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The 2007 Berkshire Hathaway Annual Meeting Top 20 Questions

During the question and answer portion of the 2007 Berkshire Hathaway annual meeting, shareholders asked Warren Buffett and Charlie Munger a total of 54 questions. Some questions were more pertinent to investors than others, so in order to focus on the most relevant questions and answers, we have selected 20 for closer review. Although this article is billed as "The Top 20 Questions," we don't presume to judge the questions per se, or the answers. We simply selected the questions and answers we considered to be the most helpful for individual investors. In addition, although Buffett and Munger need no clarification, we've supplemented their answers with elaborating comments.

The ground rules at Berkshire meetings include a ban on recording devices, so the following material is based on three individuals' handwritten notes taken during approximately five hours of questions and answers. In all cases, we have tried to remain faithful to Buffett and Munger's wording and intent—although it is possible that their exact words varied from our notes. Further, please note that neither Buffett nor Munger has reviewed or endorsed our summaries of their comments or our own.

Jerry Bruni and Sarah Roach collaborated on this article. Sarah distilled dozens of pages of handwritten notes into a summary of the 20 questions and answers. In addition, she provided important editing of this entire article. Jerry was the primary author of our elaborating comments. First-person references in these comments refer to his views, and he is solely responsible for any errors or omissions.

Before we get to the questions and answers, imagine that you had the opportunity to sit down with Albert Einstein for a limited time. What a fantastic opportunity that would be to ask him his thoughts on physics, astronomy or science in general. On the other hand, using your limited time to ask Einstein whether he thought the Boston Red Sox would win this year's pennant might not be a wise choice. In our view, a similar argument applies to questions directed at Warren Buffett. Each year some people see fit to ask questions about politics, abortion, global warming, etc. Mr. Buffett is too polite to criticize any questioner, and he always does his best to address all questions. Nevertheless, we can't help but feel that most Berkshire shareholders, many of whom travel far to attend the meeting, would rather listen to arguably the best investor in the world—on the subject of investing.

Gambling.

A German shareholder asked if Buffett and Munger thought gambling companies have a great future.

> Buffett: Yes, as long as it's legal. People love to gamble. In stocks, by the way—day trading came close to gambling. People like to gamble. They will enjoy watching a football game more, especially a dull one, with a few dollars on it. We insure hurricanes, so I watch *The Weather Channel*. It can be pretty exciting! [laughter] The desire to gamble is huge. As states learned what a great source of revenue it is, they've made it easier to gamble. When my kids were little, I put a slot machine on the third floor of our house. I could pay them any allowance, [yet] as long as it was in dimes, I had it back by nightfall. I'm not a prude about it, but gambling is a tax on ignorance. It's socially revolting to see a government that preys on the weaknesses of its citizenry. [Taking people's] Social Security checks [for gambling purposes] is a pretty cynical act by government. It is not government at its best.
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> Munger: I would argue that casinos use a lot of clever psychological tricks and cause grievous injury. It's a dirty business, and I don't think you'll find a casino soon in Berkshire.
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> > Comment: Buffett is an excellent student of human nature, and he knows that gambling is popular. Although the odds at all casinos favor the house, casinos in competitive environments like Las Vegas or Atlantic City can't offer ridiculously poor odds and still attract gamblers. Truly poor odds require a near-monopoly environment, which various state governments have created and then abused. People gamble because (1) they are truly ignorant of the likely outcome (Buffett's "tax on ignorance"), (2) they are willing to accept the likelihood of losing in return for the thrill of the gambling process, or (3) they are people who are desperate and without hope. I fear there are many people in the third group, and I hope there's a special place in Hell for government officials who take advantage of the citizenry.
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> > Stocks of companies with very low probabilities of tremendous success and very high probabilities of failure are often overpriced, because a "lottery effect" of irrational expectation contributes to a gambling-motivated (versus financially-motivated) demand for their shares. That's one reason why investors should beware of penny stocks.

How to Become a Better Investor.

A 17-year-old from San Francisco, attending his 10th consecutive meeting, asked what he should do to become a better investor.

Buffett: Read everything you can. By 10, I'd read every investing book in the Omaha Public Library—some of them twice. Fill up your mind with competing thoughts—then you've got to jump in the water and actually invest. The difference between investing on paper and investing actual money is like the difference between reading a romance novel and doing … something else. [laughter] Read and, on a small scale, invest. The earlier the better. I read a book at 19 that I still use today [presumably Benjamin Graham's *The Intelligent Investor*]. At 76, I have the same thought patterns as I got from that book at 19.

Munger: Our director, Sandy Gottesman runs a successful investment operation. He always asks prospective employees, "What do you own and why do you own it?"

Buffett: Take a yellow pad and write a good essay on why you'd buy GM at $18 billion [market capitalization]. Why is the business cheap at the price you're buying? If you can't answer, then you have no business buying even 100 shares, or whatever, at 30.

> Comment: In a sense, successful investing is all about acquiring experience. If you read voraciously, you can acquire other investors' experiences. Fortunately, some of the best investors that ever lived have written very useful books or articles. However, that's not enough. You can't read enough books on baseball, for example, to learn how to hit a ball. You also have to play the game—whether it be baseball or investing—and acquire your own experience.
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> Many times I've been asked to recommend "just one book" on investing, but you can't acquire enough knowledge to be successful by reading one investment book any more than you can acquire enough knowledge to become a successful physician by reading one book. Further, it takes a while to learn from your own investing experiences—I'd say a minimum of five years, but that may be too short. In the final analysis, investing can be a very rewarding process to master, but it takes considerable time and effort—just like anything else that's worthwhile. Buffett started studying investing before he was 10 years old, and he has continued to devote his keen intellect to intense study ever since. What makes anyone think a thirty-something or forty-something hedge fund manager can do better at investing?

Determining Berkshire's Intrinsic Value.

A Connecticut shareholder asked for comments on the intrinsic value of Berkshire Hathaway.

Buffett: The intrinsic value of Berkshire is based on the future amount of cash that can be delivered between now and Judgment Day, discounted back to today.

Alternatively, we [could] give the valuation today of our operating businesses that we use ourselves. We own lots of marketable securities and operating businesses. We have $80,000 per share in marketable securities. Since Berkshire retains all earnings, it becomes very important to consider the judgments that will be made about what to do with those earnings in the future. You need to evaluate the value of the [Berkshire] business and the skill in how the value is used. If [used] effectively, a dollar [of reinvested earnings] has greater value than if distributed or used ineffectively. If Charlie and I were to [each] write down our own estimates of intrinsic value, they wouldn't be the same, although they'd be reasonably close.

Munger: What's hard to judge at Berkshire is the likelihood that anything you've had in the past looks like anything you'll see in the future. Berkshire is extreme and unprecedented. What has caused this extreme record? A young man who got an early start and kept learning. If Warren hadn't learned so much, [Berkshire would have been] a pale shadow [of what it is]. Warren became a learning machine early, and his abilities [have] increased since [normal] retirement age. He's a ferocious learner. In this field you can improve with experience. Passing the power from one old codger to another is not necessarily the best system.

Buffett: We have established a strong culture of rationality. We will need someone who doesn't do dumb things, and occasionally does some good things. They won't do brilliant things, because that's once in a blue moon. You'd be amazed at the number of decisions made on corporate boards that come from animal spirits instead of rationality. We have our animal spirits, but we devote them to other areas. [laughter]

> Comment: Years ago, there was a tendency to consider Berkshire Hathaway a publicly-traded fund of investments, because Berkshire's portfolio of marketable securities was larger then (than now) in comparison to its total assets. Buffett bought marketable securities in the '70s and '80s in part because that's where he found the best valuations. Today, with public market valuations much higher, Buffett has focused relatively more on buying whole companies. Events like Berkshire's popular annual meetings, which call attention to its many wholly-owned subsidiaries, sometimes create a focus on these holdings. The reality is that Berkshire has a lot at stake in both public and private companies, and anyone who wants to evaluate Berkshire's intrinsic value needs to consider both.
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> Munger said that the "extreme and unprecedented" success of Berkshire Hathaway is mainly due to one remarkable man—Warren Buffett. Yes, a successor may do well to "avoid big mistakes and occasionally do some good things," but that's a long way from extending Berkshire's amazing success. Berkshire may do well after Buffett retires—maybe even quite well. However, it won't recreate Buffett's stunning historical results,

because those results are as unique as Warren Buffett himself. In addition, Berkshire's current size limits future growth rates.

Derivatives and Their Problems.

A New Yorker asked what might derail the derivatives bubble, if there is one.

Buffett: Derivatives are not evil—we have some 60 derivatives—but use of derivatives introduces more and more leverage into the system. And it's invisible leverage. Leverage contributed to the crash of '29—like pouring gasoline on fire. The government introduced margin reform and empowered the Federal Reserve to regulate margin. For decades afterward, it was a source of real attention and taken very seriously. The introduction of derivatives and index futures has made regulation of margin requirements a joke, an anachronism. We think it [leverage] will go on and will increase until some very unpleasant things happen in markets. Look at the history of "portfolio insurance." It was a joke. It was just a bunch of fancy stop loss orders. Only weeks earlier, [people] had talked about how great these things were. It was a doomsday machine—a dead hand [computerized program trading] hitting [the market] after each level [of stock prices] is reached. The same thing [is happening] now, coupled with extreme leverage. It's a crowded trade, but managers don't know it. Something will happen.

Munger: The accounting being deficient contributes enormously to phony profits [from derivatives] appearing on the books. If you get paid for phony profits, you'll continue to do it. What makes it really difficult is that most of the accounting profession doesn't even realize how stupidly it's behaving. An accountant I know tried to convince me that "marking to market" makes reporting more accurate. But if you "mark to model," and you create the models, then marking to model doesn't make values more accurate—it only makes the values fit the model you created.

Buffett: I wish we had sold our marked-to-market portfolio to the auditors who attested that it was [properly] reserved. We'd have made a lot of money! The same accounting firm might be attesting to both sides of derivative positions—and [still] they won't net to zero. The auditor's numbers may be wildly different on both sides, based on the exact same piece of paper. There are only four [major] auditing firms left in this country. In addition, some parties have reason to game the system.

Munger: It keeps on and on as it expands and balloons. But as sure as God made little green apples, eventually, there will be a denouement.

Comment: Basically, the leverage genie is out of the bottle, and he can't be put back inside. Therefore, the world will have to live with high levels of leverage until a jolt to the financial system causes investors to reassess the risks and rewards of leverage. Buffett mentioned the "portfolio insurance" folly of 1987, and he could also have pointed to the demise of the (misnamed) Long-Term Capital Management hedge fund in 1998. In both

cases, academics who knew more about the Greek alphabet than they knew about financial markets promoted simplistic and unrealistic strategies to those who were seemingly naïve about financial markets or intimidated by academic credentials. In both cases, a little of the independent reasoning for which Buffett is famous would have been most helpful, but independent thinking is frequently in short supply on Wall Street.

Munger's point that derivatives are frequently "marked to model" (priced by a model, not by market prices) is quite important. Since a derivative is essentially a zero-sum contract between two parties, it isn't possible for both parties to realize a profit. However, as Buffett noted, before a derivative contract is concluded, it is possible for both parties to ***claim*** an accounting profit—and have the same auditing firm attest to both companies' financials. Put differently, that which is impossible in reality becomes possible in audited financial statements.

Short-Term Thinking, and Other Flawed Approaches.

An attendee from Hong Kong asked Buffett and Munger to address the topics of decreasing risk premiums, increasing correlations across markets, and the proliferation of a short-term mindset in investing.

Buffett: We do think it's unhealthy. Many people think a portfolio should be evaluated daily. If you take the degree to which either bonds or stocks are owned by people [who] would change their mind tomorrow based on one event, it increases turnover. Bond turnover has increased dramatically. If you are trying to beat the other fellow on a daily basis, you are going to hit the ["enter"] key faster. It's not new—markets have done crazy things over time. Human beings do things that are entirely irrational, such as in 1987, 1998, and 2002. It's a different game [in modern times], and there are different consequences than in a buy-and-hold environment. Five to six sigma events don't mean anything. That's fine only with coin tossing—not when people are involved. It's a fool's game to watch a portfolio daily. In my original partnership, I said, "You'll hear from me once a year."

Munger: Bad things in markets are not Gaussian. When people talk about sigmas in terms of disastrous results in markets, they're all crazy! People who use Gaussian distributions have to believe in the Tooth Fairy to believe that—but it's easy to teach. I once asked a surgeon why he still did an outdated procedure. "Because it's so easy to teach!" There's more of that in (university) finance departments than you'd believe. That stuff has no utility at all, but they keep on teaching it.

Comment: If investors acted randomly, then models of investor behavior based on Gaussian ("normal") distributions would be valid. However, investors frequently act emotionally and thereby create events that would

seem to be highly improbable in a normally-distributed world. (For an interesting discussion of the actual distributions of financial market prices, read Benoit Mandelbrot's *The (Mis)Behavior of Markets*, or check out some books on "behavioral finance.") Munger's point that the use of unrealistic models is commonplace because most finance professors know and can easily teach them, is a scathing criticism. Outside academia, many financial salespeople incorporate outdated and unrealistic models into their sales pitches, because the math involved—unrealistic as it is—provides an illusion of exactness, and it may bully clients into submission.

More on Intrinsic Value.

A German shareholder said he would appreciate more "transparency" regarding investment decisions and asked about Berkshire's intrinsic value.

Munger: There is no one easy method that can be simply [or] mechanically applied by computer. You must use multiple techniques and multiple models. You can't become a good investor rapidly, you need experience. It's very important to be learning, [to] start early and to continue.

Buffett: [For example,] try to figure out what a corporate farm is going to produce. The mathematics of investments was set out by Aesop 600 years ago—a bird in the hand is worth two in the bush. [You have to consider such things as:] When will I get the two birds? Are there really two? What's the net present value of the two? Could there be more birds? It's the ability to distribute cash that gives Berkshire its value. You have to know when [it is that] you know what you're doing. We know about very few businesses but stay inside our circle of competence.

Munger: Almost all decisions go into the "too hard" pile, and then we sift through the rest. If you want to know how to evaluate ***all*** businesses at ***all*** times, we can't help you.

Buffett: We stay away from seven-foot bars and step over one-foot bars [instead].

Comment: I sense that a number of the questioners were looking for simple, quantifiable stock valuation models. However, they don't exist. The fact that so few people achieve remarkable investment success tells us that the investment process isn't easy. It requires intuitive and analytical insight that very few people possess.

Stocks for the Long Term.

A shareholder from Indiana (who recently re-read a variety of material written by and about Buffett) perceived a "sea change" in Buffett's thinking regarding risk. The shareholder said he thought Buffett sounded "worried."

Buffett: I wrote a letter in '69 in which I said that I felt prospective returns on munis and equities would be about the same. If I were managing a pension fund now, I would be 100% in stocks, long-term bonds or short-term bonds—not 60% of this and 40% of that. I don't believe in layering stocks, bonds, short-term bonds. Over a 20-year period, I could choose an index fund or 20-year bonds, [but] it would not be a close decision—I'd buy the stocks. I'd rather buy cheaply, but I'd also prefer long bonds with higher yield. We don't predict where markets will be.

Comment: If you are managing for long-term returns—20 years or more—as a pension fund needs to do, it makes sense to invest wherever you anticipate the highest returns. Buffett sees that in stocks. Today, however, the popular—nearly ritualistic—approach is to buy A% large-cap growth stocks, B% large-cap value stocks, C% mid-cap growth stocks, D% mid-cap value, E% small-cap growth, F% small-cap value, G% "alternative" investments, H% international stocks, I% long-term bonds, J% intermediate-term bonds, K% short-term bonds, L% real estate, M% precious metals and so on. Indeed, many of these categories are sometimes further subdivided. Compared to Buffett's focus on wherever investment returns seem most promising, the alphabet-soup approach will typically do two things: (1) It will produce less short-term volatility, and (2) It will produce lower long-term returns. (It may also produce a certain amount of CYA for pension fund consultants and trustees.) Unfortunately for pensioners—and many other long-term investors—the questionable benefit of a reduction in short-term volatility is no match for the foregone benefit of higher long-term returns.

Silver, and Conspiracies.

A Canadian shareholder asked Buffett why, when and to whom he'd sold Berkshire's silver bouillon investment. (The questioner seemed to question whether the buyer was part of some conspiracy.)

Buffett: I'm not sure who we sold it to, but they were a lot smarter than we were. We bought too early and sold too early. Otherwise, it was a perfect trade. [laughter]

Munger: I think we've proven what we know about silver.

Buffett: No one asks us about silver—we're flattered even to be asked! Pricing of [commodities such as] oil is not related to [oil] executives conspiring. It's supply and demand.

Comment: Stock prices fluctuate around a long-term trend that's determined by productivity growth and inflation. Commodities fluctuate more dramatically than stocks around a long-term trend determined only by

inflation. If it's hard to invest successfully in stocks, it's doubly hard to invest successfully in commodities.

It's an unfortunate statement about the public's lack of economic understanding that Buffett felt he needed to point out that supply and demand, not conspiracy, sets oil prices. If there is one sure thing capable of killing the golden goose of economic growth, it is widespread ignorance of basic economic concepts. Yet it's been said that if ignorance paid dividends, most people could retire on what they ***don't*** know about economics.

Subprime Lending.

An attendee from New York asked Buffett and Munger for their opinions on the subprime market.

Buffett: [Recent subprime lending policies] resulted in people buying a lot of houses they don't want or couldn't make payments on. [Lending] institutions, intermediaries, and borrowers all contributed. The question is spillover. My guess is that it's unlikely that subprime alone will trigger anything massive in the general economy. Subnormal payments [negative amortization] lead to higher payments later—on larger [loan] amounts. It's unlikely that someone who can't make a small payment early will be able to make larger payments later. People were betting that housing prices would keep going up and up. It's dumb lending and dumb borrowing.

Munger: It's a combination of sin and folly. Lending institutions showed profits where no one would do so until loans matured. The accounting profession laid down on the job again. Poor lending—how could they do it and still shave in the morning? The face looking back at them was evil and stupid.

Buffett: We had a prelude to this in the manufactured housing industry in the late 90's (6 – 7 years ago). Two thousand dollars down [payment] and $6,000 commission to the salesman—and discipline left the system. Securitization was an increasing problem. In some places, it will be several years before it recovers.

Comment: Any time people can report a short-term profit doing something that doesn't make long-term sense, you have the precondition for a problem. A company might sell lots of earthquake insurance or long-term health care insurance and appear quite profitable—until an earthquake hits or lots of policyholders become elderly. As Buffett has noted, "You don't know who is swimming naked until the tide goes out." It's simply not wise to take corporate financial statements at face value. Instead, the successful investor needs to assess the reasonableness of the various business and accounting assumptions that produce stated earnings.

Managed Futures.

A shareholder asked Buffett and Munger for their opinions regarding managed futures funds.

> Buffett: The most logical fund is the one at Berkshire. We can do anything that makes sense and do not need to do anything that doesn't make sense. Any fund that is devoted to just one thing is at a disadvantage. It's a mistake to shrink the universe of possibilities. There's no form that produces investment results, such as hedge funds, futures funds, etc.

> Munger: If you average out the returns per dollar per year on managed futures funds, they're between lousy and negative.

> Buffett: Usually the form is a sales tool. It's a mistake to be sold on the form. Areas don't make opportunities. Brains make opportunities.

>> Comment: Buffett and Munger drove a stake through the heart of specialized funds. Today, there are hedge funds that hedge and so-called "long only" hedge funds that don't hedge. It seems that lots of people want to run something called a "hedge fund," because sales of hedge funds are hot—whether or not they produce decent returns for their investors. P. T. Barnum was right: "There's a sucker born every minute." And the financial industry is amazingly adept at separating these people from their money.

Volatility is Not Risk.

A shareholder from Los Angeles referred to the fact that many people talk about "sigmas" (the standard deviations of price changes) and equate volatility with risk. He asked why a rational person would substitute the opinions of the public (as reflected in volatility caused by mass decisions) for one's own measurement of the inherent risk of a company.

> Buffett: The measurement of volatility: it's nice, it's mathematical, and wrong. Volatility is not risk. Those who have written about risk don't know how to measure risk. Past volatility does not measure risk. When farm prices crashed, [farm price] volatility went up, but a farm priced at $600 per acre that was formerly $2,000 per acre isn't riskier because it's more volatile. [Measures like] beta let people who teach finance use the math they've learned. That's nonsense. Risk comes from not knowing what you're doing. Dexter Shoes was a terrible mistake—I was wrong about the business, but not because shoe prices were volatile. If you understand the business you own, you're not taking risk. Volatility is useful for people who want a career in teaching. I cannot recall a case where we lost a lot of money due to volatility. The whole concept of volatility as a measure of risk has developed in my lifetime and isn't any use to us.

Munger: Finance taught in business schools is about 50% twaddle. We early recognized that very smart people do very dumb things. We wanted to figure out when and why…and ***who***, so we could avoid them.

Comment: This was one of the best questions asked, and Buffett and Munger were characteristically straightforward in their answer. If volatility is risk, then an investment that does nothing but shoot sharply upward—that's volatility, too—is risky. Similarly, suppose that an average worker regularly saves a modest amount from each paycheck and invests in T-Bills for retirement. It's unlikely that this worker will amass sufficient purchasing power to retire comfortably, but because T-Bills aren't volatile should we say that this investment approach is low risk? Investment managers may be quick with their opinions, but at least you can usually see their investment track records before you judge their insightfulness. Academics are free to spout nonsense, and there is usually nothing to alert the public that they may not know what they're talking about. As the questioner implied, it's a mistake to let Mr. Market—or Professor Beta—decide what's risky and what isn't.

Evaluating Corporate Management.

A New Yorker asked how Buffett and Munger evaluate the quality and integrity of management.

Buffett: We've bought stocks without ever meeting managements or even talking to them. We read a lot of annual reports, especially on marketable securities. When we read dishonest messages from management, it's something we pay attention to. You can learn a lot from reading annual letters. If a CEO isn't willing to talk once a year through a few pages to the people investing with them, I have some questions. It's different when buying whole companies. I like when I'm hearing from someone who makes me feel like a partner.

Munger: [You need to understand] the quality of the business and the quality of the management. A good business can carry a bad manager. It's tough for a good manager to turn around a bad business, [like] Warren and [Berkshire's] textile business.

Buffett: It took me 20 years to figure out I was in a terrible business. The CEO is dependent on too many good things happening to make him responsible for carrying the corporation. Turning around, say, Ford, isn't under the control of one person.

Comment: This was another good question, but it's a hard one to answer with any specificity. Buffett writes an annual shareholder letter that's dozens of pages long and filled with highly readable insights. In contrast, the average CEO writes something that looks more like an advertisement produced by his public relations staff. Buffett is candid about his failures

and modest about his successes, while the average CEO is silent on his failures and overeager about his successes. CEOs don't wear baseball caps with "honest" or "deceptive" stamped on them, but they do the next best thing—they reveal themselves in their actions and in their writing. You just have to know where to look.

Market "News."

A shareholder from San Jose asked Buffett to follow up on the thoughts he expressed in a 1999 *Fortune* magazine article regarding 17-year lean and fat periods.

Buffett: There's nothing magic about given periods of time. If I were writing now, if I had to own stocks or long-term bonds, I'd rather have equities. I wouldn't have high expectations, but I'd expect more than 4.75% [that I'd get from long-term bonds].

Munger: I'd have modest expectations.

Buffett: You can't say something terribly important about markets every day, week or month—but you don't have to. Every now and then things get really out of whack, and you can say something important.

Comment: Buffett tells us, as he did earlier, that he prefers the long-term outlook for stocks to the long-term outlook for bonds. I included this question and answer because Buffett highlighted an important investment truth: "You can't say something terribly important about markets every day, week or month." Viewers of CNBC and the like should realize that most "talking head" commentators, however sincere they may seem, have very little useful to say to investors. So turn off the TV and go read an annual report or a good book on investing.

Who Do You Trust?

An attendee from Seattle asked how to determine which people to trust.

Buffett: I hear all the time from people who've been taken advantage of in financial transactions. We filter out a lot [of transactions]. We've been around a long time and have had good luck. People give themselves away pretty quickly by what they talk about, what they consider important or not important. We've had a better than 90% success rate—better than I would've expected.

Munger: We're deeply suspicious when a proposition is too good to be true. I was offered [the chance] to invest in a company that [supposedly] only insured fire for bridges covered by water—it's like taking candy from babies. We're going to rule things out 90% of the time. It ain't that easy.

Buffett: We're looking for the obvious cases of people you can trust. We rule out most people and may have been wrong about many. It's more important to be right about those we rule in. We don't like sensational fee structures. The three [investors] I recommended in '69 [when Buffett dissolved his partnership] I knew would be sensational stewards of money. They were going to care more about the people who turned their money over to them than how much commissions they were going to get.

Comment: Financial fraud is a serious problem, and nowadays the elderly are prime targets, so—paraphrasing Crosby, Stills, Nash and Young—teach your parents well. You'd be surprised at the number of otherwise very intelligent people who can't spot an investment that's too good to be true, primarily because they don't have much knowledge about risk and historical rates of return. There simply are no low-risk, high-return investments, other than those we see in our investment rearview mirror. Concerning junk mail newsletters promising spectacular returns, ask yourself why anyone who had such valuable knowledge about investments would offer to sell it to you for the price of a subscription, rather than keep it and profit handsomely. Finally, although you might rule out an honest adviser or two, avoid "free dinner" seminars like the plague. As Buffett noted, it's more important who you rule in than who you rule out.

Discount Rates and Opportunity Costs.

A shareholder asked what market rates of return Buffett and Munger anticipate going forward and how they select the discount rates they use to determine intrinsic value.

Buffett: We don't formally have a discount rate. We want a significantly higher return than from a government bond—that's the yardstick, but not if government bond rates are 2 – 3%. It's a little of wanting enough that we're comfortable. It sounds fuzzy because it is. Charlie and I have never talked in terms of hurdle rates.

Munger: The concept of hurdle rates makes nothing but sense, but it doesn't work. Hurdle rates don't work as well as a system of comparing things. Finance departments ignore it, because it's not easy to teach. Just because you can measure something doesn't mean it's the determining variable in an uncertain world. The concept of opportunity cost is overlooked. In the real world, your opportunity costs are what you want to base your decisions on.

Buffett: If [corporate] boards would've burned all their charts of IRR [internal rate of return], they would've been better off. [They create] nonsense numbers to give their audience what they want to hear and get CEOs what they want.

Munger: I have a young friend who sells private partnerships promising 20% returns. When I asked how he arrived at that number, he said, "I chose that number so they'd give me the money."

Buffett: There's nobody in the world who can earn 20% with big money. I'm amazed at the gullibility of big investors.

Comment: Here we go again—questioners looking for help with an investing formula. I've seen a thousand dividend/earnings discount models, and each of them is less a precise instrument and more a simple (or perhaps, simplistic) means of projecting a variety of important—and very uncertain—assumptions. Formula or not, there can be no more precision in the result than there is in the assumptions. Virtually nobody knows what rate XYZ Corporation's earnings will be growing 10 years from now—or whether they'll even have earnings then—yet that's the sort of information formula-investors need. As Buffett suggests, when evaluating a corporation's business opportunities, there is essentially no formula that can add much to basic business insight and judgment—that's where the rubber meets the road.

Role Models.

A shareholder from Michigan asked Buffett and Munger to name their present-day role models.

Buffett: I've been lucky that the ones I've had have never let me down. That would be terrible and hard to get over. Choosing your heroes is very important. Associate with people who are better than you. Marry up—and find someone who doesn't mind marrying down! [laughter]

Munger: You don't have to choose your mentors from among the living. Some of the very best people are dead.

Comment: You can choose almost anyone who ever lived to serve as your role model or mentor, provided you have access to their ideas. Benjamin Graham can be your role model, just as he was Buffett's. Buffett himself can be your role model—and an excellent one at that. All you have to do is read what they've written and take it to heart. I have never had the privilege of meeting Buffett, Graham, John Templeton, John Neff, Peter Lynch or other investment legends. Nevertheless, I've studied each of them, and you can too. Thank you, Mr. Gutenberg!

Inflation Protection.

A shareholder from New Jersey asked how Buffett and Munger protect the Berkshire portfolio against inflation. He specifically wondered if they use currency or metals for that purpose.

Buffett: I don't recommend metals. The best inflation protection is your own earning power. The second best is to own a wonderful business. Products like

Coke, Hershey's, and Snickers that people will want to keep putting a portion of their income into.

> Comment: We live in a knowledge-based world, so virtually nothing will pay off like a meaningful investment in your own intellectual skills. Further—and fortunately—never before in the history of the world has so much valuable information been available to the average individual, who must only supply dedication and a willingness to learn. Metals, in general, may keep pace with inflation (before taxes), but with very significant volatility. A "wonderful business," as Buffett put it, will almost always grow faster than inflation. The choice seems easy.

Advice for 10-Year-Olds.

A 10-year-old from Kentucky asked about the best ways for a 10-year-old to earn money.

Buffett: There's a study I've often quoted (and can no longer lay my hands on!) that shows that the best correlation with business success is the age at which you started your first business. [The earlier, the better.] I got half the [investment] capital I started with delivering newspapers. Ten may be a little young to deliver papers—maybe 12 or 13. I must have tried 20 businesses by the time I graduated from high school. Charlie, didn't you sell time to yourself?

Munger: I did that. I sold myself one hour a day of my own time—I gave the best hour of the day to developing my mind. Read *The Richest Man in Babylon*—under-spend your income and invest over time. Make yourself a reliable person. If you stay a reliable person all your life, it will be very hard to fail in anything you want. [applause] Be faithful to yourself.

> Comment: Obviously, Buffett developed an entrepreneurial spirit very early in life, and that's probably essential for anyone who wants to be a successful investor. Munger's answer should be required reading for all parents. We keep children so busy nowadays that they have little time to think and reflect. Free time that leads to reflection is very valuable during childhood.

Boards of Directors.

A Des Moines shareholder asked for thoughts on how a board of directors should interact with management.

Buffett: Most writers have a distorted view of how corporations work. For a long time, boards were largely potted plants. Management didn't want input. CEOs want to be the boss, so they look for famous names [for boards], but don't want them involved in the business. Ninety percent of the job of the board is getting the

right CEO. Second, they have the obligation to see that the CEO doesn't overreach. Finally, they should [provide] independent judgment on major acquisitions.

Munger: Big deals, on average, are not in the shareholders' interest.

Buffett: In stock deals, they think about what they're getting and not what they're giving away—often when they wouldn't sell the company at market prices. Very seldom, if ever, have I heard a discussion of the cost of equity dilution. At Gillette, we had 10 deals in a row that didn't come close to expectations. That's normal, [but] shareholders never saw that.

Munger: The self-serving delusional nature of good minds, in terms of IQ points, is amazing.

Buffett: The momentum is to get the deal done. I know the [board's] answer in advance. There's no voice of reason on the other side. At Berkshire, we have a real owners' board. Bill [Gates] has hundreds of millions in Berkshire. I'm glad I can get them to work cheap!

> Comment: Boards of directors are becoming increasingly active, and that should be good. However, much board activity is of the Sarbanes-Oxley regulatory type, rather than anything else. Most highly successful companies are the corporate children of visionary CEOs. Think Walt Disney, Sam Walton, Thomas Watson, Bill Gates, Ray Kroc and, of course, Warren Buffett. One of the best guidelines for investors is to hitch your wagon to a star—but make sure it's a real star.

Commodities.

A college student from New York City noted what he thought was an increasing exposure to commodities in Berkshire. He asked for Buffett's long-term view of commodities.

Buffett: No opinion—seldom would we have an opinion on commodities. We buy only when it's a good business. We never think about future commodity prices. [Our] owning the company does not reflect thoughts on the industry or the price of the product. We like businesses best [that require] low capital investment. You can't have a business that requires lots of capital and then earn high returns on capital. We do not have a bias for businesses in commodities. If anything, we have a bias against them.

Munger: We're going to be investors in businesses, not commodities.

> Comment: The nature of commodities is that they are largely undifferentiated, and that's typically not conducive to earning high returns. Further, as an indication of commodity price variability, although gold might ultimately keep pace with inflation, the price of gold is lower now than it was in 1980—despite 27 years of inflation. Given the significant

variability of commodity valuations, fewer useful commodity valuation standards, and the lack of long-term real (after-inflation) price growth, it's harder for most investors to make money in commodity investing than stock investing. As Buffett and Munger have mentioned before, investing is not like an Olympic diving competition—you don't get points for attempting something difficult. Investors should seek to make investments that have the greatest likelihood of success. And for most investors, that isn't commodities.

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