

Notes from 2005 Wesco Financial Annual Meeting

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By Whitney Tilson

Note: This is not a transcript. No recording devices were allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory. I have reorganized comments by subject matter. Words in [brackets] are my comments or edits.

For my columns and notes on previous Berkshire and Wesco meetings, click [here](#).

CHARLIE MUNGER'S OPENING REMARKS

I feel a duty in these later years to talk a little bit because so many of you have come so far and therefore I'm going to talk a little about current change conditions in corporate governance, the investment world, how we're adapting at Berkshire Hathaway and Wesco, and how you might face these challenges.

Corporate Governance

First, corporate governance. We're having a mild revolution in corporate governance. Congress passed rules requiring that a majority of directors be independent, which has affected all kinds of companies, including Berkshire Hathaway and Wesco. At Costco, we added Bill Gates Sr. [actually, Bill Gates's father is Jr. and Bill Gates, the head of Microsoft, is Bill Gates III (hence the nickname "Trey"), but everyone calls them Sr. and Jr.] and Daniel Evans – I like to see young people joining the board. [Laughter. Gates and Evans are both 79 years old.]

I think it's a plus at Berkshire Hathaway. We have a very able, brilliant group of shareholders. We pay a pittance but everyone we asked [to join our board] agreed to come aboard: Bill Gates, Sandy Gottesman, Tom Murphy, Don Keough, Charlotte Guyman – there's a couple of billion dollars of Berkshire Hathaway stock in the Gottesman family.

Sarbanes-Oxley

Then they passed Sarbanes-Oxley, which creates all kinds of oaths and compliance procedures. One thing it caused was an enormous increase in costs. The auditors must certify the internal controls. At Berkshire Hathaway, including Wesco, this used to cost \$200,000 but now it's in the multiple millions. It's not all wasted though – only about 80% is wasted. (Laughter)

There are some results to the good. But the cost of being a publicly traded stock has gone way, way up. It doesn't make sense for a little company to be public anymore. A lot of little companies are going private to be rid of these burdensome requirements.

The problem is that you can require people to solemnly swear that their financials are accurate, but the only way to do it is to trust a lot of other people. That's what they did before and that's what they do now. I think someone in Congress thought that the President of Exxon would run around and count the barrels of oil. Well, it's not going to happen. There needs to be deserved trust.

I think the current requirements are good. It makes it easier to prosecute crooks. But for the organization and for ordinary people, I don't think Sarbanes-Oxley will create a lot of control.

Impact of Scandals and Press Coverage

But another change is having a dramatic effect on corporate governance and behavior – that's the widespread scandal and press coverage which has caused shame, disgrace, personal legal costs, and ruined many lives. *That* has changed behavior – even more so than in the past, during the price-fixing scandal when they carted executives off to jail. That had an effect [but the current scandals are having more of an effect].

This wave of scandal and widespread press coverage has had an unbelievably strong impact on corporation behavior – it's overdue.

Think of the publicity of Enron, WorldCom and Tyco. And the mutual fund industry – many firms had some whiff of scandal. Personally, I think what happened to the Strong funds was an outrage. The independent directors found him stealing, but instead of firing him and finding another manager for the funds, they instead allowed him to sell the firm. This shows how permissive and evil a culture can become.

Kudos to Spitzer

Prosecutors have used the press instead of relying on quiet lawyerly procedures. Personally, I'm in favor of this approach. While some have claimed that this is abusive, 99% of the time it's not.

As far I'm concerned Eliot Spitzer has behaved very well and has done a lot of good. He's caused a lot of reforms the SEC wouldn't have caused.

Some claim that those targeted by Spitzer are not getting due process, but only lawyers like endless due process – they get paid by the hour. It reminds me of the story about the lawyer who goes to hell and all he gets is endless due process and no decision.

There's been a tremendous change in behavior. In the insurance business, I'd say it's changed virtually overnight. All kinds of gamey insurance products which fall under financial reinsurance – a meaningless term, by the way – you couldn't get written today.

Obsession With Quarterly Earnings

In many corporations, there's an obsession with meeting quarterly earnings targets. To do so, they'd fudge a little, sell stock at a capital gain, sell a building or two... Then, if that wasn't enough, they'd engage in channel stuffing – if you were selling through a middleman, you could unload your product at the end of the quarter and make the current quarter look better, but of course the next quarter would be worse. It went on a lot and the penalties were pretty light. For many major pharmaceutical, consumer products and software companies, at the end of quarter, this was very common. That's pretty well over. A few public hangings will really change behavior.

One of our Presidents said if he could execute three people each year for no cause, it would make it a lot easier to govern. When someone said that's not enough, he said, "Oh yes it is, because I'd publish the list of people under consideration." (Laughter)

So this is all to the good and the cost of doing it has been really low. The public hanging aspect has really worked. People now go to seminars to learn how to avoid this.

Sentencing shows that if you try to avoid this [companies trying to avoid reporting false or misleading earnings], you'll get lower penalties, so corporations are putting in policies to prevent this.

Temptation of Commissions

This has worked in the insurance and reinsurance industries. It has worked less well where you have direct commissions because you have a sales force relying on commissions. You'll always have brokers, annuity salesman and the like who go astray. You'll never be able to stamp it out in these areas. It's human nature – people will rationalize all sorts of things to get paid.

If you want good behavior, don't pay on a commission basis. Our judges aren't paid so much a case. We keep them pretty well isolated with a fixed salary. Judges in this whole thing have come out pretty well – there have been relatively few scandals.

So not everything has gone to hell in a bucket in our civilization. (Laughter)

Accounting Firms and Investment Banks

Accounting firms and investment banks had reached a near bottom. The combination helped messes like Enron to happen.

In the accounting business, you've had a change – it's been separated from the consulting business.

There's another temptation: building buildings. You can save a lot of money by pouring less concrete, which is why buildings in Latin America often fall down. People will yield to temptation if they're not carefully checked, so we have regulations and the building commissioners actually have to be present when the concrete is poured. By and large, [the result is that] the building record is pretty good in the U.S.

Building inspectors and permitters are like judges – they are paid a salary.

In accounting, we're not going to treat them like building permit issuers – limit them to just checking things. We let them do consulting for tax shelters, etc. I was for it all the way along because for the most part they could do these things and the behavior was pretty good. But four or five years ago, this changed and pretty much every major accounting firm was selling fraudulent tax shelters and were participating – at least one partner was – in accounting fraud. They have thrown out those partners, in some cases reluctantly, but in any case they're gone and the accounting is way better.

Whether we should have gone all the way and only let accounting firms do audits is an interesting question. I like accounting firms – we've had good service. But given all the temptations, I don't know if it wouldn't be best to make them do only audits.

If we have another wave of scandals, CPAs will be asked to choose between certifying the accounts of publicly traded corporations vs. other activities. They hate it – checking the accounts is very boring; other work is more interesting, so they won't be able to attract good people [to the profession].

The investment banks were just unbelievable. If you want to be really horrified, those of you who haven't already read FIASCO [The Inside Story of a Wall Street Trader, by Frank Partnoy], the account of the derivatives trading desk at Morgan Stanley, it will turn your stomach.

I recommend the new book by Kurt Eichenwald, Conspiracy of Fools [about the Enron scandal]. He takes some liberties, like what the guy was thinking as he got on the elevator, but I don't think the gist is wrong. The title is right: Conspiracy of Fools. A lot of this was delusion.

But the thing that is sickening is the investment bankers – but lawyers and accountants behave badly too.

It's good to rub your nose in it. If you can't stand it all at once, then do it in bursts. If you throw up in between episodes, that's OK too. (Laughter)

Some of these faults ought to be judged as they are in the church – as mortal vs. venial. The sin of smoothing of earnings was so widely done by so many people that we have to

accept it as a venial sin. But now we're changing the category, and we should. I think we should think long and hard before we smooth the achievement record.

I think a lot of smart people have decided "I'm not going within 10 miles of this whirlpool that can suck you down, break you up and spit you out." Some people who only had small sins are going to get clobbered. But overall the prosecutorial discretion has not been abused.

However, once people are disgraced, pay a fine, etc., what's the point of beating up a guy who's half dead? Once he's disgraced, do you need to stomp on him?

I don't want to suggest that all of the puffery and folly is over, however.

Now they wear tailored suits, but there's a good bit of the old Mark Twain culture in those suits.

Part of it is from people who shrink from doing unpleasant things. Who hasn't? It's terribly unpleasant to fire someone. Or how do you tell someone not to go into a field [of business] with lots of money to be made because it smells? Or if their incomes are going down, there's huge pressure to invent some products to keep their income up.

That's why Warren doesn't lay people off when our home-grown insurance company volume goes down.

There's been ghastly behavior in the sale of annuities. The idea of shifting an old lady from one annuity to another to make a commission – you laugh, but it happens. The trouble is always with us.

At the cost of being sickened by all the scandal, I think the behavior is getting better.

Hedge Funds

I don't know what will happen with hedge funds. They now have \$1 trillion and all of them are on margin. History would indicate a certain percentage will lie about their results if they have any discretion whatsoever, and will try to cover up market errors if they can. I can confidently predict scandals. It will always be thus.

Corporate Compensation

The corporate governance thing, as it affects compensation, I do not think is getting improved. They [CEOs] will accomplish the same old thing, helped by clever lawyers. People will just get more sophisticated in the way they do it.

Perhaps a semi-public place like the NYSE will behave better, but the ordinary corporation will continue to escalate compensation. The key officers appoint the directors and then the directors decide how much the officers make. And then the

officers increase the compensation of the directors, etc. You look around the table and nobody else is objecting. There are psychological pressures tending to gross abuse. That's not to say that all CEOs are overpaid. In my opinion, Jack Welch was *underpaid* for what he did at GE.

But if you rise high in a corporation or elsewhere in life, you have a duty to be an exemplar – you have a duty to take less than you deserve, to set an example. This goes all the way back to Athens. The Athenians were like today's United Jewish Appeal. Public duty was not optional. Civilized man had a duty to act as an exemplar – and this was not a minor duty; it was a major duty of life. This is not mentioned by compensation consultants. (Laughter)

Conduct Unbecoming an Officer

This should change. When I was an officer in the military, we had a rule called Conduct Unbecoming an Officer. It was not specific, but it said there were certain ways to behave as an example for others. I don't see why we shouldn't have this for our corporate executives. I would argue the CEO of Boeing was removed for Conduct Unbecoming an Officer. Messing up the email system of a corporation with hot and dirty email is Conduct Unbecoming an Officer. I would *love* to see the SEC make it explicit: "We hereby exercise our authority and say that there will be a new standard for officers of public companies called Conduct Unbecoming an Officer." The lawyers would scream though – it's not specific enough.

But if we ask our military officers, who risk their lives and risk being maimed [to adhere to this standard], then why can't we ask this of some guy making \$2 million per year? (Applause)

Well that's corporate governance. It's certainly been interesting to watch as these messy stories unfurl.

More on Bad Accounting

Oh, I'd say this: if you read the Eichenwald book on Enron, if there's one issue to highlight, it's that Arthur Andersen and the SEC allowed them to use Wall Street accounting to account for long-term contracts. It's one of the worst things. A well-trained orangutan could see what it would lead to, but the SEC and the accountants lay down. This was 90% of the problem.

When accountants lie down, they are failing civilization in a truly important way. There's no reason that people so secure – there are only four firms and they're all the same, so it doesn't do any good to fire them – can't do better than they do. They're secure and it's terrible publicity, so there's no reason the accounting can't be better.

Investment returns

There's \$1 trillion in hedge funds and private equity is 3-4 times larger. Private universities have fixed-income departments, private equity for mid-stage investments, masses of complicated math to track risk in each class and how to judge each class, etc.

So far, it's worked beautifully for Harvard and Yale – they got into some good things. But I feel about Harvard and Yale the way I feel about my own career: I feel that by getting rich in the way I did, I think my own example has hurt my own country. I think that Harvard and Yale have caused every charitable foundation to act in the same way. I think it has pernicious effects on civilization.

Too Much Brainpower Going Into Money Management

It's my guess that something like 5% of GDP goes to money management and its attendant friction. I define it broadly – annuities, incentive pay, all trading, etc. Nobody else has used figures that high, but that's my guess. Worst of all, the people doing this are among the best and the brightest. Hundreds and thousands of engineers, etc. are going into hedge funds and investment banking. That is *not* an intelligent allocation of the brainpower of the civilization.

While we're doing this, in Korea at Samsung, they have a meeting every day at 11 pm to review the day. Well, who is going to win if our brainpower is going into hedge funds and theirs is having a meeting at 11 pm? But nobody is talking about this. These people are honored. If people talk at the country club, one person might say, "Boy, my daughter is getting married to a hedge fund manager." They're making heroes.

My daughter is an art dealer and she says that most of her business is selling to hedge fund managers. If you make \$100 million, why not have a fancy apartment and two Chagalls? You can't get this [kind of money] elsewhere, so it goes on.

Too Much Credit

The action, the trading, the amount of credit... And to get good returns, the hedge funds need more use of credit.

Of course, the firms that are extending the credit are the investment banks. If there's any great wave of running for the exits, those people will get out fast. Unless the Federal Reserve decides to protect hedge funds, you could have a real mess.

Tough Environment

So that's where we're at. Meanwhile, it's like an Easter egg hunt with too many hunters and not enough eggs. So you value investors, look around the room. There are a lot of hunters. So if you're having trouble, please join the club.

I regard that as a very interesting development. I don't think I've ever seen in my whole life – it's hit all asset classes together. Real estate is priced very high by past standards. Stocks are priced very high by past standards. Fixed income is priced very high by past standards. All of these asset classes have been hit. And all of these people accounting for a vast part of GDP want to get rich, and they will likely push.

This could end up in two ways: keep going up or there could be a classic bust, as occurred in Japan.

The competition to buy companies is heating up. The private equity firms will rationalize almost any price. My friend buys warehouses and for months he's been unable to buy anything. He says, "All I do is raise the price paid to the owner of the warehouse." So my friend stopped trying to buy warehouses.

The Rise of the Orient

Take the vast improvement of conditions in the Orient – that is really something. At Berkshire Hathaway we do *not* like to compete against Chinese manufacturers. They learn fast and are good at getting things to you. They're coming up fast.

The amount of talent in the Asian populations is amazing. They were held down by ridiculous systems -- first ruled by autocrats and then by communists – but now under capitalism, the potential is awesome.

My test is I look at symphony orchestras. For the hardest instruments, that require the most dedicated training, 80% of the faces are Asian. This was not true years ago. They are a very talented, driven ethnic group. A good thing about the U.S. is that they come here. Look around this room – look how many Asians are here. 20 years ago at the Wesco meeting, this was not true.

Go to the UC Berkeley engineering department – you'd think you were in Asia.

My grandchildren may be displaced [by Asians]. If so, that's too damn bad for the Mungers. I'm all for meritocracy.

The economic implications are huge when you have a population base so large, so intrinsically talented, with family values so good. I don't know an Asian family that doesn't kill itself for education. In Korea, one of the biggest businesses is tutors. Kids go to school all day and then the tutor comes – and the kid is three! (Laughter)

We're getting a taste of meritocracy. It does not mean you can just go invest in China, however. The first movers can get killed. There's a saying in Indonesia: "What you're calling corrupt is Asian family values." (Laughter)

Future Outlook

There may be implications for the rest of you. Something weirdly bad can happen, so prepare for it. Or we could be in for a period with no calamity, but lousy returns. There have been long periods when this was the case – most recently, the 15 years ending in 1981. But now everyone is conditioned to expect high returns. Read the committee reports from Harvard and Yale – they see no reason not to do better than average. After all, they have done so historically.

I think size will hurt returns. Look at Berkshire Hathaway – the last five things Warren has done have generated returns that are splendid by historical standards, but now give him \$100 billion in assets and measure outcomes across all of it, it doesn't look so good.

We can only buy big positions, and the only time we can get big positions is during a horrible period of decline or stasis. That really doesn't happen very often. You people are lucky to not have a lot of money. We have a lot of money and we'll endure.
(Laughter)

Well, that's the investment climate.

CHARLIE MUNGER RESPONSES DURING Q&A SESSION

Berkshire Operates With a Seamless Web of Deserved Trust

Everybody likes being appreciated and treated fairly, and dominant personalities who are capable of running a business like being trusted. A kid trusted with the key to the computer room said, "It's wonderful to be trusted."

That's how we operate Berkshire – a seamless web of deserved trust. We get rid of the craziness, of people checking to make sure it's done right. When you get a seamless web of deserved trust, you get enormous efficiencies. It's what the Japanese did to beat our brains out in manufacturing: suppliers, employers, the purchasing company, management – all created a seamless web of deserved trust. That's why we have firms – they create a seamless web of deserved trust. It's the same with good football teams.

Berkshire Hathaway is always trying to create a seamless web of deserved trust. Every once in a while, it doesn't work, not because someone's evil but because somebody drifts to inappropriate behavior and then rationalizes it. Our basic attitude is to create a seamless web of deserved trust.

How can Berkshire Hathaway work with only 15 people at headquarters? *Nobody* can operate this way. But we do.

Take Wesco. Every once in a while we get surprised by something – maybe once a decade. It's what we all want. Who in the hell would not want to be in a family without

a seamless web of deserved trust? We try for the same thing in business. It's not rocket science; it's elementary. Why more people don't do it, I don't know. Perhaps *because* it's so elementary. We didn't copy the Japanese until they were clobbering us – and they copied from us!

Lowered Investment Standards at Berkshire Hathaway

At Berkshire Hathaway, we've lowered our standards a little – we're willing to invest with lower standards than in the past. We're not waiting for 1974 or even 1984. If you have the money, you have to invest it somewhere. It may well be that you have to take something that obviously promises a lower return than you were used to.

I think the people who say “I need more” and therefore try to get more than they need, are likely to get into terrible trouble. I know a man who owned his house free and clear, had \$5 million of securities and lived on the income from those securities. But this left him a little short of what he wanted, so he said to himself, “I'll go do a little work to get my return up,” and he sold puts, backed by his entire account. At the time, the highest price was on naked puts on Internet stocks and in due course he lost all of his money and now works in a restaurant.

We Buy With Reduced Expectations

Warren said at the annual meeting that with most of our present holdings, we're not buying or selling. And when we do buy, it's not, “Oh boy! A lollapalooza!” We buy with reduced expectations. How else can one behave? Would anyone want us to reduce Berkshire Hathaway's assets to cash and sit around waiting for a calamity so Berkshire can put the cash to work?

By No Means Have We Given Up on Putting Our Cash to Work

Warren answered this at the [Berkshire] annual meeting. By no means have we given up on putting our cash to work. And if we don't, the money is not going away.

Did You Predict Berkshire's Success?

Well, some of our success we predicted and some of it was fortuitous. [Regardless,] like most human beings, we took a bow. (Laughter)

Common Elements of Berkshire's Best All-Time Investments

Some eventualities came to pass. What the 15 best deals all have in common is that they all worked. There were different models – See's Candies was different from Shaw Carpets. But both are good businesses that will generate durable returns for the grandchildren of people sitting in this room. The reason I keep talking about the record without the 15 best deals is that it shows how few deals you need in a lifetime. The

people who need a deal every month, by and large, they all crater. Patience and aggressive opportunism is what you need – an odd combination, but it’s what works best.

Berkshire and Wesco Buying Back Stock?

Buffett answered this question [at the Berkshire annual meeting]. At some price, we’d buy back Berkshire, but it’s quite a bit less than the price that currently exists. We’re not looking for the chance to gleefully buy out shareholders at a substantial discount to its value. We like to behave so this doesn’t happen.

As for Wesco, because you people have created this cult, it always trades at a premium to its liquidation value.

Bull on Berkshire

Despite my words, I’m a bull on Berkshire Hathaway. There may be some considerable waiting, but I think there are some good days ahead.

Stocks We’re Buying

[I missed the rest of the sentence, but at one point Munger said: “...the stocks [plural] that we’re buying today...”]

Problem of Buffett Foundation Having to Eventually Sell Berkshire Stock

I regard that as so easily solvable that I don’t give two seconds to it. If the foundation has to sell 5% of its stock [every year to comply with the law that says all foundations must give away 5% of their assets each year], then Berkshire could pay a dividend or buy back the stock. It wouldn’t bother me – we’re drowning in cash. The needs of any one shareholder are easily dealt with in our current circumstances. You lead a very favored life if you worry about things like that.

COMMENTS ON BERKSHIRE HATHAWAY BUSINESSES

Advantage of Berkshire’s AAA Credit Rating In Insurance

There’s a little price tiering – there’s a difference among insurers based on their credit worthiness. But is there enough difference? The answer is no. Do I expect a cascade of business to Berkshire Hathaway? No. But there’s a modest and increasing trickle. People are not as credit-leery as they should be.

Pricing Super-Cat Insurance Policies

We’re very peculiar. We don’t have a department where we trust people to do it on their own. All decisions must be approved by Ajit Jain and Warren, and neither of them uses standard actuarial tables. In other words, after a long period with no hurricanes, the

actuarial tables would tell you that the hurricane risk has gone down – that’s not how they think at Berkshire Hathaway. There’re very rational. We don’t use standard actuarial tables, just as we start with [companies’] reported financials, but then go from there.

You don’t need dozens of people to write super-cat policies. So there’s our plan: get Ajit Jain, add Warren Buffett working for free and then raise tens of billions of dollars because people trust you and there you go. (Laughter)

We Have Simple Compensation Systems

It isn’t enough to buy the right business. You’ve also have to have a compensation system that’s satisfactory to the people running them. At Berkshire Hathaway, we have no [single] system; we have different systems. They’re very simple and we don’t tend to revisit them very often. It’s *amazing* how well it’s worked. We wrote a one-page deal with Chuck Huggins when we bought See’s and it’s never been touched. We have *never* hired a compensation consultant.

Clayton Homes and the Disaster in the Manufactured Home Sector

The recent historical experience of mobile homes – actually, it’s “manufactured”; they’re not manufactured to move – is that you had a bunch of no-good nut cases and a balloon of unfortunate, commission-sales-driven activity. Any time you let people on sales commission set the credit standards for people using margin [e.g., debt to buy the home], you create a disaster. It’s like mixing oxygen and hydrogen and lighting a match.

The homes deteriorated... It was an absolute disaster. If it hadn’t been, we wouldn’t have been able to buy [Clayton Homes]. [The distress in the industry was so great that] they were losing their securitization capacity. Clayton was the best, but even they were at risk so they sold to us.

What do you know about foreclosing on a house in a trailer park? And what do you do with it? We’re now the largest in the country. I think it will work quite well for Berkshire and Clayton. If Clayton were an independent company, they’d have trouble. The people who claim we underpaid for it are out of their minds. It’s amazing how many people think they know more than the people selling it.

Cort Will Be Successful Over Time

Cort benefited from the venture-capital-financed, new-company boom. You could argue that we made a macro mistake. These companies went away for a while and Cort was affected. But you can see in the first quarter earnings that it’s coming back.

There’s a class of people that just want to rent, not own. They are trying to be the Enterprise Rent-A-Car in the furniture rental business. It’s not a gold mine, but we think it’ll be successful over time.

INVESTMENT ADVICE

Behavior of Investment Managers

If you're an investment manager and they're going to fire you if you don't keep up with your benchmark, that can cause some weird things to happen in the markets as a whole. That's the world that we live in, whether you like it or not. It has some perverse consequences – for one thing, closet indexing. You're paying a manager a fortune and he has 85% of his assets invested parallel to the indexes. If you have such a system, you're being played for a sucker.

You have these fads in investment management. With so many bodies and minds and computers, I see figures of risk by asset class, but I don't have the faintest idea what they mean. They don't either, but they learned a fad, a way of thinking. If you learn a formula, you can run the numbers and print it up, but it doesn't mean anything.

Are Stocks Too High?

Too high is a funny word – they are high to those of us who are accustomed to finding real bargains. But it's not a promise [that there will always be such bargains]. I don't think it's unfair; I don't think it's too high in the sense that we're being deprived.

Our future prospects are way worse than what they used to be. But I'm 81; I've got bigger problems than diminished returns. (Laughter)

Spotting Bad People

It's hard to judge the combination of character and intelligence and other things. It's not at all simple, which explains why we have so many divorces. (Laughter) Think about how much people know about the person they marry, yet so many break up. It's not easy, it is in some cases. If people are splashing around with money like Dennis Kozlowski, with vodka at parties coming out of some body part, and if it looks like Sodom and Gomorrah, then maybe this isn't what you're looking for. (Laughter) But beyond that, it's hard. If you have some unfortunate experiences while getting that knowledge, well, welcome to the human race. (Laughter)

It's Tough to Make Money Investing in China

I think it's very tough to make money in China. A lot of terrible things can happen to you and you have no good antidote. China makes a lot of cheap well-made goods, but it could be that we won't have attractive investment opportunities in China even though the country may prosper.

We Want the Chinese to Get Richer

China is a nuclear power. We have no option but to have friendly relations with China – anything else would be really stupid. We *want* the Chinese to get richer and richer. I'm not unhappy that Wal-Mart is expanding in China.

Risk of a Calamity Investing in Currencies

I do think that it's conceivable that some enormously talented person that studied economics and relative value of currencies and devoted his life to it and only bet occasionally, that such a man could do very well [investing in currencies]. It's not my line of talent.

I'd rather do something that's not such a zero-sum game. If I invest in equities – the businesses are growing; for example, Wrigley's will make more gum. It's automatically working for me, even if I do nothing. But if I invest in currencies, it's not working for me.

If I had to make a living outside of equities, it might be in currencies. But I don't have to do it. There's less chance of a big calamity in equities. The problem with currencies is that it sucks you into margin, and then if it moves against you but you're sure you're right, it sucks you in deeper. And then one more twist of the screw...

If you're already rich, why would you live under such conditions? I think more people will do well if they follow the Warren Buffett model.

COMMENTS ON OTHER COMPANIES

I Think the Country Is Better Off for Having Wal-Mart

With Wal-Mart and the like getting so powerful, have we made a pact with the devil? My answer is I think the country is better off for having Wal-Mart. It's a fabulous enterprise that does a lot of good and delivers value to the customer and that's why it's successful. I think the country is better off for having this system for distributing goods.

When I go into Wal-Mart, I see elderly people as greeters – they're working part time and it gets them out of the house, but people say, "Isn't Wal-Mart nasty [for exploiting the elderly]?"

As far as I'm concerned, I think Wal-Mart does a lot of good with efficient distribution. I'm a director of Costco. Do we really want our entrepreneurs not to try very hard? Do we really want to wake and say, "Let's stop competing so hard?" I say, let winners run instead of investing in losers.

I like Wal-Mart's culture. As far as I'm concerned, Wal-Mart is one of the glories of civilization.

McDonald's Is a Great Educator

I get flack for saying [when I visit a college and give a speech], "This is a nice college, but the really great educator is McDonald's." They hate me for saying this and think I'm a slimy creature. But McDonald's hires people with bad work habits, trains them, and teaches them to come to work on time and have good work habits. I think a lot of what goes on there is better than at Harvard.

There's a Lot That Was Strong and Good at AIG

I've never examined AIG in great detail. AIG was run by a truly brilliant, dominant personality for a long, long time and had a fabulous record. I don't think we're going to find a fraud like Enron. Rather, a good company with a chieftain that maybe gilded the lily. I think he thought it was his duty to help along the reputation of AIG. I think he thought it deserved a better reputation than it had. I agree. I think every corporate chieftain feels the same way. I don't think it's blue smoke and mirrors.

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AIG, GE Credit and the Risks of the Carry Trade

That said, it's a lot like GE. It is a fabulously successful insurance operator, and with success it morphed into a massive carry business: borrowing a lot of money at one price and investing it at another price. AIG was a big operator that was a lot like GE Credit. We never owned either because even the best and wisest people make us nervous in great big credit operations with swollen balance sheets. It just makes me nervous, that many people borrowing so many billions.

As you can tell in our operations, we are much more conservative. We borrow less, on more favorable terms. We're happier with less leverage. They've been successful, but we're too chicken to join them. You could argue that we've been wrong, and that it's cost us a fortune, but that doesn't bother us. Missing out on some opportunity never bothers us. What's wrong with someone getting a little richer than you? It's crazy to worry about this.

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I look at telecom and all the change and my reaction is that of Samuel Goldman: "Include me out." I'm just not suited for this; I don't know how to predict those outcomes, so I leave it to other people.

COMMENTS ON ECONOMIC MATTERS

Awash in Capital

It is weird the way that capital occurs. We have monetized houses in this country in a way that's never occurred before. Ask Joe how he bought a new Cadillac [and he'll say] from borrowing on his house. We are awash in capital.

[Being] awash is leading to very terrible behavior by credit cards and subprime lenders -- a very dirty business, luring people into a disadvantageous position. It's a new way of getting serfs, and it's a dirty business. We have financial institutions, including those with big names, extending high-cost credit to the least able people. I find a lot of it revolting. Just because it's a free market doesn't mean it's honorable.

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Likelihood of an Energy Shortage

There's a lot of evidence of that -- that our conventional techniques of extracting oil will eventually taper off, [a theory called] Hubert's Peak. [First articulated more than 50 years ago by a Shell Oil geologist, this theory describes how production rates of oil and gas will increase to a peak and then rapidly taper off as reserves are depleted.] I'm sure that will happen eventually. But you can never be sure. Some people think that energy reserves are not from deceased former life -- for example, there's methane in the heavens where there was no former life. So there may be more energy than people expect...

I recall reading something about Chevron finding a lot of energy way deep, some kind of hydride -- a deep reserve with a lot of energy locked up. So there may be one last gasp -- one more windfall coming of hydrocarbons. If we have to live without hydrocarbons, we can, but it would just be unpleasant. An awful lot of energy comes to the earth every day from the sun. If we had to adjust, we could.

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I’m more optimistic about the staying power of what’s good in this country. But just because you have a wonderful spouse doesn’t mean you should treat her badly. You have the feeling that some of the old virtues [that made this country great] are lessening. But there’s so much good and so much strength left that I would not expect this country to suddenly founder.

But there are some developments that would make us commit to the old ways. I think there are certain classes of people who if they were swept away, it would be desirable. (Laughter)

Biggest Threat to Our Way of Life

Warren answered this at the annual meeting. The biggest threat in the next 60 years is a really unpleasant nuclear event. Next is that someone does some terrible things with pathogens. I don’t think either is unlikely in the next 60 years. If we have to go through some recessions and convulsions, these are minor compared to nuclear events. People in this room certainly should be wise enough to handle their lives so they can do OK even in big stretches of unpleasant economic conditions. I think the big threats are not the ones we’re talking about here.

Rick Guerin’s Not Crazy – We Are

[Guerin was one of the investors Buffett profiled in his famous speech, [The Superinvestors of Graham-and-Doddsville](#)]

I think it’s fair to say that once he got rich, he stopped spending his time trying to get

richer. He has a new family. He's 75 and has a 12-year-old child. He does a lot of things because he enjoys doing them. He's stopped trying to get richer. There's *nothing* crazy about that. We're the crazy ones. (Laughter)

Advice on Reading and Enron's Extreme Evil

I believe in reading the best people, and reading because you like learning. I don't spend my time reading detective stories or romances. In spite of Warren's wise-ass comment about better late than never about me...[I missed the rest of this sentence]

But a book like the one I just recommended [*Conspiracy of Fools*, by Kurt Eichenwald] – that Enron book is *really* worth reading because the evil is so extreme. You see people getting sucked in by the evil all around them. You just learn so much. You know the outcome – it's like a tragedy. Not everyone likes tragedy – I took my wife to a movie where the rats were eating the bodies of the dead soldiers in World War I. Afterward, she told me, "You may like this, but I never want to go to another one." It was *King & Country*.

Book Recommendations

Any other favorite books [in addition to *Conspiracy of Fools*] to recommend? Yeah, you're paying \$49 for it. [Laughter. *Poor Charlie's Almanack* was for sale at the Wesco meeting.] If you find you don't like it, you can always give it to a more intelligent friend. I don't have another one that really grabbed me this year. That Enron book had a really powerful emotional connection for me.

Humor

One of the shareholders ended his question by saying: "I guess I'm an advice mooch," to which Munger replied: "That's OK – we get a lot of them."

One way to find a lot of love in yourself is to surround yourself with a lot of hard-core nut cases. Yes I do. You're my kind of people – my kind of screwy.

Notes from 2005 Wesco Financial Annual Meeting, Part Two

May 4, 2005

By Whitney Tilson

Note: This is not a transcript. No recording devices were allowed at the meeting, so this is based on many hours of rapid typing, combined with my memory. I have reorganized his comments by subject matter. Words in [brackets] are my comments or edits.

For my columns and notes on previous Berkshire and Wesco meetings, click [here](#).

CHARLIE MUNGER RESPONSES DURING Q&A SESSION

Berkshire Operates With a Seamless Web of Deserved Trust

Everybody likes being appreciated and treated fairly, and dominant personalities who are capable of running a business like being trusted. A kid trusted with the key to the computer room said, "It's wonderful to be trusted."

That's how we operate Berkshire – a seamless web of deserved trust. We get rid of the craziness, of people checking to make sure it's done right. When you get a seamless web of deserved trust, you get enormous efficiencies. It's what the Japanese did to beat our brains out in manufacturing: suppliers, employers, the purchasing company, management – all created a seamless web of deserved trust. That's why we have firms – they create a seamless web of deserved trust. It's the same with good football teams.

Berkshire Hathaway is always trying to create a seamless web of deserved trust. Every once in a while, it doesn't work, not because someone's evil but because somebody drifts to inappropriate behavior and then rationalizes it. Our basic attitude is to create a seamless web of deserved trust.

How can Berkshire Hathaway work with only 15 people at headquarters? *Nobody* can operate this way. But we do.

Take Wesco. Every once in a while we get surprised by something – maybe once a decade. It's what we all want. Who in the hell would not want to be in a family without a seamless web of deserved trust? We try for the same thing in business. It's not rocket science; it's elementary. Why more people don't do it, I don't know. Perhaps *because* it's so elementary. We didn't copy the Japanese until they were clobbering us – and they copied from us!

Lowered Investment Standards at Berkshire Hathaway

At Berkshire Hathaway, we've lowered our standards a little – we're willing to invest with lower standards than in the past. We're not waiting for 1974 or even 1984. If you have the money, you have to invest it somewhere. It may well be that you have to take something that obviously promises a lower return than you were used to.

I think the people who say "I need more" and therefore try to get more than they need, are likely to get into terrible trouble. I know a man who owned his house free and clear, had \$5 million of securities and lived on the income from those securities. But this left him a little short of what he wanted, so he said to himself, "I'll go do a little work to get my return up," and he sold puts, backed by his entire account. At the time, the highest price was on naked puts on Internet stocks and in due course he lost all of his money and now works in a restaurant.

We Buy With Reduced Expectations

Warren said at the annual meeting that with most of our present holdings, we're not buying or selling. And when we do buy, it's not, "Oh boy! A lollapalooza!" We buy with reduced expectations. How else can one behave? Would anyone want us to reduce Berkshire Hathaway's assets to cash and sit around waiting for a calamity so Berkshire can put the cash to work?

By No Means Have We Given Up on Putting Our Cash to Work

Warren answered this at the [Berkshire] annual meeting. By no means have we given up on putting our cash to work. And if we don't, the money is not going away.

Did You Predict Berkshire's Success?

Well, some of our success we predicted and some of it was fortuitous. [Regardless,] like most human beings, we took a bow. (Laughter)

Common Elements of Berkshire's Best All-Time Investments

Some eventualities came to pass. What the 15 best deals all have in common is that they all worked. There were different models – See's Candies was different from Shaw Carpets. But both are good businesses that will generate durable returns for the grandchildren of people sitting in this room. The reason I keep talking about the record without the 15 best deals is that it shows how few deals you need in a lifetime. The people who need a deal every month, by and large, they all crater. Patience and aggressive opportunism is what you need – an odd combination, but it's what works best.

Berkshire and Wesco Buying Back Stock?

Buffett answered this question [at the Berkshire annual meeting]. At some price, we'd buy back Berkshire, but it's quite a bit less than the price that currently exists. We're not looking for the chance to gleefully buy out shareholders at a substantial discount to its value. We like to behave so this doesn't happen.

As for Wesco, because you people have created this cult, it always trades at a premium to its liquidation value.

Bull on Berkshire

Despite my words, I'm a bull on Berkshire Hathaway. There may be some considerable waiting, but I think there are some good days ahead.

Stocks We're Buying

[I missed the rest of the sentence, but at one point Munger said: "...the stocks [plural] that we're buying today..."]

Problem of Buffett Foundation Having to Eventually Sell Berkshire Stock

I regard that as so easily solvable that I don't give two seconds to it. If the foundation has to sell 5% of its stock [every year to comply with the law that says all foundations must give away 5% of their assets each year], then Berkshire could pay a dividend or buy back the stock. It wouldn't bother me – we're drowning in cash. The needs of any one shareholder are easily dealt with in our current circumstances. You lead a very favored life if you worry about things like that.

COMMENTS ON BERKSHIRE HATHAWAY BUSINESSES

Advantage of Berkshire's AAA Credit Rating In Insurance

There's a little price tiering – there's a difference among insurers based on their credit worthiness. But is there enough difference? The answer is no. Do I expect a cascade of business to Berkshire Hathaway? No. But there's a modest and increasing trickle. People are not as credit-leery as they should be.

Pricing Super-Cat Insurance Policies

We're very peculiar. We don't have a department where we trust people to do it on their own. All decisions must be approved by Ajit Jain and Warren, and neither of them uses standard actuarial tables. In other words, after a long period with no hurricanes, the actuarial tables would tell you that the hurricane risk has gone down – that's not how they think at Berkshire Hathaway. There're very rational. We don't use standard actuarial tables, just as we start with [companies'] reported financials, but

then go from there.

You don't need dozens of people to write super-cat policies. So there's our plan: get Ajit Jain, add Warren Buffett working for free and then raise tens of billions of dollars because people trust you and there you go. (Laughter)

We Have Simple Compensation Systems

It isn't enough to buy the right business. You've also have to have a compensation system that's satisfactory to the people running them. At Berkshire Hathaway, we have no [single] system; we have different systems. They're very simple and we don't tend to revisit them very often. It's *amazing* how well it's worked. We wrote a one-page deal with Chuck Huggins when we bought See's and it's never been touched. We have *never* hired a compensation consultant.

Clayton Homes and the Disaster in the Manufactured Home Sector

The recent historical experience of mobile homes – actually, it's “manufactured”; they're not manufactured to move – is that you had a bunch of no-good nut cases and a balloon of unfortunate, commission-sales-driven activity. Any time you let people on sales commission set the credit standards for people using margin [e.g., debt to buy the home], you create a disaster. It's like mixing oxygen and hydrogen and lighting a match.

The homes deteriorated... It was an absolute disaster. If it hadn't been, we wouldn't have been able to buy [Clayton Homes]. [The distress in the industry was so great that] they were losing their securitization capacity. Clayton was the best, but even they were at risk so they sold to us.

What do you know about foreclosing on a house in a trailer park? And what do you do with it? We're now the largest in the country. I think it will work quite well for Berkshire and Clayton. If Clayton were an independent company, they'd have trouble. The people who claim we underpaid for it are out of their minds. It's amazing how many people think they know more than the people selling it.

Cort Will Be Successful Over Time

Cort benefited from the venture-capital-financed, new-company boom. You could argue that we made a macro mistake. These companies went away for a while and Cort was affected. But you can see in the first quarter earnings that it's coming back.

There's a class of people that just want to rent, not own. They are trying to be the Enterprise Rent-A-Car in the furniture rental business. It's not a gold mine, but we think it'll be successful over time.

INVESTMENT ADVICE

Behavior of Investment Managers

If you're an investment manager and they're going to fire you if you don't keep up with your benchmark, that can cause some weird things to happen in the markets as a whole. That's the world that we live in, whether you like it or not. It has some perverse consequences – for one thing, closet indexing. You're paying a manager a fortune and he has 85% of his assets invested parallel to the indexes. If you have such a system, you're being played for a sucker.

You have these fads in investment management. With so many bodies and minds and computers, I see figures of risk by asset class, but I don't have the faintest idea what they mean. They don't either, but they learned a fad, a way of thinking. If you learn a formula, you can run the numbers and print it up, but it doesn't mean anything.

Are Stocks Too High?

Too high is a funny word – they are high to those of us who are accustomed to finding real bargains. But it's not a promise [that there will always be such bargains]. I don't think it's unfair; I don't think it's too high in the sense that we're being deprived.

Our future prospects are way worse than what they used to be. But I'm 81; I've got bigger problems than diminished returns. (Laughter)

Spotting Bad People

It's hard to judge the combination of character and intelligence and other things. It's not at all simple, which explains why we have so many divorces. (Laughter) Think about how much people know about the person they marry, yet so many break up. It's not easy, it is in some cases. If people are splashing around with money like Dennis Kozlowski, with vodka at parties coming out of some body part, and if it looks like Sodom and Gomorrah, then maybe this isn't what you're looking for. (Laughter) But beyond that, it's hard. If you have some unfortunate experiences while getting that knowledge, well, welcome to the human race. (Laughter)

It's Tough to Make Money Investing in China

I think it's very tough to make money in China. A lot of terrible things can happen to you and you have no good antidote. China makes a lot of cheap well-made goods, but it could be that we won't have attractive investment opportunities in China even though the country may prosper.

We Want the Chinese to Get Richer

China is a nuclear power. We have no option but to have friendly relations with China – anything else would be really stupid. We *want* the Chinese to get richer and richer. I'm not unhappy that Wal-Mart is expanding in China.

Risk of a Calamity Investing in Currencies

I do think that it's conceivable that some enormously talented person that studied economics and relative value of currencies and devoted his life to it and only bet occasionally, that such a man could do very well [investing in currencies]. It's not my line of talent.

I'd rather do something that's not such a zero-sum game. If I invest in equities – the businesses are growing; for example, Wrigley's will make more gum. It's automatically working for me, even if I do nothing. But if I invest in currencies, it's not working for me.

If I had to make a living outside of equities, it might be in currencies. But I don't have to do it. There's less chance of a big calamity in equities. The problem with currencies is that it sucks you into margin, and then if it moves against you but you're sure you're right, it sucks you in deeper. And then one more twist of the screw...

If you're already rich, why would you live under such conditions? I think more people will do well if they follow the Warren Buffett model.

COMMENTS ON OTHER COMPANIES

I Think the Country Is Better Off for Having Wal-Mart

With Wal-Mart and the like getting so powerful, have we made a pact with the devil? My answer is I think the country is better off for having Wal-Mart. It's a fabulous enterprise that does a lot of good and delivers value to the customer and that's why it's successful. I think the country is better off for having this system for distributing goods.

When I go into Wal-Mart, I see elderly people as greeters – they're working part time and it gets them out of the house, but people say, "Isn't Wal-Mart nasty [for exploiting the elderly]?"

As far as I'm concerned, I think Wal-Mart does a lot of good with efficient distribution. I'm a director of Costco. Do we really want our entrepreneurs not to try very hard? Do we really want to wake and say, "Let's stop competing so hard?" I say, let winners run instead of investing in losers.

I like Wal-Mart's culture. As far as I'm concerned, Wal-Mart is one of the glories of civilization.

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Over the long term, the eclipse rate of great civilizations being overtaken is 100%. So you know how it’s going to end. (Laughter)

I’m more optimistic about the staying power of what’s good in this country. But just because you have a wonderful spouse doesn’t mean you should treat her badly. You have the feeling that some of the old virtues [that made this country great] are lessening. But there’s so much good and so much strength left that I would not expect this country to suddenly founder.

But there are some developments that would make us commit to the old ways. I think there are certain classes of people who if they were swept away, it would be desirable. (Laughter)

Biggest Threat to Our Way of Life

Warren answered this at the annual meeting. The biggest threat in the next 60 years is a really unpleasant nuclear event. Next is that someone does some terrible things with pathogens. I don’t think either is unlikely in the next 60 years. If we have to go through some recessions and convulsions, these are minor compared to nuclear events. People in this room certainly should be wise enough to handle their lives so they can do

OK even in big stretches of unpleasant economic conditions. I think the big threats are not the ones we're talking about here.

Rick Guerin's Not Crazy – We Are

[Guerin was one of the investors Buffett profiled in his famous speech, [The Superinvestors of Graham-and-Doddsville](#)]

I think it's fair to say that once he got rich, he stopped spending his time trying to get richer. He has a new family. He's 75 and has a 12-year-old child. He does a lot of things because he enjoys doing them. He's stopped trying to get richer. There's *nothing* crazy about that. We're the crazy ones. (Laughter)

Advice on Reading and Enron's Extreme Evil

I believe in reading the best people, and reading because you like learning. I don't spend my time reading detective stories or romances. In spite of Warren's wise-ass comment about better late than never about me...[I missed the rest of this sentence]

But a book like the one I just recommended [*Conspiracy of Fools*, by Kurt Eichenwald] – that Enron book is *really* worth reading because the evil is so extreme. You see people getting sucked in by the evil all around them. You just learn so much. You know the outcome – it's like a tragedy. Not everyone likes tragedy – I took my wife to a movie where the rats were eating the bodies of the dead soldiers in World War I. Afterward, she told me, “You may like this, but I never want to go to another one.” It was *King & Country*.

Book Recommendations

Any other favorite books [in addition to *Conspiracy of Fools*] to recommend? Yeah, you're paying \$49 for it. [Laughter. *Poor Charlie's Almanack* was for sale at the Wesco meeting.] If you find you don't like it, you can always give it to a more intelligent friend. I don't have another one that really grabbed me this year. That Enron book had a really powerful emotional connection for me.

Humor

One of the shareholders ended his question by saying: “I guess I'm an advice mooch,” to which Munger replied: “That's OK – we get a lot of them.”

One way to find a lot of love in yourself is to surround yourself with a lot of hard-core nut cases. Yes I do. You're my kind of people – my kind of screwy.