

Whitney Tilson's Notes from the 2001 Wesco Annual Meeting

Note: This is not a transcript. No recording devices were allowed at the meeting, so this has been reconstructed from 21 pages of frantic scribbles. I did not take notes on certain questions and answers that I felt weren't very interesting or that repeated what Munger has said many times in the past (or maybe my mind and/or wrist just needed to rest periodically).

Wesco and Berkshire Hathaway

Using Wesco as a vehicle for small investments

I asked Munger the following question: "Mr. Munger, an hour ago someone asked me what Wesco was worth. I threw up my hands and said, 'I don't know. With \$1 billion in cash and a \$2 billion market cap, Wesco's future returns will be largely dependent on how that cash is allocated.' Can you tell us how you plan to invest that money? In particular, you and Mr. Buffett have been saying for a long time that Berkshire Hathaway's increasing size is an anchor on the percentage rate of return it will be able to generate in the future. You have also said that certain investors with smaller pools of capital could generate very high rates of return. So why don't you use Wesco as your vehicle to do smaller investments, such as those that Mr. Buffett sometimes does in his personal portfolio?"

Munger replied, "Warren spends 70 hours a week thinking about investing, and we're not talking about large sums [in his personal portfolio]. He does these investments to amuse himself when he's not playing bridge."

"Even with the amount of money that Wesco has makes it very hard to play this game. You just have to have a prepared mind and be able to move rapidly."

"It took us months of buying all the Coke stock we could to accumulate \$1 billion worth -- equal to 7% of the company. It's very hard to accumulate major positions."

Competitive advantages

"We don't have automatic competitive advantages. We're seeing some more insurance volume, mainly from General Re, and Cort and Precision Steel have momentum, but we have to find future advantages through our own intellect. We don't have enough critical mass and momentum in place at Wesco, so investors are betting on management."

"We have one slight edge that helps us: there's a lot of human love in building at least some businesses and some people who own businesses love them. They don't want to sell to a financial buyer who will dress it up and strip it down. When we buy a company, we don't tinker with winning businesses. So, for some sellers such as Justin, Berkshire Hathaway was the only acceptable buyer."

"If you want a culture like ours, I don't know anywhere to get it if not here. In that sense, we're stronger than we were years ago because we're better known. I don't think GE is going to catch us in this area."

"So, we may well have a competitive advantage buying decent businesses at decent prices. But they won't be fabulous businesses and fabulous prices. There's too much competition and money out there, with many buyout specialists. Debt is tight right now, which helps us. Berkshire wouldn't have been able to buy Johns Manville were it not for this."

Wesco's history

"Wesco had a market capitalization of \$40 million when we bought it [in the early 1970s]. It's \$2 billion now. It's been a long slog to a perfectly respectable outcome -- not as good as Berkshire Hathaway or Microsoft, but there's always someone in life who's done better."

Berkshire buying Wesco outright

"It's a historical accident [that Wesco is only 80.1% owned by Berkshire and that its stock continues to trade], due to complicated tax reasons. I suspect that it will eventually become wholly owned by Berkshire, but it's hard to do when you people maintain this enthusiasm [for the stock]."

Berkshire's future returns

"Warren said [at the Berkshire annual meeting] that he hoped to do modestly better than the market. 15% would be a hell of a number, so the target is the 6-15% range."

"You're in the same boat we are."

Buffett's decision making

"Warren is amazingly quick to say both yes and no."

Cort

"Cort will keep growing, both via acquisitions and expanding in its current markets. It will do pretty well. It's like Enterprise Rent-A-Car. They both have a terrific culture, service and incentive system."

"Cort has good relationships with its suppliers. Capitalism works better when there's trust in the system."

General Re

"It's one of the best reinsurance operations in the world. It has a strong distribution network and culture -- a culture of intelligence and discipline. It sees reinsurance opportunities that Berkshire doesn't. They have a huge advantage being there for so long. Gen Re's competitive advantage is that it's smarter and sees more opportunities."

"I don't think its returns in the future will be as good, but a 2-3%/year advantage is a lot over time."

"Reinsurance is interesting. A lot of people get into the business because of the money. Then, reinsurance brokers -- who are very well paid and can make dumb ideas look good

-- pitch them business. Boy, is this dangerous! Very smart people can make very dumb investments. Even GEICO and Gen Re get caught sometimes."

Insurance reserves

"In the past, we've under-reserved, but more often been overly conservative. Consequently, Berkshire and especially Wesco have been reversing some reserves."

Insuring against natural disasters

"No-one wanted to write California earthquake coverage [as Berkshire did]. We're like that."

"We don't think because it's never happened that it won't. There's no actuarial science, it's rough judgment. We just try to be conservative."

Wesco's and Berkshire's inefficient tax structure

"We don't have any miraculous way of avoiding taxes at Wesco and Berkshire. With float, we get some tax benefit."

[Munger said something about some of the most foolish behavior he's ever seen was a result of trying to avoid paying taxes.]

"What a terrible, inefficient thing it is to own real estate and securities in a Section C Corporation [like Wesco and Berkshire]. The enormous taxes we paid when we sold Freddie Mac last year is an example of this. If we were a partnership, you wouldn't have had to pay this. It's very hard."

"We drifted into this structure by accident. We bought a doomed textile mill [Berkshire Hathaway] and a California S&L [Savings & Loan; Wesco] just before a calamity. Both were bought at a discount to liquidation value. It turned out wonderful for many people in this room -- Wesco's market cap has grown from \$40 million to \$2 billion -- but it was dumb. The structure is terribly inefficient and bad. It's much better when we buy wholly owned businesses like Precision Steel."

Why not franchise See's candy stores?

"It takes almost no capital to open a new See's candy store. We're drowning in capital of our own that has almost no cost. It would be crazy to franchise stores like some capital-starved pancake house. We like owning our own stores as a matter of quality control."

Walter Scott, Level 3 Communications, and Berkshire's investment in electricity

"Walter Scott has one of the best business records ever. People put a lot of money in new fiber optic networks, and now there is a bloodbath that has driven Level 3 stock down. I don't think it means that Walter Scott is any less of a businessman."

"Berkshire's electricity investment [in Mid-American Energy] was in a total system in Iowa and a distribution system in Britain. It's doing perfectly fine. I would not extrapolate

these results to new capacity in a new field [such as Level 3]. Ours is a much more conservative investment."

"Electricity is a HUGE field. It's enormously stupid to run short of electricity. There's an opportunity to make reasonable returns and we're going to try."

Finova

"We're never done anything like this before, so there's no model. We think our offer is a good example for the creditors of Finova -- an honorable, intelligent transaction. It's fair to bondholders -- we're the largest -- and leaves some room for the stock to come back. It brings in good management with the right incentives. Of course there will be some complaints, but I'd be surprised if someone else comes in with the same offer."

"I wish every place in which we had a junk bond investment, someone came forward with an offer like ours."

Auto insurance pricing

"I think auto insurance is getting some rate increases. It was almost too good a business over the last 6-7 years."

Conservative nature

"We don't feel some compulsion to swing. We're perfectly willing to wait for something decent to come along."

"We're rich in relation to the business that we're doing."

Future returns from equities

"In certain periods, we have a hell of a time finding places to invest our money. We are in such a period."

"In Warren's *Fortune* article [11/22/99], he described the last two 18-year periods. During the first period, the market was essentially flat. The most recent one has been a marvelous period. Warren said that in the nature of things, double-digit returns couldn't go on and on and on. Therefore, individual shareholders and pension funds should reduce their expectations. My guess is that he'll be right for a long period ahead. There will be way lower returns over the next 15-18 years."

"The normal expectancy of the average investor -- for example, the pension funds of AT&T or IBM -- is 6% for a long time."

"With stocks yielding 1.5% and trading at 4-5x book value, it's not as much fun as it was buying Coke and Gillette at much lower prices relative to their valuations."

Recent stock market decline

"What you've recently seen is just a tea party. If you, like me, lived through 1973-74 or even the early 1990s... There was a waiting list to get OUT of the country club -- that's when you know things are tough. If you live long enough, you'll see it."

Purchase vs. pooling for acquisitions

"The problem is that the exact same transaction is treated differently. That's crazy. The proposal to require that all acquisitions be done using purchase accounting is perfectly reasonable. Berkshire made a mistake buying Dexter Shoes. When we found out, we wrote it down and took a charge against earnings. The difference is that we didn't say it was a one-time or unusual charge -- we just took it against earnings."

Retailing and Costco

"If I were teaching at business school, I'd take people through retailing because it's easy to understand. Retailing is pretty simple. There are four or five strategies."

"I'm a director of Costco. It's easy to understand. In the history of the world, few companies have succeeded on a 12% mark-up. They make it up with high volume. Costco has the right culture. They promote from within. It's a wonderful place to work."

"I think that Costco is a better operator in the warehouse club format than Sam's. Both companies will do well in the future, but I predict that Costco will do better."

"I don't know why schools don't teach this, but I'd teach a lot of things differently."

State Farm

"State Farm is one of the very richest insurance companies in the world. It's an honorable, old fashioned, high-grade place. They have integrity and skill. In condominium insurance, for example, they're the best. They're in Indiana, don't have elaborate compensation schemes, no stock options, and no high-falutin' advisors -- and they've blown by competitors. We admire them."

"They're enormously rich, so if they decide to keep a lid on auto insurance, I can't predict when they might stop. We [at GEICO] have a better model though."

Demutualization

"Are policy holders treated fairly [when an insurance company demutualizes]? The ordinary answer is 'No.' What a surprise."

How to detect bad reserving

"If [an insurance company's] combined ratio is wonderfully regular, then it's probably crooked. It's also a bad sign if a company is consistently under-reserving."

"Sometimes you can tell by the people that the numbers are good. For example, George Joseph of Mercury General is a genius and you know his numbers are right."

Wrigley

"Wrigley is a great business, but that doesn't solve the problem. Buying great businesses at advantageous prices is very tough."

Financial industry

"The financial industry has become so big. We keep pushing it further and further and further. For example, we now lease new autos for 36 months and guarantee a high residual value. How much further can you push consumer credit? We don't like it. We don't like pushing credit to extremes. We don't like daisy chain stock promotion. However, one of Berkshire's largest holdings is American Express, so we think it has a great future."

Medicare and HMOs

"The cost was projected to be X, but was actually 10X. People forgot that effects have effects. Incentives have super-effects. [Notes are sketchy here.] The original system was on a cost-plus basis. For example, a test was not reimbursed in a doctor's office, but was at a hospital, so doctors referred patients to the hospital to have the test. It was great for doctors and hospitals, but bad for patients and taxpayers."

"So then the system switched to DRGs [whereby providers were reimbursed a fixed amount for a certain disease/problem], which controlled costs somewhat. Then, there was a switch to HMOs, which did control costs. People who hate HMOs should realize that it was a needed response to a totally out of control system."

"Yes, HMOs have an incentive to deny needed care -- this kind of behavior is just unspeakable -- but no-one ever gives HMOs credit for preventing unnecessary, harmful procedures that doctors would otherwise do."

The decline of family-controlled businesses when family foundations take over

"Don't confuse correlation and causation. Almost all great records eventually dwindle. Those you mention [Reader's Digest, Kellogg] would have dwindled, even without family ownership."

"I think the foundation at Berkshire [Buffett's stake in Berkshire will pass to the Buffett Foundation upon his death] will be a plus because there will be a continuation of the culture. We'd still take in fine businesses run by people who love them."

Money managers

"We have a number of high-IQ individuals -- an enormous group compared to the past, 4-5 times as many -- devoting extraordinary time to beating the market. They have new vehicles: hedge funds, LBO funds, venture capital, international investing, etc. In the nature of things, some will succeed. But I don't think the mass of people's results, even pretty sound, glued-together people, will be very high."

"It's natural that you'd have more brains going into money management. There are so many huge incomes in money management and investment banking -- it's like ants to

sugar. There are huge incentives for a man to take up money management as opposed to, say, physics, and it's a lot easier."

"I think it's inevitable but terrible -- a disaster for the wider civilization. I'm somewhat ashamed... That I've profited from being shrewd with money is not by itself satisfying to me. To atone, I teach and try to set an example. I would hate it if the example of my life caused people to pursue the passive ownership of pieces of paper. I think lives so spent are disastrous lives. I think it's a better career if you help build something. I wish I'd built more, but I was cursed at being so good at stock picking. 'The man is the prisoner of his talents.' You can laugh, but I'll bet this room is full of people who are prisoners of their talents. It tends to be the human condition."

Asbestos litigation

"This is one of the most interesting things on the current scene. It affects you as both citizens and investors."

"Asbestos had many wonderful qualities. But when the health risks became clear, the companies that were major users of asbestos such as Johns Manville covered it up and were rightly hit with damages through the tort system. But other companies only used small amounts -- for example, in brake pads or a bit in USG's paste. Because of a tiny bit of asbestos in brake pads, Ford has set aside \$1.7 billion to pay claims. There was a gain to society and the risk was low. It's not clear to me the damage from these uses."

"The claims bar quickly drove into bankruptcy anyone who behaved like Johns Manville, and then went after companies that didn't know they did anything wrong."

"The tobacco companies caused almost all of this."

"Now there is a whole class of people filing claims who have no symptoms. This accounts for way more than half the money being paid out. You could argue that it was a mistake to pay these claimants."

"It's coming from companies on an extortion basis. There are judges in Texas who are in the pockets of the plaintiff's bar, and there are compliant juries. It's turning the courts into an extortion system."

"Isn't it interesting that the only brand names that plaintiffs can remember are the brands of the only two solvent companies?"

"Is it good for society that lawyers, workmen, etc. are lying, that junk science is accepted? It's a national disgrace. I don't know where it will stop."

"I regard what's happening to USG as a dishonorable mugging of an honorable place. I don't think they should be driven out of business, but I don't want to make predictions about this."

"Is the system sound when obvious fraud goes on a massive scale? I would say no. And it spreads. You get what you reward for. That's why the claims keep coming and coming and coming. If you want ants, put sugar on the floor."

Later, another shareholder asked if he'd been too harsh on this topic. That set Munger off again:

"I wasn't harsh enough! Once you've got people benefiting from the system and use the money to influence judges and politicians [you've got a real mess]. It creates a situation that's very hard to fix. It would have been relatively easy to prevent if we'd had the will, but now it will be hell to fix. As Ben Franklin once said, 'An ounce of prevention is worth a pound of cure.'"

The decline of public schools

"There's a similar situation with schools. In Omaha years ago, there was an influx of poor minorities and white flight. It was obvious that Omaha Central High School was tipping toward 100% low-income minority students. If this happened, there would be no good high school in Omaha for minorities. This happened everywhere else. But in Omaha, a group of blacks demanded that there be an anti-black quota at Omaha Central, which passed and saved the school. It's a wonderful story, but the tragedy is that it only happened in Omaha."

"If you let it go, I don't see how you can reverse a lot of this stuff."

Estate tax

"Personally, I'm against the estate tax at its current rate, with its rapid rise to 55%. It hits owners of auto dealers, plumbers, etc. I think the exemption should be raised. [Since this appears likely to happen,] out of our crazy democratic system, we're going to get a reasonable outcome.

"I have no problem with this rate [for estates] in the hundreds of millions of dollars. I have no problem personally with the estate tax."

California energy crisis

"The California energy crisis is a disgrace -- to schools, executives, both political parties. There's enough disgrace to go around. We richly deserve this miserable result, which is due to extreme stupidity and indifference. [Quit beating around the bush, Mr. Munger. Tell us what you really think!] We are like the canary in a coal mine for other states, which are saying, 'Boy, have these guys done us a favor!' It's ABC basic what needs to be done: decrease pollution, increase conservation, and have the right incentives in the rates."

"In modern academia, there's no shame. People are taught Beowulf, but can't think their way out of a paper sack."

Investing abroad

"We don't feel any compulsion to go abroad because of any strategic considerations. We haven't taken the advice of any financial planner that I'm aware of. We have more comparative advantage buying in the U.S. because we're well known. There's no master plan. We're individual opportunity driven."

Mental models

"If you have the right mental equipment from the right education, you know it. We [at Berkshire and Wesco] have experienced people with the right models. You don't want to be the patient of a surgeon who's doing his first complicated procedure."

"My speech about mental models using Coke as an example was a failure. People had to read it two or three times before it sunk in, and even then it only sunk in if people already half knew it."

Prediction of interest rates

"Neither Warren nor I has ever made a dime in this area."

John Train

Asked to comment on John Train's books (The Money Masters, etc.), Munger said, "He's a gifted writer with moderate insights into the investment process."

Damn Right (biography of Munger by Janet Lowe)

"I didn't want it done. I felt that the disadvantages outweighed the advantages. I like to keep private. But once it became clear that she would write it with or without me, it was obviously the right decision to cooperate. I got to like Janet Lowe -- she's a very high-grade person. The book gave me the chance to spread some of my ideas without having to do the work. One idea is that whenever you think something or some person is ruining your life, it's you. A victimization mentality is so debilitating. I love spreading this stuff around. Just because it's trite doesn't mean it isn't right. In fact, I like to say, 'If it's trite, it's right.'"

Munger's writings

"For you masochists, I taught a course at Stanford Law School recently and compiled some readings. Copies are available in boxes at the front of the room."

The booklet, privately printed by Munger, is entitled "Some Investment-Related Talks and Writings Made or Selected by Charles T. Munger." In it is:

- 1) "The Great Financial Scandal of 2003, An Account by Charles T. Munger." Unlike the other readings in this booklet, I don't believe this has ever been published before. It details a hypothetical financial scandal in 2003, triggered by dishonest accounting, especially for options, at an imaginary tech company called Quant Tech (which appears to be a bit of Cisco, IBM and the like).
- 2) "11/10/00 Talk of Charles T. Munger to Breakfast Meeting of the Philanthropy Round Table." Munger rails against --among other things -- "common-stock-price-

related 'wealth effects'" and foundations and other investors "wasting 3% of assets per year in unnecessary, nonproductive investment costs."

- 3) "Investment Practices of Leading Charitable Foundations, Speech of Charles T. Munger on October 14, 1998 to a meeting of the foundation financial officers group." Munger continues railing against the investment practices of foundations -- lessons that apply to nearly all investors. You can read it at http://www.tiff.org/pub/pages/othres.html?body=Munger_Speech.html.
- 4) "Mr. Buffett on the Stock Market," 11/22/99. A reprint of Buffett's *Fortune* magazine article, in which Buffett presciently warns investors about the tech bubble and argues that stock market returns for the foreseeable will be in the mid-single digits. You can read it at <http://w3.res.ulaval.ca/cours-gsf-60808/buffet.html>.
- 5) Munger's 1994 presentation to the USC Business School on "Investment Expertise as a Subdivision of Elementary, Worldly Wisdom." The transcript is from the 5/5/95 Outstanding Investor Digest. In this speech, Munger talks about the importance of mental models and argues that "you're got to hang experience on a latticework of models in your head" to be a successful investor and thinker.
- 6) A transcript of last year's Wesco annual meeting, published in the 12/18/00 edition of Outstanding Investor Digest. My notes from that meeting are available at <http://www.fool.com/boringport/2000/boringport00051500.htm>.