

Notes from the 2004 Wesco Annual Meeting

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Notes: This is not a transcript. Recording devices are not allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory (egads!). I have reorganized the content of the meeting by subject area. All quotes are Munger's unless otherwise noted. Words in [brackets] are my comments or edits, and all web link insertions are mine.

For more on this meeting, see my 5/7/04 column, [Charlie Munger In Rare Form](#). To read my columns and notes from previous Berkshire and Wesco meetings, click [here](#). Links to all of my published columns are [here](#).

OFFICIAL MEETING

[The official business of the annual meeting is generally wrapped up in five minutes, with Munger calling for approval of directors, etc. He said, "All those in favor, say "Aye." (Audience: "Aye") All those opposed? (Audience: silence) Those people may leave. (Laughter)]

OPENING SPEECH

[After the official affairs of the meeting are taken care of, Munger always gives an opening speech. Unlike previous years, however, it went on for nearly an hour. I had trouble typing fast enough to keep up, so my notes are a little spotty in places.]

What Explains the Phenomenon of Berkshire's Annual Meeting?

This of course is the aftermath of the Berkshire meeting held in Omaha four days ago. 19,500 people were there, packed to the gills in the main arena, plus 2,500 or more in a separate room with video.

When something as unusual as that – 19,500 shareholders at a meeting, and everyone having a whee of a time – you might ask two questions: What the hell is going on here? and Why did it happen?

What's going on of course is that alone among all companies in the history of the capitalist world, Berkshire has created an annual meeting that has cult-like attractions – attractions that attract an enormous number of people. It's like Chautauqua [an area in upstate New York where there are various cultural and educational activities; here's a link to the [Chautauqua Institution](#)]. There are parties and all sort of other events, as well as discount shopping (on which Berkshire makes a substantial profit because we have so many subsidiaries).

The reason this thing happens is because there's a value system at Berkshire – and also at Wesco – and that value system is really adored by shareholders. It's partly because people are so mad at the rest of corporate America – which is not so flattering – and partly because we've been around for so many years and made a lot of money, of course. But IBM made more money for shareholders back in its heyday from [the stock's] bottom to top, yet people didn't flock to its meetings, even though it had a widely admired culture.

Berkshire has created this system, and the intellectual content has been limited to a fairly short catechism: low pay for the people at the top and a high sense of duty. A lot of shareholders trusted us when we were young and in many cases it was almost all of their money. So our shareholders were not represented by analysts; we know a lot of them personally. It's hard to love a group of analysts working for institutions. The analysts who are here are not from institutions; they're oddballs like us.

The typical analyst would sell his mother to get another 10 cents in earnings per share so the stock would pop and he would look good. The analysts who represent institutions are not liked by CEOs – but the CEOs of course are smart enough not to let on.

A lot of [corporations' annual] meetings are set up to avoid groups like you – they're in inconvenient locations and at inconvenient times – and they hope people like you won't come.

Not just shareholders attend the Berkshire annual meetings. People from our subsidiaries come and bring their families. It's enormously valuable. It wouldn't work with just discount shopping. It takes ethos. In that sense we're cult-like and like a religion.

So we try to run this [in a certain way]. We don't hire compensation consultants or financial relations people, and there's no [in-]house [legal] counsel (not that there's anything wrong with house counsel).

Lou Vincenti [former Chairman of Wesco; briefly mentioned in Buffett's [1977](#) and [1979](#) annual letters], who used to sit here, said, "If you tell the truth, you don't have to remember your lies." [Laughter]

We don't care about quarterly earnings (though obviously we care about how the business is doing over time) and are unwilling to manipulate in any way to make some quarter look better. So that's a very different ethos.

When it comes to intellectual content, we try harder to be rational and ethical and not be abusive. Now, with 175,000 employees at Berkshire, I'll bet one of them is doing something I wouldn't like right now, but overall Berkshire has been remarkably free of scandal over the decades.

I think these things [referring to well-attended annual meetings] happen when 3-4 things work together. I don't think it would happen if Warren and I didn't have a significant wise-ass streak. To sit for six hours – people wouldn't do it without this. [Laughter]

With this sense of ethos, people sense we're trying to do it right. We don't have an isolated group [of senior managers] surrounded by servants. Berkshire's headquarters is a tiny little suite. We just came back from Berkshire's board meeting; it had moved up to the board room of the Kiewit company and [it was so large and luxurious that] I felt uncomfortable.

Long ago, every S&L [Savings & Loan like Wesco] had big, luxurious offices built, but Louie just made his own office extra large for board meetings. He wasn't about to pay for an extra room.

Many companies have financial counselors. Many hope they'll learn something. If one guy won 50% of all bass fishing tournaments, and he had a talk on how he twisted the reel, a lot of people would come. I think our meetings are a big source [I missed this – I think he talked about how people come to Berkshire meetings for similar reasons: to learn how Buffett and Munger have had so much success].

The Wesco meeting of course gets the hard-core nutcases. [Laughter] There's a little group that comes locally, but the rest come from far away – some come from Europe. Like the Catholic catechism, we don't have much new to say, but like the Catholic priesthood, we just say the same old catechism.

Investment Philosophy

We don't believe that markets are totally efficient and we don't believe that widespread diversification will yield a good result. We believe almost all good investments will involve relatively low diversification.

Maybe 2% of people will come into our corner of the tent and the rest of the 98% will believe what they've been told [e.g., that markets are totally efficient, etc.].

Investing as Taught By Academia

We've had very little impact. Warren once said to me, "I'm probably misjudging academia generally [in thinking so poorly of it] because the people that interact with me have bonkers theories." Beta and modern portfolio theory and the like – none of it makes any sense to me. We're trying to buy businesses with sustainable competitive advantages at a low – or even a fair price. [The reason the professors teach such nonsense is that if they didn't], what would they teach the rest of the semester? [Laughter] Teaching people formulas that don't really work in real life is a disaster for the world.

At Stanford, Jack McDonald is the most popular professor at Stanford business school [he teaches a value investing course rooted in Graham/Buffett/Munger principles]. He teaches a double course load, yet still his courses are oversubscribed and he is voted the most popular teacher, yet they can hardly wait for Jack to leave [I assume Munger is referring to other finance professors, because what McDonald is teaching is so threatening to what they're teaching]. [Laughter] I'm not making this up.

[For more on Jack McDonald, I've posted [Chapter 4](#) (with his permission, of course) from my friend Andy Kilpatrick's outstanding book, [Of Permanent Value: The Story of Warren Buffett/More in '04, California Edition](#), which I highly recommend.]

Berkshire has never believed in extreme diversification.

Moral Code

We believe there should be a huge area between everything you should do and everything you can do without getting into legal trouble. I don't think you should come anywhere *near* that line. We don't deserve much credit for this. It helps us make more money. I'd like to believe that we'd behave well even if it didn't work. But more often, we've made extra money from doing the right thing. Ben Franklin said I'm not moral because of it's the right thing to do – but because it's the best policy.

Berkshire's and Wesco's Cash Hoard and Valuations

Berkshire and Wesco are full of cash that we don't know what to do with. Berkshire has \$70 billion if you count the bonds, and Wesco is drowning in cash. It's the most extreme it's ever been. In the past, we've just been patient and we were able to put it to work.

In the early days, Wesco had \$40 million in book value, and it's now \$2 billion – and the market value is 20-30% above book. This is ridiculous. [A premium to book] happened in Ben Graham's closed-end fund, which traded for 120% of liquidation value. I never would have paid this. But Ben Graham bought control of GEICO, which wasn't legal, so when he realized it, he distributed the stock to shareholders, and people who paid 120% [of book for the fund] and held it [the GEICO stock], did extremely well.

I can almost promise you that there will not be a similar result here. [Laughter] We're too big and too old. [Laughter] But I hope we will do credibly. I don't think we'll do badly, and given that I don't see much else out there that's attractive, [I missed this, but basically he said that investors in Wesco (he might also be referring to Berkshire investors) might well do better than the average investor, given how overpriced nearly all types of assets are].

If you're locked into a security [like Wesco stock], there are worse things. If you want to create a cult, you gotta expect you'll pay some consequences. [Laughter]

How Has Berkshire Succeeded?

How does a little company in the textile business, sure to go blooey, [succeed on such a massive scale?] Textiles are [little more than] congealed power, so if Warren had just stayed in the textile business, he would have been sure to go bankrupt. But he wrung a little money out of it,

invested it in insurance and many years later, a business with a \$10 million market cap become one with \$100 billion – and there aren't a lot more shares outstanding.

How did this happen? If you took the top 15 decisions out, we'd have a pretty average record. It wasn't hyperactivity, but a hell of a lot of patience. You stuck to your principles and when opportunities came along, you pounced on them with vigor. With all that vigor, you only made a decision every two years. We do more deals now, but it happened with a relatively few decisions and staying the course for decades and holding our fire until something came along worth doing.

Master Plans

And there has never been a master plan. Anyone who wanted to do it, we fired because it takes on a life of its own and doesn't cover new reality. We want people taking into account new information.

It wasn't just Berkshire Hathaway that had this attitude about master plans. The modern Johns Hopkins [hospital and medical school] was created by [Sir William Osler](#). He built it following what [Carlyle](#) said: "Our main business is not to see what lies dimly in the distance but to do what lies clearly at hand."

Look at the guy who took over the company that became IBM. At the time, it had three equal sized business: [a division that made] scales, like those a butcher uses; one that made time clocks (the bought this for a block of shares, making an obscure family very rich); and the [Hollerith Machine Company](#), which became IBM. He didn't know this would be the winner, but when it took off, he had the good sense to focus on it. It was enlightened opportunism, not some master plan.

I happen to think great cities develop the way IBM or Berkshire did. I think master plans do more harm than good. Anyway, we don't allow them at Berkshire, so you don't have to worry about them.

Outlook

I don't have the slightest glimmer that things are getting a lot better [in terms of investing all of Berkshire's and Wesco's cash]. It's still a world awash in cash. Every university has to have a fixed income arbitrage department, a leveraged buyout department, a department for small cap investing, mid-cap investing, and so forth – and consultants to tell them what do with it all. There's enormous manpower to shuffle paper. But anyway, that's where we live in the culture.

Scandals

One thing that people ask about is the enormous amount of scandal. This isn't new – there's a lot of historical precedent. You can go back to [Jay Gould](#) – there was a lot of misbehavior by the robber barons, though they did some good too.

[In recent years,] We've had an enormous amount of corporate misbehavior, and it's affected the lawyers, accountants and investment bankers (though they never used to behave well).

Where will it stop? Royal Dutch Shell was about the best: it had a rigid meritocracy comprised mainly of excellent engineers. And to have the [lying about the reserves](#) become so extreme that the #2 guy creates a written record when he tells the top guy he's tired of lying about the reserves – [when this happens at a company like Shell], I can guarantee you [that corporate misbehavior] is widespread. When everyone [every CEO] becomes Jack Welch, [who managed GE] to have income go up steadily [it's a bad thing]. [GE under Welch was notorious for managing the natural volatility of its earnings so show investors a false picture of steadily rising profits.]

[Part of the problem is that] The time horizon is wrong. The guy who fudged the reserves [at Shell] was near retirement, so [the accounting games] only had to last 3-4 years. The time horizons of CEOs are wrong.

And it's not just CEOs – the people investing the pension plans of municipalities have done terrible things. And the pension plans of police departments [my notes are weak here; I think he talked about how the pension plans are gamed by retiring cops working a lot of extra hours in their last year, which translates into much higher pension payouts]. No-one has the least sense of shame; [they rationalize that] everyone else does it...

Demise of Ethics Among the Major Accounting Firms

When I was younger, the senior partners at the major accounting firms were Scottish – more than half were. And they were quite ethical places and nobody got filthy rich – I know because I handled some of their estates. There were many Indians and few chiefs.

But in the space of 25 years, they sold out to terrible behavior, one little step at a time. Once you start doing something bad, then it's easy to take the next step – and in the end, you're a moral sewer. The idea that the major accounting firms of the country would sell obviously fraudulent tax shelters... [Their strategy was to] make it so obscure that it won't be caught. One after another, the accounting firms went into it. And the lawyers got paid big fees. I don't know where it would have stopped had the scandal not hit. Deloitte has cashiered all of its culpable tax partners, but they waited until it was obvious – they should have acted sooner. It was the same at the other accounting firms.

[I spoke with Wesco's auditor from Deloitte, who was on stage with Munger at the meeting, and he took issue with Munger's characterization of his firm, saying that Deloitte was alone among the big accounting firms in not pushing abusive tax shelters. (But he said he loved everything else Munger had to say!)]

J.P. Morgan Chase set up something in the Canary Islands to avoid taxes. What the hell were they thinking? [I missed some of his rant here – but it was a good one!]

To a guy who's a Republican like me, [all of this bad behavior – I think he's referring to behavior across corporate America, not just accountants] is awkward because they [the perpetrators] were all Republicans. [Laughter]

I do think we're coming back from that. When the guys went to the penitentiary to pound rocks for price fixing, I think it changed [that type of behavior]. I think a goodly number of people

going to prison will help things. But there are enormous pressures. There's so much money [at stake], and it's easy to report a little more [in earnings, to keep the stock price up]. I don't think we've seen the last person to succumb to the temptations.

Impact of Sarbanes-Oxley

I think you'll even get some bad things from Sarbanes-Oxley. Some people will have a really good quarter, and they formerly wanted to be conservative, but under their impression of Sarbanes-Oxley, they will make a wrong call [and not be as conservative as they otherwise would be].

There's nothing wrong with conservatism, as long as it's consistent. Reporting more earnings when the business is weak and less when it's strong – that's obviously wrong. The world would be better if everybody was consistently conservative, but we're a long way from that result.

[I was initially confused by these comments because being excessively conservative is hardly a problem in Corporate America – though some companies do use “cookie-jar” accounting to smooth earnings. A friend of mine thinks that what Munger is really talking about is the impact on Berkshire (and the few other companies that are as conservative as Berkshire is). Let's say Berkshire was extremely conservative and set aside \$3 billion (he's making up this number) in reserves for World Trade Center losses. In past years, my friend argues, if it turned out that losses were only going to come in at \$2 billion, then Buffett and Munger would say to themselves, “Well, let's keep the extra \$1 billion in reserves, rather than running it through the income statement as unexpected profit, just to be extra conservative and because we're sure to get hit with surprises on other policies that we haven't reserved for at all.” Now, under Sarbanes-Oxley, Berkshire can no longer be extra conservative like this, which Munger surely thinks is a bad thing.]

Signs of Hope – New Zealand Example

There are a lot of hopeful signs – and this ought to cheer up Republicans. New Zealand over time developed socialist systems – it had every sign you could image of socialism gone mad: import barriers, high unemployment, big deficits, high taxes, big government, etc. But in now has low taxes, a flat 10% consumption tax, a budget surplus, reduced debt, and so forth. The school system was a disaster, but in one fell swoop they revised it the way Milton Friedman would like. And this was led by the Labor Party!

So, at least there's some hope somewhere where a highly socialist system like New Zealand can change. And the change was dramatic – it made what Margaret Thatcher did in the UK look like nothing. New Zealand took folly by its neck and wrung it out. It took one department, the works ministry, and cut [all of its staff] to one person. They just hired private firms to do it.

They had terrible unemployment – nobody was working. That's what caused the Labor party to say, “We're this tiny little island, nobody's working, so we have to fix it.”

But the scandal and dysfunction has to get very extreme before someone will do something.

Workman's Comp

Take Workman's comp in California – to say it was sinful is an understatement. It had crooked chiropractors, lawyers, legislators, etc. It was a miracle that we got 20% of the reform that we needed – we needed a recall [of the governor], threats from Schwarzenegger, etc. [to make it happen].

So it happened, and we do get reform, so my guess is that we'll see some of the worst behavior in modern business dissipate.

Lawyers

The lawyers have escaped most criticism [and undeservedly so]. The tax shelters [were approved by lawyers, who got paid huge commissions to do so] and every miscreant had a high-falutin' lawyer at his side. Why don't more law firms vote with their feet and not take clients who have signs on them that say, "I'm a skunk and will be hard to handle?" I've noticed that firms that avoid trouble over long periods of time have an institutional process that tunes bad clients out. Boy, if I were running a law firm, I'd want a system like that because a lot of firms have a lot of bad clients.

Martha Stewart

What happened with Martha Stewart was that she heard some news, panicked and sold the stock. It turns out that if she's just told the truth [about what she did], she'd have been OK, but because she had a vague idea that what she'd done was wrong, she had a totally phony story when the investigators came and she lied to them and that's a felony. And she did these acts *after* she'd hired high-falutin' lawyers! And I'm sure they charged her a lot. [Laughter] I do not invent these stories.

Were I her lawyer, I would have said, "You know Martha, that's an interesting story and I'm your lawyer, so I'm required to believe you, but nobody else will. So, you're going to have to come up with a different story or you'll have to tell it through a different lawyer because I don't like losing cases." [Laughter] And it'll work. It's so simple. Literally, she's going to prison for her behavior *after* she'd hired a lawyer!

Tell the Truth

Look at Bill Clinton and the Paula Jones case. Because he lied, he lost his license to practice law, which is a significant disgrace for a sitting President of the United States. I would have advised him to just settle.

It's everywhere you turn. Remember Louis Vincenti's rule: "Tell truth and you won't have to remember your lies." It's such a simple concept.

Imagine what it was like in third or fourth year [after the [lying about reserves](#) had begun] at Shell. What seemed like a good idea in year one is getting really uncomfortable. You [the CEO] have been knighted by the Queen and you don't want to admit that reserves went down a bit. What's wrong with that? Why get your ego involved?

These things happen over again and the plots are very similar – they come back time after time.

Bad Behavior in the Money Management Industry

I feel obligated to ramble a bit when people have traveled so far. [Laughter]

I have one more anecdote: I have fun with this when I speak in front of students and professors. I say, “You all understand supply and demand curves. If you raise price, you sell less, but make more margin. So, give me four instances where the correct answer is to raise the price [meaning volume will go *up*].” I’ve done this about four times, and maybe one person in 50 can give me one answer that’s correct.

I can easily name four or five: Say you sold widgets to company X, and then raised your prices, but used some of the proceeds to bribe the purchasing agent for X. [For an example of this,] Look at the mutual fund industry. Many mutual funds pay a 5% commission [load on the fund] to buy their mutual fund instead of other securities or funds. So, in substance, they’re really bribing the purchasing agent [the purchasing agent is the financial advisor who receives the bribe/kickback from the mutual fund company to which he steered his clients’ assets]. [Munger added, however, that:] Many people [referring to the fund companies that pay the bribes] behave well once they’re over this.

But not always. Can you *imagine* the people who mutual fund taking a bribe to steal from their own clients?! This is not a minor sin. I think [Chris Davis](#) [of [Davis Funds](#)] is here. At his shop, when they came in and offered [to invest] \$40 million [in the Davis Funds in exchange for] allowing [abusive] trading, it went through two layers before someone said, “This is crazy!” [I think Munger is praising the Davis Funds – a great value-oriented firm that I’m sure Munger admires – for making the right decision, though I’m sure everyone agrees that the right decision should have been arrived at instantly.]

It’s as if someone approached you and said, “Let’s murder your mother and split the life insurance proceeds 50/50,” and you saying, “Well, I have other siblings [so losing my mom wouldn’t be so bad], and I’m not sure 50/50 is fair, but let’s do it.” [Laughter]

It was not only immoral, but stupid. Imagine you’re as rich and successful as Dick Strong was, and then stealing \$500,000 more?

I think that will get a lot better. We really ended up with something in the mutual fund business that we didn’t intend. [I missed some here; he talked about how the industry was originally set up by investment counseling operations.] If mutual fund directors are independent, then I’m the lead character in the [Bolshoi Ballet](#). [Laughter]

I don’t think management companies should be allowed to sell [their] mutual funds. I think [Capital Guardian](#) took the high moral ground [I’m not sure what he’s referring to]. But if you spent so much time building it, and everyone else is doing it...[of course they’re going to want to sell it].

QUESTION & ANSWER PERIOD

COMMENTS ON WESCO

Intrinsic Value of Berkshire and Wesco

Berkshire has more in intrinsic value per dollar of book value than Wesco, and the gap is widening. I've written that many times. It's easy to calculate the intrinsic value of Wesco, but hard to do so for Berkshire. You'll have to do this yourself.

What If Munger Dies?

As you can tell, we're planning on immortality here. [Laughter] What do you need – [isn't it enough that we're] sitting on a pile of money and Warren Buffett [is] sitting at the parent corporation?

Quant Tech

[At the 2001 Wesco annual meeting, Munger passed out a booklet entitled "Some Investment-Related Talks and Writings Made or Selected by Charles T. Munger," which contained a number of articles and writings by Buffett and Munger. One of the essays in the handout was entitled "[The Great Financial Scandal of 2003](#)." It's a story Munger wrote – that I think loosely resembles Cisco, IMB and the like – in which the managers of a formerly reputable tech company become greedy, start giving themselves vast numbers of stock options and cooking the books, and it eventually all comes crashing down. Asked to comment on this, Munger said:]

It wasn't hard for a person with any mathematical training to see the scale to which the misleading was possible. All I did in that story was escalate the scale using the accounting conventions. Of course, since I was writing the story, I could punish the miscreants. I sent the accountants to the lowest rung of hell – they were the custodians of a great profession (whereas we expected the investment bankers to behave terribly). Remember that traders occupy the lowest rungs of hell. The accountants who lived in the nice neighborhoods [who sold out] were sent to join the traders. It's fun sending people to where you think they belong. I had a lot of fun writing that story.

Cort

Cort has blipped a little tiny bit back from the pit. Obviously, our timing was terrible. I don't see how we could have had worse timing if we'd tried to have bad timing. But it will work out OK over time.

Wesco Movie

[A shareholder asked, tongue-in-cheek, when there would be a movie at the Wesco annual meeting.]

There will *never* be a Wesco Corporation annual meeting movie. [Laughter]

COMMENTS ON BERKSHIRE HATHAWAY & ITS SUBSIDIARIES

Munger's Impact on Buffett

I think those authors give me more credit than I deserve. It is true that Warren had a touch of brain block from working under Ben Graham and making a ton of money – it's hard to switch from something that's worked so well. But if Charlie Munger had never lived, the Buffett record would still be pretty much what it is.

What Happens When Buffett's Gone?

When Warren is gone, the acquisition side of Berkshire will not do as well, but the rest will do well. And the acquisition side will do just fine. In any case, we've guaranteed you that the historical rate of growth will go down, and we wouldn't want to make a liar out of me.

[Laughter]

[Later in the meeting, Munger returned this topic:]

I think the top guy won't be as smart as Warren. But it's silly to complain: "What kind of world is this that gives me Warren Buffett for 40 years and then some bastard comes along who's worse?" [Laughter]

Danger of Losing Berkshire's Corporate Culture?

[One shareholder asked about the danger of Buffett's descendants being outflanked by professional managers who destroyed the culture, as happened at Disney and Hewlett-Packard?]

I am not worried about the Munger family having a huge concentration in Berkshire stock long after I'm dead. I think Berkshire's culture will last, just as Wal-Mart's culture has lasted for 15 years after Sam Walton's death. There are some real similarities, including roughly similar percentage ownership levels by the families.

I can't be responsible for the conduct of my heirs – I have enough difficulty being responsible for my own conduct, so I don't want to be blamed for my children. And for my nieces and nephews [and more distant descendants], I *really* don't want to be blamed. [Laughter]

I think Berkshire has a *way* better chance of maintaining its culture than just about any company. I think we're way more like Wal-mart than Disney. I think we won't lose the culture – that it'll last a long, long time.

Comments on Gen Re

Regret Purchase of Gen Re?

Shortly after acquiring Gen Re, of course, we soon came into adverse developments, including the happenstance of the World Trade Center events. But we also found that the culture was weaker than we thought. But we're delighted now and it's fixed.

I don't know where we'd get a Gen Re now, like the Gen Re we have, if we wanted one, so I'm not gnashing my teeth. We bought at the peak of the market, sold everything [Gen Re's stock holding], took losses, and we now we have the capital asset. So it made us look silly for a while,

but in the long game for Berkshire, the bad part was a blip and the long-term looks quite favorable.

Comparative Merits of Gen Re vs. Other Reinsurers

I don't like to appraise the comparative merits of other reinsure companies because we do business with them all the time, but the problem I have is that in my heart of hearts, I like my business so much better than theirs.

Flight to Quality in Reinsurance?

There's obviously been some flight to quality in reinsure, but I'd call it more of a dribble to quality. [Laughter]

Impact of Judge's Ruling on How Much Insurers Have to Pay Larry Silverstein, the Developer of the World Trade Center Site

[Missed this – it was a quick answer; something about multiple verdicts expected and that based on the first verdict, Gen Re's share was \$109 million.]

Gen Re's Declining Volumes and Loss of Market Share

[Munger asked Gen Re's CEO, Joe Brandon, to answer this question. Brandon said:]

There's no doubt that Gen Re's share of North American premium volume has gone down in the last few years. That's because we've had a deliberate focus on profitability. We've made no macro calls on which lines [of insurance or reinsurance] we want to be in. We underwrite the transactions one at a time, only doing what makes sense. If they don't make sense, we just say "no thank you" and don't write the business. We have no premium volume or market share goals. I expect the premium volume will be down again, modestly, in 2004.

From 1986 to 1988, Gen Re's premiums declined by about 28%. From 2001-2004, it will likely be similar before it bottoms out -- it's impossible to predict for sure. We are not focused on share, but profitability.

Munger: "The tone of your question implied that it's terrible that we're losing share, but you'd be out of your mind to focus on share as opposed to profitability.

[After the meeting, Brandon talked with a group of shareholders about the efforts to change Gen Re's culture from one focused on premium growth to one not caring if premiums fell if the pricing wasn't right. The key, he said, is to convince people that their jobs are safe, even if they don't write as much business as they used to. He also tells them, "If we do nothing (i.e., don't write any business), we'll make almost \$1 billion pre-tax this year, so we don't want to mess it up by being undisciplined in how we price and underwrite business." Overall, he said that the culture isn't entirely fixed, but he's pleased with the progress. He also noted that overall pricing in the insurance market, after rising strongly in recent years, has stopped rising, and, in some lines, has begun to fall. (These notes are included with Brandon's permission.)]

Coke's Future

Well, the nature of all remarkable growth rates is that they peak in due course. Personally, I don't think Coke has reached a peak in its volume, though perhaps in its growth rate. 10 years from now, I think they'll be selling more volume. It's a mature product, but its decline phase is *way* out there.

Clayton Homes Acquisition and Controversy

Regarding Clayton Homes, we did get a reaction that it was worth more [than what we offered], but that wasn't so. The Claytons knew more than we did. There had been so much disgrace and bad behavior by so many people in the industry that lenders weren't willing to lend to anyone in the sector, so even Clayton Homes, which is the class of the industry, was having serious problems making their business model work.

I suppose it's flattering that people think that if we're so smart [to buy Clayton at the price we did, then] we must be stealing, but it's not true. We paid a fair price.

Commissions Paid and Market Impact When Buying or Selling

On commissions, we pay under five cents per share. As for market impact, we generally don't try to buy thinly traded stocks. Is there market impact? That depends on what we're buying, but it's been so long since we've bought anything that it's like asking Rip Van Winkle about the past 20 years. [Laughter] We try not to have much market impact. There's a little art in this process.

Silver

We don't comment on what we're doing or whether we're still in it. If we know enough to beat the market over time, we know enough not to tell everyone, who could act in ways that might hurt us.

Do You Have Thoughts on How to Calculate the Intrinsic Value of Commodities Like Silver

No.

Home for Entrepreneurs

[Munger was asked what advice he would give if someone wanted to create another home for entrepreneurs (and their businesses) like Berkshire. He said he didn't know.]

HOW TO BECOME A BETTER INVESTOR

Keys to Investment Success

It's a common question – like the fellow who wins all the bass tournaments, to ask how did you jiggle the lure? Partly its temperament – most people are too fretful, they worry too much. Success means being very patient, but aggressive when it's time. And the more hard lessons you can learn vicariously rather than through your own hard experience, the better.

I don't know anyone who [learned to be a great investor] with great rapidity. Warren has gotten to be one hell of a lot better investor over the period I've known him, so have I. So the game is to keep learning. You gotta like the learning process.

You seem to like learning a lot. But I'd inject one line of caution: there's an apocryphal story about Mozart. A 14-year-old came to him and said, "I want to learn to be a great composer." And Mozart said, "You're too young." The young man replied, "But I'm 14 years old and you were only eight or nine when you started composing." To which Mozart replied, "Yes, but I wasn't running around asking other people how to do it." [Laughter]

Proper Thinking

Einstein was reported to have said, "Everything should be made as simple as possible, but no more simple." If he didn't say it, he should have.

And another thing: Thinking success comes from four things [I missed one]: curiosity, perseverance, and self-criticism. Any year that passes in which you don't destroy one of your best loved ideas is a wasted year.

[I missed this. He quoted Philip Wiley (?) saying something about there's nothing you can squeeze between what you know and what you want to know...(?)] You want a guy who can destroy his well-loved ideas.

Investing Overconfidence

Most people who try it don't do well at it. But the trouble is that if even 90% are no good, everyone looks around and says, "I'm the 10%."

BUSINESS AND INVESTING TOPICS

Are Any Asset Classes Undervalued?

Our cash is speaking for itself. If we had a lot of wonderful ideas, we wouldn't have so much cash.

Concerns About Consumer Debt

Gigantic macroeconomic predictions are something I've never made any money on, and neither has Warren. Of course I'm troubled by huge consumer debt levels – we've pushed consumer credit very hard in the US. Eventually, if it keeps growing, it will stop growing. As [Herb Stein](#) said, "If something cannot go on forever, it will stop." When it stops, it may be unpleasant. Other than Herb Stein's quote, I have no comment. But the things that trouble you are troubling me.

Channel Stuffing

The channel stuffing in the soda [pop] industry, where it has occurred, has not been [having excess inventories] at end of the aisles in supermarkets, because the supermarkets would not allow this. Where it's occurred has been in excesses concentrate sent to the distributors. With Gillette, it was excess razor blades sent to distributors.

A lot of channel stuffing in America was done to make quarterly numbers. I think it's gone way down compared to its earlier times, and I think this is to the good – it was a very pernicious practice. It happened because CEO's said, "I'm a steward of shareholders and by moving things out a quarter [e.g., stuffing the channel], I can report better earnings, so I'm obligated to do it. I think that's changed a lot. It's less common now, though I think there was a recent case in ethical drugs [I think he's referring to [Biovail](#)]. It's a pernicious practice.

Asbestos

I don't think only allowing the truly sick to sue is politically viable, which is why we don't have a settlement. There's so much money in the system that you don't get a sensible solution. 70-80% of the money doesn't go to the people who have been injured. It's a crazy system. The guy who has mesothelioma gets a little bit [of money], and the guy who has nothing wrong with him gets way more than he deserves, along with his dishonorable doctor and lawyer.

And the subornation of perjury is a disgrace. The people who are left [the companies who have not yet gone bankrupt] had no moral fault at all – their products caused no damage, but they're the few people left solvent, so if you want to make money, you find guy with a spot on his lung, get him to testify that he spends his life worrying cancer, that it's ruining his life, and that of the 50 brand names, he only remembers the three brand names of the companies that happen to be solvent today. It creates behavior that's beneath contempt. Most of these claimants were smokers, so the net incremental damage [caused by asbestos] was between zero and trivial. It's a total disgrace, but there's so much money that there's no way to stop it. The politicians say that if we took enough money from Gen Re and its ilk, we'd solve the problem. But if you take money from Paul to pay Peter, but you just create more Peters – it's like dousing a fire by pouring gas in it. I predict it goes on and on and on.

Impact of Baby Boomers

Regarding the demographic trend called Baby Boomers, it's peanuts compared to the trend of economic growth. Over the last century, [our] GNP is up seven times. This was not caused by Baby Boomers, but by the general success of capitalism and the march of technology. Those trends were so favorable that little blips in the birth rate were not that significant.

We can keep social peace as long as GNP rises 3% annually – this can pay for spending by politicians. If we ever got to stasis [no growth], then with all the promises, you'd get real tensions between the generations. The Baby Boomers would exacerbate it, but the real cause would be lack of growth.

[When asked whether he thought growth would slow or cease, Munger said:] I don't think my prediction is any better than yours. There certainly been some remarkable technology. When I was young, there was no medicine for most diseases, no joint replacement surgery, etc.

The key is energy: in 100 years, if we get 3% growth worldwide – it's be higher in India and China – then I think we'll have to rethink how we use energy.

Independent Directors and Compensation

Generally speaking, if you're counting on outside directors to act [forcefully to protect your interests as a shareholder, then you're crazy]. As a general rule in America, boards act only if there's been a severe disgrace.

My friend Joe was asked to be on the board of Northwestern Bell and he jokes that "it was the last thing they ever asked me." [Laughter]

I think you get better directors when you get directors who don't need the money. When it's half your income and all your retirement, you're not likely to be very independent. But when you have money and an existing reputation that you don't want to lose, then you'll act more independently.

I'd argue that's the board we have at Berkshire and to a lesser extent at Wesco. Warren said to me once, "I think we may have the best board in the country" – and he wouldn't say it if he didn't believe it. They're awfully high grade people, and they're serving with little pay and no directors and officers insurance.

The best idea is to not pay [people to be directors at all]. I think tons of eminent people would serve on boards of companies like Exxon without being paid. The lower courts in England are run by unpaid magistrates. And Harvard is run by boards of people who don't get paid – in fact, they have to pay [in the form of donations to the school].

I think boards would be better if they were run like Berkshire Hathaway's.

It's incredible the reciprocity that happens when CEOs keep recommending that directors get paid more, and then the directors raise the CEO's pay – it's a big game of pitty pat. And then

they hire compensation consultants to make sure no-one else is getting paid more. This is true even if the CEO is a klutz and a little dishonorable.

I think the existing system is very bad and my system would work better, but it's not going to happen.

Franklin said government would run better if no-one was paid. The Mormon church doesn't pay its clergy, but other than that...

Can Two Brands Co-Exist in a Market?

Obviously there are industries where two brands can co-exist like Ford and Chevrolet, but there are others like newspapers in one city where one brand tends to destroy the other. That's just the way it is. It's hard to predict what will happen with two brands in a market. Sometimes they will behave in a gentlemanly way, and sometimes they'll pound each other. I know of no way to predict whether they'll compete moderately or to the death. If you could figure it out, you could make a lot of money.

Under-Reserving in the Insurance Industry

It's a field where you get a fair amount of discretion on what you get to report. I would bet a lot of money that both Gen Re and Berkshire are *way* more conservative than average and will stay that way, even if they have terrible quarters to report. Generally speaking, I don't think you've seen the last scandal in insurance.

Derivatives

[I missed some of this, but he talked about how much money was involved, how much leeway people have in valuation positions, and the problems this raises.]

The real scandal will come in derivatives. Gen Re is running off its derivative book and we're seeing a lot of losses – far more than were stated.

I think a good litmus test of the mental and moral quality at any large institution [with significant derivatives exposure] would be to ask them, "Do you really understand your derivatives book?" Anyone who says yes is either crazy or lying.

Investment Advisors

The investment advisors who come to the Berkshire meeting are not a cross-section – we get the cream of the crop. Many have gotten rich [by following our teachings]. [I think I missed something in here.] Franklin said it's hard for an empty sack to stand upright.

Comments on Hedge Funds

Mine [the [Munger Partnership](#)] wasn't a hedge fund in legal terms. I had the power to go short, but I rarely did. In the last years, I didn't short anything.

Today, there are 8,000 hedge funds and the number is growing rapidly. There are hundreds of billions of dollars in them. Every university has to have hedge fund investments, and there are funds of hedge funds and layers upon layers of fees. There are hedge funds giving layers of

incentive fees to operating businesses beneath them. [I think he's referring to fund of funds charging fees on top of the already-high fees charged by the underlying hedge funds.]

I think you can confidently predict that per dollar year, all the hedge funds, for the hedge fund owners [meaning investors], after all fees and losses, they will not be moneymakers. In fact, the results will be somewhere between mediocre and lousy.

That being said, Berkshire has a hedge fund that's like a private fixed arb account. Some will do well. The trouble is, as someone once said about banks: "We have more banks than bankers." The problem is that there are more hedge funds than competent people to run them. Some hedge funds will do well no doubt.

I think it's very pernicious for the civilization that so much brainpower is going into hedge funds. Wesco is trying to build some property in Pasadena, and part of the reason we're doing it is that I don't want to be known a person who just bought and sold paper [securities/investments]. I would regards this as a failure. I want to be doing something to make civilization better.

Think about it. Would you really like it if all five of your children went into hedge funds, even if they were successful? Would you say to yourself, "Boy, I really hit it out of the park with these kids?" Wouldn't it be better if one was a surgeon, a lawyer, someone who rose through the ranks at Costco, and so forth?

It's amazing the brainpower being drawn into the hedge fund industry. When I was young, guys in the investment business were mediocre at best – they had eastern [East Coast] tailoring and didn't know very much. Now, it's a cascade of brainpower. Collectively, they add nothing to the GNP. Indeed, they're adding costs, collectively. If you take the money invested in common stocks, and then subtract the 2% per year that goes out in investment management costs and frictional trading costs, that's more than companies pay in dividends. It's more than the twin deficits. This would fit very well into Alice in Wonderland: pay dividends of X and pay the same amount to investment managers and advisors.

COMMENTS ON GOVERNMENT, REGULATORY & POLITICAL MATTERS

More on Sarbanes-Oxley

The pain [of so many scandals and trials] is helping to cleanse the system. But there's all this prejudice and ignorance in major power centers.

By no means everything that is done will improve matters. I don't think Sarbanes-Oxley is going to work very well. A CEO can't possibly attest to the veracity of the financial statements, as required by law, except by relying on other people. Now, if he was personally engaged in cooking the books, it's easier for the government to get him. If you took an extra \$1 million in your expense account and then certified incorrect financial statements, it's easier to get him.

Dennis Kozlowski got so accustomed to taking so much, that one of the jurors said "He couldn't possibly have had criminal intent because there's no sense of shame." [Laughter]

Sarbanes-Oxley makes it easier to prosecute something like Martha Stewart.

Sarbanes-Oxley has raised our costs. I don't think it's done anything favorable for the quality [of our financial results], because there was quality to begin with.

Will it outsmart the crooks? I little bit. The incentives to fudge must be extreme if the head of Royal Dutch will fall into it. Passing Sarbanes-Oxley will not change it all that much. It will change it a little bit. Sarbanes-Oxley is not making it worse – it was terrible to begin with.

Congress Recent Relaxing Rules Requiring Companies to Set Aside Enough Money to Meet Pension Obligations

You had some very important institutions like airlines that couldn't pay their pension obligations, so Congress just papered it over by saying they didn't have to pay. Whether that's a good idea, I'll leave that up to you. It can't be a good sign for the civilization.

Recent Spitzer Inquiry Into Insurance Brokers

[I missed some of this.] A lot of the customers are big, sophisticated institutions who know the industry, so it's not like a little old lady trusting her broker.

Which Country Should America Emulate?

I still prefer this country, and so does Warren. But we're both troubled deeply by the twin deficits [trade and budget]. [Bad] Things can go on for a long time, starting from our [wealthy] base and especially if other countries have things wrong with them, so it's a very complex subject.

Iraq

Regarding Iraq, there are a lot of very intelligent people in this country that believe it was invading the country was totally stupid and that everything bad that's happened since then was totally predictable, and some believe that we should get the hell out.

All regret the loss of life and everyone concedes we overestimated the weapons of mass destruction risk, but a lot of people believe it was nevertheless worth it remove this terrible man that was so rich with so much hatred.

I don't think it was an easy decision – that's why so many intelligent people have such different views. It's not clear how it's going to work out and I don't have any special competence to predict this. But I think it's very wrong to assume that people on the other side are stupid and evil. If you're absolutely sure you're right, then you're probably committing a significant intellectual sin.

Schwarzenegger's Impact

Of course budgets in the real world are political compromises, and I don't think we've repealed that in California. But I think it's changed because Arnold Schwarzenegger became governor. Reforming Workman's comp is a huge step in the right direction, and it wouldn't have happened without the recall. So, overall I think Arnold Schwarzenegger has been good for California.

How to Fix the U.S. Healthcare System

I'm all for capitalism and the kind of cap that New Zealand went to, but I think that if you have a single payer system and an opt-out for people who want to pay more [for better service, etc.], I think it would be better – and I think we'll eventually get there. It wouldn't be better at the top – [our current system] is the best in the world at the top. But the waste in the present system is awesome and we do get some very perverse incentives.

Proper Tax Policy

My attitude toward taxes is that if I were running the world, we'd have a very substantial consumption tax, and the tax on earned income would be 40% at the top and taxes on long-term capital gains would be 20%.

And by the accident of history, we're not that far away from where we ought to be. I love consumption taxes – they're so effective. That that's why conservatives hate them – they work and the government gets a lot of money to spend.

In New Zealand, there's a national 10% consumption tax. Is it so bad to have to pay 10% extra if you go out for a nice meal or charter a plane? I don't worry about the miser who accumulates money and dies with it. What harm is he doing?

A 50% corporate tax rate would be too high. [I missed this. I think he said something about being fine on capital gains (?) and that 35% plus state taxes is just too high (for whom?)]. I'm not in favor of doing away with the 50% estate tax on people like me, but there should be a big exemption. Someone who builds a small business shouldn't be whacked, but there's nothing wrong with saying give 50% to society when you die if you've done really well.

My views would make me anathema in both parties.

Inflation Under Democracies

I think democracies are prone to inflation because politicians will naturally spend [excessively] – they have the power to print money and will use money to get votes. If you look at inflation under the Roman Empire, with absolute rulers, they had much greater inflation, so we don't set the record.

It happens over the long-term under *any* form of government. There was no inflation in the US from 1860-1914, and this period was accompanied by strong growth. I don't think we'll get deflation. The bias is way more pro-inflation than it was between 1860-1914. But I don't think other forms of government will necessarily do better. Some of the worst excesses occur under the tyrannies.

ADVICE ON LIFE AND OTHER

Things That Keep Munger Up at Night

Personally, I think the most important issue is still the threat that something really god-awful happens in terms of an atomic bomb or pathogens. It's so unpleasant to think about that people put it off, but if you think about what's likely to really spoil the party, that's far worse than a little inflation or one president vs. another.

What makes the Iraq thing so hard is that it's hard to know whether we're reduced or increased this risk [of a WMD attack]. But I don't think we want to have a lot of really rich countries in the hands of nuts full of hatred. I think the policy of sitting back and doing nothing is the wrong policy, because the nut will eventually do something awful.

The threat of bioterrorism and an atomic attack is still our worst problem. But people prefer to talk about Workman's comp and corporate malfeasance...

How to Teach Ethics

I think the best single way to teach ethics is by example: take in people who demonstrate in all their daily conduct a good ethical framework. But if your ethics slip and people are rewarded [nevertheless, then] it cascades downward. Ethics are terribly important, but best taught indirectly by example. If you just learn a few rules [by having ethics taught in school] so they can pass the test, it doesn't do much. But if you see people you respect behaving in a certain way, especially under stress, [that has a real impact].

Incentive Cause Bias

Incentive cause bias is widespread because it's routinely used in all compensation systems. If you're rewarding a man for believing his mutual fund is the best in the world and he needs the money to feed his family, he will believe this [however wrong]. Routine stuff creates incentive cause bias. It's good if you're a reputable institution. Take Mass General [the famed Boston hospital]: people who work there believe it's great institution – and this is good.

But there can be terrible effects for both good and ill. Think about those fraudulent accountants. I talked to one accountant, a very nice fellow who I would have been glad to have his family marry into mine. He said, "What these other accounting firms have done is very unethical. The [tax avoidance scheme] works best if it's not found out [by the IRS], so we only give it to our best clients, not the rest, so it's unlikely to be discovered. So my firm is better than the others." [Laughter] I'm not kidding. And he was a perfectly nice man. People just follow the crowd... Their mind just drifts off in a ghastly way...

I recall one story when Arco was celebrating making a lot of money on its oil fields. Their house counsel was an Irish guy who could get away with saying things, so he said: "I want to toast the guy who really deserves the credit for our success: Here's to King Faisal! All the predictions we made were wrong, costs were way over budget, etc. But along came King Faisal, who formed a cartel [OPEC], caused the price of oil to soar, and made us a fortune."

That is the kind of toast you seldom hear in corporate life, because it'll get you fired. But I love the kind of man who'll make a toast like that – a credit to the human race and an ornament to the civilization. Anyone who can join that [group], do so.

Deterioration in Union and Political Structure

I think we have enormous deterioration in union structure and political structure. [I missed this rant, but I think he referred to the union that represents prison guards in California, which has attained extraordinary political power and protects guards, allowing them to be abusive, which is especially worrisome since “I think the people who are attracted to be prison guards are not nature’s noblemen to begin with.” (Laughter)]

It’s similar to the guards [who abused the prisoners] in Iraq. Remember the people at Stanford in the famous experiment? [He’s referring to Zimbardo’s famous [Stanford Prison Experiment](#)] They started abusing the prisoners almost immediately – and they weren’t even really guards!

Book Recommendations

You can’t predict when earthquakes will occur, but you can predict the distribution of their size, which follows what’s called a power law. It’s sort of like gravity – a very useful idea. A lot of think type of thinking is in [Deep Simplicity](#) [by John Gribbon. It’s not published yet in North America, but here is a [link](#) to the book on Amazon.com’s UK web site; they’ll ship to the U.S.] Not everyone will like [Deep Simplicity](#). It’s pretty hard to understand everything, but if you can’t understand it, you can always give it to a more intelligent friend. [Laughter]

I want to thank Peter Bevelin [author of [Seeking Wisdom: From Darwin to Munger](#), which is only available at Hudson Booksellers in Omaha at (402) 345-8676 or jamhross@aol.com], who keeps sending me books. They’re so good that I send them to all of my friends, which gets expensive, so I can’t afford too many friends like Peter Bevelin.

I loved Caro’s book – I thought it was very well done. [I assume he’s referring to the first book, [The Path to Power \(The Years of Lyndon Johnson, Volume 1\)](#). Caro wrote second and third books: [Means of Ascent \(The Years of Lyndon Johnson, Volume 2\)](#) and [Master of the Senate : The Years of LBJ, Vol. III.](#)] I think reading his biography on LBJ is very important for anyone who wants a view into the human condition. LBJ never told the truth when a lie would be better. This is the way he went through life. He had a high intellect and extraordinary energy and did a lot of good along with the bad. I’m not sure he didn’t do more good than bad. But I think it’s an appalling life to lie as much as LBJ. What I said at Berkshire meeting about the robber barons applies here: “When he’s talking, he’s lying, and when he’s quiet, he’s stealing.” [Laughter]

The Isaacson book on Franklin was terrific [[Benjamin Franklin: An American Life](#)]. He had a terrific subject – it’s hard to write a bad book on such an interesting subject.

[At the Berkshire meeting, Munger also said: If you want to read one book, read the autobiography of Les Schwab [[Les Schwab Pride in Performance: Keep It Going](#)]. He ran tire shops in the Midwest and made a fortune by being shrewd in a tough business by having good systems...He made hundreds of millions selling tires.]