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EXECUTIVE SUMMARY

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

Market Update - The Tepid Stove Market

"The cat, having sat upon on a hot stove lid, will not sit upon a hot stove lid again. But he won't sit upon a cold stove lid either." - Mark Twain

Fund investors, burned by the Internet bubble and the subprime mortgage debacle, turned positively frigid toward the stock market over the past five years, moving roughly $1 trillion into bond funds and shifting $500 billion out of U.S. equity funds. The average investment cat was no longer interested in stoves of any temperature. We have followed mutual fund flows for years as an excellent contra-indicator. Usually we look for sectors that are in liquidation and disrepute for bargain hunting. This time the area of disrepute has been *the entire U.S. stock market*.

Meanwhile, the U.S. bull market has entered its fifth year. The S&P 500 has surged 145 percent from a 12-year low in 2009, driven by better-than-estimated corporate earnings and three rounds of bond purchases from the Federal Reserve. The S&P 500 recently returned to its old high of 1550, a level attained in the years 2000 and 2007. During this infamous "no return" thirteen years, U.S. GDP increased 50% and global GDP doubled. Thus, the S&P 500 is much cheaper today than it was in the year 2000.

With the return to new highs, the media is abuzz with warnings of eminent danger (selling "fear" seems to be its number one business). However, at about 16 times earnings, this market is only tepidly priced. While fund flows did recently turn positive for stocks, those amounts are still smaller than flows into bonds. (For the first four months, fixed-income funds took in $83 billion, balanced funds $35 billion, and U.S. equity funds $16 billion.) Despite the stock market's doubling over the past three years, attitudes towards stocks have thawed only slightly. There are good reasons for continued caution. Record earnings are coming in on record high margins, so there is risk (likelihood) of earnings getting pressured as margins revert to the mean. The Fed's Zero Based Interest Rate plan has no doubt driven some yield-hungry investors into stocks. In addition, global debt problems persist, budget issues are ongoing, and whether Central Bankers can unwind their massive stimulus worldwide without undo dislocations remains to be seen.

Corey and I note that with the headlines full of concerns about the huge debts of world governments, the media has largely missed another story: the rise of America as a low-cost manufacturer. Indeed, some countries' (esp. China) import/export problems are due in part to the U.S. becoming less dependent on foreign energy and goods. Cheap energy is fueling an "on-shoring" of American manufacturing. The U.S. financial and industrial sectors are on much firmer footing. The banking system is the best capitalized it's been in 70 years. Balance sheets are flush with cash. This is not the stuff of market calamities. Again, while stocks are less cheap with the recent rally, the market sentiment has merely moved from frigid to tepid, underestimating these improvements.

Meanwhile, bonds are as expensive as ever. So stocks are still the better value by a wide margin. In addition, we prefer to own earning assets with high free cash flows to offset the risks of inflation and the unexpected event. Fixed-rate, dollar-based securities will be challenged to keep up in the event of rising inflation. Indeed, as we speak, short term Treasuries offer negative real returns.

Stocks Good, Bonds Bad

This is Corey's four word summary of the Berkshire Hathaway annual meeting. For those of you behind on your gardening due to the late spring we're having, you may return to the great outdoors. For those who want more read on for our summary report on the "University of Berkshire Hathaway".

Berkshire in the Age of Allocation

Warren Buffett has acted in the extreme on his judgment that businesses and stocks offer better value than bonds over the last five years. If you take a gander at our Cash/Bond/Equity review (on back page), you'll see Buffett took his equity percentage from the 40% area during the "lost decade" (during which he was criticized long and hard for holding too much cash) and then stepped it up to 58% during the 2008 crash. Nice move, eh? However, that does not tell the tale of just how aggressive Buffett has been. For 2012, Berkshire invested nearly $10 billion in capital improvements for Burlington Northern Santa Fe and MidAmerican Energy, $2.3 billion in bolt-on acquisitions, $1.5 billion in additional ownership of Marmon Group, added $1 billion each to the portfolios managed by Ted Weschler and Todd Combs and more. Most recently he joined with 3G Partners in buying Heinz where each party invested $4 billion in equity and Berkshire also invested $8 billion in a 9% preferred with warrants attached (Warren loves warrants). At the time of the meeting, Berkshire announced it was buying the 20% of Iscar it didn't already own for $2 billion from the Wertheimer family. In sum, Buffett has been on a buying spree since 2008, with *Berkshire putting well over $100 billion to work in equities and business investments.*

THE UNIVERSITY OF BERKSHIRE HATHAWAY

Corey (and his daughter, Sarah) made the annual pilgrimage to Omaha for the Berkshire meeting, joined by 45,000 of Warren Buffett's closest friends - in sharp contrast to Corey's first annual meeting at the Red Lion Inn in 1984 when a few dozen of the faithful attended. The CenturyLink Center convention floor was turned into the "Berkshire mall" with all sorts of subsidiaries hawking their wares.

Dan and John missed the annual confab to attend a relative's wedding (where are our priorities!). Corey took his daughter, Sarah, for support and for her rookie Berkshire meeting. Her fresh observations: "They are really sharp" and Buffett seldom seems to answer a question directly. She liked Munger's answers better as "he's more to the point." Based on our single data point analysis, in an upset, Warren is losing the younger crowd to Charlie!

The convention arena was packed as eager attendees sought to hear the latest wisdom from Chairman Warren Buffett and Vice-Chairman Charlie Munger during the 6-hour shareholder meeting. It is an impressive learning experience, especially considering that "Professors" Buffett and Munger (ages 82 and 89, respectively) are still going strong.

Buffett and Munger have presided over one of the greatest records of wealth building in history. Since Buffett took over Berkshire 48 years ago, Berkshire's per-share book value has grown from $19 to $114,214 a rate of 19.7% compounded annually. That's more than double the S&P 500's 9.4% annualized percentage gain for the same period. Since compounding is a geometric progression, a small advantage in the annual rate of gain creates a huge advantage in total dollars compounded over time. In terms of the overall percentage gain from 1964-2012, a dollar invested in Berkshire in 1964 experienced an amazing gain of ***586,817%*** versus a gain of 7,433% for the S&P 500.

Over those 48 years, Berkshire Hathaway has grown from a small New England textile company into one of the world's most powerful conglomerates. Berkshire now ranks 5th in revenue ($162 billion), 10th in profits ($14.8 billion) and 14th in assets ($427 billion) in the most recent edition of the *Fortune 500*. In terms of market value, Berkshire now trails only Apple, Exxon Mobil, and Google for the title of America's most valuable company.

Back in 2011, Berkshire traded for around $117,000 per A share, roughly a 25% discount to our appraisal of intrinsic value per share at the time. With the recent rally to $171,000 per A share, the price has actually risen a bit faster than the growth in the company, closing the discount for the first time in a number of years. So while intrinsic value has grown significantly, the value gap has narrowed a bit.

The quality of questions for the meeting was significantly improved by having a panel of three journalists and a panel of three analysts (including short seller, Doug Kass) ask a majority of the questions.

Here is our annual write up from the meeting, aggregated by topic.

GEICO

We have talked often of the big getting bigger and the strong getting stronger with the way the global economy is unfolding. Well run companies with winning business models are taking market share from the less well run. Those companies with scale can more easily deal with the increasing regulation and complexity of modern society. We love the little guy, but the way to bet has been on the big. GEICO is getting big fast.

GEICO has always had a winning business model – selling auto insurance direct. By cutting out agents, GEICO has a lower cost delivery system, and low cost providers usually win in commodity type businesses. Buffett wrote his Columbia grad school thesis on the company. In the 1970's, GEICO got into trouble and Buffett took advantage of a weak stock price to buy a lot of the stock. Berkshire's percentage ownership of GEICO continued to grow as CEO Jack Byrne bought in the shares aggressively. Then, in 1995, Berkshire bought in the portion of GEICO it didn't already own at around 3 times book value. At the time, the price seemed rich. However, Buffett realized that GEICO, as a public company, was limited in how aggressively it could grow the business. Fully owned by Berkshire, Buffett could put the pedal to the metal. GEICO's advertising budget soon exceeded the ad spend of *the rest of the auto insurance industry combined.* That nationwide branding created a share of mind that has led to exceptional growth in market share. *Since 1995, GEICO's share of the personal-auto market has grown from 2.5% to 9.7%.* And business is accelerating.

At the annual meeting, Buffett was virtually giddy with delight about the gains at GEICO in both the closure rate and the persistency (renewal) rate. High and rising closure rates add significant value as GEICO already added over 470,000 new policyholders for the year and might exceed 1 million new policyholders to date, which Buffett estimated would account for *two thirds of all new auto policies written in 2013*. This is astonishing. In addition, GEICO has enjoyed a meaningful increase in its renewal rate for existing policyholders ("persistency") as well. Buffett called this "pure gold". Any business where people send you a check year after year certainly has appeal. Buffett went on to say that each policy has a mathematical value of about $1,500. So if GEICO does add 1 million new policyholders this year, that would create an additional $1.5 billion of intrinsic value for Berkshire; none of which shows up directly on the income statement or the balance sheet but clearly increases the value of GEICO over what it is carried for on the books. (Ed: This growth suggests that GEICO will pass Allstate this year as the #2 auto insurer in the nation, trailing only the long time king of auto insurance, State Farm. Quite a ride since 1995.)

Auto Insurance Primer

Asked about Progressive's new "Snapshot" product, Buffett launched into a lecture on the essentials of the business. He noted that insurance underwriting involves figuring out the probability of a person generating a claim – i.e. having an accident. GEICO asks a lot of questions to help them calculate this probability and Progressive uses their Snapshot tool to help them assess the same thing.

To help explain, he used an example from the life insurance industry, noting that someone who is 100 years old is more likely to die next year than someone who is 20. With auto insurance, figuring out who's more likely to have an accident involves looking at many more variables and that every company does it its own way.

He went on to explain that if you're a 16 year old male, you are more likely to have an accident than he is. This isn't because he's a better driver but because the 16 year old will drive a lot more and also will be trying to impress his girlfriend. "That doesn't work for me anymore, so I've given up." Effectively if your risk selection process treats 16 year olds like 82 year olds, you're going to get horrible underwriting results.

Buffett added a story that Progressive's Peter Lewis had shared with him. When Lewis started Progressive, it was a tiny little mutual company without much capital that underwrote motorcycle policies. The first reported loss was some guy who was redheaded, so Lewis decided not to insure redheads!

GEICO's ability to sell insurance at a price considerably below the competition's, as shown by the large numbers of people moving to them, and write at a large underwriting profit shows that GEICO's system is working well. He added that since they've been doing this for decades and have many policyholders, their underwriting is extremely credible. (Ed: The mantra for insurance underwriting is that data must be credible and reliable. Large amounts of data are required to achieve this.) Buffett finished by saying that they're watching Snapshot but are quite happy with the current system. Munger concluded in his usually understated way, "Well, obviously we're not going to copy the odd ball things every competitor does when we've got an operation that's working so well."

Berkshire Reinsurance

Ajit Jain has built a remarkable reinsurance business for Berkshire Hathaway and recently his operation made two important decisions. Buffett discussed how Ajit's division signed a deal where they would participate in 7½% of all the business in the entire London market. He also noted that Berkshire had a similar arrangement with Marsh on some of the business there before, but never across the board like this.

The second decision was to hire 4 well known insurance people from AIG to write commercial insurance. These are people that reached out to Ajit in the past. Buffett believes this could make Berkshire a very significant factor worldwide in the commercial insurance business, perhaps in the billions. While they have made acquisitions of insurance businesses in the past, Buffett said that it's really better to build than buy if you can find the right people and the right mindset. In effect, Berkshire will be able to build a very large commercial business at essentially book value and won't pick up any bad habits from other companies.

Munger observed that the reinsurance business is usually not very good for most people. The key to Berkshire's success with reinsurance is the unique way it is run. Buffett concluded that they have "the right people, capital like no one else, and can write business without spreading things out."

Reinsurance Primer

Buffett emphasized several times that Berkshire is "an unusually rational place". It has been a benefit that he and Charlie did not have outside influences pushing them in unwanted directions. Insurance in particular should be conducted as a rational activity. One problem some insurers have is that they have pressure from Wall Street to increase premiums every year. In contrast, Berkshire will walk away when the pricing is inadequate. He recalled that at one time, National Indemnity contracted by 80% because pricing was inadequate. (Ed: We recall that National Indemnity subsequently did business hand over fist during the next hard market.)

Buffett added that if Berkshire does something stupid, it's not because of outside influences. In contrast, most managers, especially if they have little vested interest in a company they are running, would have a hard time resisting what Wall Street wanted them to do. They wouldn't want to be subjected to media criticism and other unwanted pressure.

Buffett noted that Berkshire wrote a lot of catastrophe insurance in the U.S. when prices were right. Now the prices aren't right so they aren't writing it. Buffett concluded, "We haven't left the market. The market left us."

He went on to compare this to refusing to buy Internet stocks in the late 1990's. Referring to it as a "social proof or bandwagon effect," adding that it's hard to resist this pressure when people around you are making a bunch of money and friends and the media are questioning why you aren't doing it. Berkshire's advantage is that they don't have such pressures – "we just don't give a damn".

Munger added that the Bible says things like – "you can't covet your neighbor's ass," for a reason. Borrowing from past comments, he finished with, "Even worse, envy is the one sin that's no fun."

Buffett chimed in, "Gluttony is a lot of fun (while reaching for a piece of peanut brittle). Lust has its place too, but we won't get into that."

Buffett acknowledged that hedge funds have recently entered the reinsurance market in a big way. He opined that it is a product that is easily sold to investors. Buffett huffed, "Anything Wall Street can sell they will. You can count on that." Munger added, "They'll throw in a lot of big words, too."

Adding a life lesson to the discussion, Buffett emphasized "***that you can't afford to go along with the crowd in investment or insurance or a lot of things****."* He recounted that if you own a gas station and the guy across the street sells below cost you've got a huge problem. In insurance, if the guy across the street is selling below his cost, the standby costs are reasonable and aren't backbreaking. Effectively, Berkshire can just wait for better days and better pricing to come along.

Buffett once again praised his insurance managers saying that Berkshire was very lucky to get such great people like Ted Montross at General Re, Ajit Jain, Don Wurster, and Tony Nicely at GEICO. He went on to conclude that they like it at Berkshire because they are not pressured to do dumb things.

Munger agreed, "With our cranky methods, we probably have the best insurance operation in the world. So why change?"

The BNSF Railroad

Buffett reported that the railroad is doing very well. Figures displayed at the start of the meeting showed gains in railcar loadings of 3.8% versus a gain for all other U.S. based railroads combined of just 0.3%. Buffett noted that that is a significant difference. It's helped that a lot of oil was found close to their tracks. "What better place to find oil!", he quipped. In fact, Buffett talked with oil producers in the Bakken oil play and he sees increasing rail usage for a long time. He added that oil moves faster by rail than by pipeline. (Ed: An engineer friend at MidAmerican tells us oil can only move about 30 miles per hour max without causing undo corrosion. The rail can go twice as fast though it has a bit more handling risk.) Burlington Northern Santa Fe CEO Matt Rose said that they're moving about 650,000 barrels of crude a day. He thinks it will be 750,000 by year end and could go up to 1.4 million in the years ahead. Buffett added perspective, noting that the whole country produced just 5 million barrels a day not too long ago. This is a lot of oil and it's not just the Bakken. There's shale developments and more unfolding. (Ed: Kinder Morgan recently proposed a pipeline from Texas to the West Coast to supply refiners there. Refiners have declined to sign up, preferring the new-found flexibility of oil by rail.)

In terms of BNSF's coal franchise, they look for it to stay about where it is today. With some track dedicated to coal, there could be some loss of value over time. Business will fluctuate depending upon natural gas prices and the EPA. Some generating capacity can go in either direction.

BNSF versus the New Normal

Asked about Bill Gross' concept of lower future returns dubbed "the new normal", Buffett stressed that he and Charlie don't pay any attention to macro forecasts. He noted that people talk all the time about future and macro issues, but they don't know what they're talking about. It's not very productive. Buffett profoundly noted, ***"To ignore what you know to listen to someone else who doesn't know, doesn't make sense."*** Buffett went on to say that he does know that BNSF will be carrying more and more carloads and there will be no substitute. There will be only two railroads in the West, so BNSF has incredible replacement value. He suggested that people will do very well owning good businesses if they don't pay too much for them.

Munger demurred saying that he believes that it's conceivable that the next 10 years may be no better than the last 10.

ISCAR

Just prior to the meeting it was announced that Berkshire would buy the final 20% of ISCAR held by the Wertheimer family for about $2 billion. Buffett noted that the relationship with the Wertheimer family would continue. Comparing ISCAR to Sandvik (Ed: Sandvik is a Swedish company that owns Sandvik Tooling and Seco Tools – major ISCAR competitors.), Buffett noted that Sandvik is very good but ISCAR is much better. The advantage is in brains and incredible passion for the business. When Seth Wertheimer started the company around 1951, here was this 25 year-old buying tungsten, the raw material for cutting tools, from China along with everyone else. Then he's selling to customers using machine tools all over the world, basically heavy industry.

He had no advantage doing business from Israel. Yet he's getting tungsten from miles away, selling to customers miles away, and he's competing with well run companies like Sandvik. How did he do it? He had some incredibly hard working and talented people who constantly improved the product and worked to make customers happier. And they haven't stopped doing this. Buffett concluded that ISCAR is one of the world's greatest companies and he feels very fortunate to be associated with its management.

Heinz

Buffett said the $23 billion deal came about at the airport in Boulder, Colorado when 3G's Jorge Paulo Lemann asked if Buffett would be interested in joining him on a deal to buy Heinz. Since he respected both Heinz and Jorge Paulo, Buffett said, "I'm in." He's known Jorge Paulo for years from being on the board of Gillette together. In a week or so, Buffett said he received a term sheet on the deal and he didn't need to change a thing on it. In all respects, Buffett said it was an absolutely fair deal to both parties.

Buffett acknowledged that they paid a bit more than they wanted to, as always, and wouldn't have done the deal without 3G. He added that they believe the people of 3G are both classy and are extraordinary managers. While each party has invested $4.1 billion in equity, 3G wanted more leverage in the deal so Berkshire agreed to invest $8 billion in that 9% preferred.

Too Big To Succeed?

Asked whether Berkshire was morphing into an index fund, Buffett acknowledged that as Berkshire gets bigger it gets harder to move the needle and returns, although satisfactory, will not be as good as the past. However, Berkshire's success will also depend on opportunities provided by turbulent markets like 2008 when size and a lot of capital gave them an advantage. Thanks to Charlie's prodding, they have paid up for good businesses. Adding that if you buy a great business for what appears to be a high price, it's seldom a mistake.

Munger attempted to do Buffett one better and noted that the record of holding companies that got really big is not good. He added that Standard Oil was pretty much the only one that got "monstrously big and continued to do monstrously well." Even with that backdrop, he added that Berkshire has a better system than most others.

Buffett added that they have been buying some very good businesses and in fact, 8 of them would be on the *Fortune 500* as standalone entities… 8 ½ counting their 50% stake in the Heinz acquisition.

The Dollar

Buffett declared that he thinks the dollar will be the world's reserve currency for some decades to come. While China and the U.S. will be the world's economic super powers, he thinks it extremely unlikely that any currency will supplant the U.S. dollar. Munger acknowledged that having the reserve currency is an advantage. However, if the U.S. dollar was displaced as the world's reserve currency, so be it. Munger noted that it is in the nature of things that sooner or later the leader is no longer the leader. As Keynes said, "In the long run, we're all dead."

Buffett joked, "This is the cheery part of the section."

Munger continued, "Well, if you stop to think about it, every great civilization of the past has passed the baton."

Corporate Profits as a Percentage of GDP

Buffett was reminded of a 1999 *Fortune* article where he wrote that one would have to be wildly optimistic to think that corporate profits as a percentage of GDP could be much above 6% for a sustained period. Today, corporate profits are greater than *10% of GDP*. Buffett, said that people should take with a grain of salt complaints of high corporate taxes. He noted that business has done much better since the 2008 meltdown than private citizens and noted how employment levels have not recovered. Buffett's best guess is that profits as percentage of GDP will trend downward from here, but GDP will keep growing so it's not anything terrible.

Munger noted that it is important to recognize that stocks are owned by many pension funds which support the masses in some way; so though the figures show that there is an income gap it doesn't mean that the world has become more unequal and that the two figures aren't automatically correlated. He said he likes Warren's idea that the rich should pay more but would prefer to see a lower corporate tax rate.

Buffett concluded, "He's the Republican and I'm the Democrat."

The Huge Fed Experiment

Asked about the Fed buying $85 billion per month of mortgage securities and treasuries and what the long term risks might be, Munger replied, "The basic answer is I don't know." Buffett added that it really is uncharted territory. However, as the Hunt brothers found out when they were buying silver, *it's a lot easier to buy things sometimes than to sell them*. He noted the Fed's balance sheet is up around $3.4 trillion. This is somewhat balanced out by banks with huge reserve positions. He pointed out that Wells Fargo has $175 billion at the Fed earning effectively nothing.

Buffett noted that he has a lot of faith in Bernanke, though he does wonder if Bernanke is affected by the fact his term is expiring. Buffett quipped that maybe Bernanke's advice to his successor to help him bring down the Fed's balance sheet by a few trillion will be to tell him to read a few of the speeches he gave at George Washington University. On a serious note, Buffett warned that this does have the potential to be quite inflationary. He also speculated that some of the Fed members were probably disappointed that they haven't seen more inflation.

Turning to the market, Buffett predicted that the impact on the market will not be when the Fed starts selling. It will be when the market senses that the Fed has changed course – stopped buying in securities. He called this the shot that might be heard around the world. He speculated that this wouldn't necessarily be cataclysmic, but that this change will cause investors to reevaluate their investments – especially those that made their decisions based on low interest rates.

Munger took a shot at the field of economics adding that the economists thought they knew the answers, but have been surprised by the outcome. Adding that with their track record, maybe they should be more cautious in their behavior. He recommended that they re-evaluate their belief that they won't get us into trouble when they print lots of money.

Upon prodding by Buffett, Munger indicated that he is worried about inflation and that the next century will be harder, but that he won't be here to see it.

Buffett joked, "Charlie says he won't be here to see it. I reject such defeatism."

Affects of ZBIR

Moving into a tutorial on interest rates, Buffett observed, ***"Interest rates are to asset prices sort of like gravity is to the apple."*** When there are very low interest rates there is a not much of a gravitational pull on asset prices. People behave differently today, when money costs virtually nothing, versus the early 80's when Volker was trying to stem inflation and rates were 15%.

Buffett continued, ***"Interest rates power everything in the economic universe."*** He added that part of paying a bit more for Heinz included being able to borrow money so cheaply. He noted that interest rates will change, but when it changes cannot be predicted, as was the case in Japan for 20 plus years. He surmised that asset prices were higher because people believe that interest rates will stay low. Relating the interest rate environment to bonds, he added that when the 30 year Treasury bond is 2.8%, it makes houses very attractive.

Noting that its been a smart policy, Buffett ventured that selling $85 billion per month will be much more difficult than buying $85 billion a month. He concluded that it is like watching a good movie because he doesn't know how it's going to end.

Munger noted that Berkshire has this enormous float (Ed: $73 billion) that is worth less than it used to be because of the low rates. So Berkshire would benefit in that regard if and when rates rise.

Buffett emphasized that at Berkshire they ***never stretch for yield***. At the end of the first quarter Berkshire had about $49 billion in short term Treasuries earning basically nothing. If short term interest rates got back up to 5% that would bring Berkshire a couple billion dollars of pre-tax earnings, though it would have lots of other effects on all their businesses.

Flim-flam

A favorite meeting moment came when Buffett was comparing two multi-level marketing companies, Pampered Chef and Herbalife (which has been very publicly shorted by hedge fund manager Bill Ackman). The claim by the short sellers is that Herbalife loads product up on unsuspecting people that they can never sell and that is sort of the main business. In contrast, Buffett contended that Berkshire's Pampered Chef is focused on selling to the end user through thousands of parties every week.

Munger nailed it: ***"I think there is likely more flim-flam in selling magic potions than in selling pots and pans."***

Buffett joked, “At our age, we’re in the market for magic potions!”

1-800-brk-deal

There is no doubt that Buffett’s reputation and deal acumen have resulted in some remarkable deals for Berkshire. Will his successor be so successful? Buffett noted that his successor will have even more capital to work with and that will be especially valuable at turbulent times. Being able to say “yes” very quickly to large deals sets you apart from every other investor. “*Berkshire is the 800 number when there is a panic in the markets*” Buffett further noted that this happens occasionally as it did in 2008 and in 2011. Using one of his favorite metaphors, Buffett pointed out that when the investment tide goes out, you will see who has been swimming naked. Adding dryly, “Those naked swimmers will call Berkshire.”

Interestingly, Buffett was asked about what he would do when one of those quick investment decisions made in February of 2009 comes due in 2014. Berkshire invested $300 million in a 5-year 15% Harley Davidson note. Buffett joked that they would like to just not answer the mail and keep getting the 15%. Further noting that it will be a sad day when it comes due. He indicated that they were able to make the decision quickly because he believed they would not go broke. Concluding his thoughts on Harley Davidson – “**Any company that gets its customers to tattoo ads on their chests can’t be all that bad.”**

Munger observed that in the early days Buffett was successful because he had no real competition. Interestingly, by moving into a field where Berkshire is a great home for businesses that don’t want a home office overseeing everything they do, he has moved into an area where there isn’t a lot of competition.

Buffett affirmed that Berkshire gets the calls that no one else gets because they have the money and the willingness to act immediately. Interestingly, Buffett noted that this area becomes more and more Berkshire’s own as Berkshire gets bigger and bigger.

Munger spoke about Berkshire’s competitive advantages. In his mind, those include the ability to stay sane when others are crazy. Another advantage he talked about was living by a corporate governance golden rule where they treat subsidiaries like they would want to be treated. Noting how rare that was in corporate America, he noted that it attracts businesses to Berkshire. He opined that by Berkshire positioning itself in a less competitive space, it has become quite unusual “This is a very good idea…I wish I’d done it on purpose.”
Buffett shared the story of a business owner that was thinking about selling his business. He was concerned if he sold it to competitors, they would fire the people that helped him build the business. They would come in like Attila the Hun. If he sold to some private equity firm, they’d load it up with debt and resell it later on at which point the Attila the Hun scenario would play itself out again. So when he thought about it, he wasn’t interested in selling to Berkshire because it was so attractive but because Berkshire was the last man standing. It turned out to be a wonderful acquisition for Berkshire and his people stayed and he continues to do what he loves doing. Buffett concluded, “Our competitive advantage is that we have no competitors.”

Buffett also added that he thought one of the advantages was that Berkshire has a shareholder base that’s different, where Berkshire looks at shareholders as partners. The owner/managers want shareholders to get the same result that they get.

Energy Management

On the subject of their work habits, Munger offered a fascinating insight. By accident, he and Buffett have ideal habits for what they do. For example, they didn’t know when they started out about modern psychological evidence that you shouldn’t make important decisions when you’re tired and that difficult decisions are tiring. He joked that they didn’t’ know important decision making was helped by consuming lots of caffeine and sugar. (Cherry Coke and See’s peanut brittle at the meeting!)

Munger offered up that because they both live on auto – pilot they don’t waste energy on the ordinary things that come up every day. He said this is an ideal way to do what they do. He further commented that he has never seen Buffett tired, that he sleeps soundly, and that his lifestyle works ideally for what he does.

Newspapers

Buffett stated that Berkshire has been buying papers at very low prices compared to current earnings and must do so because the earnings will go down. In addition, Buffett noted that his recent newspaper purchases have some tax benefits. Buffett said he expects at least a 10% after-tax return with declining earnings over time. In terms of scale, it doesn’t move the needle at Berkshire. Altogether Buffett estimated that they have $100 million in pretax earnings from their newspaper holdings. Interestingly, although the group is below the threshold for reporting, he said he would report the results of the newspaper group annually.

Munger deadpanned: “I think I hear you saying that this is an exception and you like doing it.”

Biggest Threat

As in past years, Buffett asserted that health care costs are the biggest threat to American competitiveness. We're spending something like 17 % of GDP on health care while our rivals are paying around 10%. He compared it to a raw material cost where U.S. industry pays about 7% more than global competitors. It's just like having a raw material or something of the sort that costs you more. Yet because any one company can't control the cost, it's a big disadvantage.

Munger eagerly addressed this issue and offered up that this "grossly swollen securities and derivatives markets" doesn't really help competitiveness. He added that Cal-Tech and MIT graduates doing derivative trading was a "perfectly crazy outcome in terms of the country." He agreed with Buffet about health care but finds this other issue more revolting.

Warren concluded, "Charlie is very Old Testament."

Advice for Life

Munger declared that he and Warren are basically old fashioned. He thinks the key to life is that the old virtues still work, like plugging along and staying rational. Warren recommended doing what turns you on. Munger agreed saying he'd never done anything really well that he didn't like to do. Buffett reminisced that he and Charlie both started at the same grocery store and neither one of them is in the grocery business today. Munger joked that the young Buffett was in no danger of being promoted either even though his family owned the store. Buffett interjected, "Grandpa was right, too!"

Buffett went on to say that he's been lucky; lucky to live in this country, lucky to find things he liked to do early in life. He said, "It's so much fun running Berkshire, it's almost sinful."

Munger joked, "You found a way to atone for your sins from having so much fun – you're giving all the money back."

Buffett shot back, "you give it all back whether you want to or not."

Timing

Bill Gross recently made comments that his generation of investors owed a lot of their success to the timing of their birth. Buffett agreed that there was no question that being born male and in the U.S. was a huge advantage. Spinning a story he first related in a 1979 *Fortune* article, he talked about his dad being in the securities business and since his dad had no one to call on after the crash he stayed home in the afternoons. "And there was no television…so here I am. I feel lucky the crash of 1929 came along!"

He related that the crash turned people off to the market for an entire decade and that business was horrible. (Buffett noted that we had a similar sort of decade up to 2010 for stocks.) He allowed that the 1950's were a favorable environment for investing with low competition for ideas and that if he would have made more money had he been born five years earlier and probably made less if he'd been born 15 to 20 years later.

Buffett said he envies the baby being born today in the United States. That's the luckiest individual ever. He opined that that baby will do better in all sorts of different ways than when he was born. Just as we live far better than people like John D. Rockefeller, the person born today will live far better than we do.

Munger noted that the competition for investment ideas in Buffett's early career was much weaker than it is today. However, that does not mean that there's nothing to be done ahead in the world of investing.

Buffett bragged up Charlie a bit, noting that in 2008 and 2009 there were thousands and thousands of high IQ, investment professionals. And Charlie invested the cash at Daily Journal (of which Munger is Chairman of the Board) in equities at X that are now worth 3X-4X. (Ed: We'll brag up Warren here, as we noted earlier Berkshire has put to work over $100 billion since 2008!)

Munger observed that Buffett was drowning in opportunities when they first met but what he lacked was money.

Buffett finished with the punch-line, "Now we've got money and no ideas."

Solar Power

Munger confidently predicted that there will be more solar generation in deserts than on rooftops. Berkshire's big solar operations get very favorable terms and are located in the desert, so Berkshire will do fine. However, he's skeptical about rooftop panels harming Berkshire's utilities. He suspects there's some twaddle and in that area. MidAmerican Energy CEO Greg Abel added that while the cost of installing rooftop solar has come down, there are tariffs protecting the utilities.

Banks

Asked about Dodd Frank, Buffett noted that the higher the capital ratio, the lower the return on equity. Overall he thinks that U.S. banks are much stronger they've been in 25 years. For the most part, the old bad loans are gone and the new ones are much better. He added that our banking system is far stronger than Europe's.

Buffett declared that he's not worried about the banking system or a housing boom causing the next bubble. It will be something else. He noted we will always have bubbles because it is the nature of Capitalism to go to excess. That's what humans do. But the next bubble will come in some other way.

Buffett said he feels very good about investments in Wells Fargo, US Bank, and M&T Bank. Their earnings should be decent over time, but their returns on equity will be lower than they were 7 or 8 years ago because of Dodd Frank.

Munger noted that he's a little less optimistic about the banking system long term than Warren. He still does not see why massive derivative books should be mixed up with deposits that are insured by this country. (Buffett agreed.) Munger concluded, "The more bankers want to be like investment bankers instead of bankers the worse I like it. I can't say more. I'm in enough trouble on this subject already."

Buffett joked, "I can see the journalists just licking their chops waiting for Charlie to throw a thunderbolt. He's unusually restrained today! "

Succession Plan - The Culture

There were yet again a number of questions concerning the succession issue. Andrew Ross Sorkin asked the question "Is Ajit your successor"?

To which Buffett replied, after pausing for a moment, "I noticed you started with the A's, you'll have just as much luck with the B's. "

Buffett said he and the board think about succession all the time. Adding that it is the number one thing discussed at board meetings and that the board "solidly" agrees with who the successor is. The important thing will be to preserve the culture and that picking the right CEO will be the key to that. Buffett believes the culture has been intensified year after year and that any type of foreign behavior would be "cast out" The wrong sort of person would be rejected like "foreign tissue."

Around succession, Berkshire has thought about "what can go wrong." When indelicately asked by the short-seller Doug Kass about Howard Buffett's qualifications to be the non-executive Chairman on the board, Buffett reflected that the intention of the position is to solely look after the culture of Berkshire and no one is more committed to that than Howard.

When asked about the complexity brought on by the multiple number of companies that he oversees, Buffett allowed that his successor may organize things in a somewhat different way. However, Berkshire will continue to leave its CEO's running their businesses with capital allocation decisions being made in the home office. Buffett joked that if his successor really went crazy he might hire one more person at headquarters.

Munger noted that managing this structure would be unwieldy if Berkshire had an imperial headquarters that forced its will on the subsidiaries, but pointed out that Berkshire doesn't operate like that. Concluding, "If your system is decentralization to the point of abdication, what difference does it make how many subsidiaries you have?"

Munger, ever inverting the topic for insight, noted that if what they were doing was too hard, it would be impossible. But it isn't.

Buffett joked, "I'll have to think about that a little."

Munger continued, suggesting that if 50 years ago someone would have said that Buffett would manage a huge firm like Berkshire from Omaha Nebraska with a tiny office staff, people would have said it could never work. But it has.

Munger concluded: "I want to say to the many Mungers' out there, don't be so stupid as to sell your shares."

Buffett quipped, "That goes for the Buffetts' too."

Berkshire's Cash/Bond/Stock Ratios 1979 through 2012

In a reprise of our April 1999 newsletter, we review Berkshire's cash/bond/stock allocations. We find it worthwhile to contemplate changes in allocations. For example, after keeping equities around 40% for much of the "lost decade", Buffett's had the pedal down since 2008, with equities steady at 58%. Note that the investment portfolio increased a handsome 15% last year and has increased over 286-fold in 33 years. The chart illustrates that Berkshire has been a significant buyer of equities and other deals. Buffett keeps a minimum $20 billion in cash reserve for insurance catastrophes

		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
2009	145,982	19	22	59
2010	147,772	24	23	53
2011	153,909	22	20	58
2012	176,331	24	18	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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