Pecaut & Company

Our Mission: To Be Our Clients' Most Trusted Financial Advisor

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EXECUTIVE SUMMARY

- **Market Update**
- **University of Berkshire Hathaway**
- **Berkshire's Cash/Bond/Stock Ratio**

MARKET UPDATE

"Here's the way they put it at Pecaut and Company: Overall we see all the seeds of an enormous rally: extreme fear, enormous cash positions (over $9 trillion in cash, CD's, and money market accounts), insiders are buying at record levels (and of course they've been dead wrong so far), universal negativity, low valuations. What will turn the tide? It could be something as simple as job losses are 400,000 instead of 600,000."

- Richard Russell's *Dow Theory Letter*, March 10, 2009

We feel honored to be quoted again in Russell's letter. At the age of 85, Russell is clearly the dean of newsletter writers. Corey attended a tribute dinner for him in San Diego recently. We have always appreciated his intellectual honesty and especially enjoy his bits about his early days in the business and memories from WWII.

His timing in quoting us was superb. From the March 9 low of 676 to the May 13 close of 884, the S&P 500 has rallied 31%.

Now what? Well this has been the "it's not as bad as we thought" rally. Anything short of the Great Depression II has been seen as something to celebrate. From this point forward, it may well be slower going. Healing is clearly underway. However, some problems will take years to unwind, such as the oversupply of housing.

The key pieces for us are (1) **Stimulus is huge.** And it's not just the U.S. Nearly all major countries around the globe have some sort of stimulus package, and (2) **The big get bigger.** This is a time when the well-run and the well-capitalized can buy assets cheap and grow market share (see Berkshire below).

THE UNIVERSITY OF BERKSHIRE HATHAWAY

Attending the Berkshire Hathaway annual meeting has long been required continuing education here at Pecaut and Company. As Buffett's fame and wealth have grown, so have the meetings, morphing from a small private lecture series in the '80's into a chamber of commerce dream event we refer to as the University of Berkshire Hathaway. On May 2, "professors" Warren Buffett and Charles Munger, chairman and vice chairman respectively of Berkshire Hathaway, held court with a record gathering of 35,000 or so eager students and shoppers at the Qwest Center in Omaha. This year's "Berkshire Mall" featured the wares of dozens of Berkshire companies on display from See's Candy to Justin Boots (complete with live bulls).

Buffett and Munger have presided over one of the greatest records of wealth building in history. Since Buffett took over Berkshire 44 years ago, Berkshire's per-share book value has grown from $19 to $70,530, a rate of 20.8% compounded annually. That's more than double the S&P 500's 8.9% annualized percentage gain for the same period. Over those 44 years Berkshire Hathaway has grown from a small New England textile company into one of the world's most powerful conglomerates. In the most recent edition of the Fortune 500, Berkshire ranked 13th in revenue ($108 billion), 25th in profits ($5.0 billion), and 17th in assets ($267 billion).

Like everyone else, Buffett had a tough 2008 with Berkshire's per share book value *decreasing* by $11.5 billion or 9.6% for 2008. Berkshire, trading around $90,000 for the A shares, trades at a discount to our estimates of intrinsic value. Using the year-end 2008 numbers for investments per share ($77,793) plus 10 times pre-tax non-insurance earnings per share ($39,210) suggests a value of $117,003 per share. Using our in house adjusted book value method yields a similar number. So Berkshire, currently selling at about a 25% discount to value, represents solid value and lower than average risk.

Our ideal situation as value investors is to find a company that is increasing its intrinsic value even as the stock price is declining, creating an even better bargain as time unfolds. That appears to be the case with Berkshire at this time.

Before we get to our meeting notes, we have a few observations to make to give them some context.

HIDDEN IN PLAIN SIGHT: BUFFETT'S ALL IN

Our biggest surprise around the event was the media's downbeat take on the Berkshire meeting. *The Wall Street Journal* article headers included "*Buffett Withholds Hoopla, Hope*" and "*Slump Has Dealt Buffett a Rather Rough Hand*" with a picture of Buffett playing bridge. Our header for that picture would have been "*Buffett's All In*".

Perhaps it's simply a matter of being hidden in plain sight. But if a gambler who is famous for holding large amounts of cash over many hands suddenly leans in and shoves all his chips to the center of the table, believe me, we'd take notice. That's just what Buffett has done over the past 12 months. Check out our cash/bond/stock ratio chart on the last page of this letter. Not since 1997 has Berkshire's "Equities and Other Investments" percentage been this high (and you can add a few more percentage points to that number with recent investments in Swiss Re and Dow Chemical). Our big takeaway is that Warren Buffett has Berkshire Hathaway *fully invested for the first time in a decade*. Is this the action of a man who has a bad hand? Hardly. The Slump has dealt Buffett one of the best investment opportunities of his illustrious career.

THE ANCHOR IS UP

This fully invested position is new and significant as it suggests Berkshire's rate of compounding value can and will pick up a bit. As we noted in our June, 2006 newsletter reviewing Berkshire: "*Berkshire has added a lot of value over the last decade, compounding value at nearly 15% annually….like a boat dragging its anchor in the water, Berkshire has added that value while keeping 45-60% of investment assets in cash and bonds since 1998. How fast could this boat go if she were to pull in the anchor?*" Sounds like we are about to find out.

INSURANCE IS THE BIG DOG, AND THE BIG DOG IS RUNNING

The media, audience, and journalists seem to miss this point annually: Berkshire Hathaway is predominantly an insurance company, comprising roughly two thirds of the company. The ebb and flow of the insurance world impacts Berkshire more than anything else. Yet, this year, as in years past, there were but a handful of insurance related questions. Again, perhaps it is a case of being hidden in plain sight. Fortunately, Buffett *wants* folks to know how the insurance businesses are doing, so he volunteers a fair bit of information throughout the meeting. And the word we get this year is that they are doing great. From GEICO to Gen Re to BH Reinsurance, Berkshire's insurance operations are on a roll.

FLOAT MATTERS

Part of the reason the insurance operations are so important to Buffett is the **float** (think of an interest free margin account) they generate for Berkshire. With $109 billion in equity and $58 billion in float at year-end, Berkshire is levered at about 1.5 to 1 relative to its equity. This is a significant cog in the wealth-compounding machine at Berkshire, and we believe accounts for something like half of its performance advantage over the S&P 500 over the past 44 years.

Imagine if you and I could set up an interest free margin account levered 1.5 to 1 and we simply bought the S&P 500 Index (and we didn't get wiped out in a downdraft), we'd be set to outperform the S&P by 1.5 to 1 over time. This is a no-brainer. Well, while this may be over-simplified, this is essentially what Buffett has done by building float at Berkshire's insurance companies. Buffett has built an enormous structural advantage for wealth-compounding at Berkshire with the float that the insurance operations generate. And, as long as the insurance companies operate profitably, this float has no cost to Berkshire (actually a negative cost equal to those profits!). Roughly put, premiums paid today are set aside as a reserve for potential future claims. While they wait, those reserve dollars can earn investment income. Buffett has been very intentional about building those premium reserves - a perfectly legal way to use "other people's money" to build the Berkshire empire.

UTILITIES ARE LIGHTING IT UP

Buffett and Munger are clearly very proud of the fact that MidAmerican Energy (MEC) is a top operator. MEC is number one in the nation in the generation of wind power having grown it to almost 20% of total capacity. MEC is also rapidly building wind power in the Pacific northwest. Berkshire's pipeline operators were mediocre when first acquired but are now all top-ranked. In addition, the utility area offers lots of reinvestment opportunities and Berkshire is reinvesting all of what MEC earns and more into those operations. Finally, utility revenues and profits are only modestly affected by the current recession.

FORTRESS BERKSHIRE IS ON A ROLL

This is what the talking-heads are missing, in our not-so-humble opinion. The companies that comprise some 80-85% of Berkshire, insurance and utilities, are rolling. Buffett is all in, so investment returns will be significantly sweeter over the next five years. And, yes, the retail, manufacturing, and finance businesses are definitely sucking wind along with the rest of the economy.

However, these divisions are in the minority at Berkshire. Compared to the rest of the world, Berkshire is in excellent shape to grow value over the next five years.

Now on with the meeting.

UBH – THE MOVIE

Each year, the Berkshire meeting kicks off with a one hour movie featuring subsidiary commercials, skits, news clips, and all things Berkshire. The highlight of this year's movie was a tongue-in-cheek skit where Buffett turns floor salesman for Nebraska Furniture Mart. After a miserable year of investing in 2008, the board suggests Buffett might help the company more by selling a few more mattresses. The new best selling mattress is the "Nervous Nellie", with a special "night deposit" compartment under the mattress for storing important items. A shopper tries out the mattress and notes that "it bounces back slow". Once the sale is made, Buffett hurries to remove his valuables from under the mattress, including some vintage Playboys. Quite hilarious.

NEGATIVE TREASURY YIELDS

Buffett opened the meeting with an overhead. (We always take special note when Buffett goes to visuals.) The overhead was of a trade ticket dated 12/18/08 where Berkshire sold a $5 million Treasury bill due in April of 2009 for more than its maturity value: $5,000,090.97. This means the buyer was willing to accept a *negative* yield. Extraordinary. Buffett quipped that the ticket was, in effect, an ad for the Nervous Nellie mattress and added that we may not see such a thing again in our lifetimes.

FIRST QUARTER EARNINGS

Buffett gave a heads up on first quarter earnings sharing that Berkshire operating earnings were $1.7 billion down from $1.9 billion a year ago. He sees Berkshire's insurance and utility operations doing well for 2009 as they are not all that economically sensitive. The retail and manufacturing subsidiaries have been hit hard by the recession. He noted that MidAmerican's $1.0 billion of operating earnings would be reinvested in utility operations. Float bumped up from $58 billion to $60 billion due to a deal with SwissRe. Cash ended the quarter at $23 billion, though cash has since dropped to $20 billion as Berkshire invested $3 billion in a Dow Chemical convertible preferred.

DEBT? EQUITY? HOW ABOUT BOTH?

You want yield? How about something in the double digits! You want appreciation? How about equity participation in some of the biggest companies in the world? Well, that's what Buffett has done with his special deals. Buffett upped his "other" category in investments with deals combining both high yields and equity kickers with Goldman Sachs ($5 billion of a 10% preferred and warrants to buy 43 million shares at $115/sh), General Electric ($3 billion of a 10% preferred and warrants to buy 135 million shares at $22.25/sh) and Wrigley ($6.5 billion total - $4.4 billion in 11.45% notes and $2.1 billion of 5% preferred). We note also that preferred dividends are tax preferenced for corporations, so, in the case of Goldman and GE, that 10% preferred dividend is equal to nearly a 14% interest coupon on an after-tax basis to Berkshire.

(Ed: Again, this is the best of all worlds – double digit yields AND equity participation rights. And Buffett isn't done yet. Subsequent to year-end, Berkshire acquired $3 billion swiss francs worth of a 12% convertible note with Swiss Re and invested $3 billion in an 8.5% convertible preferred of Dow Chemical. All in, that's over $20 billion in high yield securities with equity kickers. Amazing.)

This is why we would guess that while Buffett and Munger agreed that the opportunities of 2008 were great though not as compelling as the 1974-75 bear market when PE's were 4 (though interest rates were higher then), they were referring to the general market, not the unique opportunities Buffett was able to create during this meltdown. Summarizing 1974, Munger declared: "I knew I'd never get another trip to the counter like that."

Buffett said, as with hamburger, he'd rather pay ½ X than X, so he liked the lower prices. With stocks down 40% and interest rates down, stocks and bonds had to be more attractive. He noted that the corporate bond market was very disorganized. For Berkshire's life insurance companies, they barreled into good quality corporate bonds yielding 10% or better with great call protection.

FINANCIAL LITERACY

Buffett allowed that financial literacy is a tough sell in a world of calculators. Few can actually do the math anymore. Add in credit cards and you've made it easy for people to do silly things. Munger chimed in with an anecdote about going to Vegas for his honeymoon back in 1952 at the Flamingo. There he saw very well dressed people who had travelled for miles to do something dumb with negative probabilities and he thought to himself, "what a world of opportunity!" Munger added that states legalize gambling with lotteries, effectively *encouraging* the populace to bet against the odds.

BANKS

Buffett and Munger were both complementary of the government's actions in the midst of crisis and are optimistic for the recovery of the banking system. Buffett asserted that mid-September, we were at the brink of a total meltdown throughout the financial system. There was that one weekend where Lehman went down, AIG went down, and Merrill Lynch would have gone down if not acquired by the Bank of America. Under such pressure, overall, he believes the government did a good job, particularly in guaranteeing the safety of bank deposits and money market funds.

Buffett spoke especially well of Wells Fargo, calling it a fabulous bank with advantages that the other large banks do not have. In particular, Wells has the lowest cost deposit base, making it the low-cost producer in the business. Buffett predicted Wells will come out of this way stronger than it went in.

In a fascinating aside, Buffett shared that he was teaching a class the day Wells Fargo went under 9. Usually he refuses to answer the old "name a stock to buy" question, but on that day he said that "If I had to put all my net worth in one stock, I'd buy Wells Fargo." Wells has a fabulous business model. With Wachovia, they picked up the fourth largest deposit base in America. Wells will be much better off in a couple of years *because* this debacle happened.

EFFICIENT MARKET JAB

Buffett and Munger do their level best each year to debunk the efficient market hypothesis that dominates academic thinking. Buffett noted that investing is really all about laying out cash now to get more back later. Buffett joked that in 600 B.C. Aesop, who was a very smart man, though he didn't know it was 600 BC, he couldn't know everything – said "a bird in the hand is worth two in the bush". That's really it.

Munger noted that a lot of spreadsheets and fancy math can lead to false precision and worse decisions. He allowed: "They teach the fancy math in business schools because….well, they gotta do something." Buffett chimed in that if you taught the "bird in the hand" maxim you would not get tenure. Rising in the priesthood requires complexity. Buffett added that this false precision only arises with very high IQs. You only need an IQ of 120 or so to be a good investor. In fact, he suggested, if you have a high IQ, keep your 120 and sell the rest. Higher math can lead you astray.

THE HOUSING BUBBLE

Buffett noted that housing prices had risen for so long that there became an almost total belief that housing prices would never fall. They could only go up. Thus a $20 trillion asset class, housing, out of the nation's $50 trillion in assets became increasingly levered up. And the blame is shared by all players. Buffett pointed out that it was Congress that presided over the two largest mortgage entities in the world, Fannie Mae and Freddie Mac, and both are in receivership.

As for the ratings agencies, especially Moody's in which Berkshire owns a 20% stake, Munger noted that they are good at fancy math and, as with the man with a hammer, treated each problem like a nail. Going forward, Buffett believes the rating agencies are good businesses: there are few competitors, they affect a large segment of the economy, and they don't require much capital (though they are still very much attackable).

Buffett noted that the biggest surprise may have been that so many of these AAA toxic creations ended up in the hands of the creators themselves! They drank their own KoolAid. Stupidity ran wild and "everyone else was doing it" became the primary rationale. It's hard to stop once there is such widespread industry acceptance.

REAL ESTATE

California volumes are up for real estate transactions, especially in the lower to mid-priced homes, so Buffett sees some stability coming to parts of the real estate market. The new mortgages going on the books each day are much better in quality than the old ones they are replacing. Low interest rates are helping.

Buffett laid out the big picture brilliantly: There are about 1.3 million new households created each year. Maybe a bit less right now with the recession. During the bubble we were building 2 million new homes annually which far outstripped the household formation rate. The current total excess in homes is about 1.5 million. The building rate has plunged to about 500,000 units annually. So if we continue to build homes at that reduced rate, we can sop up about 800,000 of the excess housing inventory annually for a couple years and supply and demand will roughly come back into balance. Buffett quipped we could take care of the overhang tomorrow by blowing up 1.5 million homes or accelerate household formation by having 14 year-olds start marrying. However, what is happening is that we're producing less and eventually the excess inventory will get absorbed. In sum, housing is more affordable, mortgage rates are low, payment terms are more sound….we're on the road to healing.

FOUR INVESTMENT MANAGERS

Buffett has four investment managers, inside and/or outside Berkshire, and each of the four did no better than the S&P 500's 37% decline in 2008. Buffett added that he's tolerant of that as "I didn't cover myself with glory". Munger added that practically every investment manager he regards highly got creamed last year. Furthermore, they don't want a manager at Berkshire that thinks he can jump into cash and back into the market. They have excluded those types. (Ed: For Corey and me, this news was a nice balm for our bruised egos.)

WARRENOMICS 101

Buffett loves to teach college students. Buffett noted that he had 8 sessions last year with students from 49 different universities last year. His two courses, if he were to run a business school, would be 1) How to value a business, and 2) How to think about markets. That would be it. In valuing businesses it is important to understand the language of accounting, to stay within your circle of competence, and to focus on what is meaningful and sustainable. In thinking about markets, it is important to remember that markets are there to serve you, not instruct you. The key here is emotional stability, to have an inner peace about your decisions. It is important to think for yourself and to make good decisions over time. (Ed: So focus on the *process*, not the outcome.) It is simple but not easy.

The key with markets is that you cannot allow yourself to be forced to sell (from using too much leverage) and that you must not sell in a panic mode, emotionally pulling the rug out from under yourself.

Munger added that there is so much that is false and nutty in modern banking, investing, and academia the most one can hope for is to reduce the nonsense. If someone has an IQ of 150 but thinks it is 160, it leads to disaster.

Buffett imagined himself an economics teacher professing the efficient market hypothesis: "Everything is priced properly." And mused "What do you do for the rest of the hour?" And this is the stuff of Nobel Prizes! Buffett concluded with Max Plank's observation of the inexorable evolution of science despite the strong resistance to new ideas by even the best and brightest of his peers: "Science advances one funeral at a time."

REPLACE AJIT?

Ajit Jain heads up BH Reinsurance and has done wonders, building float to an incredible $24 billion as of year-end 2008. What would Berkshire do without him? Buffett noted that the authority here goes with the person, not the position. While he's happy to give his pen to Ajit, signing for major deals, he would not do so with anyone else. He recounted the story of how Mutual of Omaha back in the 1980's, the largest health and accident association at the time, got into property and casualty insurance. By handing their pen to insurance brokers, Mutual of Omaha lost half of its net worth in a very short time. A huge scandal. In sum, if Ajit were gone, some of what BH Reinsurance does would not be replaced.

Munger added that Berkshire is not looking for mismanagement. While they like businesses that can withstand some folly, some fabulous things are one off. That's the case with Ajit.

WHAT MATTERS AT BERKSHIRE

Buffett asserted that Berkshire was cheaper at the end of 2008 than it was at the end of 2007. The investments are worth more than what they are carried for. And the non-insurance operating earnings may suffer for a bit but long term will do very well.

Munger noted that 2008 was a bad year for a float business. (Ed: We believe he's referring to that 1.5 to one leverage factor – just as it has turbo-charged Berkshire's up market returns, it leverages the losses incurred in a down market.) However, long term, the fact that Berkshire can have so much float at a cost of less than zero is a great advantage. The key is to focus on what matters. According to Munger, what matters at Berkshire is that the property and casualty business is probably the best in the world, the utility subsidiary is the best, ISCAR is the best at what it does, etc. Munger emphasized that it is not easy to get into these positions.

GEICO

Perhaps no world-beating subsidiary is hotter right now than GEICO, the low-cost provider of auto insurance. Buffett noted that the economic downturn changed consumer behavior like ringing a bell. Everyone is a bargain shopper now. That has hurt at American Express where the average ticket is down 10%. It has helped at GEICO where the phone is ringing off the hook. Thousands are coming to the website everyday to see if they can save money. In the first 4 months of 2009, GEICO has added 505,000 policyholders. The competitive advantage GEICO has built over the past decade is paying off hugely. Buffett sees market share going to 8.5% by year-end, that's up from 7.2% at the beginning of 2007. Incredible! And each policyholder has significant value – effectively an annuity, paying on average around $1500 annually for a policy they must have if they want to drive – and Americans love to drive.

Buffett quoted Marshall Fields: "we waste half of the money we spend on advertising…the problem is we just don't know which half." From a paltry $20 million ad budget when Berkshire took full control of GEICO in 1995, Buffett has amped up the annual ad budget to $800 million – far more than State Farm or Allstate. (Ed: We haven't seen recent numbers, but GEICO outspent the entire rest of the auto insurance industry *combined* on advertising for most of the past decade.) He wants everyone in the U.S. to have in mind that there's a good chance to save money at GEICO. He related that to Coca Cola which since 1886 has advertised to associate Coke with moments of pleasure and happiness all around the world. And that share of mind is paying off for GEICO -

with the economic downturn, thousands more are checking to see if they can save even $100 with GEICO.

Munger noted that in effect GEICO is earning $800 million pre-tax (the ad spend) that never shows in the earnings. Buffett agreed, saying GEICO could probably go to a maintenance advertising level of, say, $100 million and maintain the present policyholder count for many years.

INFRASTRUCTURE – BUILD THE GRID

Munger nearly elbowed Buffett out of the way to answer a question on whether the U.S. should be spending more on infrastructure. "YES" was his answer. He went on to say that there is one big no brainer that would hugely improve U.S. industry and commerce and that is to build a nationwide electricity grid. We have the technology and know-how and it would be 100% likely to make the system better. (Ed: Munger said much about the grid at the Wesco Financial meeting as well.)

DERIVATIVES

Buffett asserted that the use of derivatives caused leverage to run wild, straining an already fragile economic system, and causing problems to pop up in unexpected places. After 1929, Congress decided is was very dangerous to let people borrow against their securities. The Federal Reserve instituted margin requirements of 50%. Derivatives totally went around these regulations of the markets. In addition, while normal securities settle in 3 days or less, keeping counterparty risk to a minimum, derivative contracts can have very long settlements. These unsettled contracts pile up over time, adding to the risk in the system. (Buffett recommended reading John Kenneth Galbreath's The Crash.)

Munger believed the deeper problem was that the derivatives dealer was not only the croupier at the gambling table, but was also playing the game itself against his clients with an informational advantage. He concluded that society does not need this sort of thing.

BERKSHIRE DERIVATIVES

Buffett has written derivative contracts on both equity markets and on high yield bond markets which has caused quite a stir. The equity puts raised $4.9 billion in cash which Berkshire will hold for the duration of the contracts and the contracts do not require Berkshire to post much (if any) collateral. In effect, it's much like writing long tail catastrophe reinsurance where Berkshire creates that much coveted "float". The high yield bond contracts are experiencing higher than expected default rates, so Buffett is not doing so well with those and may end up losing some money.

THE BERKSHIRE ADVANTAGE

Buffett noted that the Berkshire culture and business model are very difficult to copy. Shareholders are high grade with an average turnover of 20% a year versus 100% for the average publicly traded large company. They run the business without teams of lawyers and bankers. Management is decentralized and incentives are rational. The culture is constantly reinforced as the managers see it works. In contrast, Munger opined that many corporations are run stupidly, forcing things down from headquarters, worrying about quarterly profits.

For companies selling to Berkshire, Buffett noted that it is important that "it is known that we like allocating cash flows, our reputation is that we buy to keep, and people can trust us on that."

Buffett noted one of his standard management questions is "what would you do differently if you owned 100% of the company?" Answering the question for himself, he said he wouldn't change a thing at Berkshire.

COPY BERKSHIRE

Buffett noted there are things that Berkshire does that the average investor cannot copy. 1. Float – Berkshire has that $58 billion interest free loan. 2. Berkshire makes direct purchases and deals of its own design. 3. Berkshire sometimes buys whole companies. Beyond that, Buffett shared that he did copy Ben Graham by studying Graham Newman reports years ago. Coattailing was the term. Munger concluded that it is quite smart to follow very good investors around.

INFLATION

Buffett said it is certain we will have some inflation over time. For the U.S., and governments throughout history, this is the classic way of reducing the cost of external debt. Inflate and pay the world back with cheaper dollars. Buffett noted that the Chinese, the largest holder of government bonds, will suffer the most with devaluation, as it is fixed dollar investors whose notes are worth less at maturity. Buffett also chided politicians who constantly refer to how much all of this government bailing out is costing the taxpayers. The taxpayers have yet to pay one cent more than in years past!

Buffett guaranteed that the dollar will buy less over time, and that is happening with all other currencies as well. All major nations are electing to run major deficits in the face of the economic crisis. Buffett was emphatic: "You can bet on inflation." Munger reflected that when he was growing up in Omaha, a postage stamp was 2 cents and a hamburger was a nickel. And, yet, he has lived in the most privileged era of history.

Buffett added that a Coke was 5 cents with a 2 cent deposit – so it really hasn't gone up that much. Meanwhile a newspaper was a penny, now costs a $1 and loses money.

The best protection against inflation, according to Buffett, is your own earning power. If you constantly increase your earning power, you'll be sure to get your share of the economic pie. The next best thing is to own wonderful businesses, especially those that have low capital requirements. For example, Coca Cola requires little capital to grow and is sure to get its percentage of income, however it is measured, whatever the currency. Munger summed up: "A young man should become a brain surgeon and invest in Coke instead of government bonds."

NEWSPAPERS

Buffett loves newspapers, reading at least 5 a day. However, he said that most newspaper companies today are not a buy at any price. What was an absolutely essential business 30 years ago is now a business looking at unending losses. Buffett said Walter Annenberg invented a term, "essentiality", and that newspapers once had that for advertisers and customers. Over time that essentiality has eroded and there appears to be no end to that erosion. At Berkshire's Buffalo News, Buffett said the unions have been very cooperative and it can still make a little money. At the Washington Post, there is a good cable business and a very good education business but no answers yet for the newspaper. Munger said it was a national tragedy to lose such an important sinew of the civilization; the newspaper, with its desirable editorial influence, kept government honest.

RETAIL AND MANUFACTURING

Buffett again said he looks for housing supply and demand to return to equilibrium in a couple years. Business for Berkshire's housing related products will recover at that point. As for retail, Buffett sees a big change in consumer behavior going for the low-priced products and he suspects it will last quite a long time. He wryly noted that for years government has asked people to save more while the savings rate drifted down to zero. Now government wants people to *spend* more and the savings rate has jumped up to about 4-5%.

In commercial real estate, the 5% cap rates of recent years look silly now. Vacancies are up. Shopping centers are suffering. Real estate could be tough for quite a period. South Florida in particular he expects to be flat for a long time due to huge oversupply.

SHARE REPURCHASES

Buffett noted that corporate America as a whole has not added value with its stock repurchases. Back in the '70's and '80's, stocks were cheap - clearly well below intrinsic value - and very few corporations repurchased shares. Then, during the last 10 years, buying stock became the thing to do. Many companies had stock buyback programs at high to even silly prices. Buffett estimated that 90% of the buyback activity in the last 5 years was mostly herd behavior. Now, with stock prices dramatically marked down, many at less than half the prices at which repurchases were made, there are few buybacks going on.

OPPORTUNITY COST

Buffett noted that calibrating opportunity costs last year got a little crazy with prices and intrinsic values changing so fast. He shared that Berkshire got lots of calls and ignored most of them, but, interestingly, even the calls he chose to ignore were helpful in calibrating the more promising ones. (Ed: Who can match Buffett's flow of information?!) For example, Goldman Sachs called on a Wednesday. The time for that transaction was NOW – it wouldn't be there a week later. So in a chaotic market, Berkshire was able to put large sums to work fast. The Constellation Energy offer (which "failed" though Berkshire took home a $1 billion profit), $5 billion in Goldman Sachs preferred and warrants, $3 billion in GE preferred and warrants, etc. Buffett noted that he hadn't had a flurry of activity like this in a long time.

THE NEW PE AT BYD

Munger was very excited about Berkshire's attempt to acquire 10% of BYD, a Chinese manufacturer. He noted that BYD is no start up, with $4 billion of revenue and having already pulled off miracles in becoming a world leader in lithium batteries and a major player in cell phone components. Now the company aims to take on the auto world from a standing start by building electric cars. They already have the best selling car model in China and make each of the parts themselves. Munger seemed especially excited by the fact that BYD has 17,000 engineering graduates – the top of the class in a country of 1.3 billion people. The thought occurs to us that Munger may be on the verge of a new analytic device – the PE ratio – that is, Price to Engineers. (We note that Munger gave us the "GURF" asset accounting idea last year - "Good Until Reached For".)

Lithium batteries are needed in every utility function. To harness the power of the sun, we will need batteries. BYD is in the sweet spot, Munger concluded. Buffett quipped, the Irish banks were my big idea (Berkshire lost a few hundred million dollars on them last year) and BYD was Charlie's. He's the winner!

MOODY'S DOWNGRADE

Buffett admitted to being irritated with the Moody's downgrade of Berkshire from AAA to AA. Buffett claimed it makes little difference in Berkshire's borrowing costs and there remains no stronger credit than Berkshire, having always conducted its affairs so that no one worries about getting their insurance checks well into the future.

Munger noted that at least Moody's showed considerable independence in making the change (Berkshire owns 20% of Moody's). And he predicted the next change by Moody's in the Berkshire rating will be in the other direction.

Buffett quipped that as Charlie has told him before: "In the end you'll see it my way, because you're smart and I'm right."

UTILITY INVESTMENTS

MEC is now the largest wind utility in the nation. Iowa is #1 in wind power with some 20% of its power wind generated. The wind blows 35% of the time, so this is not base capacity. Overall, MEC is a net exporter of energy for Iowa. Berkshire is a big taxpayer so it can use the 1.8 cents per kilowatt/hour tax credit. They are putting in wind power in the Pacific northwest and are looking to do more. Munger noted that he's very proud that MEC is a leader in the field.

Buffett noted that he wished that he had been able to purchase Constellation Energy. The day David Sokol heard CEG was in trouble, facing bankruptcy, he called Buffett with an idea to make an offer. That very evening, Sokol and Greg Abel were in Baltimore with an all cash offer. So Berkshire went from an 11am phone call by Sokol to an in person bid that night!

Munger added that Berkshire once bought a pipeline in 2 hours. Dynergy had purchased the Northern Natural Gas pipeline from Enron, and then Dynergy itself went down. To close the deal Berkshire needed FERC approval so Buffett agreed to do whatever FERC said to do post deal. Buffett noted that while it's the shareholders you need to please in most deals, it's the *regulators* you need to please in utility transactions.

CHINA

Munger weighed in with praise for Chinese economic policy. China has one of the most successful economic policies in the world. Growth is so significant and important to China that it amounts to just a trifle if the dollar declines. Their goal has been to make it very hard to compete with them all over the world That's exactly what they've done and what they should do.

GEN RE

Buffett announced that Gen Re is working well after a terrible start. When Berkshire bought it in 1998, Gen Re's premier reputation was not reality. It was an enormous mess. Thanks to Tad Montross and Joe Brandon, the operations have been turned around. Now Buffett feels terrific about its future. Munger noted that it is important sometimes to turn lemons into lemonade, and, while it wasn't pretty or pleasant, Joe Brandon was the one brilliant hero in the transaction.

INSURANCE

Buffett said we have marvelous insurance businesses. His worst case estimate was that Berkshire could lose 3-4% of a major industry loss. For example, Hurricane Katrina amounted to about a $60 billion loss, while Berkshire lost less than $3 billion. In a $100 billion event, Buffett guessed Berkshire would now pay around $3-4 billion. (Ed: Again we wonder how can Berkshire have 6-7% market share in reinsurance and yet have only 3-4% exposure in a catastrophe?)

SWISS RE – A FOUR COURSE MEAL

In another exciting tale of fast action, Buffett related how Swiss Re was under extreme pressure last year during the crisis. Buffett met with them in Washington D.C. to hammer out a deal that met their needs and that was good for Berkshire. Buffett emphasized that Swiss Re's problems were ones of capital adequacy, not underwriting standards. Berkshire agreed to a quota share arrangement where it will receive 20% of Swiss Re's property casualty reinsurance business over 5 years. Earlier in 2008 Berkshire had purchased 3% of Swiss Re. Then, in February of this year, Berkshire invested $3 billion swiss francs in a 12% note that is callable at 120% of par for 2 years and in 3 years is convertible at $25 francs/share. The notes are senior to Swiss Re equity of $20 billion. Buffett said the odds are good that the note will get called, which would not make him happy. Then, in addition to all that, Berkshire did a $2 billion swiss franc adverse loss cover with Swiss Re. That pushed Berkshire's float to just over $60 billion at quarter end.

So to summarize, Berkshire bought shares of Swiss Re, wrote a 20% quota share contract, invested in a 12% convertible note, and provided an adverse loss cover. That's a lot of bites from one apple!

HOPE FOR THE WORLD

Buffett offered that there is always a lot wrong with the world, but it's the only world we got. Fortunately over time, people do better and better. For all its flaws, the capitalist system works, unleashing human potential. Consider that there were 35,000 people at the Berkshire meeting – that would have been 10% of the entire population of the U.S. in 1790.

Buffett allowed that we'll have bad years in capitalism. There were 6 panics in the nineteenth century. While we have had these interruptions, we have grown at a great clip overall. The standard of living increased 7 to 1 in the 20^{th} century. At one time a black man was considered 3/5 of a person and women couldn't vote for our first 130 years. We were wasting human potential. Our kids and grandkids will live better and better.

Buffett repeated that he hopes to grow 2% or so faster than the S&P 500 in intrinsic business value. And that's a far cry from outperforming the market by 10% annually in his partnership days. However, Munger beamed, Berkshire's best days of contributing to civilization are ahead. He noted that mankind is getting close to solving *the* technical problem of our time – solar power. Cheap, clean, storable power will change the world.

Munger said, "As I get closer and closer to my death, I get more cheerful about the future I won't see." He talked about the potential of solar power as the final breakthrough. It would solve the main technical problems of mankind. He's excited that MEC and BYD will participate. If we have enough clean energy, we can do all sorts of things.

Berkshire's Cash/Bond/Stock Ratios 1979 through 2008

In a reprise of our April 1999 newsletter, we review Berkshire's cash/bond/stock allocations. While Berkshire's operating businesses are of growing importance, investment assets still comprise a lion's share of Berkshire's value. We find it worthwhile to contemplate changes in allocations. Note that the investment portfolio increased over 198-fold in 29 years. The chart illustrates that Berkshire has been a significant buyer of equities and other deals - increasing the percentage from 41% to 58% over the past three years. With Buffett keeping a minimum of $10 billion in cash for insurance catastrophes, Berkshire is "all-in" for now.

		Percentage Allocation		
Year	Investment Portfolio (in millions)	Cash and Cash Equivalents	Securities with Fixed Maturities	Equities and Other Investments
1979	$ 615	5%	30%	65%
1980	764	8	24	68
1981	911	8	22	70
1982	1,162	5	16	79
1983	1,516	5	14	81
1984	1,710	10	18	72
1985	2,676	38	18	44
1986	3,288	9	34	57
1987	4,666	5	44	51
1988	5,639	5	32	63
1989	8,263	2	34	64
1990	8,994	3	34	63
1991	12,283	6	19	75
1992	14,948	8	14	78
1993	16,487	11	13	76
1994	18,355	2	15	83
1995	26,362	10	6	84
1996	35,537	4	18	78
1997	47,548	2	22	76
1998	74,589	18	29	53
1999	73,565	5	41	54
2000	77,086	6	43	51
2001	72,471	7	51	42
2002	80,494	13	50	37
2003	95,589	33	27	40
2004	102,929	39	22	39
2005	115,615	34	23	41
2006	125,715	30	20	49
2007	141,217	27	20	53
2008	122,025	20	22	58

Note: In 1985 cash swelled due largely to the buy-out of General Foods by Philip Morris**.**
The 1998 General Reinsurance merger shifted the percentage in equities from 76% to roughly 55%.

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