

BERKSHIRE HATHAWAY 2009 ANNUAL MEETING NOTES

For the Meeting Held on 5-2-09

Berkshire Hathaway started the meeting with its usual movie which featured a clip on the Nebraska Furniture Mart's new mattress, named The Nervous Nellie, which has a hidden compartment for people who prefer to hide their money in the mattress than put it in the bank. This was a good introduction to a slide used later at the meeting which showed just how nervous folks had become during the past year. The slide showed a Dec. 19 trade ticket of a Berkshire sale of \$5 million of Treasury bills. They were coming due on April 29 this year, roughly four months after Berkshire sold them. Berkshire sold the bills for \$5,000,090.70. If that buyer had instead put the money in a Nervous Nellie mattress, they would have been \$90.70 better off. Negative yields on Treasury bills show just how fearful folks were last year. Buffett noted, "We may never see that again in our lifetimes."

A record crowd of 35,000 folks from around the world attended this year's annual meeting to hear the wit and wisdom of Warren Buffett, chairman, and Charlie Munger, vice chairman of Berkshire Hathaway. A new format was used for the question and answer period with questions being rotated among individuals at the meeting and three reporters, who asked from among 5,000 questions that had been submitted to them prior to the meeting. I was delighted when the question I submitted on General Re was one of the questions asked at this year's annual meeting.

PREVIEW OF FIRST QUARTER RESULTS

Buffett reported that first quarter operating earnings were \$1.7 billion, down about 11% from \$1.9 billion a year ago. Book value fell 6% in the first quarter due in part to losses in its investing portfolio and losses on credit default swaps. Earnings fell in Berkshire's utilities operations in the quarter due to mark-to-market accounting on Constellation Energy stock which declined during the quarter and payments made to increase Berkshire's interest in MidAmerican. Overall, utility earnings were satisfactory while underwriting profit in the insurance businesses gained "a bit" from last year. All the other businesses were basically down because of the weak economy. Float increased to \$58 billion primarily due to the \$2 billion addition of Swiss Re float. Cash at quarter end was \$22.7 billion, but Berkshire spent \$3 billion of that on cash on Dow preferred stock the day after the quarter ended so effectively Berkshire ended the quarter with \$20 billion in cash. Buffett said Berkshire should do quite well in the insurance and utility businesses for the balance of the year. Buffett wants to reinvest \$1 billion of utility earnings in MidAmerican, but that will leave the rest of the company's earnings and change in float available for any other investments that may come along.

DERIVATIVES

Berkshire's derivatives require minimal collateral posting, less than 1% of the value of Berkshire's marketable securities. While Buffett stated in the past that derivatives were "weapons of financial mass destruction" for the financial system as a whole, Buffett believes Berkshire will make money on the equity put derivatives Berkshire holds. The odds are extremely good that Berkshire will make money even though mark-to-market accounting can cause wild swings in earnings during the interim. Despite the wild accounting swings, Buffett believed shareholders would understand how advantageous these derivatives would be to Berkshire once he explained them. Berkshire received \$4.9 billion in cash on these equity puts which Buffett was able to initially invest for 15-20 years. However, in the last week, two equity put derivatives were modified in terms and strike prices, but still have 10 years to run. The modifications came about at the request of the counterparty. At the time the derivatives were established, Berkshire received billions in cash and set up a liability. The counterparty paid the cash and set up a receivable. However, the more the receivable went up, the more credit default swaps the counterparty needed to buy to protect the receivable. Due to the crazy market, the demand for Berkshire's credit default swaps increased and resulted in some silly prices. However, the net result was that Buffett was holding billions in

cash on what will likely be a profitable outcome for Berkshire, while the counterparty was forced to continue to pay out more cash and wanted relief through modification of the terms of the deal.

On the credit default swaps, Buffett now says Berkshire will likely lose money as there have been far more bankruptcies than he expected due to the “financial hurricane.” The derivative contracts Berkshire holds have had no impact on the company’s financial flexibility as Berkshire is ideally suited to hold them.

Buffett said Ben Graham probably would not have liked derivatives because the leverage associated with them caused them to “run wild” which added strains to a fragile economic system. However, he does think Graham would have acted on them if they were mispriced but not to the extent that they could get him in trouble by investing in them. During the Great Depression, the Fed regulated how much people could borrow through margin requirements. Derivatives made margin rules a “laughingstock” as they were designed to get around leverage rules. By pushing out settlement dates for the derivatives, this caused even more problems because of the associated potential defaults by weak counterparties. Buffett recommended that everyone read “The Great Crash” by John Kenneth Galbraith.

Charlie summarized that “derivatives are a dirty business” with a croupier advantage that results in investment bankers selling things that are bad for their clients. He proclaimed, “We don’t need more derivatives, we need less!”

FINANCIAL LITERACY

Financial literacy is a tough sell in a world of credit cards and calculators as people would rather use these items than do the math behind their transactions. Buffett warned that folks can’t come out ahead if they borrow using high-cost credit cards. Berkshire tries to contribute to financial literacy through its annual reports.

People do foolish things with money. Buffett recounted going to Las Vegas on his honeymoon in 1952. He noted that people traveled miles to do something really dumb as the math expectation behind gambling results in negative returns. However, as Buffett observed this, he saw it as a world of opportunity for those folks who could calculate odds properly.

GOVERNMENT POLICIES DURING THE FINANCIAL CRISIS

Charlie Munger noted that in the midst of the worst financial crisis, it is unreasonable to expect perfect government policies. The government should be judged leniently when they are attempting their best. Buffett also “commended” the government actions noting that last September we were facing a total meltdown of the financial system with a run on money market funds, commercial paper markets frozen, and financial institutions falling like dominoes. When we are being “punched from all sides,” the government won’t do everything perfectly. Decisions could have been made better if they didn’t need to be made under emergency conditions. Buffett commented that by and large, the authorities did a good job.

He also recommended that all investors read Jamie Dimon’s letter to JP Morgan shareholders for a good overview of the financial crisis. He said it is one of the best letters to shareholders he has ever seen. (I concur with both Buffett’s recommendation and accolades for the JP Morgan letter.)

Buffett was asked whether he would let the government pressure him on disclosure (as they supposedly did with Bank of America on the disclosure of Merrill Lynch losses). Buffett noted that last December the financial system was still in a fragile position, and he could understand Bernanke and Paulson’s decisions under those circumstances. Charlie added that you could criticize Bank of America’s original deal in acquiring Merrill Lynch, but once they signed the contract, both the U.S. Treasury and Bank of America acted “honorably.” Buffett joked, “I’m sure they hope you will be on the jury!”

Given the massive government intervention in the market, there will be new rules in the game for all financial institutions, including Berkshire. Charlie said it is hard to predict what will happen with the new regulations, but that it will be very interesting. There is a "climate of hatred" in Washington that is now directed at the financial industry. People are "coldly furious." Berkshire will have to adapt to whatever happens. Buffett concurred that there will be new regulations, and they don't know how it will all turn out as Washington DC thrashes the rules around. Americans don't like bankers now because they had to worry about even their safest assets like money market funds. This anger has been accentuated since no one is going to jail. The fury right now is hard to satisfy. The result has been legislation such as the proposed 90% tax on AIG bonuses, which was an act of uncontrolled fury. Some of the new regulations will certainly impact Berkshire and make life more complicated and costly.

FREE CASH FLOW ANALYSIS

Buffett noted that free cash flow analysis basically boils down to Aesop's fable which concludes that a bird in the hand is worth two in the bush. Investing is all about laying out cash now to get more cash in the future. The more certain you are about the future cash flow, the better off you will be. You don't need fancy spreadsheets to do the analysis. If you need a calculator to figure out the value, you shouldn't make the investment. You only want to make investments where the "value is shouting out at you." Charlie added that some of the worst investment decisions have been made with lots of elaborate projections. Both Charlie and Warren chided business schools for making investing more difficult than it has to be. Warren joked that if a professor explained investing as "a bird in the hand is worth two in the bush," he wouldn't get tenure. Instead, they teach students about standard deviations, but the false precision provided by thinking about two standard deviation events is "crazy." Just look at what happened at Long Term Capital Management. Luckily this only happens to people with high IQ's. Buffett also cited what happened last September and noted you can't calculate the standard deviation when people get fearful. While math will help you with investing, you don't need higher math and fancy Greek letters to be a successful investor.

MOODY'S

Buffett said supposed conflicts of interests at the rating agencies like Moody's (which Berkshire owns a 20% interest in) was not a major cause of the shortcomings in the ratings of the mortgage-backed securities and CDO ratings. He noted that no one was modeling in the probability of a housing decline as there was almost a total belief that home prices wouldn't fall significantly. The ratings agencies built this belief into their systems. However, the housing bubble leveraged up significantly and once it melted down, it became a self-reinforcing cycle. Moody's thus made a major mistake in analyzing the mortgage-backed financial instruments. Congress who was presiding over Fannie Mae and Freddie Mac also made the same mistake as did individuals who were buying homes they really couldn't afford. Berkshire didn't try to influence Moody's ratings as they don't make calls to companies they invest in to tell them how to run their business. Berkshire wouldn't question Burlington Northern on their safety practices or American Express on their credit card policies. Even if Berkshire did call companies, their luck on changing company behavior would be very low. Berkshire continues to maintain their investment in Moody's as Buffett calculates that the odds are that the rating agency business is still a good business as 1) there are very few competitors, 2) ratings still affect a large part of the economy and 3) the business doesn't require much capital. Moody's, however, won't be doing the same volume of business as they did during their peak years for a very long time. At Berkshire, they never have believed in outsourcing their ratings decisions on credit decisions they make.

Charlie noted that the rating agencies being good at math, eagerly sought "stupid assumptions" when supporting their rating decisions on CDO's. Charlie repeated one of his favorite quotes, "To a man with a hammer, every problem looks like a nail." Warren added, "People believed their own

baloney and paid a big penalty.” In the securities markets when everyone else is “doing it” and making money, it soon becomes industry acceptance, and it is very hard to stop. Buffett cited the example of Salomon Brothers doing business with Marc Rich, a commodities trader with a dubious background. When Buffett and Munger became involved in running Salomon, they wanted to stop doing business with Marc Rich and faced a great deal of opposition...as Salomon executives knew if they didn’t get rich doing business with Rich, their competitors would.

RESIDENTIAL REAL ESTATE MARKET

Buffett said he doesn’t know what real estate prices will do over the next couple of years. However, in the last few months, Berkshire’s real estate brokerage business has seen a real pickup in activity in California in the mid-to-low price (less than \$750,000) homes. However, they are not seeing a bounce back in home prices only in volume. Berkshire owns the largest real estate brokerage firm in California, and they are seeing price stability in the mid-to-lower price homes. However, with the higher price homes, there still is not much activity. The mortgage market is getting much better in California. Buffett cited the statistics nationally about the housing market with 1.3 million households being formed each year, although fewer households are formed during a recession. During the peak housing years, 2 million housing starts were occurring annually which resulted in the housing industry running into trouble as there was more supply than demand. Now we have 1.5 million excess houses in the U.S. Housing starts have now slowed to 500,000 units a year so it will still take 2-3 years to eat up the excess housing inventory. Buffett noted that south Florida is in the worst shape, and it will be a tough real estate market there for many years. Charlie added that there never was a crazy housing boom in Omaha. With current low interest rates, he would buy a house in Omaha tomorrow. Buffett also noted that there are 80 million houses in the U.S. and 25 million of them don’t have any mortgages since they’ve been paid off. However, there are 5-6 million mortgages in trouble.

SUCCESSION

Buffett was once again asked about management succession plans at Berkshire. He repeated that there are three internal candidates for the Chief Executive Officer. The Board knows who they are and will tap an immediate replacement when needed. Howard Buffett will serve as Chairman of the Board of Berkshire primarily to ensure Berkshire’s unique culture remains intact and Bill Gates (a Berkshire board member) also has recently committed to maintaining Berkshire culture in the decades ahead. There are also four current candidates willing to serve as Berkshire’s investment officers, who all said they would be willing to work for Berkshire when necessary. Buffett said the investment officer may be chosen on a more leisurely basis (within a month or so of Buffett no longer being available) as the Board and new CEO make the final decision. While the four current candidates did no better than match the S&P 500’s performance last year, Buffett said they all remain on the list. Charlie wryly commented that “practically every intelligent investment manager got creamed last year.” However, Buffett noted that over the last 10 years, all these investment managers have modestly-to-significantly performed better than average, and he expects them to do the same in the future. Charlie added that Berkshire doesn’t want an investment manager who tries to time the market by going to cash. He said Berkshire will leave out anybody like that as they are “not dumb enough for us.”

Buffett said there was no need to bring the CEO succession candidates into headquarters for “training” under Buffett. He said all three candidates are currently running businesses for Berkshire and making capital allocation decisions. Buffett added it would be a “waste of talent” for them to sit in his office and watch him read. He said all three CEO candidates are 100% ready for the job now. Their biggest new challenge will be to develop relationships and get to know the management styles of all the other Berkshire managers. Buffett concluded that he saw no advantage of having a “Crown Prince” around now. In fact, it might even drive away the other managers as it did at GE when Jeff Immelt was named the CEO successor.

When asked about the succession plans for Ajit Jain, who heads up Berkshire's highly successful reinsurance business, Buffett said it would be impossible to replace Ajit. He said he won't even try because Ajit is a unique talent. In reinsurance the authority goes with the individual. He won't "give the pen away in insurance" citing how Mutual of Omaha lost half of their net worth by not being careful with who did their underwriting. Ajit and Buffett talk every day primarily because Buffett finds Ajit's deals so interesting, such as pricing Mike Tyson's life insurance (and hoping there are no angry girlfriends still around). While Ajit is needed and there is no substitute, Charlie says Berkshire likes having businesses that are managed magnificently even if there is no successor. Buffett concluded that they won't assign a task to people which is beyond their capacity and that not having a successor for Ajit is a one-off situation.

HEALTHCARE NATIONALIZATION

Charlie said the future U.S. healthcare system will likely resemble something more like Europe's system and be supplemented by a private system. He added, "As a Republican I am not horrified by this but personally wish they would put it off for a year to focus on the economy." Buffett added that Berkshire will adjust to any new healthcare system as will other businesses.

HOW TO TEACH VALUE INVESTING

Buffett said he does his part in teaching the next generation about value investing as he hosts students from universities every year in Omaha. If he were to teach value investing at a business school, he would have just two courses:

- 1) How to Value a business
- 2) How to Think About Markets

There would be no classes on efficient market theory, beta or modern portfolio theory. Instead, students should just stay within their circle of competence and look for businesses selling for less than they are worth. While Buffett thinks it is important to understand accounting as it is the language of business, one must also understand what a durable competitive advantage is in a business...i.e. the difference between a hula hoop and Coca-Cola. It is also important to understand that the market is there to serve you not to instruct you. Buffett joked that someone with a 160 IQ could sell 30 of those points to someone else, since you don't need a high IQ to be a successful investor. Far more important is inner peace with your investment decisions and emotional stability. You need to be able to think for yourself. Investing is not complicated. However, investing is simple but not easy because of the emotional stability needed to make sound investment decisions over time. Charlie added that half the future investors will be in the bottom 50% of investors and that you can't homogenize investment expertise. He said so much taught in modern investment schools is "nutty." The best that can be hoped for is that business schools just "reduce the nonsense." Buffett added that 25 years ago Efficient Market Theory was taught as Holy Writ. He asked, "If everything is priced perfectly, how does a professor fill the rest of the hour of a business class?" Buffett continued, "The famous physicist Max Planck was talking about the resistance of the human mind, even the bright human mind, to new ideas.... and he said science advances one funeral at a time, and I think there's a lot of truth to that and it's certainly been true in finance."

BERKSHIRE'S MARKET VALUATION

Last year, the value of Berkshire's investments declined 13% as earnings dropped 4% yet Berkshire Hathaway's own stock value declined 31%. Buffett was asked if this then implied an attractive valuation for Berkshire's stock. In valuing Berkshire, Buffett noted that it is reasonable to look at Berkshire's investments and the earnings power of the operating companies. Buffett explained that the investments are worth what they are carried for on the balance sheet, even though Berkshire's stock investments generally are priced less than their intrinsic value. Buffett further explained that while the earnings power of the operating companies (excluding the

insurance business which provides no-cost float) was not as good last year as it has been in normal times, most of Berkshire's businesses will do well over time with operating earnings increasing. At the end of 2008, Berkshire's stock price was cheaper than its intrinsic value when compared to the same metric at the end of 2007. However, Buffett was quick to add that this was the case for many companies.

Charlie added that last year was a bad year for a float business. However, over the long term having a large float at a cost of zero is a big competitive advantage. He noted that Berkshire's casualty insurance business is the best in the world, Berkshire's utility subsidiary is among the best in the industry, and that Iscar is the best in the world in its industry. Charlie said you could continue to go down the list of all Berkshire's businesses, and it would be a long way down the list before finding a business that wasn't among the best in its class. Charlie snorted, "If you think it is easy to get that way, then you are living in a different world than I am."

Buffett added that the financial meltdown last September, which he likened to the China Syndrome, hurt Berkshire's jewelry businesses, NetJets, the carpeting business and companies Berkshire invested in like American Express, which saw its average ticket decline 10%. However, the same meltdown caused the phone to ring off the hook at GEICO, as more people than ever were looking to save \$100 on their insurance. Last year, GEICO added 665,000 new policyholders and through the first four months of this year, they have already added 505,000 new policyholders. GEICO has a strong competitive advantage as the low-cost provider of auto insurance, which is paying off hugely now as people seek value. GEICO is the third largest auto insurer in the U.S. with its market share having grown from 2.5% (when Tony Nicely took over managing the business) to an expected 8.5% at the end of this year.

DIVIDEND POLICY

Buffett was asked about principle number nine in Berkshire's owner manual:

We feel noble intentions should be checked periodically against results. We test the wisdom of retaining earnings by assessing whether retention, over time, delivers shareholders at least \$1 of market value for each \$1 retained. To date, this test has been met. We will continue to apply it on a five-year rolling basis. As our net worth grows, it is more difficult to use retained earnings wisely.

We continue to pass the test, but the challenges of doing so have grown more difficult. If we reach the point that we can't create extra value by retaining earnings, we will pay them out and let our shareholders deploy the funds.

The shareholder asking the question indicated that Berkshire had not met this test for the rolling five year period which ended on 12/31/08 and asked whether this meant Berkshire would now pay out a dividend. While Buffett didn't directly answer the question, he noted that there has never been a rolling five-year period where Berkshire's book value growth had underperformed the S&P 500 (which is a different test than stated in the principle.)

Charlie added that he doesn't get too excited about "oddball things" that happen every fifty years implying that not meeting the test last year was one of those "oddball things."

WELLS FARGO

Buffett noted that when Wells Fargo's stock price dropped to \$9 last year, their competitive advantage had never been better and that they will come out of this financial mess even stronger. At the time, Buffett told students that were visiting him that if he had to put his net worth in just one stock, it would have been Wells Fargo when it was trading for \$9 per share. Wells Fargo will be much better off than if none of this had happened. Buffett noted that leverage is what causes problems in the world. You don't want to have emotions which force you to sell. He puzzled over

why people sold Wells Fargo at \$9 per share when they were willing to hold it at \$25 per share....noting that emotions can cause people to do funny things. He reminded folks that they should be looking at the asset to make intelligent investment decisions. "Don't look at the price, look at the underlying business." Investors would be wise to re-read chapter eight of Ben Graham's book, "The Intelligent Investor."

Unlike Fannie Mae and Freddie Mac who saw their preferred stock wiped out, Buffett doesn't think Wells Fargo should have their preferred stock converted to common equity through the bank stress test. He says Wells Fargo has lots of common equity and earnings power. Buffett added that he would love to be able to buy all of Wells Fargo and U.S. Bancorp if he could.

STIMULUS BILL

A shareholder asked if it would be better for the money in the stimulus bill to go to investments in assets like building the Hoover Dam, which also put people to work.

Charlie answered with one word, an emphatic, "YES!"

Buffett added that he has received a notice from Social Security that he will personally benefit from the stimulus package by getting \$250. He joked that should last him 6-7 months. With the stimulus package, one hopes that the money is used as intelligently as possible, although there likely will be a fair amount of "slop." The intent of the package is to get the money into action quickly. Today's current system with all its earmarks is not perfectly effective. Folks will get distressed with what gets added to bills. However, the government needs to step in with fiscal stimulus even with the likely consequences.

Charlie added that a "no-brainer" for the fiscal stimulus would be to establish a huge smart electrical grid, acknowledging that this would benefit Berkshire's utility subsidiary.

THE DISADVANTAGE OF A STRONG BALANCE SHEET

As Buffett wrote in the annual report, Berkshire currently is in the unusual position of being at a significant disadvantage due to its strong balance sheet. This is especially the case at Clayton Homes which has to compete against those institutions getting government aid. Money is the raw material to fund mortgages, and it is costing Berkshire more for this money than those banks which are receiving government guarantees. This can be seen even within the same companies like Goldman Sachs and GE, which are able to issue debt at significantly lower spreads for the funds guaranteed by the government versus the debt they issue without the government guarantee. Fortunately, Berkshire does not need to borrow much except in its utility businesses, which compete for funding against other utility companies with no competitive funding advantages. Berkshire luckily gets most of its funding from its \$58 billion in insurance float with no cost at this time.

Charlie added that while Berkshire is at a disadvantage not being regulated as a bank holding company right now, "we'd be ungrateful if we obsessed over this one disadvantage."

SMALL INVESTORS

A shareholder asked about the number of positions a small investor should have and whether they should sell stocks after they double in price which could result in high portfolio turnover. Buffett said if he were small, he would own half a dozen stocks that he liked the best based on their price/value relationship. He said the cost basis makes no difference to him. Charlie chuckled, "Warren is tactfully suggesting that you change your way of thinking."

BERKSHIRE'S COMPETITIVE ADVANTAGE

Buffett stated Berkshire's competitive advantage is its business model and culture, which is very difficult to copy. Other competitive advantages include Berkshire's loyal shareholders, managers who understand business differently, and Berkshire's ability to provide private businesses with a good home. No other company in the U.S. can adopt the same business model. Berkshire's culture is deeply embedded in the CEO's of its various companies and will continue. This will provide long-lasting advantages to Berkshire even without Buffett and Munger around. As a result of Berkshire's unique culture, the future Iscar's and GEICO's of the world will want to join with Berkshire.

Charlie added that many companies in the U.S. are "run stupidly." When they focus on quarterly earnings management, they make terrible business decisions. This is not the case at Berkshire. The stupid practices of the rest of the world will give Berkshire a competitive advantage well into the future.

BUY AND HOLD

A shareholder asked how Buffett justifies holding stocks "forever" when business fundamentals change. Buffett responded, "We don't." Berkshire sells stocks plenty of the time if management or business fundamentals change. However, if Berkshire owns a wonderful business, they do want to hold it forever. While Berkshire is more reluctant to sell stocks than other investment managers, if the business loses its competitive advantage or Berkshire was wrong in its analysis of if a better opportunity comes along, Buffett will sell. He cited his sale of part of his position in Johnson & Johnson last fall to enable him to make the investments in Goldman and GE as an example of a better opportunity coming along when he didn't have available cash (as he was keeping extra cash handy for the insurance business).

ANNUAL MEETING WEBCAST

Buffett said it was unlikely that he would webcast the annual meeting because there is something to be gained by personal contact. Besides, Buffett likes the turnout of the shareholders, and most of what goes on at the meeting gets plenty of publicity for those that are unable to attend.

PIGGYBACKING BUFFET'S IDEAS

Buffett said some folks do "piggyback" his investment ideas instead of buying Berkshire Hathaway stock directly. However, he says they don't have the advantage of free float. Charlie said there is nothing wrong with identifying skilled investors and copying what you please from their investments. Buffett noted that he used to get ideas from Graham-Newman when he started.

INFLATION

Buffett commented that it is certain that we will have inflation over time. While inflation is unpredictable, Buffett said he could guarantee that the dollar will buy less in terms of purchasing power 15-20 years from now given the unprecedented deficits being run around the world to offset the contraction in demand. We are doing things today that haven't been done in the past which will have consequences and result in higher inflation. Paul Volcker was upset with the 2% inflation targets the Fed is supposedly considering. While 2% inflation might sound great, in a generation it will cut purchasing power by 50%. Currently, the government is following policies which will have inflationary consequences. The government would rather repay the world with dollars that are worth far less than what they borrowed, which is one way to reduce the external debt. Buffett noted that the taxpayers are upset because of all the bailout policies, but the taxpayers haven't paid anything yet as we haven't raised taxes to pay for the stimulus bill. The

people who are really paying for the fiscal stimulus are the Chinese through their purchase of U.S. Government bonds. The best protection against inflation is your own earnings power with the second best protection being the investment in a wonderful business that doesn't require much in capital investment like Coca-Cola.

Charlie summarized, "You should become a brain surgeon, and invest in Coca-Cola and not government bonds." Charlie also noted that when he was young, he could buy a \$.02 stamp and a \$.05 soda pop, saying, "A little inflation won't ruin our lives. The trick is to avoid runaway inflation." He concluded, "We'll leave that for the younger generation. "

NEWSPAPERS

Buffett joked that he and Charlie will likely be the last guys in the world to read newspapers with a landline phone nearby. Due to the erosion of newspaper moats related to advertising, Buffett will not buy newspaper stocks today at any price. While 20-30 years ago, newspapers were the ultimate business that had pricing power and were essential to the customer, newspapers today are no longer essential due to the Internet and other news sources. Ten years ago, Stan Lipsey told Buffett from an economic standpoint he should sell the *Buffalo News*, but one of Berkshire's business principles is not to sell their businesses unless they have unending losses or union problems. He commented further that while *The Washington Post* also has no answers for the newspaper part of the business, they still have good cable and education businesses. He concluded that Berkshire will "play out" the *Buffalo News* and *Post* businesses as long as they can. Charlie lamented that it is a "national tragedy" for daily newspapers to go out of business, but "this is life."

RECESSION

Buffett said he didn't know when the recession would end. However, if housing starts begin to stabilize in two years time, then Berkshire's housing-related businesses like paint, bricks and carpet will begin to improve. He expects Berkshire's retailers will continue to "struggle" for some time.

SHARE REPURCHASES

Buffett said most of the share repurchases done by companies in recent years have been "foolish" as management paid too much for their shares. He noted it was interesting to see how many companies today are NOT buying back their stock when they were eagerly buying back their stock at much higher levels. Back in the 1970's and 1980's, Buffett had advised management teams to consider share repurchases when valuations were much more attractive. The only time Berkshire had ever considered a share repurchase program was in 2000 when Berkshire's stock price was selling well below intrinsic value. Buffett doesn't think that is the case right now. Even if Berkshire announced a share repurchase program, it would likely be self-defeating as investors would likely bid the stock price up on Berkshire's announcement.

OPPORTUNITY COSTS

Buffett noted that investment opportunity costs increase when things are moving very fast in markets. In chaotic markets, Berkshire frequently faces opportunity cost calculations. However, this is a good problem to have, and it occurred last September and October when Berkshire received many calls. Berkshire always wants to keep plenty of money around. Buffett noted that the Goldman deal couldn't have been made the week before or the week after Berkshire struck the deal. However, given the \$5 billion committed to Goldman, the \$3 billion to GE, and the \$6.5 billion to Mars, Berkshire was faced with opportunity cost considerations. He thus sold part of Johnson & Johnson (which he would have preferred to hold) to ensure Berkshire maintained sufficient liquidity for the insurance businesses. Since it is harder to sell things in huge quantities than to buy them during chaotic times, he made a deal on a floor price when he placed the order to sell JNJ. Buffett's position was that he could reacquire the JNJ stock, while the other deals would not be available in the future.

GEICO ADVERTISING

Buffett noted that GEICO's advertising budget has grown from \$20 million to an expected \$800 million this year. Buffett noted that they are getting more bang for the buck from their advertising today given the soft advertising market which is providing them with more exposure for the same dollars. He noted that it is difficult to measure the returns on advertising, joking that someone said that "you waste half the money spent on advertising, you just don't know which half." Berkshire spends so much on advertising at GEICO because they want the world to know that GEICO will save them money on their insurance. GEICO's brand is a promise that consumers will save money. Buffett said you never really know when the advertising will pay off, but GEICO did begin to see big increases in sales starting Sept. 30 of last year as people everywhere were seeking to save money. Buffett noted that the value of GEICO goes up much more than the earnings show due to brand enhancement. Buffett believes Berkshire is getting terrific returns on GEICO's ads. GEICO's business model is very attractive since they are the low-cost producer in a product that people are required to buy. Buffett emphasized, "It is a very good business!"

FINANCIAL STOCKS

Buffett said he was dead wrong on making investments in the Irish banks last year, since they had incredible exposure to land development loans. He said the information was there for him to see, but he wasn't paying attention and made a terrible mistake. He said there were lots of signs in financial stocks that highly-leveraged institutions could be in trouble if housing prices declined, with the signs especially clear at Fannie Mae and Freddie Mac. Banking has real differences that most people don't look at. For example, he said there was no comparison between Wells Fargo and Washington Mutual, which was loaded with subprime loans. He believes Wells Fargo has the best competitive position of all the large banks with conservative accounting--citing their amortization policies for core deposits that are very different from other banks. Buffett added that many banks are "black boxes" that can produce numbers but not cash. He said it is much easier to analyze a business like Coke and Procter & Gamble than it is to analyze a bank. He concluded that it is not a bad idea for investors to put banks in the "too hard pile."

Charlie added that GAAP accounting allows banks to show vastly higher earnings than they should even if they make lots of dumb loans. GAAP shouldn't allow dumb decisions to be incentivized. Charlie noted that many new regulations could have been avoided if accounting had done a better job. However, Charlie has yet to meet an accountant who says he is ashamed of his profession.

BYD

On display at the meeting were electric cars from BYD. BYD makes 65% of the world's nickel-cadmium batteries and 30% of the world's lithium-ion mobile phone batteries. Based on this background, BYD Auto has ambitious plans for hybrid and electric automobiles. Berkshire owns a 10% stake in BYD. Charlie is a huge fan of the founder of BYD and brought the idea to Buffett. Charlie noted that their lithium batteries will be needed in every utility in the future as the sun's power is harnessed. Their Chinese electric car went from a zero start to become the best-selling auto in China with little capital. BYD makes practically every part of the car but the tires. Charlie described BYD as not a speculative company but a "damn miracle." They have hired thousands of engineers and have a very talented group of people working at the company. It is a small company with big ambitions that Charlie said he wouldn't want to compete against. By investing in BYD, Charlie proclaimed, "We have not gone crazy." Buffett joked, "One of us at most!" Buffett chuckled, "Last year BYD was Charlie's idea and Irish Banks were my idea. Charlie is the winner!"

LOSS OF TRIPLE-A CREDIT RATING

While S&P maintains Berkshire's Triple-A credit rating with a negative outlook, Moody's cut Berkshire's Triple-A rating. Buffett said Berkshire won't likely regain the Triple-A rating anytime

soon as the ratings agencies don't turn around that fast. However, the ratings cut will make very little difference in Berkshire's borrowing costs. Nevertheless, Buffett was disappointed in the Moody's rating cut because he liked the Triple-A rating and it caused Berkshire to lose some "bragging rights." However, in the insurance industry, Berkshire still is the strongest firm financially. In Buffett's mind, Berkshire still is a Triple-A company as he can't think of a company with a stronger capital position. Buffett will continue to run Berkshire as a Triple-A rated company. He concluded, "The rating change is not material, but it still irritates me."

Charlie wryly noted, "At least Moody's showed considerable independence." He also said Moody's will likely increase the rating in the future because they are smart. Buffett laughed noting one of Charlie's favorite sayings, "In the end you will see it my way because you're smart, and I am right."

WIND FARMS

MidAmerican is Berkshire's utility subsidiary and boasts the largest wind farms in Iowa, while producing the highest percentage of its energy from wind. In fact, MidAmerican is a net exporter of electricity in Iowa. As a result, they have not increased electricity rates in Iowa in a decade due to their operating efficiencies and wind power. MidAmerican will continue to be a leader in wind power, and Berkshire fully benefits from the wind power tax credits since Berkshire is such a big taxpayer. Buffett noted that Berkshire will do a lot more investing in utilities in the future. While the Constellation deal didn't work out, he wishes it had. He cited the Constellation deal as an example of Berkshire's durable competitive advantage. When Constellation was facing bankruptcy last fall, Berkshire was able to provide them with a firm bid within a matter of hours. Few other companies would have that capability. Charlie reminded Buffett that Berkshire used its competitive advantage to do a successful energy deal when they bought a pipeline in two hours. The Dynegy deal worked out very well for Berkshire. Buffett recalled that they needed Federal government approval for the deal which they received quickly as they didn't need to go through layers of lawyers. Buffett said Berkshire's competitive advantage is that Berkshire can move fast as they always have money and have the managers that can deliver.

OUTLOOK FOR FUTURE GROWTH

Buffett said it is impossible for Berkshire to repeat its past growth rates by growing 20% annually in the future given the company's current size. His hope is that the company's intrinsic value will increase a couple of percentage points ahead of the S&P 500's growth in the future. Berkshire's book value is an understated proxy of its intrinsic value. Charlie added that while Berkshire's percentage growth won't multiply as fast as it had in the past, Berkshire's future is "way better" than the past in terms of Berkshire's contributions.

CHINA

Buffett said he doesn't know what future Chinese investments Berkshire may make. There are some restrictions since Berkshire can't own more than 25% of an insurance company in China. China will likely increase their dollar holdings in the future. If the Chinese continue to send us \$250 billion in goods, we will send them dollars in return. They can spend that \$250 billion on bonds, stocks, U.S. real estate or seek to trade the dollars for some other currency. So far, China has elected to put the dollars in U.S. government bonds, but Chinese officials have indicated that they are not happy at the prospect of the loss in purchasing power they face from these investments. Charlie proclaimed that China's economic policies are "exactly right." With the way their economy is advancing, the loss of purchasing power will be "a trifle." China will be very hard for anyone to compete with in the future.

POST-MORTEM ON GENERAL RE ACQUISITION

While Buffett acknowledged companies should do post-mortems on acquisitions, he didn't think the post-mortems should be made public. Buffett said it is important to reflect on past decisions, but not always healthy to make those reflections public. However, he said he was "dead wrong" in buying General Re and thinking it was the same company it had been 15 years prior to the purchase. However, thanks to the good and hard work of Joe Brandon and Tad Montross, General Re today is the company he thought he was buying in 1998. It was a very tough job in restoring the business, but General Re now has a great future. Charlie added it is important to have the ability to turn lemons into lemonade. It wasn't "pleasant or pretty" and ordinary managers couldn't have fixed General Re. However, Berkshire got a "decent result" out of the deal while General Re got a "fabulous result."

CONTRACTS

Buffett said Berkshire doesn't use contracts much. When they make a deal for a business, they want people who have the same passion for the business after they sell the business as they had before they sell the business. Charlie added that at Berkshire, "We have a seamless web of trust that is deserved on both sides."

SPINNING OFF SUBSIDIARIES

Buffett said Berkshire won't spin off any of its subsidiaries as Berkshire owns wonderful businesses and will never look for a quick jump in market value as a result of a potential spin-off. Berkshire's advantage in maintaining these businesses is allocation of capital. For example, if See's Candies is generating more cash than their business can use, Berkshire can always allocate the cash to other businesses within Berkshire that can use the cash. In addition, Berkshire makes promises to companies that they acquire that Berkshire is "buying businesses to keep." This is a basic principle of Berkshire. Charlie noted that so many spin-offs are sold by Wall Street to companies just in order to generate investment banking fees.

STUDENT LOAN BUSINESS

Buffett said he doesn't know much about the student loan business while Charlie noted there has been a fair amount of scandal in the industry over the years. Buffett joked, "It has been a long time since Charlie or I thought about getting a student loan." Buffett did acknowledge that he was approached about investing in Sallie Mae, and he's glad he didn't understand the business and passed on the "opportunity."

GE AND GOLDMAN SACHS

Berkshire invested \$3 billion and \$5 billion, respectively, in GE and Goldman Sachs because they were attractive businesses selling at attractive prices. Buffett feels good about the quality of both businesses and their very smart CEO's. The extraordinary period last fall allowed Berkshire to get good coupons on both deals. Noting these were "decent deals," Buffett said he didn't see anything he liked better at the time. Charlie noted that while the investment bankers have been heavily criticized, Berkshire has had excellent service from Goldman Sachs over the years. Buffett added that Berkshire has done a lot of business with GE and will continue to sell and buy lots from them. If he also makes lots of money on his investment in GE, it will make him very happy.

WORLD ECONOMY

Buffett stated there are always lots of things wrong with the world economy, but it is the only world we have. Over time, we will live better because our system works to unleash human potential. In 1790, there were only 35,000 people in the U.S. (the approximate attendance at the

annual meeting). Since that time, we've had many bad years in capitalism with six bank panics, the Great Depression, two World Wars, etc., but overall, we have moved ahead at a very fast rate. Our standard of living has increased sevenfold. Right now the economy is sputtering, but there is enormous potential ahead. The opportunities will win in the end.

Charlie added that the closer he gets to death, the more cheerful he feels about the world's potential. He is especially excited about the potential to harness the power of the sun, which will enable us to turn seawater into fresh water and preserve hydrocarbons for future use. He said it would be a mistake to think only of misfortunes. If we have enough energy, we can solve lots of other problems.

SWISS RE

Buffett said Berkshire will assume 20% of Swiss Re's reinsurance business over the next five years and acquired 3% of their common stock. Berkshire made a three billion Swiss franc investment in Swiss Re yielding Berkshire 12%. This investment may be called at 120% of principal by the third year. Buffett said the odds are that the investment will be called, but meanwhile Berkshire is collecting 12% and then will get back 120% of their principal. Buffett also noted that Swiss Re's underwriting is fine. It was their derivative investments which got them into trouble similar to AIG but not to the same extent. Berkshire was able to make this deal when Swiss Re's stock was under pressure. Charlie commented, "If this is a terrible problem, we wish we had more of them."

COMPENSATION PLANS

For capital-intensive businesses, a compensation plan needs a factor that includes capital cost. For a business that needs no capital, the compensation structure should be different. Boards generally have really little impact on compensation packages. The CEO usually determines the compensation package, including for himself, and then seeks a Board to approve the package that is not filled with Dobermans but tail-wagging Cocker Spaniels. When choosing CEOs, it is very important to make sure they don't overreach. Boards should think like owners. Charlie added that liberally-paid Boards are counter-productive to the good management of a company. It gets very club-like in a Board where the practice is "if you raise my compensation, I'll raise yours". The whole system would work better if Boards were not paid at all. Buffett added that 100-page proxies to explain compensation packages are not necessary. Charlie grumbled that one-tenth of one percentage of America structures compensation like Berkshire, and "the way everybody else does it is silly."

Executive compensation is once again a hot button with a Senator calling Buffett on how to design an executive compensation plan following the AIG bonus fiasco. He wanted to quickly enact a statute on executive compensation. Buffett noted that the last time Congress became involved in corporate compensation, Congress passed the tax deductibility limit for compensation on the top five executive officers. This was probably the most unproductive legislation as it resulted in executive compensation getting ratcheted up even more. He told the Senator they should start by repealing that rule, but his suggestion didn't go over very well. He said the best way to address egregious executive compensation is for half a dozen of the largest investment managers to publicly speak out against it. By embarrassing the management team and the Board, director behavior will change. Directors don't like to look foolish or to see their names in the newspapers. Charlie wasn't optimistic that executive compensation could be fixed by investment managers as there is no restraining factor for compensation consultants.

WORST CASE SCENARIO FOR BERKSHIRE

Charlie said the worst case scenario for Berkshire would be some catastrophe that causes Berkshire to lose billions in its insurance business. However, he quickly added Berkshire has a marvelous insurance business. Buffett noted that Berkshire's insurance business will normally

pay 4%-5% of industry losses and cited Hurricane Katrina as one of the worst case scenarios when the losses exceeded \$60 billion. However, Berkshire has curtailed its insurance exposure and would currently likely pay 3%-4% of industry losses. However, Buffett said the worst-case scenario for Berkshire would occur if we ran into so much inflation that people expressed outrage over insurance payments and wanted to nationalize insurance. He gives this a low probability, but said it would be the worst case scenario.

HEDGING THE DOLLAR

Buffett said Berkshire has no goal designed to have x% of its earnings from international operations to hedge the dollar. Berkshire will simply keep doing things that make sense such as investing in companies like Procter & Gamble and Coca-Cola, which have substantial earnings outside of the U.S. Charlie added that democracies around the world are filled with defects.

LAYOFFS

Buffett said if business changes in a material way, then it is necessary to change the business model because competitors will. There sometimes are no alternatives to layoffs. While GEICO is adding 1,000 jobs during this recession, the brick companies have had to close half their plants, but this business will come back. On the other hand, the business at the *Buffalo News* will not come back so layoffs will likely be permanent. Berkshire had to lay off everyone in their textile business years ago as capitalism is creative destruction. Overall, Berkshire's employment this year will be reduced. Charlie cited a Ben Franklin quote: "It is hard for an empty sack to stand upright." He said while he prefers businesses that can share hardships, many operations don't lend themselves to that. Sometimes you have to amputate a limb to stay alive.

ATTRIBUTES OF GREAT MANAGERS

Buffett said Berkshire buys businesses with great managers, who have already proven their track records. He likes managers that get excited about their businesses. Charlie noted that Berkshire sometimes is slow to recognize when a manager need to be replaced citing an example of not wanting to face the problem of a manager who had developed Alzheimer's disease.

NY TIMES ARTICLE LAST OCTOBER

Last October, Buffett wrote an editorial which was titled "Buy American, I Am." Buffett noted after he wrote the article, stocks did get cheaper, but he wasn't trying to call the bottom in the stock market. He said he buys when it makes sense. "Pricing is our game, and that is not difficult." The fact that the price goes lower after he makes a purchase doesn't bother him. The cheaper things get, the better he likes buying them whether it is hamburgers or stocks. He likes low prices, and it makes sense to buy when items are on sale. Buffett said the best sale in his lifetime was in 1974 when stocks got much cheaper than today, although he acknowledged that it was a very different interest rate environment back then. Charlie observed that if stocks prices decline more than 40%, then they are obviously more attractively valued. He said the current environment is nothing like the '73/'74 period, but added, "I wouldn't wait for another '73/'74." Buffett added that while stocks did get cheaper during the current period, bonds became even cheaper. He said he bought corporate bonds with 10% yields. Charlie noted these were "perfectly safe bonds" with 9%-10% yields that subsequently have gained 25% in value.

CAPITAL-INTENSIVE BUSINESSES

Buffett acknowledged that Berkshire's utility businesses are capital-intensive but the earnings come with regulated returns on equity. He said capital-intensive businesses outside of the utility sector "scare me." However, the utility businesses will provide Berkshire with decent returns. You won't get rich investing in utilities, but you won't get poor either. Over time, Berkshire will do

better with businesses that don't require much capital and earn high returns on equity. Those types of businesses with durable competitive advantages are the best businesses.

The session ended with Buffett's grand-nephew proposing marriage and getting an enthusiastic "Yes!" in response.