Buffett said he wished he had bought the company that cheap, but it was not purchased at a discount to book value, and he paid more like 11-12 times after-tax earnings for NFM. He said he initially paid $60 million for 80% of NFM, which was not a bargain purchase, but it was a great business run by one of the finest families he has ever met. He said at the time, another company from Germany was also trying to buy NFM. He summarized the successful story of NFM, run by Mrs. B, who did not know how to read. When he purchased the company, Buffett did not have to ask for an audit because he trusted her implicitly.

Buffett urged shareholders looking for a bargain purchase to go shop at the NFM during the weekend to take advantage of shareholder discounts. Last year's annual meeting sales were up 7% to a record $40 million, which is larger than most furniture store's monthly sales. The NFM will be opening a new store in Dallas which will be 1.8 million square feet in size and sit on 40 acres. Buffett expects the Dallas NFM to do more volume than other furniture stores around the world by a factor of two times.

INDEX FUNDS VERSUS BERKSHIRE HATHAWAY

Buffett was asked why he has advised the Trustees of his wife to invest her inheritance 10% in short-term bonds and 90% in a Vanguard S&P 500 index fund after his death. Did Buffett expect the index fund to outperform Berkshire's stock in the future?

Buffett said all of his shares of Berkshire Hathaway will go to charitable foundations over a 12-year period after his death. His advice to the Trustees of the foundations is not to sell any Berkshire shares unless they have to in order to maximize returns for the foundations. This is a sign that Buffett is bullish on Berkshire for at least 12 years after his death. On the other hand, the instructions to his wife's Trustees were not designed to maximize her returns but to provide her with 100% peace of mind.

Charlie added that "Warren is peculiar on how he distributes his money. He is entitled to do what he damn well pleases." Charlie noted that Warren is a "meritocrat" in that he wants to let his money go back to civilization where it was earned. Charlie chuckled, "I like being associated with him."

BURLINGTON NORTHERN SANTA FE VERSUS UNION PACIFIC

Buffett was asked about Union Pacific performing better than Burlington Northern Santa Fe (BNSF), noting BNSF's recent service challenges.

Buffett said BNSF has handled more volume lately, but there was no question that they experienced service problems. BNSF is spending more on capital expenditures than Union

Pacific in order to anticipate future service challenges. BNSF experienced a large increase in volume due to Baaken shale oil.

Buffett asked Matt Rose, the CEO of BNSF, to address the problems related to the severe winter. Mr. Rose said he had never seen a winter like the past with all the snow and extremely cold temperatures, which created service challenges. In addition, given the geographic coverage of BNSF, they had to deal with increased oil volume as the oil came in faster than anyone expected. The industry grew 820,000 units last year with BNSF handling 53% of that growth. Rose said they handled more than 206,000 units in April with the railroad traffic now steaming ahead.

Buffett added that Berkshire will spend $5 billion on BNSF this year, which is an amount that no railroad has spent before in a year. Buffett noted that BNSF is now functioning better and that earnings will be, too. BNSF handled 22,000 miles of track, which were impacted by the cold weather and floods. Buffett expects BNSF's financial results to get better over the balance of the year.

NATURAL GAS AND WIND POWER

With Berkshire using large supplies of natural gas to generate electricity at its utilities, Buffett was asked about having adequate supplies of natural gas and whether a satisfactory return could be earned if natural gas prices rose.

Buffett said Berkshire is the largest alternative energy provider. By the end of 2015, 40% of energy needs in Iowa will be provided by wind power. Buffett asked Greg Abel, the CEO of Berkshire Energy, to address the question. Abel said given the very cold weather in the Midwest this past winter, he was very proud of how resources were handled. He said Berkshire has adequate natural gas supplies to keep the furnaces and lights on for customer. He added that Berkshire's renewable energy by wind power will only get larger in the future and meet the needs of customers in a cost-effective manner. If gas prices rise, Berkshire Energy has a clear path with regulators to pass on higher prices. Abel reassured shareholders that Berkshire Energy was well positioned to serve customers over the long term while also meeting the financial needs of the company.

Buffett said that Berkshire Energy is a point of pride. When Berkshire acquired a pipeline from Enron, the pipeline was ranked 42nd out of 42 pipelines. Today, the same pipeline is ranked number one. The pipeline went from "worse to first" under Greg Abel's able leadership.

SUCCESSION PLANNING FOR CHARLIE MUNGER

Charlie Munger is a young 90-years old, and Buffett was asked if there was a replacement for Charlie as part of succession planning.

Buffett quipped, "Charlie is my canary in the coal mine! Since he turned 90, I am very encouraged by how he is handling middle age." Buffett noted that whoever replaces Buffett will likely develop someone that works closely with them. However, there is no other Charlie Munger! Berkshire has been better off with two of them working together than either of them alone. Berkshire has two incredible people who are complementary, which is a great way to operate. But Buffett said that no one has brought up a successor question for Charlie before.

Charlie rebuked, “The world does not have much to worry about. Most 90-year old men are gone soon enough!”

Buffett laughed, “The canary has spoken!”

SUCCESSION PLANNING FOR AJIT JAIN

Buffett was asked about succession planning for Ajit Jain, the CEO in charge of Berkshire’s reinsurance operations. Buffett quipped, “Reincarnation!” He then added that Ajit cannot be recreated, but Berkshire will not have to worry about it for a long time given Ajit’s relatively young age of 62. Buffett added that he has letters from each manager of each business unit on who they would recommend as their own successor.

Charlie declared that he is not the least amount worried about succession planning at Berkshire as the company is in very good shape.

INVESTING ENTIRE NEW WORTH IN ONE COMPANY

During the financial crisis, Buffett had told college students in 2009, if he had to invest his entire net worth in one company, it would be Wells Fargo when the price had tumbled significantly below book value. A shareholder asked what company it would be in 2014.

Buffett responded, “That is a great question, but it won’t get an answer.”

Charlie concurred, “You gave him the right answer.”

COMPENSATION DISCLOSURE

Most companies are required to list the compensation of the five highest-paid executive officers in their proxy. However, Berkshire only lists three officers given the holding company nature of the company. (Buffett’s $100,000 salary, which has not changed in years, is often highlighted for its frugalness compared to other CEO’s exorbitant salaries.) In the spirit of transparency, a shareholder asked if Buffett would be willing to disclose the compensation of other highly-paid executives in Berkshire’s subsidiaries.

Buffett said Berkshire’s next CEO should be entitled to receive a lot in compensation. However, Berkshire is following the SEC’s rules on disclosing compensation in its proxy. He indicated that disclosing more than is required might have a negative impact on negotiating salaries of other executives at subsidiaries, which is a good reason not to publish the salaries of the top 10 managers at the company.

Buffett added that when he was temporarily at Salomon, everyone was dissatisfied with their salary…not on the absolute amount, but on the comparative amount. He said it drove people crazy, which made compensation a terrible problem due to jealousy. Buffett noted that it is very seldom that publishing compensation benefits shareholders. He added that corporate CEO’s would be paid less if we did not have salaries published in the proxies, as consultant’s point to other CEO salaries to ratchet up salaries in a never-ending cycle. Shareholders are paying the price.

Charlie added that despite a spirit of transparency, publishing compensation is not good for shareholders. It won't happen at Berkshire unless the SEC requires it.

Buffett concluded, "No CEO looks at a proxy and says, 'I should be paid less.'" Charlie agreed, noting that envy does the country much harm.

EXCESS CASH AT UTILITIES AND RAILROAD

A question was asked on why MidAmerican (now renamed Berkshire Energy) gets to keep its excess cash while Burlington Northern sends excess cash back to Berkshire Hathaway.

Buffett answered that Berkshire Energy will have multiple opportunities to acquire other large businesses, such as its recent acquisition of the utility in Nevada and the transmission business in Canada. That is not the case with BNSF, but the railroad will invest significantly in capital expenditures and can easily handle the debt associated with those investments.

Berkshire Energy will need more money in the future for acquisitions. Berkshire Hathaway is a 90% owner of Berkshire Energy with Greg Abel and Walter Scott owning the balance. Buffett hopes that there will be opportunities to invest many more billions of dollars in energy acquisitions. Last year, Berkshire Energy spent $5 billion on the NV Energy acquisition and $2.8 billion on capital expenditures.

Berkshire is finding things to do to "sop up their cash." However, Berkshire Hathaway will always keep $20 billion in cash as they don't want to rely on the kindness of strangers when challenges arise in credit markets like in 2008. Berkshire does not want to have to count on bank lines of credit to keep the company operating. Buffett has spent too long building Berkshire to ever want to worry about not having enough cash to meet the company's needs.

Buffett recounted how Berkshire was tapped to help other fine companies during the credit crisis because they had money to lend to companies desperate for funding during those tough times. Berkshire lent money to Harley-Davidson at 15% rates during the crisis along with lending money to Goldman Sachs and General Electric. Cash is like oxygen. You don't notice it 99% of the time, but if you don't have it, then it is the only thing you notice. Buffett expects to spend a lot more cash later this year.

Charlie responded to the question by saying that Berkshire is very lucky to have businesses that can employ lots of capital at attractive rates. "It's a blessing. I love to invest more capital intelligently, especially when interest rates are so low."

Buffett concluded, "Compound interest will catch up with us eventually, but not yet."

ALLOCATION OF CAPITAL

Buffett was asked if he ever argues with Charlie over how to allocate Berkshire's capital.

Buffett responded, "Charlie and I have never had an argument in 55 years. We have disagreed on many things, but it has never led to an argument." He laughed, "We have argued with others."

Charlie said, “Most of the time we think alike. That is a problem. If one misses it, the other does, too.”

Buffett has affectionately called Charlie, “The Abominable No Man,” when they discuss deals.

Buffett said with interest rates currently so low, every Berkshire company now is holding more cash at the operating company level than pushing it up to the parent company. Buffett said he knows where the cash is and where to get it, if he needs it. In the future, it might make sense to institute a sweep account so that excess cash is swept from the subsidiaries to the parent. However, Buffett chuckled, “When we really need the money, I grab it!”

Charlie concluded, “That is fine.”

WEAK POINTS AT BERKSHIRE

When asked what the weak points are at Berkshire, Buffett said, “We point them out, like the lack of a sweep account.” Buffett added that Berkshire is sloppy in certain ways, such as being slow in making personnel changes. He mentioned how they were slow in moving a good friend from the executive chair of a subsidiary to the Alzheimer’s home, as it was a sensitive topic.

Buffett added that there are times when the lack of supervision over subsidiaries may lead to them missing something. However, by giving managers freedom to manage their own businesses, the businesses have accomplished more. Much more has been created on the positive side than missed on the negative side. At Berkshire, they do not have a General Counsel or Human Resources department, which would be unthinkable for most companies.

Charlie concluded, “By the standards of the rest of the world, we over trust, but our results are way better.” Berkshire Hathaway works better with a culture of “deserved trust. “

SEES’S CANDIES

Buffett was asked why See’s Candies business appears to be stagnating after strong growth between 1972 and 1992.

Buffett noted that the boxed chocolate industry is not growing overall. 100 years ago, there were many candy shops. The predecessor of Pepsi had the most candy shops in New York City. However, boxed chocolates have lost market position, especially to salty snacks. Despite this, See’s Candies has done remarkably well. However, they can’t do much to increase the overall size of the market. They have tried to move out of their strong geographic presence on the West Coast, but their candy doesn’t “travel well.” Folks on the East Coast tend to prefer dark chocolates. See’s Candies has provided earnings for Buffett to redeploy into other companies. See’s also opened Buffett’s eyes to the power of brands. Berkshire has made a great deal of money on Coca-Cola, which would not have happened if not for the See’s investment. In 1972, Berkshire acquired See’s, which gave Buffett the confidence to make a significant investment in Coca-Cola in 1988.

Charlie said that the main contribution of See’s Candies to Berkshire was “ignorance removal.” He grumbled, “We were pretty damn stupid when we bought See’s.” He added, “The good thing is we still have lots of ignorance to remove.”

BANK OF AMERICA

The questioner asked about Bank of America's Tier 1 capital and recent accounting problems.

Buffett explained that Brian Moynihan, CEO of Bank of America, called and asked Buffett if he was willing to change his BAC preferred stock holding from cumulative to non-cumulative in exchange for making the preferred stock non-callable for five years. The change would help Bank of America's calculation of Tier 1 capital. In a world of 5 basis point money, Buffett was willing to do that so that he could hold 6% preferred stock for five more years.

The exchange was done before Bank of America disclosed that they had made an accounting error in their calculation of capital. An error which Buffett said did not bother him as it did not impact BAC's GAAP earnings, even though they will pay a penalty in having to reduce the amount of capital they return to shareholders.

Charlie nodded, "I agree with you."

NETJETS

What are the current prospects for NetJets?

Buffett answered that NetJets is not a big grower, but it is a perfectly decent business. The business peaked with the stock market in 2007/2008, as hedge fund managers and others were affected by the stock market decline. Net ownership had been declining since that time, but it has recently started growing again within the last 6-8 months. NetJets offers a premier product, but Buffett doesn't see the market being double or triple its current size. The Chinese market for NetJets will be a very long play, while units sold in Europe are still declining. Buffett said he was glad Berkshire owns NetJets, but he doesn't expect much growth from the business.

Charlie said he expressed his optimism for NetJets by buying 25 more hours.

SOURCE OF FUNDS FOR LARGE ACQUISITIONS

Buffett was asked if he would consider selling positions in Wells Fargo, Coca-Cola or IBM if a large acquisition became available.

Buffett said those investments could become a source of funds, although it was unlikely. He would likely sell some of his smaller investment positions first, if needed. He added that Berkshire's goal is to buy really big businesses with the objective of building the company's earnings power every day. However, big acquisition opportunities don't come along that often. If Buffett needed the money to do a big deal, he could dip into his marketable securities to fund it, although with $40 billion in cash, it has not come to that. Berkshire would have the capacity today to do a $50 billion acquisition without issuing equity.

Charlie added that acquisitions are irregular, but Berkshire will get the opportunity to intelligently redeploy capital.

Buffett concluded, "What really turns us on is buying businesses that will grow earnings for us 10-20 years from now."

INCREASING LEVERAGE

Buffett was asked why Berkshire did not increase its leverage by raising billions of dollars from bond sales given today's currently low interest rates.

Buffett said the question made a great deal of sense, while also noting that Berkshire has a good way to generate funds through cost-free float. Buffett likes operating a conservatively financed company, and if he were to increase the company's leverage, it could impact the current bonds Berkshire has issued.

When Berkshire acquired BNSF, they did borrow money and issued equity to finance the deal. The issuance of equity helped the deal get done. Buffett said he should have repurchased the shares issued.

Buffett noted that issuing another $30-$40 billion of debt would not cost the company much, but they don't have plans to do so currently, as Buffett remains reluctant to leverage up the company. However, he said if they see a good $50 billion acquisition opportunity, they might do it.

Charlie concurred, "Even though the suggestion is intelligent, we won't do it in advance of a deal."

ENVIRONMENTAL ISSUES AND CLIMATE CHANGE

Buffett noted that BNSF does carry coal and will carry it for a long time, but at some point, they will be carrying less. As a common carrier, BNSF is required to carry freight that is offered to them.

The probability of climate change does not impact the pricing of catastrophe insurance in any material way in Buffett's discussions with Ajit Jain. Alternative energy sources will increase in the future.

In making investment decisions, climate change is not a factor.

Charlie cautioned that climate change forecasters tend to "over claim" the impact of climate changes. Most are" talking through their hats." At Berkshire, he said, "We are agnostic." He added that Berkshire is not looking to structure its investment portfolio on climate changes. He did acknowledge that the world needs to produce more electricity from solar and wind power. Berkshire will make a lot of money from its solar and wind power investments. However, they don't deserve any credit for that as they "stumbled" into it.

INVESTMENT MANAGER ROLES

While Ted Weschler and Todd Combs each manage $7 billion in investments for Berkshire, it still represents less than 10% of Berkshire's investment portfolio. They will inherit Buffett's big legacy portfolio, and Buffett was asked about their roles in managing the investments.

Buffett acknowledged that each of them was managing $7 billion now, and that they would be managing more in the future. They both see that it gets more difficult managing the investments the larger the sum becomes. Buffett stated both Ted and Todd were terrific additions to Berkshire beyond their investment skills. They both know a lot about business and management and have added significant value to Berkshire as they take on additional responsibilities. Buffett concluded, “It has been a big plus to bring them on.”

Charlie said, “I have nothing to add.”

LOW INTEREST RATES AND BUBBLES

A shareholder commented that low interest rates led to a housing bubble and today, potentially a bond bubble. Should interest rates be raised?

Buffett asked, “Who would have guessed five years ago that interest rates would be this low for so long?” However, he said he would not have done much differently if he were at the Federal Reserve. He expressed surprise at how well it has worked. Ben Bernanke was the hero of the crash and the subsequent actions taken. Buffett said the situation is still like a good movie in that he does not know how it will end with interest rates kept so low for so long. He said many at the Fed did not get what was happening during the financial crisis, but Ben Bernanke did. Buffett thinks Janet Yellen does, too. Buffett noted that the Fed is tapering, but still buying bonds.

Charlie responded that in Japan no one thought interest rates would be low for 20 years with common stocks declining. “Strange things happen.” He added, “If you are not confused, you probably don’t understand very well.” At Berkshire, not many long term bonds are being bought.

Buffett concluded a zero interest rate policy will have a huge effect on asset prices and in rejuvenating the economy. It is not a bubble situation, but an unusual situation. Charlie retorted, “I am as confused as you are.”

CONGLOMERATE BUSINESS MODEL

Buffett was questioned about Berkshire’s business model, given that it has more than 70 unrelated businesses selling everything from bricks to chocolate.

Buffett said the business model has worked well for America if you took a look at the Dow with its changing group of companies over the last 100 years. During that time, the Dow rose from 66 to more than 11,000. Buffett explained that owning a group of good businesses is not a terrible business plan. In the past, many conglomerates were put together to do “financial magic.” There were companies that were serial acquirers, which would issue stock at a 20 P/E ratio and then buy companies with a 10 P/E ratio. This was the equivalent to a chain letter scheme, but not building a business.

In contrast, Berkshire owns diversified and great businesses, which are conservatively capitalized and run by great management teams. By having Berkshire’s various businesses under one umbrella, Buffett is able to allocate capital to the businesses without tax consequences. For example, Buffett can move cash generated by See’s Candies to other businesses which can more usefully employ the capital. This is what capitalism is all about. Berkshire’s business model is applied by following business principles rather than stock promotion principles like Tyco used by continuously issuing stock. Chain letters always come to a bad end.

Charlie said Berkshire has alternatives for its cash. If they cannot find businesses to acquire, they can buy marketable securities. While others are hell-bent to buy, Berkshire is patient. He concluded, “Berkshire is not a standard conglomerate and will likely continue to do well.”

FOREST RIVER

Buffett noted that Berkshire bought Forest River 10 years ago. The company had previously gone through bankruptcy under a private equity group. Buffett has never been to see their operations and has probably only had 3-4 phone calls from them over the years. Buffett noted that Forest River will do $4 billion in business this year and will do more business over time as a market leader in the recreational vehicle industry. Buffett noted it was tough to compete with Forest River’s management as they know what is going on in their business and operate on slim margins. Buffett wished he had 20 more businesses just like them.

OIL SANDS

Buffett was asked about his view on Canadian oil sands and their impact on Berkshire.

Buffett responded that Berkshire has a crane business through Marmon that does oil development. In addition, they just acquired 8,000 miles of transmission lines near the oil sands. Berkshire also owns an investment in ExxonMobil that participates in the Canadian oil sands. Berkshire also moves 700,000 barrels of oil per day on its railroad. Buffett noted that there is a significant advantage to moving oil via rail based on where it can be taken. Rail is twice as fast at moving oil as compared to moving it in pipelines. Berkshire also recently bought a specialty chemical additive company, whose products will help oil move faster through pipelines. Buffett declared that the oil sands are an important asset for mankind, but they will not dramatically change things at Berkshire.

Charlie commented that oil sands production requires the use of natural gas to produce heavy oil. The process is only economic if oil prices rise and natural gas prices decline. He described it as a “peculiar situation.”

HEDGE FUND BET UPDATE

Buffett made a $1 million dollar wager, with the proceeds going to charity, with a hedge fund manager that the S&P 500 index would outperform a group of hedge funds chosen by Protégé Partners over a 10-year period. Buffett updated the results, showing that in the past six years the S&P 500 index’s cumulative return was 43.8% versus the hedge fund’s 12.5% cumulative return.

ENERGY FUTURE HOLDINGS AND THE IMPACT OF DISRUPTIVE CHANGES

Buffett was asked about how disruptive change led to Energy Future Holdings bankruptcy and whether other disruptive changes could impact other Berkshire investments.

Buffett responded that the Energy Future Holdings investment “was all my decision and a significant mistake.” He said all businesses should think about what could mess up their business models. With Energy Future Holdings, the assumption was that gas prices would stay where they were or rise. Instead gas prices went much lower.

In 1936, GEICO operated at a low cost and passed on the savings to customers in the form of low prices for a necessity, car insurance. The insurance was initially only provided to government employees. Over time, GEICO had to adapt their business model to widen the classification of their customers along with their selling techniques from direct mail to telephone to the Internet and social media. At one point in history, GEICO became too aggressive and went broke. Buffett wants his managers to think all of the time on how change may impact their business models. As an example, he noted how BNSF is looking at using liquefied natural gas to fuel their locomotives, which is a new change. Most of Berkshire's businesses are not subject to rapid change, which can lull management to sleep.

Buffett added, "I will make mistakes in the future." However, he does not make "bet the company "decisions that could cause real anguish. He noted that some mistakes work out; recounting how Berkshire bought a department store in 1966 in Baltimore that went broke. Yet the $6 million in that store became $45 billion in Berkshire stock over time.

Charlie added that it is desirable to remove ignorance and to be able to scramble out of mistakes. In the early years, Berkshire did that with textile mills, trading stamps, and department stores. He chortled, "Think what we could have done if we had a better start!"

HEINZ

Buffett was asked about Heinz's normalized earnings power after the acquisition.

Buffett responded that Heinz will file their own 10-Q, adding that Heinz is a reasonably-run food company with 15% pre-tax margins. Buffett expects the margins will be significantly improved over the next few years as 3G restructures the business model. Heinz's brands are as strong as ever, and the cost structure will be significantly improved.

INVESTMENT DECISIONS DURING 2008/2009 FINANCIAL CRISIS

A shareholder noted that Berkshire had the opportunity to buy additional shares in companies like Coca-Cola and Moody's at low prices during the financial crisis but didn't. Buffett was asked about his investment decisions during that time period.

Buffett said Berkshire's cash was spent too early during the panic with the low in the market being set in March 2009. He had already committed $6 billion to Mars to help finance Wrigley and then spent another $16 billion in Sept. /Oct. 2008 with other deals like Goldman Sachs and GE. He noted, "We did not do as remotely well with these investments as we would have if we had spent all the dollars at the bottom, but we don't know how to time the market. We did buy BNSF during the period so we did do reasonably well. " Berkshire's goal is to buy big businesses with good management at reasonable prices and build them over the long term. A bonus is not to issue any Berkshire shares in the process. This game is still viable.

Charlie commented that private businesses have become a bigger percentage of Berkshire's overall business. In the early days, Berkshire had more common stock investments than private businesses.

Buffett chimed in that private businesses now will continue to comprise significantly more of Berkshire's net worth than common stock investments. When Berkshire is right about the private businesses it acquires, it will show up in Berkshire's earnings power over the long term, which is more enduring in increasing Berkshire's intrinsic value. However, with common stock investments, it is easier to see the investment gains.

Charlie communicated that when Berkshire buys businesses, they can put huge chunks of cash to work. They cannot invest that much in common stocks. Charlie chortled, "I love it when we buy transmission lines in Alberta. Nothing will happen to Alberta!"

Change at Berkshire is inevitable. How Berkshire adapts to it is all important.

Buffett did note that Berkshire bought a fair amount of Wells Fargo over the last few years, while acknowledging that more money was made in banks of lesser quality over that same time period as the economy recovered. However, Buffett is 100% confident with Wells Fargo and only 50% comfortable with the lesser banks that had a greater recovery.

GEICO AND SELF-DRIVING CARS

Buffett was asked how usage-based pricing and self-driving cars might impact GEICO's moat and whether he would ever sell GEICO.

Buffett stated emphatically that he would never sell GEICO. He noted that Progressive has done the most in the industry in utilizing usage-based pricing with their Snapshot product. Buffett said insurance is all about computing the propensity of loss to establish proper premiums. For example, he said someone who is aged 90, like Charlie, is more likely to die than someone who is 20. There are all kinds of variables in setting insurance prices. A usage-based factor is just one variable. GEICO has a pretty good system. Buffett feels "very, very good about GEICO's management and their ability to assess risk. There is no one better than GEICO!"

Self-driving autos may become a real threat to auto insurers. They would be good for society but bad for auto insurers if they reduce accidents.

Charlie grunted, "Some things happen more slowly than you expect." Self-driving cars will likely take awhile.

Buffett agreed by saying, "If we are wrong, we are wrong together. GEICO will do a lot more business 5-10 years from now. Thirty years from now, I will go away peacefully without knowing [the impact of self-driving cars on GEICO]."

INVESTMENTS OUTSIDE OF U.S.

A shareholder asked why Berkshire employed very little capital outside of the United States.

Buffett responded that he never turned down a chance to do a deal outside of the U.S. He cited the recent Alberta deal. However, he noted that Berkshire has not had as much luck as he would have liked in getting on the radar screen of families outside of the U.S. Many founders of companies know Berkshire Hathaway in the U.S. Buffett is disappointed that he hasn't had better luck outside of the U.S.

He did point to one successful investment Berkshire made in Israel with Iscar, which set new record financial results in April. Their results are an indication of how business is improving around the world. Global business is beginning to show strength in the industrial world. Buffett wished he could find more Iscar's.

CIRCLE OF COMPETENCE

A shareholder asked how one finds their circle of competence.

Buffett said that was a good question. An important way is to be self-realistic in your talents and short-comings. Buffett felt he was reasonably good in assessing the perimeters of his circle of competence. However, he did point out that he has strayed from his circle of competence more often in making retail investments than in other cases. He thought he understood the retail business, but his department store investments proved him wrong. He also was out of his circle of competence in making his initial textile mill investment. These were "dumb decisions" that ended up working out.

Buffett said he knows CEO's that have no idea where their circle of competence begins and ends, but Berkshire has managers that do know. The ultimate manager who understood her circle of competence was Mrs. B, who founded The Nebraska Furniture Mart. When she sold the business to Berkshire, she said she did not want Berkshire stock in exchange because she knew nothing about stock. Buffett concluded that it is a huge asset to know what your circle of competence is

Charlie said it is not that difficult to define your circle of competence. He cited numerous examples: if you are 5 foot 2 inches tall, do not try to play basketball in the NBA; if you are 95-years old, do not try to become the romantic lead in a Hollywood film; if you weigh 350 pounds, do not try to become the lead in the Bolshoi ballet; if you can't count cards, don't play poker. Competency is a relative concept. Charlie said there are a "large supply of idiots, and that's what I needed to compete."

ANNUAL PERFORMANCE STANDARD

A shareholder asked what the logic was of Berkshire comparing its book value performance annually against the S&P 500 index's performance.

Charlie jumped in and said he wanted to answer that question. He said, "You are totally right that it is a ridiculous comparison. It is insane! You are right [that it is not a rational comparison as it makes it hard for Berkshire to look good], but Warren likes to make difficult challenges!"

PRICE PAID FOR REMAINING PURCHASES OF MARMON AND ISCAR

Buffett was asked about the higher multiples he paid for the remaining stakes of Iscar and Marmon compared to the original price paid for the majority of the stakes in the companies.

Buffett responded that on the Iscar purchase, he used the same formula as the initial purchase, providing a put option for the family and a call option for Berkshire for the remaining 20% purchase of the company. There was no variation from the original purchase formula. The family elected to put the remaining 20% of the company to Berkshire.

The Marmon deal was structured as an installment sale. Berkshire initially acquired 64% of the business and had a formula set to acquire the remaining shares of the business. If the business improved, Berkshire would pay more for the remaining stake.

Charlie succinctly summarized, “The price went up because the value went up.”

Buffett added, “Everyone felt good about the transactions.” Charlie noted that they have enormous respect for both families. Buffett said the carrying value of both companies is well below their intrinsic values. Charlie pointed out that Union Tank, a unit of Marmon, was John D. Rockefeller’s first business. “It is amazing how good businesses last!”

ENTREPRENURSHIP

A young shareholder asked Buffett if he were 23, what non-technology business would be start up and why.

Buffett said, “I would do what I did at 23 and go into the investment business and look at lots of businesses and visit with CEO’s.” Ask lots of questions of the CEO’s, such as the following. “If you could put all your money into any company except your own, what company would it be for the next 10 years?” “Which business would you sell short and why?” Through these questions, you can learn lots about the economics of business. You must have real curiosity. If you keep learning things, you will find a business that interests you.

Charlie said he should follow the “Larry Bird trick.” Larry Bird asked every agent that wanted to represent him, why he should select that agent and which agent would be recommended as the second best agent to represent him. Every agent mentioned the same “second best” agent. That is who Larry Bird hired, and this agent negotiated the best contract for Bird in history.

Buffett said when they went in to manage Salomon, they needed someone to run that place. Buffett asked the senior leaders, “Who would be the ideal person to run Salomon and why?” He said you learn a lot by asking questions. People like to talk.

Charlie noted that if it is a competitive business and you lack the qualities for that type of business, you should avoid it. “I immediately decided that I was not going to be a thermodynamics professor at Caltech. I did that over and over again, and there were only a few choices left.” Buffett joked, “I did the same with athletics.”

OMAHA HOTELS

Omaha hotels significantly increase their room rates during the shareholder weekend as 40,000 folks flood into the city. Buffett had expressed his unhappiness with the situation but was asked if that just wasn’t a function of supply and demand and capitalism at work.

Buffett said that was right, and he is trying to increase the supply of rooms during the weekend by inviting Airbnb, a website that allows folks to rent out lodging in their homes, to have a presence in Omaha. Buffett noted that Omaha cannot size its hotel supply to accommodate the Berkshire Hathaway meeting. What really bothered Buffett was that hotels were requiring 3-day minimums to book hotel rooms. He said Berkshire was not going to move the meeting to Dallas, which would offer more hotel supply, as the meeting is an economic boom for Omaha. Airbnb will offer flex-supply, but the Omaha hotels will still do well.

Charlie said he had nothing to add.

GEICO'S MARKET SHARE

A shareholder noted that GEICO has the largest advertising budget in the auto insurance industry and has increased its market share to 10% with State Farm maintaining a 19% market share. Buffett was asked if GEICO would overtake State Farm.

Buffett responded that GEICO passed Allstate this year in terms of market share. State Farm has a great history as it was a company started by farmer with no insurance business background. In 1920, State Farm had the better business model. However, once GEICO arrived in 1936, they had the better business model with the goal to become the number two player in the industry. Buffett said, "If I live to be 100, projections are for GEICO to be number one in the industry." Buffett joked that he has told GEICO employees that he will do his best to live up to his part of the deal. Buffett added that Tony Nicely, GEICO's CEO, deserves to be in the Hall of Fame. He has taken GEICO's market share from 1%-2% in 1993 up to 10% today, and the market share will continue to increase despite State Farm having a net worth of $60-$70 billion and lots of satisfied customers.

Charlie noted that GEICO is like Costco. They both feel they have a "holy duty" to have great products at great prices. They then tend to do well and take market share. It is easy to talk this game, but difficult to live this game.

Buffett concluded that people don't come and go from GEICO. It is a "very reinforced" culture.

FRUGALITY

A shareholder asked who was more frugal, Buffett or Munger, and its impact on Berkshire.

Charlie said that Buffett was more frugal on personal consumption, noting that Buffett still lives in the same house he bought in 1958.

Buffett said, "I have everything in life that I want." Standard of living does not equate to cost of living. "My life would not be happier if I had 6-8 homes. It would be worse."

Charlie noted that frugality has helped Berkshire. "I see a bunch of frugal people at Berkshire, including in this crowd. We collect these people."

Buffett admonished, "Forget it, though, this weekend. The more you buy, the more you save!"

BERKSHIRE TAXES

When asked if Berkshire would consider moving overseas to save taxes, Buffett said, "No, we could not have done what we have with Berkshire in any other country."

Charlie added, “I think it would be crazy to try and take our taxes to zero when we are this prosperous.”

Buffett noted, “We don’t pay anything more than we need to with our 20,000-page tax return. We don’t add a 20% tip!” He stated that Berkshire’s wind and solar deals are tax-driven, as they take advantage of the tax credits. Otherwise, it would not make sense to do the deals. Buffett declared, “We do not begrudge the taxes we pay.”

MEXICAN FREIGHT MARKET

A shareholder noted that Union Pacific serves the growing Mexican freight market and asked whether BNSF might acquire Kansas Southern to participate in that market.

Buffett said Union Pacific does have a great advantage in Mexico, but it does not make sense to have BNSF go into Mexico as the math right now does not work. BNSF has other good prospects.

Charlie said it is awfully easy to imagine combinations, however, when a business gets to a certain size, they can’t make acquisitions. Charlie concluded, “BNSF will have to get along on its own.”

INTRINSIC VALUE and BERKSHIRE BUSINESS MODEL

Buffett was asked how his calculation of intrinsic value differed from Ben Graham’s in *Security Analysis.* He was also asked which company he feared the most as a competitor and why more companies don’t copy Berkshire’s business model.

Buffett said Graham had not been specific on his calculation of intrinsic value. Intrinsic value is equated with private business value, which may be determined by calculating the present value of all cash that will be distributed from a business over its lifetime. Aesop had it right when he said “A bird in the hand is worth two in the bush.” However, investors need to determine how sure they are that there are two birds in the bush and how far away is the bush. Philip Fisher looked at the qualitative factors in determining the number of birds in the bush. Graham focused on quantitative factors. Buffett started out more quantitative, and Charlie is more qualitative. Intrinsic value basically is calculated by determining the cash you put into an investment versus the cash you take out, while considering interest rates.

In terms of having a silver bullet to shoot Berkshire’s biggest competitor, Buffett said Berkshire has no real competition. Private equity is similar to Berkshire in acquiring companies, but they generally leverage up businesses to do so. With leverage currently cheap, they are providing competition to Berkshire on deals.

However, no one has the same business model as Berkshire in terms of buying wonderful businesses. Charlie emphasized that Berkshire’s business model “has legs” and will go on for a long time. It is a credible business model with enough advantages to last a long time. He said all of the great businesses of yesteryear are no longer still here, except Standard Oil. However, he said Berkshire will “keep doing what we are doing and learn from our mistakes.” The momentum and ecosystem are in place. He advised young folks, “Do not be too eager to sell Berkshire stock.” There are not more copycats of Berkshire’s business model because there is nothing in business school that teaches them about the business model. Buffett added that it also is a slow process that takes patience, which deters people from copying the model. Charlie chuckled, “The problem with being slow is that you are dead before it is finished.”

INFLATION

A shareholder asked about future inflation and higher interest rates and its impact on Berkshire.

Buffett answered that inflation “will hurt us and most businesses.” As an example, he said assumer that a drone drops $1 million on each household. Berkshire would be worse off as this would be highly inflationary. Wealth is not created from inflation. Although Berkshire’s EPS would increase and intrinsic value measured in dollars would increase, the value per share in real terms would decline.

Charlie noted that the German hyperinflation created so much misery that the result was ending up with someone like Hitler. Charlie said he does not like to see the U.S. printing so much money. He said the economy can handle subpar growth, but it would be “crazy to let the whole thing blow up because of politicians printing money.”

ACQUISITIONS

A question was asked about the after-tax returns resulting from acquisitions in the corporate world.

Charlie said the sum of all acquisitions has been lousy. It is the nature of companies to do dumb deals. The history of acquisitions has not been prosperous.

Buffett added, “When companies, we own but do not control, announce acquisitions, we are more likely to cry than smile.” Charlie agreed.

Buffett described how successful GEICO had been until they embarked on acquisitions in the 1970’s. While the acquisitions were not disasters, they also were not successes. Accounting costs of the acquisitions were poor but not disastrous. However, the secondary effects were huge, as management took their eye off the gains that could have been made. This turned out to be good for Berkshire as it presented them with the opportunity to buy GEICO at a great price.

Buffett noted that CEO’s are not shrinking violets, and they like to do deals. With investment bankers calling them on a daily basis, CEO’s often are pushed to do deals…most of which are dumb deals.

Charlie chuckled, “Notice how much more tactful he is.” Buffett laughed, “The comparison is not tough.”

INVESTMENT BANKERS

A shareholder noted that confidence is again waning about investment banks with new criminal charges being brought on money laundering, LIBOR rate fixing, etc. He asked if a new financial crisis might erupt because of this or are investment banks too big to fail and their bankers too big to jail?

Charlie noted that behavior on Wall Street has enormously improved after the financial crisis. However, there will never be perfect behavior. Nothing changes behavior more than regulators going after individuals.

Buffett added that based on the experience at Salomon, they learned that prosecution of individuals is better than prosecution of corporations. Otherwise, a few bad apples can destroy thousands of lives. However, prosecutors find it way easier to prosecute corporations rather than individuals, as the corporations pay the penalties with other people's money.

Charlie emphasized that they should go after individuals. When the regulators went after individuals, it changed price-fixing issues in antitrust cases.

Buffett said they have 300,000 people working at Berkshire, and it is likely that somebody is doing something wrong. If it reflects badly on the whole corporation that worries him. He added, when they find something wrong, they hope they find it early and take care of it. The way to change behavior is to have the fear that wrong doing will hit the individual hard.

INSURANCE FOR RAILROAD ACCIDENTS

Buffett was asked if there was a lack of insurance for a worst-case railroad accident.

Buffett responded that Ajit Jain has offered the rail industry very high limits on railroad accidents, but they don't like his prices. The four major railroads have the capacity to pay a worst-case scenario award. They must carry hazmat insurance. The railroads do carry insurance, but they don't discuss the limits because it becomes a honey pot for lawyers. For any nuclear or terrorist threat, the government would cover those amounts.

Charlie discussed the British Petroleum disaster in the Gulf of Mexico. He said no one in their wildest dreams would have thought billions of dollars of losses from one well was possible.

Buffett noted the biggest railroad accident cost $200 million. However, railroads are not getting paid enough for carrying products like chlorine, but they have to do it as common carriers. Buffett added that he does not stay awake worrying about the financial impact from a railroad accident. However, he acknowledged that a terrorist act could create damages like we have never seen. Charlie agreed, noting that we live in a world where unusual events will occur.

COMMERCIAL CASUALTY INSURANCE

Buffett was asked why Berkshire was expanding into commercial casualty insurance when pricing has peaked.

Buffett said Berkshire entered the commercial insurance business last year with great talent joining the company. This talent can underwrite more intelligently than most in the industry. Ajit is overseeing the operations, and it presents a terrific opportunity for Berkshire as they build a significant commercial insurance operation over time.

Charlie added, "It is a very logical thing for us to do." Berkshire does not hold back because of the business cycle. It is a long-term play.

PROFESSIONAL SPORTS TEAM

Buffett was asked if he would purchase a professional sports team.

He answered that he already personally owns one-quarter of a minor league baseball team, but that he will not buy a professional sports team for Berkshire. He joked, “If we do, start looking for our successors!” Sports equipment manufacturing is not a great business, although Berkshire does own Spalding and Russell.

Buffett asked Charlie if he was thinking about buying the L.A. Clippers. Charlie just shook his head. Buffett laughed and said, “Now, I am thinking he is!” Charlie then retorted, “Whatever Warren thinks about sports ownership, I like it less!”

ACTIVISM

Buffett was asked if Bill Ackman’s covert tactic to establish a position in Allergan and then work with Valeant to acquire the company was similar to Buffett establishing a position in Coca-Cola.

Buffett said he did not see any parallels as he purchased his Coca-Cola position on the open market and did not try to take over the company. Buffett added that activism “scares the hell out of a lot of managers” and the activists will not go away. Activism is attracting more hedge fund money.

Charlie added that activism is stirring up corporate management. No one feels immune. 20%-30% of company stock can change quickly. Activists make a lot of money. They are having an effect. Activism is like fox-hunting,” the pursuit of the uneatable by the unspeakable.” Charlie said he did not think it was good for America, but it will be bigger three years from now.

SMALL COMPANIES VERSUS ELEPHANTS

Buffett was asked whether it was better to buy a collection of smaller companies that would provide growth or elephant-sized companies that are near maturity.

Buffett said he is not precluded from acquiring small companies and that he would be delighted to buy a $2-$3 billion company. Berkshire’s subsidiaries made 25 tuck-in acquisitions last year. However, Buffett noted that one $30 billion acquisition is equal to ten $3 billion deals. Berkshire can obtain more earnings power with bigger deals.

Charlie agreed saying that the idea of buying hundreds of small companies does not make sense for Berkshire.

Buffett concluded by saying that he doesn’t feel envious of private equity.

MIDAMERICAN (BERKSHIRE ENERGY)

A shareholder noted MidAmerican’s minimal operating cash flow over the last 5 years and asked Buffett why he is allocating capital to a business that is earnings less than 1% on its tangible assets.

Buffett told the questioner he was doing great until he got to the return on tangible assets part of his question. He needs to look at operating earnings less depreciation. MidAmerican gets appropriate returns from regulators. Net investment in utilities is required, and Berkshire will do so if they can earn reasonable returns. Berkshire delivers electricity at lower rates than most utilities. Berkshire has a “deserved good reputation” with regulators, while improving the operations and safety at the utilities they own. Buffett noted, “We will get returns that are appropriate.” While Berkshire Energy may experience negative free cash flow for a substantial period as they invest in their utilities, they will get good returns over the long term.

Charlie added that if the shareholders’ numbers that he cited came from a department store, “we would hate it.” However, when the numbers come from growing a utility, we like it because we will do exceptionally well.”

Greg Abel, the CEO of Berkshire Energy, also pointed out that they were the low-cost provider. Their last rate increase in Iowa had been in 1998, prior to a recent increase. They do not see another rate increase for some time. Berkshire Energy is currently investing $1.9 billion in a project that will earn an 11.6% return. Berkshire Energy tries to keep capital expenditures close to depreciation. However, the lion share of capital spent is growth capital.

Berkshire Energy services Google data centers, which they are talking about increasing to 1000 megawatts in Iowa. Berkshire Energy provides Google with exceptionally low rates from their renewable energy. Google wants those tax credits and to be associated with green power.

EDUCATION IN CHINA VERSUS U.S.

When asked about the difference in education in China versus the U.S., Charlie said, “America made a huge mistake when they let public schools go to hell.” The Asian culture is less likely to do so. He concluded, “Wish we were more like them.”

REFORMING FANNIE MAE AND FREDDIE MAC

A shareholder asked if America should change the way it finances homes and whether there would be a role for Berkshire in that process.

Buffett said that 30-year fixed-rate mortgages have been a boon to home ownership. Government guarantees have helped to keep the costs down. This is something private industry cannot do. The problem is that politics get into the picture. Buffett wrote an op-ed in The *Washington Post* 30 years ago about FSLIC when the savings and loan industry fell apart. Berkshire will not likely be a player in setting insurance rates for housing.

Charlie said when private industry took over mortgage loans; the biggest bunch of “thieves and idiots” almost took the financial system down. At the moment, Fannie Mae and Freddie Mac are being conservative. Charlie said he is not anxious to have investment banks get back “into a race to the bottom with phony securities.”

Buffett noted that Fannie Mae and Freddie Mac were led astray by trying to serve two masters. In effect, they became the biggest hedge funds in the country.

Charlie said that Fannie Mae and Freddie Mac no longer need portfolio activity. They should just provide insurance. Their experiment in privatization was a total failure.

3G AND THE BUFFETT STAMP OF APPROVAL

A shareholder asked what the "secret sauce" was behind 3G's deals. 3G is Berkshire's partner in the Heinz acquisition. Also, what will happen to deal making at Berkshire without Buffett's long-term relationships with people or the Buffett stamp of approval on deals?

Buffett said when he is no longer around, it will become the Berkshire Stamp of Approval on deals. His successor will have the Berkshire brand and ability to do the same things as Buffett does, including writing big checks. He added that the folks at 3G are very smart and never satisfied. They are very hard-working and don't overreach or overpromise on deals. Buffett said Berkshire is very fortunate to be associated with them. It takes being a good partner to attract good partners. Lots of people have given Berkshire a good reputation and are part of the Berkshire brand.

Charlie agreed, saying that the way to get a good spouse is to deserve one. The same thing applies to business partners if you behave properly. 3G is very good at removing unnecessary costs, which is a service to civilization. It should be done with sensitivity. "We are learning from them," Buffett concluded.

$1.2 TRILLION MARKET CAP IN 20 YEARS?

A shareholder asked if Berkshire might achieve a $1.2 trillion market cap in the next 20 years.

Buffett said that at some point, Berkshire will have more cash than they can intelligently deploy. While he hopes that it is not soon, it also is not on the distant horizon. At that time, if the stock can be repurchased at an attractive valuation, Berkshire will buy back their shares aggressively. Whatever is done at that time will be done in the best interest of shareholders.

Charlie said, "It is not a tragedy to succeed so much that future returns go down. That is success!"

NEW TECHNOLOGIES

Buffett was asked about companies like Uber and Airbnb and how new technologies are changing the economy.

Buffett said these companies will be disruptive. The taxicab and hotel industry is fighting back in competitive ways and using regulators to help. Back in 1920, State Farm's agent system in the insurance industry was sacrosanct. Then GEICO came along with direct selling. In the end, the better mousetrap wins. Buffett said, "We stay away from companies with lots of change, since we don't know who the winners will be." Most of Berkshire's businesses will be winners and be around a long time, such as the railroad and energy companies.

Charlie added that new technologies will be quite disruptive especially in retail. He referred back to Greg Abel's comments on serving Google's growing server farms. Charlie said when you get computer capacity on this scale, "it is changing the world." It will hurt a bunch of people.

FINANCIAL LITERACY

Buffett was asked whether financial literacy should become part of the standard curriculum of schools and when should it begin?

Buffett responded, “The earlier, the better!” He added that habits are powerful forces. He said digging out of a financial hole is difficult. Buffett participates in “The Secret Millionaires Club” as a way to teach young children about financial literacy. He noted that when he was young, he was lucky because he learned good financial habits at home. He noted that the big problem is with adult financial literacy. He emphasized again that it is really important to have strong financial habits.

Charlie commented, “I place most of the fault with parents. It is very hard to fix people with the wrong parents.” The main problem with education in finance is in college. Universities teach asinine topics, even in economics. Buffett noted that major universities are getting better. Charlie grumbled, “They were teaching students very dumb things.”

BREAK UP BERKSHIRE?

A shareholder said he thought Berkshire was so large that its valuation was being penalized by folks who could not evaluate it and by old shareholders waiting to get dividends. He asked if Berkshire would be better off if it was broken up into four companies.

Buffett responded that it would not create value if he broke Berkshire up into four companies due to the tax situation and allocation of capital. Berkshire is worth more now in the way that it is structured. Berkshire did have a vote on paying a dividend this year, and the vast majority of shareholders do not want a dividend. Shareholders can sell part of their stock if they want to create a dividend, as Buffett described in the annual report. There is no advantage to break up Berkshire. It would be a terrible mistake.