

Notes from the 2002 Wesco annual meeting, 5/8/02

By Whitney Tilson

COMMENTS ON BERKSHIRE HATHAWAY AND WESCO

Berkshire's competitive advantages in reinsurance

"I do think we get some advantage in reinsurance because people trust our willingness and ability to pay, so it's not a commodity. I think we have some special talents. That being said, I think it's dangerous to rely on special talents -- it's better to own lots of monopolistic businesses with unregulated prices. But that's not the world today. We have made money exercising our talents and will continue to do so."

"I'm glad we have insurance, though it's not a no-brainer, I'm warning you. We have to be smart to make this work."

Outlook for Berkshire's insurance operations

"The overall result is that we're going to do pretty well -- meaning in the top 10% [of the industry] -- because we do different things. In New Jersey, when they capped rates, we said we were going to withdraw from the market, and we did. We're one of the only corporations in America to run off its derivative book. We had hoped to sell it, but that didn't work out. We're willing to do some unpleasant things."

"Generally speaking, we're mildly optimistic about our insurance operations." [This is Munger-speak for "I'm quite enthusiastic about our insurance operations."]

Berkshire's future outlook

"It's a finite and very competitive world. All large aggregations of capital eventually find it hell on earth to grow and thus find a lower rate of return."

"Personally, I think Berkshire will be a lot bigger and stronger than it is. Whether the stock will be a good investment from today's price is another question. The one thing we've always guaranteed is that the future will be a lot worse than the past."

Types of businesses Berkshire buys

"A lot of things we do are fairly basic. Bricks have been around since Babylon. Their consumption is regular and predictable. Our brickyards dominate their region."

"We tend to buy things -- a lot of things -- where we don't know exactly what will happen, but the outcome will be decent."

Would Berkshire ever invest in Level 3?

"We have the same problem as everyone else: it's very hard to predict the future [of Level 3]. Could we invest in it? Sure, it's conceivable. After all, we're in the electricity distribution business in the UK and the generating and distribution business in Iowa. We have a history when things are really horrible of wading in when no-one else will."

Berkshire's culture

"Berkshire's culture could go on for a long, long time because we've decentralized power to people who deserve it."

"For many of our shareholders, our stock is all they own, and we're acutely aware of that. Our culture [of conservatism] runs pretty deep."

Share price

"We don't like our stocks [Berkshire and Wesco] to get too high -- only deservedly high -- so we tend to throw deserved bits of cold water on them. For example, in the prospectus for the Berkshire B shares, we said we wouldn't advise anyone to buy our stock. People bought it anyway, but we tried to dampen it."

Share buybacks

"If only you people thought a lot less of us, there would be more opportunity to buy back Wesco and Berkshire shares."

Bonds

"Berkshire owns bonds in two ways:

1) Through our insurance operations. Mainly mortgage backed, with some government and a little junk.

2) Through our finance subsidiary. Interesting little things. I call it the 'miscellaneous Warren Buffett account.' As long as he's doing it, I'm OK with it. We've made a few hundred million [dollars] with little risk or fuss."

Comments on Wesco

"Wesco's insurance operations are decent, but small."

"Wesco's business has come up some in the past year or two."

Berkshire's insurance accounting

"Generally speaking, we think we're more conservative than most insurers. Nevertheless, in certain periods, we've discovered that our reserves were not adequate. But over time, we'll not only try to be more conservative, we will be."

Will Berkshire be in the S&P 500?

"If Berkshire were owned by institutions, it would already be in the S&P 500. But Berkshire's loyal shareholders would cause a price spike if it were added to the S&P 500 [because of all the index funds that would have to buy the stock], which would be an embarrassment. Sooner or later it will be in, but not tomorrow."

History of Buffett's investing philosophy

"Warren Buffett came to investing at the knee of Ben Graham, who ran a Geiger counter over the detritus of the 1930s. Stocks were ridiculously cheap. Graham bought companies that were quite mediocre on average, but made 20% when their stock bounced."

"Warren trained under this system and made money, so he was slower to come to the idea I learned that the best way to make money is to buy great businesses that earn high returns on capital over long periods of time."

"We're applying Graham's basic ideas, but now we're trying to find undervalued GREAT companies. That concept was foreign to Ben Graham."

"Warren would have morphed into a great investor without Ben Graham. He is a greater investor than Graham was. Warren would have been great had he never met anyone else. He would have excelled at any field that required a high IQ, quantitative skills and risk taking. He wouldn't have done well at ballet though."

Differences between Buffett, Munger and Simpson

"Not very much."

[Lou Simpson, who manages GEICO's investment portfolio, was in the audience, so Munger asked him to address this question. He said:] "The big difference between you and Warren and my situation is the difference is size. We're \$2.5 billion, whereas you and Warren are many times more, so we have an advantage in looking at smaller situations. If we find a \$200-\$250 million position, we can invest and make a difference."

Munger: "It does make a difference. Maybe Lou is just smarter. His returns have been better [over the past few years]."

COMMENTS ON BERKSHIRE HATHAWAY HOLDINGS

Gen Re

"Gen Re misguessed its reserves -- almost every insurer in America did -- which is why we took a big loss."

"Gen Re always tried to do it right [reserve properly]. Losses crept up on everybody. You'd think that under Berkshire, their reserving, which was always very good, would be more conservative, consistent with Berkshire's culture."

"At Warren's level, we operate through the CEO of Gen Re, who has to tinker with the culture. It's a good culture, but with the world so tough, we need to improve it a bit."

Munger's role in the purchase of Gen Re

"That thing was very far along before I ever heard of it. There will be more of this as the years go on."

Finova

"Finova is a run-off situation. It's not going to run off as well as it would have before 9/11 happened, but it will work out fine. We'll make hundreds of millions. It's a blip in the history of Berkshire."

American Express

"American Express has had some things that didn't work out. Am I satisfied by what we know at American Express? Yes. We never expected them to handle their investments the way we'd handle ours. But we're big boys. We're not depressed about American Express."

USG

"[Our investment in] USG obviously hasn't worked out very well. It wasn't just asbestos -- the market for wallboard went to hell. We missed that too. What can I say? It reminds me of a story about a man who had a wife and three kids. He conceived an illegitimate child with a woman he'd just met. When asked why he did it, he said, 'It seemed like a good idea at the time.'"

INVESTMENT ADVICE

Becoming a good investor

"If you're going to be an investor, you're going to make some investments where you don't have all the experience you need. But if you keep trying to get a little better over time, you'll start to make investments that are virtually certain to have a good outcome. The keys are discipline, hard work and practice. It's like playing golf -- you have to work on it."

Investing mental models

"You need a different checklist and different mental models for different companies. I can never make it easy by saying, 'Here are three things.' You have to derive it yourself to ingrain it in your head for the rest of your life."

Circle of competence

"There are a lot of things we pass on. We have three baskets: in, out and too tough. A lot of stuff goes into the 'too tough' basket. We can't do that if it's a problem at a Berkshire subsidiary company, but if we don't own it, we just pass."

"I don't know how people cope [trying to figure everything out]."

"We have to have a special insight, or we'll put it in the 'too tough' basket. All of you have to look for a special area of competency and focus on that."

Buying into stock declines

"Over many decades, our usual practice is that if [the stock of] something we like goes down, we buy more and more. Sometimes something happens, you realize you're wrong, and you get out. But if you develop correct confidence in your judgment, buy more and take advantage of stock prices."

COMMENTS ON VARIOUS COMPANIES, INDUSTRIES AND OTHER ECONOMIC MATTERS

Freddie Mac

"We held that stock for a great many years, and of course made a great deal of money."

"Warren and I get nervous with vast amounts of leverage unless we're 100% confident that risk-taking won't creep into the culture."

"It reminds me of a guy running a company who fired his top producer. The guy asked him, 'Why are you firing me? I'm your top producer.' To which he responded, 'You make me nervous. I'm a rich old man. Why should I be nervous?'"

Lloyd's

"At present, Lloyd's is greatly improved. Lloyd's had become a sewer. Ethics became terrible, easy money, three-hour lunches with drinks... The culture got quite bad and it degenerated into huge underwriting losses."

"It's way better now, but not totally reformed. The jury's still out."

Moody's

"Most of the bonds Berkshire buys, Warren picks. He doesn't need Moody's, nor does he look at their rating. But he believes Moody's provides a useful service."

Influence of board members (or lack thereof)

"Joe Rosenfeld -- a marvelous human being and great friend -- was asked to be on the board of Northwestern Bell. He said it was the last thing they ever asked him. That's typical. Sometimes a CEO asks for advise when a board has expertise, but they generally make their own decisions and use their staff. Averaged out, the CEO decides what he wants to do and the board says yes."

"We have very little influence [on the boards Warren and I serve on]. There's an occasional exception if someone has very high regard for us."

Risks of financial institutions

"The beauty of a financial institution is that there are a lot of ways to go to hell in a bucket. You can push credit too far, do a dumb acquisition, leverage yourself excessively -- it's not just derivatives [that can bring about your downfall]."

Consumer credit

"My method for a nation growing is Germany after World War II -- no consumer credit, but high growth."

"In the U.S. today, we push consumer credit harder year after year. There are occasional blow-ups like Providian. Could we have a big national blow-up? Yes. It tends to be self-correcting."

"Once you get used to growing each year by goosing consumer credit 5%, what do you do when you've reached the limit?"

"I don't like it. I don't like thinking up ads to get people to use their credit card more. But it's not illegal and maybe the world's even better for it. It's not my temperament though."

The wealth effect

"The wealth effect is the extent to which consumer spending is goosed upward due to increases in stock prices. Of course it exists, but to what extent? I made a speech a while back in which I said that the wealth effect is greater than economists believe. I still say this."

"The wealth effect is one driver of economic assumption, but not the only one. The government in two years has gone from back-to-back surpluses to increasing spending 10% each year. Also, the decline in interest rates has led to an increase in housing values, which makes people feel richer. So, there are countervailing effects."

"Look at Borsheim's. When Level 3 [a widely held stock in Omaha] crashed 97%, there was a big effect [on Borsheim's sales]. There are also more homes for sale [in Omaha]."

"So many people try to predict macroeconomic factors by looking at only one factor. You need to look at all the factors."

Risk of the unexpected

"A lot of things happen that you can't predict. Who would have predicted the war on terrorism, government spending increasing 10% each of the past two years, etc.?"

"We try to run our companies so there's no chance of going back to Go. I think we're way more aware of that possibility [the risk of going back to Go], but that's no guarantee [that it can't happen to us]. In our insurance underwriting, we put in more clauses [limiting our risk] and are more aware of aggregate risks."

Expect the unexpected (Japan example)

"Warren has said that over 40 years, a lot of surprising things will happen."

"What's interesting in Japan is that every life insurance company is essentially insolvent because they promised to pay 3%. Who'd have thought that this could lead to insolvency, but interest rates went to zero and stayed there for years. They tried to invest in equities, but got negative returns. Can you imagine 13 years with negative equity returns and interest rates below 1%?"

"Is it inconceivable that it could ever happen here? I don't think so. Strange things happen."

CRITIQUES OF ACCOUNTANTS AND INVESTMENT BANKERS

Wall Street's ethics (or lack thereof)

"Generally speaking, ethics on Wall Street have been imperfect throughout my lifetime. In the old days, brokers would sell old ladies very conservative utility stocks with a big mark-up."

"Underwriting standards were better then. Now, what can be sold, will be sold. It's terrible."

"With First Boston, under the Mellons, there are just some things they wouldn't do."

"It's always hard. Some guy needs to pay his kid's tuition and at the end of the month, let's say he's behind on his quota and there's Suzi's account. Lo and behold, there's some activity."

"The ethics of Wall Street will always average out to mediocre at best."

"I don't think you get a lot of credit in life for not committing adultery with the Virgin Mary."

"Analysts as shills were always present, but it reached extremes in the dot-com boom because there was so much money at stake. Wall Street firms can't make money trading stocks for two cents per share, but can make so much money doing deals."

"If you set up incentives to reward A, and then say you want B, you'll give people schizophrenia."

"This doesn't mean there aren't some wonderful, intelligent people on Wall Street -- there are, like those in this room -- but everyone I know has to fight their own firm [to do the right thing]."

Critique of legal and accounting firms

"I think there's plenty wrong with the legal profession. Plenty of law firms take business they shouldn't. Accounting has this problem in spades. All have clients they shouldn't have. All the leading law and accounting firms aren't quick enough to decline or kick out bad clients."

"Too many law and accounting firms get roped into shady things. For example, tax shelters, with their contingency fees and secrecy, are a total abomination. The troubles are contagious -- they spread."

"Lawyers have gotten away with murder. The rule of thumb now is to defend anyone, using any means, and not get sued. This is changing however. Now, people are being more careful. This tendency to pull back is good."

"I never have the least interest in defending miscreants and helping them misbehave. But the general view is that it's wonderful what Johnny Cochran did."

"They say the second-happiest day for a defense lawyer is winning an acquittal of an innocent man."

Derivatives

"Originally, there were interest rate swaps. If you did them naked, you could lose or make an enormous amount. But there wasn't enough money for traders, so they adopted mark-to-market accounting. Everyone caved, adopted loose [accounting] standards and created exotic derivatives linked to theoretical models. As a result, all kinds of earnings, blessed by

accountants, are not really being earned. When you reach for the money, it melts away. It was never there."

"The accountants have written 800 pages of rules on this."

"If you're the least bit venal, you can do what Enron did. Even if you're not, your employees will still [get you in trouble with derivatives]."

"It [accounting for derivatives] is just disgusting. It is a sewer, and if I'm right, there will be hell to pay in due course. All of you will have to prepare to deal with a blow-up of derivative books. To me, it's always been obvious it [the accounting for derivatives] is ridiculous."

"It's a crazy idea for people who are already rich -- like Berkshire -- to be in this business. It's a crazy business for big banks to be in."

[On this topic, here's an excerpt from the 5/20/02 [Business Week](#):

"Critics say FASB's nitpicking hit bottom with Financial Accounting Standard No. 133, which governs accounting for financial derivatives and hedging. Launched in 1992, the standard is based on a simple principle: Futures, swaps, options, and other derivatives should be carried on books at their market value. But revaluing derivatives every quarter can create wide and unpredictable swings in corporate earnings. To avoid that, FASB carved out exceptions for hedging deals, forward contracts for materials, insurance policies, and other special cases. 'The exceptions are legitimate,' says FASB member John M. 'Neel' Foster, 'but once you start down that path, it's hard to stop.' The result: FAS 133 and its supporting documents weigh in at 800 pages--and it's still a work in progress."]

COMMENTS ON EDUCATION AND PROPER THINKING

Fooling oneself

"The ethos of not fooling yourself is one of the best ethoses you could possibly have. It's powerful because it's so rare."

Mental models

"Generally speaking, you need to have appropriate mental models and a checklist to go through each of them. If 2-3 items are not on the checklist, and you're a pilot, you might crash."

"It [this approach] is perfectly obvious. But how many of you were taught to think this way at university?"

[One person in a room of perhaps 200 raised his hand and, when asked which university he attended, said "MIT."]

Munger snorted and said: "This wasn't rehearsed. This underscores the importance of science. If you have kids or grandkids, make them take science [classes]. Can you imagine the kind of nonsense we'd get from the head of the poetry department at Amherst?"

Personal computer use

"Do I use a computer? Not so far. I just had a computer installed, but so far it's dark. I don't even type. As for the future? We'll see."

"I'm a big follower of [Thomas Hunt Morgan](#) [in 1933, he won the Nobel Prize in Physiology or Medicine]. While at Cal Tech, he banned the Frieden calculator, which everyone used for all sorts of calculations. Why? I walk along the river and pick up gold. So why should I do placer mining? I'm willing to do placer mining if need be, but I'm hoping to go to my grave without doing so."

"Organized common (or uncommon) sense -- very basic knowledge -- is an enormously powerful tool. There are huge dangers with computers. People calculate too much and think too little."

Importance of science

"I think scientific literacy is terribly important...Habits of the mind formed from science are so valuable."

"I once spoke at one of New York's great Catholic girls schools, and they require every student to take physics."

"Even if you're not a scientist, you can pick up on the big ideas like thermodynamics. A lot of people haven't bothered to learn thermodynamics, and that's a big mistake. I recall a utility that invested in a scheme to create energy from seawater. [Anyone with even a rudimentary knowledge of science would know that] this violates the laws of thermodynamics."

Inner-city schools

"Center-city school systems are a disaster. The schools are dealt a difficult hand, but many schools have shown not an impossible one."

Universities

"There's a lot wrong [with American universities]. I'd remove 3/4 of the faculty -- everything but the hard sciences. But nobody's going to do that, so we'll have to live with the defects. It's amazing how wrongheaded [the teaching is]. There is fatal disconnectedness. You have these squirrely people in each department who don't see the big picture."

"This doesn't just happen in academia. Companies can get balkanized. Look at what happened at Arthur Andersen and Enron. They weren't all bad people, but their cultures were dysfunctional. It's easy to create such a culture, in which you have good people but terrible results. Many areas of government are dysfunctional. Universities are complicit. They don't feel guilty about the product they're producing."

"We have the best universities in the world. They are strong in the hard sciences, but if you go to business, law, sociology..."

ADVICE ON LIFE AND OTHER

Terrorism risk and immigration policy

"Our handling of the terrorism risk has been insanely sloppy. Can you imagine that someone with an Arabic name, who was Arabic looking, took lessons on flying big jets in which he didn't want to learn how to take off or land, and no-one asked any questions?! But it's the human condition. It's what bureaucracies do."

"I would be in favor of foolproof national identity cards, and wouldn't worry about due process with immigrants -- I'd really be more rigorous. But we're a democracy, and we'll muddle through."

"Canada's [immigration policies are] worse. They should have a banner that says, 'Welcome Terrorists!'"

"It's sad that we need an event like 9/11 to wake up."

Books

"[Ice Age](#) [only available in the UK; will be published in the U.S. later this year] is one of the best books I've ever read. I've spent thousands of dollars buying copies for my friends. If you don't like Ice Age, then you have some limitations."

"I also recommend [How the Scots Invented the Modern World: The True Story of How Western Europe's Poorest Nation Created Our World and Everything in It](#). It's amazing how one million poor people with a lousy climate and no resources had such a large and constructive influence on the world. I tried to figure it out and couldn't. This professor did that. It's a wonderful book."