The Best of Charlie Munger: 1994-2011

A collection of speeches, essays, and Wesco annual meeting notes

October 2, 2012

Dear fellow BRK shareholders,

I am a faithful BRK shareholder living within reasonable driving distance to Omaha. I usually drive up early morning of the BRK annual meeting, attend the meeting until 5pm, and drive back home the same day, just to save a few pennies. But I've been too cheap to pay for airfare and hotel rooms to attended Charlie Munger's Wesco annual meetings in Pasadena.

When I heard that July 2011 would be the last meeting with Mr. Munger, I felt real regret for never attending one in the past and was desperately searching for Wesco meeting notes. When I contacted Mr. Whitney Tilson, he kindly emailed me not only his articles and notes from the many Wesco annual meetings he'd attended, but also many other relevant materials from his archives, dating back to 1994. At his suggestion, I have compiled them, along with some of the materials I've collected over time, into one file that he can circulate to the BRK faithful and put on his website. I'm happy to do this as a way to give back to the value investing community.

I have set up a bookmarks system in the pdf file to ease your navigation, which you can access by clicking View, Navigation Panels, Bookmarks.

If you have Wesco meeting notes prior to 1999 or any other materials that you think I should include, please email me and I will revise my compilation.

Sincerely

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Munger on Human Misjudgments

Charlie Munger gave an insightful speech on "24 Standard Causes of Human Misjudgment," which has powerful implications for investors. Whitney Tilson summarizes some key points and provides a link to the speech, so you can read for yourself.

By Whitney Tilson
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Behavioral finance -- which examines how people's emotions, biases, and misjudgments affect their investment decisions -- is one of the least discussed and understood areas of investing. Yet I believe it's critically important -- so important, in fact, that I covered it in my very first column (in September 1999, which seems like an investing lifetime ago, doesn't it?).

Behavioral finance recently reappeared on my radar screen when I came across an 80-minute recording of a speech given by **Berkshire Hathaway** (NYSE: BRK.A) Vice Chairman Charlie Munger, Warren Buffett's right-hand man and a genius in his own right. It's a brilliant, powerful, and compelling tour de force.

In it, Munger highlights what he calls "24 Standard Causes of Human Misjudgment," and then gives numerous examples of how these mental weaknesses can combine to create "lollapalooza" effects, which can be very positive -- as in the case of Alcoholics Anonymous -- or frighteningly negative, such as experiments in which average people end up brutalizing others.

I'd like to highlight some of Munger's most important lessons, especially as they relate to investing.

Psychological denial
Munger notes that sometimes "reality is too painful to bear, so you just distort it until it's bearable." I see this all the time among investors -- both professionals and average folks. Think of all the people who simply have no business picking stocks, such as the "bull market geniuses" of the late 1990s, whose portfolios have undoubtedly been obliterated in the bear market of the past two and a half years.

You'd think these people would've recognized by now that whatever investment success they had in the late '90s was due solely to one of the most massive bubbles in the history of stock markets, and that they should get out while they still have even a little bit of money left. I'm sure some are doing so, but many aren't because they'd have to acknowledge some extremely painful truths (e.g., they should not, and should never have been, picking stocks; they speculated with their retirement money and frittered most of it away, and so on).

Instead, I'm still getting emails like this one, from people who, I suspect, are in serious psychological denial:

> Why isn't anyone suggesting WorldCom as an investment possibility? Assuming WorldCom survives, and assuming they reach a third of their highest stock value prior to the decline, why not buy shares at $0.19 (as listed now) [they're now down to $0.124] and hold them for a few years? If WorldCom manages to make it back to $10.00 a share, the profit for a small investor would be more than satisfactory. What am I missing here? It seems like another chance to 'get in on the ground floor.'

The answer is that WorldCom equity is almost certain to be worthless, and the only sane people buying the stock right now are short-sellers covering their very profitable shorts.

Bias from consistency and commitment tendency
Munger explains this bias with the following analogy: "The human mind is a lot like the human egg, and the human egg has a shut-off device. When one sperm gets in, it shuts down so the next one can't get in." In other words, once people make a decision (to buy a stock, for example), then it becomes extremely unlikely that they will reverse this decision, especially if they have publicly committed to it.

This is true even if overwhelming evidence emerges indicating the initial decision was disastrously wrong. Have you ever bought a stock such as Lucent, Enron, or WorldCom, seen your original investment thesis torn to shreds by subsequent developments -- such that you would never consider buying more of the stock (despite the lower price), *yet you didn't sell?* I've written two columns on this common, painful mistake.

Over-influence by social proof
Human beings have a natural herding tendency -- to look at what everybody else is doing and do the same, however insane that behavior might be. Munger gives a classic example from corporate America:

> Big-shot businessmen get into these waves of social proof. Do you remember some years ago when one oil company bought a fertilizer company, and every other major oil company practically ran out and bought a fertilizer company? And there was no more damned reason for all these oil companies to buy fertilizer companies, but they didn't know exactly what to do, and if Exxon was doing it, it was good enough for Mobil, and vice versa. I think they're all gone now, but it was a total disaster.

Similar behavior led to the tech stock bubble of the late 1990s. For more on this topic, see my column The Cocktail-Party Test, in which I argue, "Following the crowd and investing in what is fashionable is a recipe for disaster. Instead, look for solid companies with strong balance sheets that are either out of favor with Wall Street or, better yet, not even on Wall Street's radar screen."

Other questions Munger answers
I've cited only a few examples of Munger's powerful observations and the answers he gives to a range of perplexing questions, such as:

- Why are boards of directors so consistently dysfunctional and unable to rein in even the most egregious behavior by CEOs?
- Why was the introduction of New Coke almost one of the costliest business blunders of all time?
- Why didn't Salomon's CEO John Gutfreund or General Counsel Donald Feuerstein immediately turn in rogue employee Paul Mozer -- a failure of judgment that cost both men their careers and nearly put Salomon out of business?
- How did Joe Jett lose $210 million for Kidder Peabody (and parent company GE)?
- How did Federal Express solve the problem of processing all of its packages overnight?
- Why wouldn't Sam Walton let his purchasing agents accept even the tiniest gift from a salesperson?
- How does Johnson & Johnson ensure that it evaluates and learns from its experience making acquisitions?
- How has Tupperware "made billions of dollars out of a few manipulative psychological tricks?"
- Why do bidders consistently overpay in "open-outcry" actions?
- Why is a cash register "a great moral instrument?"
- Why would it be evil *not* to fire an employee caught stealing?
- Why might raising the price of a product lead to *greater* sales?
- Why do some academicians continue to cling to the Efficient Market Theory?
- Why are people who grow up in terrible homes likely to marry badly? And why is it so common for a terrible first marriage to be followed by an almost-as-bad second marriage?
- How can real estate brokers manipulate buyers?
- How do lotteries and slot machines prey on human psychology?
- Why should we be grateful that our founding fathers were "psychologically astute" in setting the rules of the U.S. Constitutional Convention?

There is no space here to even begin to summarize Munger's answers to these questions, so I transcribed his speech and posted it here. I urge you to read it.

If you find his thinking and the field of behavioral economics as fascinating as I do, I suggest reading *Influence*, by Robert Cialdini, *Why Smart People Make Big Money Mistakes*, by Gary Belsky and Thomas Gilovich and, for the definitive work on Munger himself, *Damn Right! Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger*, by Janet Lowe.

Guest columnist Whitney Tilson is managing partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owned shares of Berkshire Hathaway at the time of publication. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit http://www.tilsonfunds.com. The Motley Fool is investors writing for investors.

The Psychology of Human Misjudgment
by Charles T. Munger

PREFACE

When I read transcripts of my psychology talks given about fifteen years ago, I realized that I could now create a more logical but much longer "talk," including most of what I had earlier said. But I immediately saw four big disadvantages.

First, the longer "talk," because it was written out with more logical completeness, would be more boring and confusing to many people than any earlier talk. This would happen because I would use idiosyncratic definitions of psychological tendencies in a manner reminiscent of both psychology textbooks and Euclid. And who reads textbooks for fun or revisits Euclid?

Second, because my formal psychological knowledge came only from skimming three psychology textbooks about fifteen years ago, I know virtually nothing about any academic psychology later developed. Yet, in a longer talk containing guesses, I would be criticizing much academic psychology. This sort of intrusion into a professional territory by an amateur would be sure to be resented by professors who would rejoice in finding my errors and might be prompted to respond to my published criticism by providing theirs. Why should I care about new criticism? Well, who likes new hostility from articulate critics with an information advantage?

Third, a longer version of my ideas would surely draw some disapproval from people formerly disposed to like me. Not only would there be stylistic and substantive objections, but also there would be perceptions of arrogance in an old man who displayed much disregard for conventional wisdom while "popping-off" on a subject in which he had never taken a course. My old Harvard Law classmate, Ed Rothschild, always called such a popping-off "the shoe button complex," named for the condition of a family friend who spoke in oracular style on all subjects after becoming dominant in the shoe button business.

Fourth, I might make a fool of myself. Despite these four very considerable objections, I decided to publish the much-expanded version. Thus, after many decades in which I have succeeded mostly by restricting action to jobs and methods in which I was unlikely to fail, I have now chosen a course of action in which (1) I have no significant personal benefit to gain, (2) I will surely give some pain to family members and friends, and (3) I may make myself ridiculous. Why am I doing this?

One reason may be that my nature makes me incline toward diagnosing and talking about errors in conventional wisdom. And despite years of being smoothed out by the hard knocks that were inevitable for one with my attitude, I don't believe life ever knocked all the boy's brashness out of the man.

A second reason for my decision is my approval of the attitude of Diogenes when he asked: "Of what use is a philosopher who never offends anybody?"

My third and final reason is the strongest. I have fallen in love with my way of living out psychology because it has been so useful for me. And so, before I die, I want to imitate to some extent the bequest practices of three characters: the protagonist in John Bunyan's Pilgrims Progress, Benjamin Franklin, and my first employer, Ernest Buffett. Bunyan's character, the knight wonderfully named "Old Valiant for Truth," makes the only practical bequest available to him when he says at the end of his life: "My sword I leave to him who can wear it." And like this man, I don't mind if I have misappraised my sword, provided I have tried to see it correctly, or that many will not wish to try it, or that some who try to wield it may find it serves them not. Ben Franklin, to my great benefit, left behind his autobiography, his *Almanacks*, and much else. And Ernest Buffett did the best he could in the same mode when he left behind "How to Run a Grocery Store and a Few Things I Have Learned about Fishing." Whether or not this last contribution to the genre was the best, I will not say. But I will report that I have now known four generations of Ernest Buffett's descendants and that the results have encouraged my imitation of the founder.

I have long been very interested in standard thinking errors. However, I was educated in an era wherein the contributions of non-patient-treating psychology to an understanding of misjudgment met little approval from members of the mainstream elite. Instead, interest in psychology was pretty well confined to a group of professors who talked and published mostly for themselves, with much natural detriment from isolation and groupthink. And so, right after my time at Caltech and Harvard Law School, I possessed a vast ignorance of psychology. Those institutions failed to require knowledge of the subject. And, of course, they couldn't integrate psychology with their other subject matter when they didn't know psychology. Also, like the Nietzsche character who was proud of his lame leg, the institutions were proud of their willful avoidance of "fuzzy" psychology and "fuzzy" psychology professors.

I shared this ignorant mindset for a considerable time. And so did a lot of other people. What are we to think, for instance, of the Caltech course catalogue that for years listed just one psychology professor, self-described as a "Professor of Psychoanalytical Studies," who taught both "Abnormal Psychology" and "Psychoanalysis in Literature"?

Soon after leaving Harvard, I began a long struggle to get rid of the most dysfunctional part of my psychological ignorance. Today, I will describe my long struggle for elementary wisdom and a brief summary of my ending notions. After that, I will give examples, many quite vivid and interesting to me, of both psychology at work and antidotes to psychology-based dysfunction. Then, I will end by asking and answering some general questions raised by what I have said. This will be a long talk.

When I started law practice, I had respect for the power of genetic evolution and appreciation of man's many evolution-based resemblances to less cognitively-gifted animals and insects. I was aware that man was a "social animal," greatly and automatically influenced by behavior he observed in men around him. I also knew that man lived, like barnyard animals and monkeys, in limited size dominance hierarchies, wherein he tended to respect authority and to like and cooperate with his own hierarchy members while displaying considerable distrust and dislike for competing men not in his own hierarchy.

But this generalized, evolution-based theory structure was inadequate to enable me to cope properly with the cognition I encountered. I was soon surrounded by much extreme irrationality, displayed in patterns and subpatterns. So surrounded, I could see that I was not going to cope as well as I wished with life unless I could acquire a better theory-structure on which to hang my observations and experiences. By then, my craving for more theory had a long history. Partly, I had always loved theory as an aid in puzzle solving and as a means of satisfying my monkey-like curiosity. And, partly. I had found that theory-structure was a superpower in helping one get what one wanted. As I had early discovered in school wherein I had excelled without labor, guided by theory, while many others, without mastery of theory, failed despite monstrous effort. Better theory, I thought. had always worked for me and, if now available, could make me acquire capital and independence faster and better assist everything I loved. And so I slowly developed my own system of psychology. more or less in the self-help style of Ben Franklin and with the determination displayed in the refrain of the nursery story: "'Then I'll do it myself,' said the little red hen."

I was greatly helped in my quest by two turns of mind. First, I had long looked for insight by inversion in the intense manner counseled by the great algebraist, Jacobi: "Invert, always invert." I sought good judgment mostly by collecting instances of bad judgment, then pondering ways to avoid such outcomes. Second, I became so avid a collector of instances of bad judgment that I paid no attention to boundaries between professional territories. After all, why should I search for some tiny, unimportant, hard-to-find new stupidity in my own field when some large, important, easy-to find stupidity was just over the fence in the other fellow's professional territory? Besides, I could already see that real-world problems didn't neatly lie within territorial boundaries. They jumped right across. And I was as dubious of any approach that, when two things were inextricably intertwined and interconnected, would try and think about one thing but not the other. I was afraid, if I tried any such restricted approach, that I would end up, in the immortal words of John L. Lewis, "with no brain at all, just a neck that had haired over."

Pure curiosity, somewhat later, made me wonder how and why destructive cults were often able, over a single long weekend, to turn many tolerably normal people into brainwashed zombies and thereafter keep them in that state indefinitely. I resolved that I would eventually find a good answer to this cult question if I could do so by general reading and much musing.

I also got curious about social insects. It fascinated me that both the fertile female honeybee and the fertile female harvester ant could multiply their quite different normal life expectancies by exactly twenty by engaging in one gangbang in the sky. The extreme success of the ants also fascinated me-how a few behavioral algorithms caused such extreme evolutionary success grounded in extremes of cooperation within the breeding colony and, almost always, extremes of lethal hostility toward ants outside the breeding colony; even ants of the same species.

Motivated as I was, by midlife I should probably have turned to psychology textbooks, but I didn't, displaying my share of the outcome predicted by the German folk saving: "We are too soon old and too late smart." However, as I later found out, I may have been lucky to avoid for so long the academic psychology that was then laid out in most textbooks. These would not then have guided me well with respect to cults and were often written as if the authors were collecting psychology experiments as a boy collects butterflies-with a passion for more butterflies and more contact with fellow collectors and little craving for synthesis in what is already possessed. When I finally got to the psychology texts, I was reminded of the observation of Jacob Viner, the great economist, that many an academic is like the truffle hound, an animal so trained and bred for one narrow purpose that it is no good at anything else. I was also appalled by hundreds of pages of extremely nonscientific musing about comparative weights of nature and nurture in human outcomes. And I found that introductory psychology texts, by and large, didn't deal appropriately with a fundamental issue: Psychological tendencies tend to be both numerous and inseparably intertwined, now and forever, as they interplay in life. Yet the complex parsing out of effects from intertwined tendencies was usually avoided by the writers of the elementary texts. Possibly the authors did not wish, through complexity, to repel entry of new devotees to their discipline. And, possibly, the cause of their inadequacy was the one given by Samuel Johnson in response to a woman who inquired as to what accounted for his dictionary's misdefinition of the word "pastern." "Pure ignorance," Johnson replied. And, finally, the text writers showed little interest in describing standard antidotes to standard psychology-driven folly, and they thus avoided most discussion of exactly what most interested me.

But academic psychology has some very important merits alongside its defects. I learned this eventually, in the course of general reading, from a book, *Influence,* aimed at a popular audience, by a distinguished psychology professor, Robert Cialdini, at Arizona State, a very big university. Cialdini had made himself into a super-tenured "Regents' Professor" at a very young age by devising, describing, and explaining a vast group of clever experiments in which man manipulated man to his detriment, With all of this made possible by man's intrinsic thinking flaws.

I immediately sent copies of Cialdini's book to all my children. I also gave Cialdini a share of Berkshire stock [Class A] to thank him for what he had done for me and the public. Incidentally, the sale by Cialdini of hundreds of thousands of copies of a book about social psychology was a huge feat, considering that Cialdini didn't claim that he was going to improve your sex life or make you any money.

Part of Cialdini's large book-buying audience came because, like me, it wanted to learn how to become less often tricked by salesmen and circumstances. However, as an outcome not sought by Cialdini, who is a profoundly ethical man, a huge number of his books were bought by salesmen who wanted to learn how to become more effective in misleading customers. Please remember this perverse outcome when my discussion comes to incentive-caused bias as a consequence of the superpower of incentives.

With the push given by Cialdini's book, I soon skimmed through three much used textbooks covering introductory psychology. I also pondered considerably while craving synthesis and taking into account all my previous training and experience. The result was Munger's partial summary of the non-patient-treating, non-nature vs. nurture weighing parts of nondevelopmental psychology. This material was stolen from its various discoverers (most of whose names I did not even try to learn), often with new descriptions and titles selected to fit Munger's notion of what makes recall easy for Munger, then revised to make Munger's use easy as he seeks to avoid errors.

I will start my summary with a general observation that helps explain what follows. This observation is grounded in what we know about social insects. The limitations inherent in evolution's development of the nervous-system cells that control behavior are beautifully demonstrated by these insects, which often have a mere 100,000 or so cells in their entire nervous systems, compared to man's multiple billions of cells in his brain alone.

Each ant, like each human, is composed of a living physical structure plus behavioral algorithms in its nerve cells. In the ant's case, the behavioral algorithms are few in number and almost entirely genetic in origin. The ant learns a little behavior from experiences, but mostly it merely responds to ten or so stimuli with a few simple responses programmed into its nervous system by its genes, sometimes walk round and round until they perish.

It seems obvious, to me at least, that the human brain must often operate counterproductively just like the ant's, from unavoidable oversimplicity in its mental process, albeit usually in trying to solve problems more difficult than those faced by ants that don't have to design airplanes.

Naturally, the simple ant behavior system has extreme limitations because of its limited nerve system repertoire. For instance, one type of ant, when it smells a pheromone given off by a dead ant's body in the hive, immediately responds by cooperating with other ants in carrying the dead body out of the hive. And Harvard's great E.O. Wilson performed one of the best psychology experiments ever done when he painted dead-ant pheromone on a live ant. Quite naturally; the other ants dragged this useful live ant out of the hive even though it kicked and otherwise protested throughout the entire process. Such is the brain of the ant. It has a simple program of responses that generally work out all right, but which are imprudently used by rote in many cases.

Another type of ant demonstrates that the limited brain of ants can be misled by circumstances as well as by clever manipulation from other creatures. The brain of this ant contains a simple behavioral program that directs the ant, when walking, to follow the ant ahead, and when these ants stumble into walking in a big circle. The perception system of man clearly demonstrates just such an unfortunate outcome. Man is easily fooled, either by the cleverly thought out manipulation of man, by circumstances occurring by accident, or by very effective manipulation practices that man has stumbled into during "practice evolution" and kept in place because they work so well. One such outcome is caused by a quantum effect in human perception. If stimulus is kept below a certain level, it does not get through. And, for this reason, a magician was able to make the Statue of Liberty disappear after a certain amount of magician lingo expressed in the dark. The audience was not aware that it was sitting on a platform that was rotating so slowly, below man's sensory threshold, that no one could feel the acceleration implicit in the considerable rotation. When a surrounding curtain was then opened in the place on the platform where the Statue had earlier appeared, it seemed to have disappeared.

And even when perception does get through to man's brain, it is often misweighted, because what is registered in perception is in shockingness of apparent contrast, not the standard scientific units that make possible science and good engineering against often-wrong effects from generally useful tendencies in his perception and cognition.

A magician demonstrates this sort of contrast based error in your nervous system when he removes your wristwatch without your feeling it. As he does this, he applies pressure of touch on your wrist that you would sense if it was the only pressure of touch you were experiencing. But he has concurrently applied other intense pressure of touch on your body, but not on your wrist, "swamping" the wrist pressure by creating a high-contrast touch pressure elsewhere. This high contrast takes the wrist pressure below perception.

Some psychology professors like to demonstrate the inadequacy of contrast-based perception by having students put one hand in a bucket of hot water and one hand in a bucket of cold water. They are then suddenly asked to remove both hands and place them in a single bucket of room temperature water. Now, with both hands in the same water, one hand feels as if it has just been put in cold water and the other hand feels as if it has just been placed in hot water. When one thus sees perception so easily fooled by mere contrast, where a simple temperature gauge would make no error, and realizes that cognition mimics perception in being misled by mere contrast, he is well on the way toward understanding, not only how magicians fool one, but also how life will fool one. This can occur, through deliberate human manipulation or otherwise, if one doesn't take certain precautions.

Man's often wrong but generally useful psychological tendencies are quite numerous and quite different. The natural consequence of this profusion of tendencies is the grand general principle of social psychology: cognition is ordinarily situation-dependent so that different situations often cause different conclusions, even when the same person is thinking in the same general subject area. With this introductory instruction from ants, magicians, and the grand general principle of social psychology; I will next simply number and list psychology-based tendencies that, while generally useful, often mislead. Discussion of errors from each tendency will come later, together with description of some antidotes to errors, followed by some general discussion. Here are the tendencies:

1. Reward and Punishment Superresponse Tendency
2. Liking/Loving Tendency
3. Disliking/Hating Tendency
4. Doubt-Avoidance Tendency
5. Inconsistency-Avoidance Tendency
6. Curiosity Tendency
7. Kantian Fairness Tendency
8. Envy/Jealousy Tendency
9. Reciprocation Tendency
10. Influence-from-Mere Association Tendency
11. Simple, Pain-Avoiding Psychological Denial
12. Excessive Self-Regard Tendency
13. Overoptimism Tendency
14. Deprival Superreaction Tendency
15. Social-Proof Tendency
16. Contrast-Misreaction Tendency
17. Stress-Influence Tendency
18. Availability-Misweighing Tendency
19. Use-It-or-Lose-It Tendency
20. Drug-Misinfluence Tendency
21. Senescence-Misinfluence Tendency
22. Authority-Misinfluence Tendency
23. Twaddle Tendency
24. Reason-Respecting Tendency
25. Lollapalooza Tendency – The Tendency to Get Extreme Confluences of Psychological Tendencies Acting in Favor of a Particular Outcome

1. Reward and Punishment Superresponse Tendency

I place this tendency first in my discussion because almost everyone thinks he fully recognizes how important incentives and disincentives are in changing cognition and behavior. But this is not often so. For instance, I think I've been in the top five percent of my age cohort almost all my adult life in understanding the power of incentives, and yet I've always underestimated that power. Never a year passes but I get some surprise that pushes a little further my appreciation of incentive superpower.

One of my favorite cases about the power of incentives is the Federal Express case. The integrity of the Federal Express system requires that all packages be shifted rapidly among airplanes in one central airport each night. And the system has no integrity for the customers if the night work shift can't accomplish its assignment fast. And Federal Express had one hell of a time getting the night shift to do the right thing. They tried moral suasion. They tried everything in the world without luck. And, finally, somebody got the happy thought that it was foolish to pay the night shift by the hour when what the employer wanted was not maximized billable hours of employee service but fault-free, rapid performance of a particular task. Maybe, this person thought, if they paid the employees per shift and let all night shift employees go home when all the planes were loaded, the system would work better. And, lo and behold, that solution worked.

Early in the history of Xerox, Joe Wilson, who was then in the government, had a similar experience. He had to go back to Xerox because he couldn't understand why its new machine was selling so poorly in relation to its older and inferior machine. When he got back to Xerox, he found out that the commission arrangement with the salesmen gave a large and perverse incentive to push the inferior machine on customers, who deserved a better result.

And then there is the case of Mark Twain's cat that, after a bad experience with a hot stove, never again sat on a hot stove, or a cold stove either.

We should also heed the general lesson implicit in the injunction of Ben Franklin in *Poor Richard's Almanack*: "If you would persuade, appeal to interest and not to reason." This maxim is a wise guide to a great and simple precaution in life: Never, ever, think about something else when you should be thinking about the power of incentives. I once saw a very smart house counsel for a major investment bank lose his job, with no moral fault, because he ignored the lesson in this maxim of Franklin. This counsel failed to persuade his client because he told him his moral duty, as correctly conceived by the counsel, without also telling the client in vivid terms that he was very likely to be clobbered to smithereens if he didn't behave as his counsel recommended. As a result, both client and counsel lost their careers.

We should also remember how a foolish and willful ignorance of the superpower of rewards caused Soviet communists to get their final result as described by one employee: "They pretend to pay us and we pretend to work." Perhaps the most important rule in management is "Get the incentives right."

But there is some limit to a desirable emphasis on incentive superpower. One case of excess emphasis happened at Harvard, where B. F. Skinner, a psychology professor, finally made himself ridiculous. At one time, Skinner may have been the best-known psychology professor in the world. He partly deserved his peak reputation because his early experiments using rats and pigeons were ingenious, and his results were both counterintuitive and important. With incentives, he could cause more behavior change, culminating in conditioned reflexes in his rats and pigeons, than he could in any other way. He made obvious the extreme stupidity, in dealing with children or employees, of rewarding behavior one didn't want more of. Using food rewards, he even caused strong superstitions, predesigned by himself, in his pigeons. He demonstrated again and again a great recurring, generalized behavioral algorithm in nature: "Repeat behavior that works." He also demonstrated that prompt rewards worked much better than delayed rewards in changing and maintaining behavior. And, once his rats and pigeons had conditioned reflexes, caused by food rewards, he found what withdrawal pattern of rewards kept the reflexive behavior longest in place: random distribution. With this result, Skinner thought he had pretty well explained man's misgambling compulsion whereunder he often foolishly proceeds to ruin. But, as we shall later see when we discuss other psychological tendencies that contribute to misgambling compulsion, he was only partly right. Later, Skinner lost most of his personal reputation by overclaiming for incentive superpower to the point of thinking he could create a human utopia with it and by displaying hardly any recognition of the power of the rest of psychology. He thus behaved like one of Jacob Viner's truffle hounds as he tried to explain everything with incentive effects. Nonetheless, Skinner was right in his main idea: Incentives are superpowers. The outcome of his basic experiments will always remain in high repute in the annals of experimental science. And his method of monomaniacal reliance on rewards, for many decades after his death, did more good than anything else in improving autistic children.

When I was at Harvard Law School, the professors sometimes talked about an overfocused, Skinner-like professor at Yale Law School. They used to say: "Poor old Eddie Blanchard, he thinks declaratory judgments will cure cancer." Well, that's the way Skinner got with his very extreme emphasis on incentive superpower. I always call the "Johnny-one-note" turn of mind that eventually diminished Skinner's reputation the man-with-a-hammer tendency, after the folk saying: "To a man with only a hammer every problem looks pretty much like a nail." Man-with-a-hammer tendency does not exempt smart people like Blanchard and Skinner. And it won't exempt you if you don't watch out. I will return to man-with-a-hammer tendency at various times in this talk because, fortunately, there are effective antidotes that reduce the ravages of what pretty much ruined the personal reputation of the brilliant Skinner.

One of the most important consequences of incentive superpower is what I call "incentive caused bias." A man has an acculturated nature making him a pretty decent fellow, and yet, driven both consciously and subconsciously by incentives, he drifts into immoral behavior in order to get what he wants, a result he facilitates by rationalizing his bad behavior, like the salesmen at Xerox who harmed customers in order to maximize their sales commissions.

Here, my early education involved a surgeon who over the years sent bushel baskets full of normal gall bladders down to the pathology lab in the leading hospital in Lincoln, Nebraska, my grandfather's town. And, with that permissive quality control for which community hospitals are famous, many years after this surgeon should've been removed from the medical staff, he was. One of the doctors who participated in the removal was a family friend, and I asked him: "Did this surgeon think, 'Here's a way for me to exercise my talents'" – this guy was very skilled technically – "'and make a high living by doing a few maimings and murders every year in the course of routine fraud?'" And my friend answered: "Hell no, Charlie. He thought that the gall bladder was the source of all medical evil, and, if you really loved your patients, you couldn't get that organ out rapidly enough."

Now that's an extreme case, but in lesser strength, the cognitive drift of that surgeon is present in every profession and in every human being. And it causes perfectly terrible behavior. Consider the presentations of brokers selling commercial real estate and businesses. I've never seen one that I thought was even within hailing distance of objective truth. In my long life, I have never seen a management consultant's report that didn't end with the same advice: "This problem needs more management consulting services." Widespread incentive-caused bias requires that one should often distrust, or take with a grain of salt, the advice of one's professional advisor, even if he is an engineer. The general **antidotes** here are:

1) especially fear professional advice when it is especially good for the advisor;
2) learn and use the basic elements of your advisor's trade as you deal with your advisor; and
3) double check, disbelieve, or replace much of what you're told, to the degree that seems appropriate after objective thought.

The power of incentives to cause rationalized, terrible behavior is also demonstrated by Defense Department procurement history. After the Defense Department had much truly awful experience with misbehaving contractors motivated under contracts paying on a cost-plus-a-percentage-of cost basis, the reaction of our republic was to make it a crime for a contracting officer in the Defense Department to sign such a contract, and not only a crime, but a felony.

And, by the way, although the government was right to create this new felony, much of the way the rest of the world is run, including the operation of many law firms and a lot of other firms, is still under what is, in essence, a cost-plus-a-percentage-of-cost reward system. And human nature, bedeviled by incentive-caused bias, causes a lot of ghastly abuse under these standard incentive patterns of the world. And many of the people who are behaving terribly you would be glad to have married into your family, compared to what you're otherwise likely to get.

Now there are huge implications from the fact that the human mind is put together this way. One implication is that people who create things like cash registers, which make dishonest behavior hard to accomplish, are some of the effective saints of our civilization because, as Skinner so well knew, bad behavior is intensely habit-forming when it is rewarded.

And so the cash register was a great moral instrument when it was created. And, by the way, Patterson, the great evangelist of the cash register, knew that from his own experience. He had a little store, and his employees were stealing him blind, so that he never made any money. Then people sold him a couple of cash registers, and his store went to profit immediately. He promptly closed the store and went into the cash register business, creating what became the mighty National Cash Register Company, one of the glories of its time. "Repeat behavior that works" is a behavioral guide that really succeeded for Patterson, after he applied one added twist. And so did high moral cognition. An eccentric, inveterate do-gooder (except when destroying competitors, all of which he regarded as would-be patent thieves), Patterson, like Carnegie, pretty well gave away all his money to charity before he died, always pointing out that "shrouds have no pockets." So great was the contribution of Patterson's cash register to civilization, and so effectively did he improve the cash register and spread its use, that in the end, he probably deserved the epitaph chosen for the Roman poet Horace: "I did not completely die."

The strong tendency of employees to rationalize bad conduct in order to get rewards requires many antidotes in addition to the good cash control promoted by Patterson. Perhaps the most important of these antidotes is use of sound accounting theory and practice. This was seldom better demonstrated than at Westinghouse, which had a subsidiary that made loans having no connection to the rest of Westinghouse's businesses. The officers of Westinghouse, perhaps influenced by envy of General Electric, wanted to expand profits from loans to outsiders. Under Westinghouse's accounting practice, provisions for future credit losses on these loans depended largely on the past credit experience of its lending subsidiary, which mainly made loans unlikely to cause massive losses.

Now there are two special classes of loans that naturally cause much trouble for lenders. The first is ninety-five percent-of-value construction loans to any kind of real estate developer, and the second is any kind of construction loan on a hotel. So, naturally, if one were willing to loan approximately ninety-five percent of the real cost to a developer constructing a hotel, the loan would bear a much higher-than-normal interest rate because the credit loss danger would be much higher than normal. So, sound accounting for Westinghouse in making a big, new mass of ninety-five percent-of-value construction loans to hotel developers would have been to report almost no profit, or even a loss, on each loan until, years later, the loan became clearly worth par. But Westinghouse instead plunged into big-time construction lending on hotels, using accounting that made its lending officers look good because it showed extremely high starting income from loans that were very inferior to the loans from which the company had suffered small credit losses in the past. This terrible accounting was allowed by both international and outside accountants for Westinghouse as they displayed the conduct predicted by the refrain: "Whose bread I eat, his song I sing."

The result was billions of dollars of losses. Who was at fault? The guy from the refrigerator division, or some similar division, who as lending officer was suddenly in charge of loans to hotel developers: Or the accountants and other senior people who tolerated a nearly insane incentive structure, almost sure to trigger incentive-caused bias in a lending officer: My answer puts most blame on the accountants and other senior people who created the accounting system. These people became the equivalent of an armored car cash carrying service that suddenly decided to dispense with vehicles and have unarmed midgets hand-carry its customers' cash through slums in open bushel baskets.

I wish I could tell you that this sort of thing no longer happens, but this is not so. After Westinghouse blew up, General Electric's Kidder Peabody subsidiary put a silly computer program in place that allowed a bond trader to show immense fictional profits. And after that, much accounting became even worse, perhaps reaching its nadir at Enron.

So incentive-caused bias is a huge, important thing, with highly important **antidotes**, like the cash register and a sound accounting system. But when I came years ago to the psychology texts, I found that, while they were about one thousand pages long, there was as little therein that dealt with incentive-caused bias and no mention of Patterson or sound accounting systems. Somehow incentive-caused bias and its antidotes pretty well escaped the standard survey courses in psychology, even though incentive-caused bias had long been displayed prominently in much of the world's great literature, and antidotes to it had long existed in standard business routines. In the end, I concluded that when something was obvious in life but not easily demonstrable in certain kinds of easy, repeatable academic experiments, the truffle hounds of psychology very often missed it.

In some cases, other disciplines showed more interest in psychological tendencies than did psychology, at least as explicated in psychology textbooks. For instance, economists, speaking from the employer's point of view, have long had a name for the natural results of incentive-caused bias: "agency cost." As the name implies, the economists have typically known that, just as grain is always lost to rats, employers always lose to employees who improperly think of themselves first. Employer installed **antidotes** include:

1) tough internal audit systems,
2) severe public punishment for identified miscreants, as well as
3) misbehavior-preventing routines and such machines as cash registers.

From the employee's point of view, incentive-caused bias quite naturally causes opposing abuse from the employer: the sweatshop, the unsafe work place, etc. And these bad results for employees have **antidotes** not only in

1) pressure from unions, but also in
2) government action, such as wage and hour laws, workplace safety rules, measures fostering unionization, and workers' compensation systems.

Given the opposing psychology-induced strains that naturally occur in employment because of incentive-caused bias on both sides of the relationship, it is no wonder the Chinese are so much into Yin and Yang.

The inevitable ubiquity of incentive-caused bias has vast, generalized consequences. For instance, a sales force living only on commissions will be much harder to keep moral than one under less pressure from the compensation arrangement. On the other hand, a purely commissioned sales force may well be more efficient per dollar spent. Therefore, difficult decisions involving trade-offs are common in creating compensation arrangements in the sales function.

The extreme success of free-market capitalism as an economic system owes much to its prevention of many of bad effects from incentive-caused bias. Most capitalist owners in a vast web of free market economic activity are selected for ability by surviving in a brutal competition with other owners and have a strong incentive to prevent all waste in operations within their ownership. After all, they live on the difference between their competitive prices and their overall costs and their businesses will perish if costs exceed sales. Replace such owners by salaried employees of the state and you will normally get a substantial reduction in overall efficiency as each employee who replaces an owner is subject to incentive-caused bias as he determines what service he will give in exchange for his salary and how much he will yield to peer pressure from many fellow employees who do not desire his creation of any strong performance model.

Another generalized consequence of incentive caused bias is that man tends to "game" all human systems, often displaying great ingenuity in wrongly serving himself at the expense of others. Antigaming features, therefore, constitute a huge and necessary part of almost all system design. Also needed in system design is an admonition: dread, and avoid as much you can, rewarding people for what can be easily faked. Yet our legislators and judges, usually including many lawyers educated in eminent universities, often ignore this injunction. And society consequently pays a huge price in the deterioration of behavior and efficiency, as well as the incurrence of unfair costs and wealth transfers. If education were improved, with psychological reality becoming better taught and assimilated, better system design might well come out of our legislatures and courts.

Of course, money is now the main reward that drives habits. A monkey can be trained to seek and work for an intrinsically worthless token, as if it were a banana, if the token is routinely exchangeable for a banana. So it is also with humans working for money – only more so, because human money is exchangeable for many desired things in addition to food, and one ordinarily gains status from either holding or spending it. Moreover, a rich person will often, through habit, work or connive energetically for more money long after he has almost no real need for more. Averaged out, money is a mainspring of modern civilization, having little precedent in the behavior of nonhuman animals. Money rewards are also intertwined with other forms of reward. For instance, some people use money to buy status and others use status to get money, while still others sort of do both things at the same time.

Although money is the main driver among rewards, it is not the only reward that works. People also change their behavior and cognition for sex, friendship, companionship, advancement in status, and other nonmonetary items.

"Granny's Rule" provides another example of reward superpower, so extreme in its effects that it must be mentioned here. You can successfully manipulate your own behavior with this rule, even if you are using as rewards items that you already possess! Indeed, consultant Ph.D. psychologists often urge business organizations to improve their reward systems by teaching executives to use "Granny's Rule" to govern their own daily behavior. Granny's Rule, to be specific, is the requirement that children eat their carrots before they get dessert. And the business version requires that executives force themselves daily to first do their unpleasant and necessary tasks before rewarding themselves by proceeding to their pleasant tasks. Given reward superpower, this practice is nice and sound. Moreover, the rule can also be used in the nonbusiness part of life. The emphasis on daily use of this practice is not accidental. The consultants well know, after the teaching of Skinner, that prompt rewards work best.

Punishments, of course, also strongly influence behavior and cognition, although not so flexibly and wonderfully as rewards. For instance, illegal price fixing was fairly common in America when it was customarily punished by modest fines. Then, after a few prominent business executives were removed from their eminent positions and sent to federal prisons, price-fixing behavior was greatly reduced.

Military and naval organizations have very often been extreme in using punishment to change behavior, probably because they needed to cause extreme behavior. Around the time of Caesar, there was a European tribe that, when the assembly horn blew, always killed the last warrior to reach his assigned place, and no one enjoyed fighting this tribe. And George Washington hanged farm-boy deserters forty feet high as an example to others who might contemplate desertion.

2. Liking/Loving Tendency

A newly hatched baby goose is programmed, through the economy of its genetic program, to "love" and follow the first creature that is nice to it, which is almost always its mother. But, if the mother goose is not present right after the hatching, and a man is there instead, the gosling will "love" and follow the man, who becomes a sort of substitute mother.

Somewhat similarly, a newly arrived human is "born to like and love" under the normal and abnormal triggering outcomes for its kind. Perhaps the strongest inborn tendency to love – ready to be triggered – is that of the human mother for its child. On the other hand, the similar "child-loving" behavior of a mouse can be eliminated by the deletion of a single gene, which suggests there is some sort of triggering gene in a mother mouse as well as in a gosling.

Each child, like a gosling, will almost surely come to like and love, not only as driven by its sexual nature, but also in social groups not limited to its genetic or adoptive "family." Current extremes of romantic love almost surely did not occur in man's remote past. Our early human ancestors were surely more like apes triggered into mating in a pretty mundane fashion.

And what will a man naturally come to like and love, apart from his parent, spouse and child? Well, he will like and love being liked and loved. And so many a courtship competition will be won by a person displaying exceptional devotion, and man will generally strive, lifelong, for the affection and approval of many people not related to him.

One very practical consequence of Liking/Loving Tendency is that it acts as a conditioning device that makes the liker or lover tend:

1) to ignore faults of, and comply with wishes of, the object of his affection,
2) to favor people, products, and actions merely associated with the object of his affection (as we shall see when we get to "Influence-from-Mere-Association Tendency," and
3) to distort other facts to facilitate love.

There are large social policy implications in the amazingly good consequences that ordinarily come from people likely to trigger extremes of love and admiration boosting each other in a feedback mode. For instance, it is obviously desirable to attract a lot of lovable, admirable people into the teaching profession. The phenomenon of liking and loving causing admiration also works in reverse. Admiration also causes or intensifies liking or love. With this "feedback mode" in place, the consequences are often extreme, sometimes even causing deliberate self-destruction to help what is loved.

Liking or loving, intertwined with admiration in a feedback mode, often has vast practical consequences in areas far removed from sexual attachments. For instance, a man who is so constructed that he loves admirable persons and ideas with a special intensity has a huge advantage in life. This blessing came to both Buffett and myself in large measure, sometimes from the same persons and ideas. One common, beneficial example for us both was Warren's uncle, Fred Buffett, who cheerfully did the endless grocery-store work that Warren and I ended up admiring from a safe distance. Even now, after I have known so many other people, I doubt if it is possible to be a nicer man than Fred Buffett was, and he changed me for the better.

3. Disliking/Hating Tendency

In a pattern obverse to Liking/Loving Tendency, the newly arrived human is also "born to dislike and hate" as triggered by normal and abnormal triggering forces in its life. It is the same with most apes and monkeys.

As a result, the long history of man contains almost continuous war. For instance, most American Indian tribes warred incessantly, and some tribes would occasionally bring captives home to women so that all could join in the fun of torturing captives to death. Even with the spread of religion, and the advent of advanced civilization, much modern war remains pretty savage. But we also get what we observe in present-day Switzerland and the United States, wherein the clever political arrangements of man "channel" the hatreds and dislikings of individuals and groups into nonlethal patterns including elections.

But the dislikings and hatreds never go away completely. Born into man, these driving tendencies remain strong. Thus, we get maxims like the one from England: "Politics is the art of marshalling hatreds." And we also get the extreme popularity of very negative political advertising in the United States.

At the family level, we often see one sibling hate his other siblings and litigate with them endlessly if he can afford it. Indeed, Warren Buffett has repeatedly explained to me that "a major difference between rich and poor people is that the rich people can spend their lives suing their relatives." My father's law practice in Omaha was full of such intrafamily hatreds. And when I got to the Harvard Law School and its professors taught me "property law" with no mention of sibling rivalry in the family business, I appraised the School as a pretty unrealistic place that wore "blinders" like the milk-wagon horses of yore. My current guess is that sibling rivalry has not yet made it into property law as taught at Harvard.

Disliking/Hating Tendency also acts as a conditioning device that makes the disliker/hater tend to:

1) ignore virtues in the object of dislike,
2) dislike people, products, and actions merely associated with the object of his dislike, and
3) distort other facts to facilitate hatred.

Distortion of that kind is often so extreme that miscognition is shockingly large. When the world Trade Center was destroyed, many Muslims immediately concluded that the Hindus did it, while many Arabs concluded that the Jews did it. Such factual distortions often make mediation between opponents locked in hatred either difficult or impossible. Mediations between Israelis and Palestinians are difficult because facts in one side's history overlap very little with facts from the other side's.

4. Doubt-Avoidance Tendency

The brain of man is programmed with a tendency to quickly remove doubt by reaching some decision. It is easy to see how evolution would make animals, over the eons, drift toward such quick elimination of doubt. After all, the one thing that is surely counterproductive for a prey animal that is threatened by a predator is to take a long time in deciding what to do. And so man's Doubt Avoidance Tendency is quite consistent with the history of his ancient, nonhuman ancestors.

So pronounced is the tendency in man to quickly remove doubt by reaching some decision that behavior to counter the tendency is required from judges and jurors. Here, delay before decision making is forced. And one is required to so comport himself, prior to conclusion time, so that he is wearing a "mask" of objectivity. And the "mask" works to help real objectivity along, as we shall see when we next consider man's Inconsistency-Avoidance Tendency.

Of course, once one has recognized that man has a strong Doubt-Avoidance Tendency, it is logical to believe that at least some leaps of religious faith are greatly boosted by this tendency. Even if one is satisfied that his own faith comes from revelation, one still must account for the inconsistent faiths of others. And man's Doubt-

Avoidance Tendency is almost surely a big part of the answer.

What triggers Doubt-Avoidance Tendency? Well, an unthreatened man, thinking of nothing in particular, is not being prompted to remove doubt through rushing to some decision. As we shall see later when we get to Social-Proof Tendency and Stress-Influence Tendency, what usually triggers Doubt-Avoidance Tendency is some combination of puzzlement and stress. Both of these factors naturally occur in facing religious issues. Thus, the natural state of most men is in some form of doubt-removing religious faith.

5. Inconsistency-Avoidance Tendency

The brain of man conserves programming space by being reluctant to change, which is a form of inconsistency avoidance. We see this in all human habits, constructive and destructive. Few people can list a lot of bad habits that they have eliminated, and some people cannot identify even one of these. Instead, practically everyone has a great many bad habits he has long maintained despite their being known as bad. Given this situation, it is not too much in many cases to appraise early-formed habits as destiny. When Marley's miserable ghost says, "I wear the chains I forged in life," he is talking about chains of habit that were too light to be felt before they became too strong to be broken.

The rare life that is wisely lived has in it many good habits maintained and many bad habits avoided or cured. And the great rule that helps here is again from Franklin's *Poor Richard's Almanack:* "An ounce of prevention is worth a pound of cure." What Franklin is here indicating, in part, is that Inconsistency-Avoidance Tendency makes it much easier to prevent a habit than to change it.

Also tending to be maintained in place by the anti-change tendency of the brain are one's previous conclusions, human loyalties, reputational identity, commitments, accepted role in a civilization, etc. It is not entirely clear why evolution would program into man's brain an anti-change mode alongside his tendency to quickly remove doubt. My guess is the anti-change mode was significantly caused by a combination of the following factors:

1) It facilitated faster decisions when speed of decision was an important contribution to the survival of nonhuman ancestors that were prey.
2) It facilitated the survival advantage that our ancestors gained by cooperating in groups, which would have been more difficult to do if everyone was always changing responses.
3) It was the best form of solution that evolution could get to in the limited number of generations between the start of literacy and today's complex modern life.

It is easy to see that a quickly reached conclusion, triggered by Doubt-Avoidance Tendency, when combined with a tendency to resist any change in that conclusion, will naturally cause a lot of errors in cognition for modern man. And so it observably works out. We all deal much with others whom we correctly diagnose as imprisoned in poor conclusions that are maintained by mental habits they formed early and will carry to their graves.

So great is the bad-decision problem caused by Inconsistency-Avoidance Tendency that our courts have adopted important strategies against it. For instance, before making decisions, judges and juries are required to hear long and skillful presentations of evidence and argument from the side they will not naturally favor, given their ideas in place. And this helps prevent considerable bad thinking from "first conclusion bias." Similarly, other modern decision makers will often force groups to consider skillful counterarguments before making decisions.

And proper education is one long exercise in augmentation of high cognition so that our wisdom becomes strong enough to destroy wrong thinking, maintained by resistance to change. As Lord Keynes pointed out about his exalted intellectual group at one of the greatest universities in the world, it was not the intrinsic difficulty of new ideas that prevented their acceptance. Instead, the new ideas were not accepted because they were inconsistent with old ideas in place. What Keynes was reporting is that the human mind works a lot like the human egg. When one sperm gets into a human egg, there's an automatic shut-off device that bars any other sperm from getting in. The human mind tends strongly toward the same sort of result.

And so, people tend to accumulate large mental holdings of fixed conclusions and attitudes that are not often reexamined or changed, even though there is plenty of good evidence that they are wrong.

Moreover, this doesn't just happen in social science departments, like the one that once thought Freud should serve as the only choice as a psychology teacher for Caltech. Holding to old errors even happens, although with less frequency and severity, in hard science departments. We have no less an authority for this than Max Planck, Nobel laureate, finder of "Planck's constant." Planck is famous not only for his science but also for saying that even in physics the radically new ideas are seldom really accepted by the old guard. Instead, said Planck, the progress is made by a new generation that comes along, less brain-blocked by its previous conclusions. Indeed, precisely this sort of brain-blocking happened to a degree in Einstein. At his peak, Einstein was a great destroyer of his own ideas, but an older Einstein never accepted the full implications of quantum mechanics.

One of the most successful users of an antidote to first conclusion bias was Charles Darwin. He trained himself, early, to intensively consider any evidence tending to disconfirm any hypothesis of his, more so if he thought his hypothesis was a particularly good one. The opposite of what Darwin did is now called confirmation bias, a term of opprobrium. Darwin's practice came from his acute recognition of man's natural cognitive faults arising from Inconsistency-Avoidance Tendency. He provides a great example of psychological insight correctly used to advance some of the finest mental work ever done.

Inconsistency-Avoidance Tendency has many good effects in civilization. For instance, rather than act inconsistently with public commitments, new or old public identities, etc., most people are more loyal in their roles in life as priests, physicians, citizens, soldiers, spouses, teachers, employees, etc.

One corollary of Inconsistency-Avoidance Tendency is that a person making big sacrifices in the course of assuming a new identity will intensify his devotion to the new identity. After all, it would be quite inconsistent behavior to make a large sacrifice for something that was no good. And thus civilization has invented many tough and solemn initiation ceremonies, often public in nature, that intensify new commitments made.

Tough initiation ceremonies can intensify bad contact as well as good. The loyalty of the new, "made-man" mafia member, or of the military officer making the required "blood oath" of loyalty to Hitler, was boosted through the triggering of Inconsistency-Avoidance Tendency.

Moreover, the tendency will often make man a "patsy" of manipulative "compliance-practitioners," who gain advantage from triggering his subconscious Inconsistency-Avoidance Tendency. Few people demonstrated this process better than Ben Franklin. As he was rising from obscurity in Philadelphia and wanted the approval of some important man, Franklin would often maneuver that man into doing Franklin some unimportant favor, like lending Franklin a book. Thereafter, the man would admire and trust Franklin more because a nonadmired and nontrusted Franklin would be inconsistent with the appraisal implicit in lending Franklin the book.

During the Korean War, this technique of Franklin's was the most important feature of the Chinese brainwashing system that was used on enemy prisoners. Small step by small step, the technique often worked better than torture in altering prisoner cognition in favor of Chinese captors.

The practice of Franklin, whereunder he got approval from someone by maneuvering him into treating Franklin favorably, works viciously well in reverse. When one is maneuvered into deliberately hurting some other person, one will tend to disapprove or even hate that person. This effect, from Inconsistency-Avoidance Tendency, accounts for the insight implicit in the saying: "A man never forgets where he has buried the hatchet." The effect accounts for much prisoner abuse by guards, increasing their dislike and hatred for prisoners that exists as a consequence of the guards' reciprocation of hostility from prisoners who are treated like animals. Given the psychology-based hostility natural in prisons between guards and prisoners, an intense, continuous effort should be made to prevent prisoner abuse from starting and to stop it instantly when it starts because it will grow by feeding on itself, like a cluster of infectious disease. More psychological acuity on this subject, aided by more insightful teaching, would probably improve the overall effectiveness of the U.S. Army.

So strong is Inconsistency-Avoidance Tendency that it will often prevail after one has merely pretended to have some identity, habit, or conclusion. Thus, for a while, many an actor sort of believes he is Hamlet, Prince of Denmark. And many a hypocrite is improved by his pretensions of virtue. And many a judge and juror, while pretending objectivity, is gaining objectivity. And many a trial lawyer or other advocate comes to believe what he formerly only pretended to believe.

While Inconsistency-Avoidance Tendency, with its "status quo bias," immensely harms sound education, it also causes much benefit. For instance, a near-ultimate inconsistency would be to teach something to others that one did not believe true. And so, in clinical medical education, the learner is forced to "see one, do one, and then teach one," with the teaching pounding the learning into the teacher. Of course, the power of teaching to influence the cognition of the teacher is not always a benefit to society. When such power flows into political and cult evangelism, there are often bad consequences.

For instance, modern education often does much damage when young students are taught dubious political notions and then enthusiastically push these notions on the rest of us. The pushing seldom convinces others. But as students pound into their mental habits what they are pushing out, the students are often permanently damaged. Educational institutions that create a climate where much of this goes on are, I think, irresponsible. It is important not to thus put one's brain in chains before one has come anywhere near his full potentiality as a rational person.

6. Curiosity Tendency

There is a lot of innate curiosity in mammals, but its nonhuman version is highest among apes and monkeys. Man's curiosity, in turn, is much stronger than that of his simian relatives. In advanced human civilization, culture greatly increases the effectiveness of curiosity in advancing knowledge. For instance, Athens (including its colony, Alexandria) developed much math and science out of pure curiosity while the Romans made almost no contribution to either math or science. They instead concentrated their attention on the "practical" engineering of mines, roads, aqueducts, etc. Curiosity, enhanced by the best of modern education (which is by definition a minority part in many places), much helps man to prevent or reduce bad consequences arising from other psychological tendencies. The curious are also provided with much fun and wisdom long after formal education has ended.

7. Kantian Fairness Tendency

Kant was famous for his "categorical imperative," a sort of a "golden rule" that required humans to follow those behavior patterns that, if followed by all others, would make the surrounding human system work best for everybody. And it is not too much to say that modern acculturated man displays, and expects from others, a lot of fairness as thus defined by Kant.

In a small community having a one-way bridge or tunnel for autos, it is the norm in the United States to see a lot of reciprocal courtesy, despite the absence of signs or signals. And many freeway drivers, including myself, will often let other drivers come in front of them, in lane changes or the like, because that is the courtesy they desire when roles are reversed. Moreover, there is, in modern human culture, a lot of courteous lining up by strangers so that all are served on a "first-come-first-served" basis.

Also, strangers often voluntarily share equally in unexpected, unearned good and bad fortune. And, as an obverse consequence of such "fair-sharing" conduct, much reactive hostility occurs when fairsharing is expected yet not provided.

It is interesting how the world's slavery was pretty well abolished during the last three centuries after being tolerated for a great many previous centuries during which it coexisted with the world's major religions. My guess is that Kantian Fairness Tendency was a major contributor to this result.

8. Envy/Jealousy Tendency

A member of a species designed through evolutionary process to want often-scarce food is going to be driven strongly toward getting food when it first sees food. And this is going to occur often and tend to create some conflict when the food is seen in the possession of another member of the same species. This is probably the evolutionary origin of the Envy/Jealousy Tendency that lies so deep in human nature. Sibling jealousy is clearly very strong and usually greater in children than adults. It is often stronger than jealousy directed at strangers. Kantian Fairness Tendency probably contributes to this result.

Envy/jealousy is extreme in myth, religion, and literature wherein, in account after account, it triggers hatred and injury. It was regarded as so pernicious by the Jews of the civilization that preceded Christ that it was forbidden, by phrase after phrase, in the laws of Moses. You were even warned by the Prophet not to covet your neighbor's donkey.

And envy/jealousy is also extreme in modern life. For instance, university communities often go bananas when some university employee in money management, or some professor in surgery, gets annual compensation in multiples of the standard professorial salary. And in modern investment banks, law firms, etc., the envy/jealousy effects are usually more extreme than they are in university faculties. Many big law firms, fearing disorder from envy/jealousy, have long treated all senior partners alike in compensation, no matter how different their contributions to firm welfare. As I have shared the observation of life with Warren Buffett over decades, I have heard him wisely say on several occasions: "It is not greed that drives the world, but envy."

And, because this is roughly right, one would expect a vast coverage of envy/jealousy in psychology textbooks. But no such vast coverage existed when I read my three textbooks. Indeed, the very words "envy" and "jealousy" were often absent from the index.

Nondiscussion of envy/jealousy is not a phenomenon confined to psychology texts. When did any of you last engage in any large group discussion of some issue wherein adult envy/jealousy was identified as the cause of someone's argument? There seems to be a general taboo against any such claim. If so, what accounts for the taboo?

My guess is that people widely and generally sense that labeling some position as driven by envy/jealousy will be regarded as extremely insulting to the position taker, possibly more so when the diagnosis is correct than when it is wrong. And if calling a position "envy-driven" is perceived as the equivalent of describing its holder as a childish mental basket case, then it is quite understandable how a general taboo has arisen.

But should this general taboo extend to psychology texts when it creates such a large gap in the correct, psychological explanation of what is widespread and important? My answer is no.

9. Reciprocation Tendency

The automatic tendency of humans to reciprocate both favors and disfavors has long been noticed as it is in apes, monkeys, dogs, and many less cognitively gifted animals. The tendency facilitates group cooperation for the benefit of members. In this respect, it mimics much genetic programming of the social insects. We see the extreme power of the tendency to reciprocate disfavors in some wars, wherein it increases hatred to a level causing very brutal conduct. For long stretches in many wars, no prisoners were taken; the only acceptable enemy a dead one. And sometimes that was not enough, as in the case of Genghis Khan, who was not satisfied with corpses. He insisted on their being hacked into pieces.

One interesting mental exercise is to compare Genghis Khan, who exercised extreme, lethal hostility toward other men, with ants that display extreme, lethal hostility toward members of their own species that are not part of their breeding colony. Genghis looks sweetly lovable when compared to the ants. The ants are more disposed to fight and fight with more extreme cruelty.

Indeed, E. O. Wilson once waggishly suggested that if ants were suddenly to get atom bombs, all ants would be dead within eighteen hours. What both human and ant history suggest is

1) that nature has no general algorithm making intra-species, turn-the-other-cheek behavior a booster of species survival;
2) that it is not clear that a country would have good prospects were it to abandon all reciprocate-disfavor tendency directed at outsiders; and
3) if turn-the-other-cheek behavior is a good idea for a country as it deals with outsiders, man's culture is going to have to do a lot of heavy lifting because his genes won't be of much help.

I next turn to man's reciprocated hostility that falls well short of war. Peacetime hostility can be pretty extreme, as in many modern cases of "road rage" or injury-producing temper tantrums on athletic fields.

The standard antidote to one's overactive hostility is to train oneself to defer reaction. As my smart friend Tom Murphy so frequently says, "You can always tell the man off tomorrow, if it is such a good idea."

Of course, the tendency to reciprocate favor for favor is also very intense, so much so that it occasionally reverses the course of reciprocated hostility. Weird pauses in fighting have sometimes occurred right in the middle of wars, triggered by some minor courtesy or favor on the part of one side, followed by favor reciprocation from the other side, and so on, until fighting stopped for a considerable period. This happened more than once in the trench warfare of World War I, over big stretches of the front and much to the dismay of the generals.

It is obvious that commercial trade, a fundamental cause of modern prosperity, is enormously facilitated by man's innate tendency to reciprocate favors. In trade, enlightened self-interest joining with Reciprocation Tendency results in constructive conduct. Daily interchange in marriage is also assisted by Reciprocation Tendency, without which marriage would lose much of its allure.

And Reciprocation Tendency, insomuch as it causes good results, does not join forces only with the superpower of incentives. It also joins Inconsistency-Avoidance Tendency in helping cause:

1) the fulfillment of promises made as part of a bargain, including loyalty promises in marriage ceremonies, and
2) correct behavior expected from persons serving as priests, shoemakers, physicians, and all else.

Like other psychological tendencies, and also man's ability to turn somersaults, reciprocate-favor tendency operates to a very considerable degree at a subconscious level. This helps make the tendency a strong force that can sometimes be used by some men to mislead others, which happens all the time.

For instance, when an automobile salesman graciously steers you into a comfortable place to sit and gives you a cup of coffee, you are very likely being tricked, by this small courtesy alone, into parting with an extra five hundred dollars. This is far from the most extreme case of sales success that is rooted in a salesman dispensing minor favors. However, in this scenario of buying a car, you are going to be disadvantaged by parting with an extra five hundred dollars of your own money. This potential loss will protect you to some extent.

But suppose you are the purchasing agent of someone else – a rich employer, for instance. Now the minor favor you receive from the salesman is less opposed by the threat of extra cost to you because someone else is paying the extra cost. Under such circumstances, the salesman is often able to maximize his advantage, particularly when government is the purchaser.

Wise employers, therefore, try to oppose reciprocate-favor tendencies of employees engaged in purchasing. The simplest antidote works best: Don't let them accept any favors from vendors. Sam Walton agreed with this idea of absolute prohibition. He wouldn't let purchasing agents accept so much as a hot dog from a vendor. Given the subconscious level at which much Reciprocation Tendency operates, this policy of Walton's was profoundly correct. If I controlled the Defense Department, its policies would mimic Walton's.

In a famous psychology experiment, Cialdini brilliantly demonstrated the power of "compliance practitioners" to mislead people by triggering their subconscious Reciprocation Tendency.

Carrying out this experiment, Cialdini caused his "compliance practitioners" to wander around his campus and ask strangers to supervise a bunch of juvenile delinquents on a trip to a zoo. Because this happed on a campus, one person in six out of a large sample actually agreed to do this. After accumulating this one-in-six statistic, Cialdini changed his procedure. His practitioners next wandered around the campus asking strangers to devote a big chunk of time every week for two years to the supervision of juvenile delinquents. This ridiculous request got him a one hundred percent rejection rate. But the practitioner had a follow-up question: "Will you at least spend one afternoon taking juvenile delinquents to a zoo?" This raised Cialdini's former acceptance rate of 1/6 to ½ – a tripling.

What Cialdini's "compliance practitioners" had done was make a small concession, which was reciprocated by a small concession from the other side. This subconscious reciprocation of a concession by Cialdini's experimental subjects actually caused a much increased percentage of them to end up irrationally agreeing to go to a zoo with juvenile delinquents. Now, a professor who can invent an experiment like that, which so powerfully demonstrates something so important, deserves much recognition in the wider world, which he indeed got to the credit of many universities that learned a great deal from Cialdini.

Why is Reciprocation Tendency so important? Well, consider the folly of having law students graduate, and go out in the world representing clients in negotiations, not knowing the nature of the subconscious processes of the mind as exhibited in Cialdini's experiment. Yet such folly was prevalent in the law schools of the world for decades, in fact, generations. The correct name for that is educational malpractice. The law schools didn't know, or care to teach, what Sam Walton so well knew.

The importance and power of reciprocate-favor tendency was also demonstrated in Cialdini's explanation of the foolish decision of the attorney general of the United States to authorize the Watergate burglary. There, an aggressive subordinate made some extreme proposal for advancing Republican interests through use of some combination of whores and a gigantic yacht. When this ridiculous request was rejected, the subordinate backed off, in gracious concession, to merely asking for consent to a burglary, and the attorney general went along. Cialdini believes that subconscious Reciprocation Tendency thus became one important cause of the resignation of a United States president in the Watergate debacle, and so do I. Reciprocation Tendency subtly causes many extreme and dangerous consequences, not just on rare occasions but pretty much all the time.

Man's belief in reciprocate-favor tendency, following eons of his practicing it, has done some queer and bad things in religions. The ritualized murder of the Phoenicians and the Aztecs, in which they sacrificed human victims to their gods, was a particularly egregious example. And we should not forget that as late as the Punic Wars, the civilized Romans, out of fear of defeat, returned in a few instances to the practice of human sacrifice. On the other hand, the reciprocity-based, religion-boosting idea of obtaining help from God in reciprocation for good human behavior has probably been vastly constructive.

Overall, both inside and outside religions, it seems clear to me that Reciprocation Tendency's constructive contributions to man far outweigh its destructive effects. In cases of psychological tendencies being used to counter or prevent bad results from one or more other psychological tendencies – for instance, in the case of interventions to end chemical dependency – you will usually find Reciprocation Tendency performing strongly on the constructive side.

And the very best part of human life probably lies in relationships of affection wherein parties are more interested in pleasing than being pleased – a not uncommon outcome in display of reciprocate favor tendency.

Before we leave reciprocate-favor tendency, the final phenomenon we will consider is widespread human misery from feelings of guilt. To the extent the feeling of guilt has an evolutionary base, I believe the most plausible cause is the mental conflict triggered in one direction by reciprocate favor tendency and in the opposite direction by Reward Superresponse Tendency pushing one to enjoy one hundred percent of some good thing. Of course, human culture has often greatly boosted the genetic tendency to suffer from feelings of guilt. Most especially, religious culture has imposed hard-to-follow ethical and devotional demands on people. There is a charming Irish Catholic priest in my neighborhood who, with rough accuracy, often says, "The old Jews may have invented guilt, but we Catholics perfected it." And if you, like me and this priest, believe that, averaged out, feelings of guilt do more good than harm, you may join in my special gratitude for reciprocate-favor tendency, no matter how unpleasant you find feelings of guilt.

10. Influence-from-Mere-Association Tendency

In the standard conditioned reflexes studied by Skinner and most common in the world, responsive behavior, creating a new habit, is directly triggered by rewards previously bestowed. For instance, a man buys a can of branded shoe polish, has a good experience with it when shining his shoes, and because of this "reward," buys the same shoe polish when he needs another can.

But there is another type of conditioned reflex wherein mere association triggers a response. For instance, consider the case of many men who have been trained by their previous experience in life to believe that when several similar items are presented for purchase, the one with the highest price will have the highest quality. Knowing this, some seller of an ordinary industrial product will often change his product's trade dress and raise its price significantly hoping that quality-seeking buyers will be tricked into becoming purchasers by mere association of his product and its high price. This industrial practice frequently is effective in driving up sales and even more so in driving up profits. For instance, it worked wonderfully with high-priced power tools for a long time. And it would work better yet with highpriced pumps at the bottom of oil wells. With luxury goods, the process works with a special boost because buyers who pay high prices often gain extra status from thus demonstrating botb their good taste and their ability to pay.

Even association that appears to be trivial, if carefully planned, can have extreme and peculiar effects on purchasers of products. The target purchaser of shoe polish may like pretty girls. And so he chooses the polish with the pretty girl on the can or the one with the pretty girl in the last ad for shoe polish that he saw.

Advertisers know about the power of mere association. You won't see Coke advertised alongside some account of the death of a child. Instead, Coke ads picture life as happier than reality.

Similarly, it is not from mere chance that military bands play such impressive music. That kind of music, appearing in mere association with military service, helps to attract soldiers and keep them in the army. Most armies have learned to use mere association in this successful way.

However, the most damaging miscalculations from mere association do not ordinarily come from advertisers and music providers.

Some of the most important miscalculations come from what is accidentally associated with one's past success, or one's liking and loving, or one's disliking and hating, which includes a natural hatred for bad news.

To avoid being misled by the mere association of some fact with past success, use this memory clue. Think of Napoleon and Hitler when they invaded Russia after using their armies with much success elsewhere. And there are plenty of mundane examples of results like those of Napoleon and Hitler. For instance, a man foolishly gambles in a casino and yet wins. This unlikely correlation causes him to try the casino again, or again and again, to his horrid detriment. Or a man gets lucky in an odds-against venture headed by an untalented friend. So influenced, he tries again what worked before – with terrible results.

The proper **antidotes** to being made such a patsy by past success are:

1) to carefully examine each past success, looking for accidental, noncausative factors associated with such success that will tend to mislead as one appraises odds implicit in a proposed new undertaking, and
2) to look for dangerous aspects of the new undertaking that were not present when past success occurred.

The damage to the mind that can come from liking and loving was once demonstrated by obviously false testimony given by an otherwise very admirable woman, the wife of a party in a jury case. The famous opposing counsel wanted to minimize his attack on such an admirable woman yet destroy the credibility of her testimony. And so, in his closing argument, he came to her testimony last. He then shook his head sadly and said, "What are we to make of such testimony? The answer lies in the old rhyme:

> As the husband is, So the wife is.
> She is married to a clown,
> And the grossness of his nature Drags her down."

The jury disbelieved the woman's testimony. They easily recognized the strong misinfluence of love on her cognition. And we now often see even stronger misinfluence from love as tearful mothers, with heartfelt conviction, declare before TV cameras the innocence of their obviously guilty sons.

People disagree about how much blindness should accompany the association called love. In *Poor Richard's Almanack* Franklin counseled: "Keep your eyes wide open before marriage and half shut thereafter." Perhaps this "eyes-half-shut" solution is about right, but I favor a tougher prescription: "See it like it is and love anyway."

Hating and disliking also cause miscalculation triggered by mere association. In business, I commonly see people underappraise both the competency and morals of competitors they dislike. This is a dangerous practice, usually disguised because it occurs on a subconscious basis.

Another common bad effect from the mere association of a person and a hated outcome is displayed in "Persian Messenger Syndrome." Ancient Persians actually killed some messengers whose sole fault was that they brought home truthful bad news, say, of a battle lost. It was actually safer for the messenger to run away and hide, instead of doing his job as a wiser boss would have wanted it done.

And Persian Messenger Syndrome is alive and well in modern life, albeit in less lethal versions. It is actually dangerous in many careers to be a carrier of unwelcome news. Union negotiators and employer representatives often know this, and it leads to many tragedies in labor relations. Sometimes lawyers, knowing their clients will hate them if they recommend an unwelcome but wise settlement, will carry on to disaster. Even in places well known for high cognition, one will sometimes find Persian Messenger Syndrome. For instance, years ago, two major oil companies litigated in a Texas trial court over some ambiguity in an operating agreement covering one of the largest oil reservoirs in the Western hemisphere. My guess is that the cause of the trial was some general counsel's unwillingness to carry bad news to a strong-minded CEO.

CBS, in its late heyday, was famous for occurrence of Persian Messenger Syndrome because Chairman Bill Paley was hostile to people who brought him bad news. The result was that Paley lived in a cocoon of unreality, from which he made one bad deal after another, even exchanging a large share of CBS for a company that had to be liquidated shortly thereafter.

The proper antidote to creating Persian Messenger Syndrome and its bad effects, like those at CBS, is to develop, through exercise of will, a habit of welcoming bad news. At Berkshire, there is a common injunction: "Always tell us the bad news promptly. It is only the good news that can wait." It also helps to be so wise and informed that people fear not telling you bad news because you are so likely to get it elsewhere.

Influence-from-Mere-Association Tendency often has a shocking effect that helps swamp the normal tendency to return favor for favor, [especially when the favor recipient's] condition is unpleasant, due to poverty, sickness, subjugation, or something else. Sometimes, when one receives a favor, the favor may trigger an envy-driven dislike for the person who was in so favorable a state that he could easily be a favor giver. Under such circumstances, the favor receiver, prompted partly by mere association of the favor giver with past pain, will not only dislike the man who helped him but also try to injure him. This accounts for a famous response, sometimes dubiously attributed to Henry Ford: "Why does that man hate me so? I never did anything for him."

I have a friend, whom I will now call "Glotz," who had an amusing experience in favor-giving. Glotz owned an apartment building that he had bought because he wanted, eventually, to use the land in different development. Pending this outcome, Glotz was very lenient in collecting below-market rents from tenants. When, at last, there was a public hearing on Glotz's proposal to tear down the building, one tenant who was far behind in his rent payments was particularly angry and hostile. He came to the public hearing and said, "This proposal is outrageous. Glotz doesn't need any more money. I know this because I was supported in college by Glotz fellowships."

A final serious clump of bad thinking caused by mere association lies in the common use of classification stereotypes. Because Pete knows that Joe is ninety years old and that most ninety-year-old persons don't think very well, Pete appraises old Joe as a thinking klutz even if old Joe still thinks very well. Or, because Jane is a white-haired woman, and Pete knows no old women good at higher math, Pete appraises Jane as no good at it even if Jane is a whiz. This sort of wrong thinking is both natural and common. Pete's **antidote** is not to believe that, on average, ninety-year-olds think as well as forty year-olds or that there are as many females as males among Ph.D.'s in math. Instead, just as he must learn that trend does not always correctly predict destiny, he must learn that the average dimension in some group will not reliably guide him to the dimension of some specific item. Otherwise Pete will make many errors, like that of the fellow who drowned in a river that averaged out only eighteen inches deep.

11. Simple, Pain-Avoiding Psychological Denial

This phenomenon first hit me hard in World War II when the superathlete, superstudent son of a family friend flew off over the Atlantic Ocean and never came back. His mother, who was a very sane woman, then refused to believe he was dead. That's Simple, Pain-Avoiding Psychological Denial. The reality is too painful to bear, so one distorts the facts until they become bearable. We all do that to some extent, often causing terrible problems. The tendency's most extreme outcomes are usually mixed up with love, death, and chemical dependency.

Where denial is used to make dying easier, the conduct meets almost no criticism. Who would begrudge a fellow man such help at such a time? But some people hope to leave life hewing to the iron prescription, "It is not necessary to hope in order to persevere." And there is something admirable in anyone able to do this.

In chemical dependency, wherein morals usually break down horribly, addicted persons tend to believe that they remain in respectable condition, with respectable prospects. They thus display an extremely unrealistic denial of reality as they go deeper and deeper into deterioration. In my youth, Freudian remedies failed utterly in reversing chemical dependency, but nowadays Alcoholics Anonymous routinely achieves a fifty percent cure rate by causing several psychological tendencies to act together to counter addiction. However, the cure process is typically difficult and draining, and a fifty percent success rate implies a fifty percent failure rate. One should stay far away from any conduct at all likely to drift into chemical dependency. Even a small chance of suffering so great a damage should be avoided.

12. Excessive Self-Regard Tendency

We all commonly observe the excessive self-regard of man. He mostly misappraises himself on the high side, like the ninety percent of Swedish drivers that judge themselves to be above average. Such misappraisals also apply to a person's major "possessions." One spouse usually overappraises the other spouse. And a man's children are likewise appraised higher by him than they are likely to be in a more objective view. Even man's minor possessions tend to be overappraised. Once owned, they suddenly become worth more to him than he would pay if they were offered for sale to him and he didn't already own them. There is a name in psychology for this overappraisal-of-our-own-possessions phenomenon: the "endowment effect." And all man's decisions are suddenly regarded by him as better than would have been the case just before he made them.

Man's excess of self-regard typically makes him strongly prefer people like himself. Psychology professors have had much fun demonstrating this effect in "lost-wallet" experiments. Their experiments all show that the finder of a lost wallet containing identity clues will be most likely to return the wallet when the owner most closely resembles the finder. Given this quality in psychosocial nature, cliquish groups of similar persons will always be a very influential part of human culture, even after we wisely try to dampen the worst effects.

Some of the worst consequences in modern life come when dysfunctional groups of cliquish persons, dominated by Excessive Self-Regard Tendency, select as new members of their organizations persons who are very much like themselves. Thus if the English department at an elite university becomes mentally dysfunctional or the sales department of a brokerage firm slips into routine fraud, the problem will have a natural tendency to get worse and to be quite resistant to change for the better. So also with a police department or prison-guard unit or political group gone sour and countless other places mired in evil and folly, such as the worst of our big-city teachers' unions that harm our children by preventing discharge of ineffective teachers.

Therefore, some of the most useful members of our civilization are those who are willing to "clean house" when they find a mess under their ambit of control.

Well, naturally, all forms of excess of self-regard cause much error. How could it be otherwise?

Let us consider some foolish gambling decisions. In lotteries, the play is much lower when numbers are distributed randomly than it is when the player picks his own number. This is quite irrational. The odds are almost exactly the same and much against the player. Because state lotteries take advantage of man's irrational love of self-picked numbers, modern man buys more lottery tickets than he otherwise would have, with each purchase foolish.

Intensify man's love of his own conclusions by adding the possessory wallop from the "endowment effect," and you will find that a man who has already bought a pork-belly future on a commodity exchange now foolishly believes, even more strongly than before, in the merits of his speculative bet.

And foolish sports betting, by people who love sports and think they know a lot about relative merits of teams, is a lot more addictive than race track betting – partly because of man's automatic overappraisal of his own complicated conclusions.

Also extremely counterproductive is man's tendency to bet, time after time, in games of skill, like golf or poker, against people who are obviously much better players. Excessive Self-Regard Tendency diminishes the foolish bettor's accuracy in appraising his relative degree of talent.

More counterproductive yet are man's appraisals, typically excessive, of the quality of the future service he is to provide to his business. His overappraisal of these prospective contributions will frequently cause disaster.

Excesses of self-regard often cause bad hiring decisions because employers grossly overappraise the worth of their own conclusions that rely on impressions in face-to-face contact. The correct antidote to this sort of folly is to underweigh face-to-face impressions and overweigh the applicant's past record.

I once chose exactly this course of action while I served as chairman of an academic search committee. I convinced fellow committee members to stop all further interviews and simply appoint a person whose achievement record was much better than that of any other applicant. And when it was suggested to me that I wasn't giving "academic due process," I replied that I was the one being true to academic values because I was using academic research showing poor predictive value of impressions from face-to-face interviews.

Because man is likely to be overinfluenced by face-to-face impressions that by definition involve his active participation, a job candidate who is a marvelous "presenter" often causes great danger under modern executive-search practice. In my opinion, Hewlett-Packard faced just such a danger when it interviewed the articulate, dynamic Carly Fiorina in its search for a new CEO. And I believe that Hewlett-Packard made a bad decision when it chose Ms. Fiorina, and that this bad decision would not have been made if Hewlett-Packard had taken the methodological precautions it would have taken if it knew more psychology.

There is a famous passage somewhere in Tolstoy that illuminates the power of Excessive Self-Regard Tendency. According to Tolstoy, the worst criminals don't appraise themselves as all that bad. They come to believe either (1) that they didn't commit their crimes or (2) that, considering the pressures and disadvantages of their lives, it is understandable and forgivable that they behaved as they did and became what they became.

The second half of the "Tolstoy effect," where the man makes excuses for his fixable poor performance, instead of providing the fix, is enormously important. Because a majority of mankind will try to get along by making way too many unreasonable excuses for fixable poor performance, it is very important to have personal and institutional **antidotes** limiting the ravages of such folly. On the personal level a man should try to face the two simple facts:

1) fixable but unfixed bad performance is bad character and tends to create more of itself, causing more damage to the excuse giver with each tolerated instance, and
2) in demanding places, like athletic teams and General Electric, you are almost sure to be discarded in due course if you keep giving excuses instead of behaving as you should.

The main institutional **antidotes** to this part of the "Tolstoy effect" are:

1) a fair, meritocratic, demanding culture plus personnel handling methods that build up morale, and
2) severance of the worst offenders.

Of course, when you can't sever – as in the case of your own child – you must try to fix the child as best you can. I once heard of child-teaching method so effective that the child remembered the learning experience over fifty years later. The child later became Dean of the USC School of Music and then related to me what father said when he saw his child taking candy from the stock of his employer with the excuse that he intended to replace it later. The father said, "Son, it would be better for you to simply take all you want and call yourself a thief every time you do it."

The best **antidote** to folly from an excess of self-regard is to force yourself to be more objective when you are thinking about yourself, your family and friends, your property, and the value of your past and future activity. This isn't easy to do well won't work perfectly, but it will work much better than simply letting psychological nature take its normal course.

While an excess of self-regard is often counterproductive in its effects on cognition, it can cause some weird successes from overconfidence that happens to cause success. This factor accounts for the adage: "Never underestimate the man who overestimates himself."

Of course, some high self-appraisals are correct and serve better than false modesty. Moreover, self-regard in the form of a justified pride in a job well done, or a life well lived, is a large constructive force. Without such justified pride, many more airplanes would crash. "Pride" is another word generally left out of psychology textbooks, and this omission is not a good idea. It is also not a good idea to construe the bible's parable about the Pharisee and the Publican as condemning all pride.

Of all forms of useful pride, perhaps the most desirable is a justified pride in being trustworthy. Moreover, the trustworthy man, even after allowing for the inconveniences of his chosen course, ordinarily has a life that averages out better than he would have if he provided less reliability.

13. Overoptimism Tendency

About three centuries before the birth of Christ, Demosthenes, the most famous Greek orator, said, "What a man wishes, that also will he believe."

Demosthenes, parsed out, was thus saying that man displays not only Simple, Pain-Avoiding Psychological Denial but also an excess of optimism even when he is already doing well.

The Greek orator was clearly right about an excess of optimism being the normal human condition, even when pain or the threat of pain is absent. Witness happy people buying lottery tickets or believing that credit-furnishing, delivery-making grocery stores were going to displace a great many superefficient cash-and-carry supermarkets.

One standard **antidote** to foolish optimism is trained, habitual use of the simple probability math of Fermat and Pascal, taught in my youth to high school sophomores. The mental rules of thumb that evolution gives you to deal with risk are not adequate. They resemble the dysfunctional golf grip you would have if you relied on a grip driven by evolution instead of golf lessons.

14. Deprival Superreaction Tendency

The quantity of man's pleasure from a ten dollar gain does not exactly match the quantity of his displeasure from a ten-dollar loss. That is, the loss seems to hurt much more than the gain seems to help. Moreover, if a man almost gets something he greatly wants and has it jerked away from him at the last moment, he will react much as if he had long owned the reward and had it jerked away. I include the natural human reactions to both kind of loss experience – the loss of the possessed reward and the loss of the almost-possessed reward – under one description, Deprival Superreaction Tendency.

In displaying Deprival Superreaction Tendency, man frequently incurs disadvantage by misframing his problems. He will often compare what is near instead of what really matters. For instance, a man with $10 million in his brokerage account will often be extremely irritated by the accidental loss of $100 out of the $300 in his wallet.

The Mungers once owned a tame and good-natured dog that displayed the canine version of Deprival Superreaction Tendency. There was only one way to get bitten by this dog. And that was to try and take some food away from him after he already had it in his mouth. If you did that, this friendly dog would automatically bite. He couldn't help it. Nothing could be more stupid than for the dog to bite his master. But the dog couldn't help being foolish. He had an automatic Deprival Superreaction Tendency in his nature.

Humans are much the same as this Munger dog. A man ordinarily reacts with irrational intensity to even a small loss, or threatened loss, of property, love, friendship, dominated territory, opportunity: status, or any other valued thing. As a natural result, bureaucratic infighting over the threatened loss of dominated territory often causes immense damage to an institution as a whole. This factor among others, accounts for much of the wisdom of Jack Welch's long fight against bureaucratic ills at General Electric. Few business leaders have ever conducted wiser campaigns.

Deprival Superreaction Tendency often protects ideological or religious views by triggering and hatred directed toward vocal nonbelievers. This happens, in part, because the ideas of the nonbelievers, if they spread, will diminish the influence of views that are now supported by a comfortable environment including a strong relief-maintenance system. University liberal arts departments, law schools, and business organizations all display plenty of such ideology-based groupthink that rejects almost all conflicting inputs. When the vocal critic is a former believer, hostility is often boosted both by:

1) a concept of betrayal that triggers additional Deprival Superreaction Tendency because a colleague is lost, and
2) fears that conflicting views will have extra persuasive power when they come from a former colleague.

The foregoing considerations help account for the old idea of heresy, which for centuries justified much killing of heretics, frequently after torture and frequently accomplished by burning the victim alive.

It is almost everywhere the case that extremes of ideology are maintained with great intensity and with great antipathy to non-believers, causing extremes of cognitive dysfunction. This happens, I believe, because two psychological tendencies are usually acting concurrently toward this same sad result: Inconsistency-Avoidance Tendency, plus Deprival Superreaction Tendency.

One **antidote** to intense, deliberate maintenance of groupthink is an extreme culture of courtesy, kept in place despite ideological differences, like the behavior of the justices now serving on the U.S. Supreme Court. Another antidote is to deliberately bring in able and articulate disbelievers of incumbent groupthink. Successful corrective measures to evil examples of groupthink maintenance have included actions like that of Derek Bok when, as president of Harvard, he started disapproving tenure appointments proposed by ideologues at Harvard Law School.

Even a one-degree loss from a 180-degree view will sometime create enough Deprival Superreaction Tendency to turn a neighbor into an enemy, as I once observed when I bought a house from one of two neighbors locked into hatred by a tiny tree newly installed by one of them.

As the case of these two neighbors illustrated, the clamor of almost any group of neighbors displaying irrational, extreme deprival superreaction over some trifle in a zoning hearing is not a pretty thing to watch. Such bad behavior drives some people from the zoning field. I once bought some golf clubs from an artisan who was formerly a lawyer. When I asked him what kind of law he had practiced, I expected to hear him say, "divorce law." But his answer was, "zoning law."

Deprival Superreaction Tendency has ghastly effects in labor relations. Most of the deaths in the labor strife that occurred before World War I came when employers tried to reduce wages. Nowadays, we see fewer deaths and more occasions when whole companies disappear, as competition requires either takeaways from labor – which it will not consent to – or death of the business. Deprival Superreaction Tendency causes much of this labor resistance, often in cases where it would be in labor's interest to make a different decision.

In contexts other than labor relations, takeaways are also difficult to get. Many tragedies, therefore, occur that would have been avoided had there been more rationality and less subconscious heed of the imperative from Deprival Superreaction Tendency.

Deprival Superreaction Tendency and Inconsistency-Avoidance Tendency often join to cause one form of business failure. In this form of ruin, a man gradually uses up all his good assets in a fruitless attempt to rescue a big venture going bad. One of the best **antidotes** to this folly is good poker skill learned young. The teaching value of poker demonstrates that not all effective teaching occurs on a standard academic path.

Deprival Superreaction Tendency is also a huge contributor to ruin from compulsion to gamble. First, it causes the gambler to have a passion to get even once he has suffered loss, and the passion grows with the loss. Second, the most addictive forms of gambling provide a lot of near misses and each one triggers Deprival Superreaction Tendency. Some slot machine creators are vicious in exploiting this weakness of man. Electronic machines enable these creators to produce a lot of meaningless bar-bar-lemon results that greatly increase play by fools who think they have very nearly won large rewards.

Deprival Superreaction Tendency often does much damage to man in open-outcry auctions. The "social proof" that we will next consider tends to convince man that the last price from another bidder was reasonable, and then Deprival Superreaction Tendency prompts him strongly to top the last bid. The best **antidote** to being thus triggered into paying foolish prices at open-outcry auctions is the simple Buffett practice: Don't go to such auctions.

I myself, the would-be instructor here, many decades ago made a big mistake caused in part by subconscious operation of my Deprival Superreaction Tendency. A friendly broker called and offered me 300 shares of ridiculously underpriced, very thinly traded Belridge Oil at $115 per share, which I purchased using cash I had on hand. The next day, he offered me 1,500 more shares at the same price, which I declined to buy, partly because I could only have made the purchase had I sold something or borrowed the required $173,000. This was a very irrational decision. I was a well-to-do man with no debt; there was no risk of loss; and similar no risk opportunities were not likely to come along. Within two years, Belridge Oil sold out to Shell at a price of about $3,700 per share, which made me about $5.4 million poorer than I would have been had I then been psychologically acute. As this tale demonstrates, psychological ignorance can be very expensive.

Some people may question my defining Deprival Superreaction Tendency to include reaction to profit barely missed, as in the well-documented responses of slot machine players. However, I believe that I haven't defined the tendency as broadly as I should. My reason for suggesting an even broader definition is that many Berkshire Hathaway shareholders I know never sell or give away a single share after immense gains in market value have occurred. Some of this reaction is caused by rational calculation, and some is, no doubt, attributable to some combination of (1) reward superresponse, (2) "status quo bias" from Inconsistency-Avoidance Tendency, and (3) "the endowment effect" from Excessive Self-Regard Tendency. But I believe the single strongest irrational explanation is a form of Deprival Superreaction Tendency. Many of these shareholders simply can't stand the idea of having their Berkshire Hathaway holdings smaller. Partly they dislike facing what they consider an impairment of identity, but mostly they fear missing out on future gains from stock sold or given away.

15. Social-Proof Tendency

The otherwise complex behavior of man is much simplified when he automatically thinks and does what he observes to be thought and done around him. And such followership often works fine. For instance, what simpler way could there be to find out how to walk to a big football game in a strange city than by following the flow of the crowd. For some such reason, man's evolution left him with Social-Proof Tendency, an automatic tendency to think and act as he sees others around him thinking and acting.

Psychology professors love Social-Proof Tendency because in their experiments it causes ridiculous results. For instance, if a professor arranges for some stranger to enter an elevator wherein ten "compliance practitioners" are all silently standing so that they face the rear of the elevator, the stranger will often turn around and do the same. The psychology professors can also use Social-Proof Tendency to cause people to make large and ridiculous measurement errors.

And, of course, teenagers' parents usually learn more than they would like about teenagers' cognitive errors from Social-Proof Tendency. This phenomenon was recently involved in a breakthrough by Judith Rich Harris who demonstrated that superrespect by young people for their peers, rather than for parents or other adults, is ordained to some considerable extent by the genes of the young people. This makes it wise for parents to rely more on manipulating the quality of the peers than on exhortations to their own offspring. A person like Ms. Harris, who can provide an insight of this quality and utility, backed by new reasons, has not lived in vain.

And in the highest reaches of business, it is not all uncommon to find leaders who display followership akin to that of teenagers. If one oil company foolishly buys a mine, other oil companies often quickly join in buying mines. So also if the purchased company makes fertilizer. Both of these oil company buying fads actually bloomed, with bad results.

Of course, it is difficult to identify and correctly weigh all the possible ways to deploy the cash flow of an oil company. So oil company executives, like everyone else, have made many bad decisions that were quickly triggered by discomfort from doubt. Going along with social proof provided by the action of other oil companies ends this discomfort in a natural way.

When will Social-Proof Tendency be most easily triggered? Here the answer is clear from many experiments: Triggering most readily occurs in the presence of puzzlement or stress, and particularly when both exist.

Because stress intensifies Social-Proof Tendency, disreputable sales organizations, engaged, for instance, in such action as selling swampland to schoolteachers, manipulate targets into situations combining isolation and stress. The isolation strengthens the social proof provided by both the knaves and the people who buy first, and the stress, often increased by fatigue, augments the targets' susceptibility to the social proof. And, of course, the techniques of our worst "religious" cults imitate those of the knavish salesmen. One cult even used rattlesnakes to heighten the stress felt by conversion targets.

Because both bad and good behavior are made contagious by Social-Proof Tendency, it is highly important that human societies stop any bad behavior before it spreads and foster and display all good behavior.

My father once told me that just after commencing law practice in Omaha, he went with a large group from Nebraska to South Dakota to hunt pheasants. A South Dakota hunting license was, say, $2 for South Dakota residents and $5 for nonresidents. All the Nebraska residents, one by one, signed up for South Dakota licenses with phony South Dakota addresses until it was my father's turn. Then, according to him, he barely prevented himself from doing what the others were doing, which was some sort of criminal offense.

Not everyone so resists the social contagion of bad behavior. And, therefore, we often get "Serpico Syndrome," named to commemorate the state of a near-totally corrupt New York police division joined by Frank Serpico. He was then nearly murdered by gunfire because of his resistance to going along with the corruption in the division. Such corruption was being driven by social proof plus incentives, the combination that creates Serpico Syndrome. The Serpico story should be taught more than it now is because the didactic power of its horror is aimed at a very important evil, driven substantially by a very important force: social proof.

In social proof, it is not only action by others that misleads but also their inaction. In the presence of doubt, inaction by others becomes social proof that inaction is the right course. Thus, the inaction of a great many bystanders led to the death of Kitty Genovese in a famous incident much discussed in introductory psychology courses.

In the ambit of social proof, the outside rectors on a corporate board usually display the near ultimate form of inaction. They fail to object to anything much short of an axe murder until some public embarrassment of the board finally causes their intervention. A typical board-of-directors' culture was once well described by my friend, Joe Rosenfield, as he said, "They asked me if I wanted become a director of Northwest Bell, and it was the last thing they ever asked me."

In advertising and sales promotion, Social-Proof Tendency is about as strong a factor as one could imagine. "Monkey-see, monkey-do" is the old phrase that reminds one of how strongly John will often wish to do something, or have something, just because Joe does or has it. One interesting consequence is that an advertiser will pay a lot to have its soup can, instead of someone else's, in a movie scene involving soup consumption only in a peripheral way.

Social-Proof Tendency often interacts in a perverse way with Envy/Jealousy and Deprival Superreaction Tendency. One such interaction amused my family for years as people recalled the time when my cousin Russ and I, at ages three and four, fought and howled over a single surplus shingle while surrounded by a virtual sea of surplus shingles.

But the adult versions of this occasion, boosted by psychological tendencies preserving ideologies, are not funny – and can bring down whole civilizations. The Middle East now presents just such a threat. By now the resources spent by Jews, Arabs and all others over a small amount of disputed land if divided arbitrarily among land claimants, would have made everyone better off, even before taking into account any benefit from reduced threat of war, possibly nuclear.

Outside domestic relations it is rare now to try to resolve disputes by techniques including discussion of impacts from psychological tendencies. Considering the implications of childishness that would be raised by such inclusion, and the defects of psychology as now taught, this result may be sound. But, given the nuclear stakes now involved and the many failures in important negotiations lasting decades, I often wonder if some day, in some way, more use of psychological insight will eventually improve outcomes. If so, correct teaching of psychology matters a lot. And, if old psychology professors are even less likely than old physics professors to learn new ways, which seems nearly certain, then we may, as Max Planck predicted, need a new generation of psychology professors who have grown up to think in a different way.

If only one lesson is to be chosen from a package of lessons involving Social-Proof Tendency, and used in self improvement, my favorite would be: Learn how to ignore the examples from others when they are wrong, because few skills are more worth having.

16. Contrast-Misreaction Tendency

Because the nervous system of man does not naturally measure in absolute scientific units, it must instead rely on something simpler. The eyes have a solution that limits their programming needs: the contrast in what is seen is registered. And as in sight, so does it go, largely, in the other senses. Moreover, as perception goes, so goes cognition. The result is man's Contrast-Misreaction Tendency. Few psychological tendencies do more damage to correct thinking. Small-scale damages involve instances such as man's buying an overpriced $1,000 leather dashboard merely because the price is so low compared to his concurrent purchase of a $65,000 car. Large-scale damages often ruin lives, as when a wonderful woman having terrible parents marries a man who would be judged satisfactory only in comparison to her parents. Or as when a man takes wife number two who would be appraised as all right only in comparison to wife number one.

A particularly reprehensible form of sales practice occurs in the offices of some real estate brokers. A buyer from out of the city, perhaps needing to shift his family there, visits the office with little time available. The salesman deliberately shows the customer three awful houses at ridiculously high prices. Then he shows him a merely bad house at a price only moderately too high. And, boom, the broker often makes an easy sale.

Contrast-Misreaction Tendency is routinely used to cause disadvantage for customers buying merchandise and services. To make an ordinary price seem low, the vendor will very frequently create a highly artificial price that is much higher than the price always sought, then advertise his standard price as a big reduction from his phony price. Even when people know that this sort of customer manipulation is being attempted, it will often work to trigger buying. This phenomenon accounts in part for much advertising in newspapers. It also demonstrates that being aware of psychological ploys is not a perfect defense. When a man's steps are consecutively taken toward disaster, with each step being very small, the brain's Contrast-Misreaction Tendency will often let the man go too far toward disaster to be able to avoid it. This happens because each step presents small a contrast from his present position.

A bridge-playing pal of mine once told me that a frog tossed into very hot water would jump out, but that the same frog would end up dying if placed in room-temperature water that was later treated at a very slow rate. My few shreds of physiological knowledge make me doubt this account. But no matter, because many businesses die in just the manner claimed by my friend for the frog. Cognition, misled by tiny changes involving low contrast, will often miss a trend that is destiny.

One of Ben Franklin's best-remembered and most useful aphorisms is "A small leak will sink great ship." The utility of the aphorism is large precisely because the brain so often misses the functional equivalent of a small leak in a great ship.

17. Stress-Influence Tendency

Everyone recognizes that sudden stress, for instance from a threat, will cause a rush of adrenaline in the human body, prompting faster and more extreme reaction. And everyone who has taken Psych 101 knows that stress makes Social-Proof Tendency more powerful.

In a phenomenon less well recognized, but still widely known, light stress can slightly improve performance – say, in examinations – whereas heavy stress causes dysfunction.

But few people know more about really heavy stress than that it can cause depression. For instance, most people know that an "acute stress depression" makes thinking dysfunctional because it causes an extreme of pessimism, often extended in length and usually accompanied by activity stopping fatigue. Fortunately, as most people also know, such a depression is one of mankind's more reversible ailments. Even before modern drugs were available, many people afflicted by depression, such as Winston Churchill and Samuel Johnson, gained great achievement in life.

Most people know very little about nondepressive mental breakdowns influenced by heavy stress. But there is at least one exception, involving the work of Pavlov when he was in his seventies and eighties. Pavlov had won a Nobel Prize early in life by using dogs to work out the physiology of digestion. Then he became world-famous by working out mere-association responses in dogs, initially salivating dogs -- so much so that changes in behavior triggered by mere-association, like those caused by much modern advertisement, are today often said to come from "Pavlovian" conditioning.

What happened to cause Pavlov's last work was especially interesting. During the great Leningrad Flood of the 1920s, Pavlov had many dogs in cages. Their habits had been transformed, by a combination of his "Pavlovian conditioning" plus standard reward responses, into distinct and different patterns. As the waters of the flood came up and receded, many dogs reached a point where they had almost no airspace between their noses and the tops of their cages. This subjected them to maximum stress. Immediately thereafter, Pavlov noticed that many of the dogs were no longer behaving as they had. For example, the dog that formerly had liked his trainer now disliked him. This result reminds one of modern cognition-reversals in which a person's love of his parents suddenly becomes hate, as new love has been shifted suddenly to a cult. The unanticipated, extreme changes in Pavlov's dogs would have driven any good experimental scientist into a near-frenzy of curiosity. That was indeed Pavlov's reaction. But not many scientists would have done what Pavlov next did.

And that was to spend the rest of his long life giving stress-induced nervous breakdowns to dogs, after which he would try to reverse the breakdowns, all the while keeping careful experimental records. He found

1) that he could classify dogs so as to predict how easily a particular dog would breakdown;
2) that the dogs hardest to break down were also the hardest to return to their pre-breakdown state;
3) that any dog could be broken down; and
4) that he couldn't reverse a breakdown except by reimposing stress.

Now, practically everyone is revolted by such experimental treatment of man's friend, the dog. Moreover, Pavlov was Russian and did his last work under the Communists. And maybe those facts account for the present extreme, widespread ignorance of Pavlov's last work. The two Freudian psychiatrists with whom I tried many years ago to discuss this work had never heard of it. And the dean of a major medical school actually asked me, several years ago, if any of Pavlov's experiments were "repeatable" in experiments of other researchers. Obviously, Pavlov is now a sort of forgotten hero in medical science.

I first found a description of Pavlov's last work in a popular paperback, written by some Rockefeller-financed psychiatrist, when I was trying to figure out how cults worked their horrible mischief and what should the law say about what parents could do to "deprogram" children who had become brainwashed zombies. Naturally, mainstream law objected to the zombies being physically captured by their parents and subjected to stress that would help to deprogram the effects of the stress they had endured in cult conversions.

I never wanted to get into the legal controversy that existed about this subject. But I did conclude that the controversy couldn't be handled with maximized rationality without considering whether as Pavlov's last work suggests, the heavy-handed imposition of stress might be the only reversal method that would work to remedy one of the worst evils imaginable: a stolen mind. I have included this discussion of Pavlov partly out of general antagonism toward taboos, partly to make my talk reasonably complete as it considers stress and partly because I hope some listener may continue my inquiry with more success.

18. Availability-Misweighing Tendency

This mental tendency echoes the words of the song: "When I'm not near the girl I love, I love the girl I'm near." Man's imperfect, limited-capacity brain easily drifts into working with what's easily available to it. And the brain can't use what it can't remember or what it is blocked from recognizing because it is heavily influenced by one or more psychological tendencies bearing strongly on it, as the fellow is influenced by the nearby girl in the song. And so the mind overweighs what is easily available and thus displays Availability-Misweighing Tendency.

The main **antidotes** to miscues from Availability-Misweighing Tendency often involve procedures, including use of checklists, which are almost always helpful.

Another **antidote** is to behave somewhat like Darwin did when he emphasized disconfirming evidence. What should be done is to especially emphasize factors that don't produce reams of easily available numbers, instead of drifting mostly or entirely into considering factors that do produce such numbers. Still another antidote is to find and hire some skeptical, articulate people with far-reaching minds to act as advocates for notions that are opposite to the incumbent notions.

One consequence of this tendency is that extra vivid evidence, being so memorable and thus more available in cognition, should often consciously be underweighed while less vivid evidence should be overweighed.

Still, the special strength of extra-vivid images in influencing the mind can be constructively used

1) in persuading someone else to reach a correct conclusion or
2) as a device for improving one's own memory by attaching vivid images, one after the other, to many items one doesn't want to forget.

Indeed, such use of vivid images as memory boosters is what enabled the great orators of classical Greece and Rome to give such long, organized speeches without using notes.

The great algorithm to remember in dealing with this tendency is simple: An idea or a fact is not worth more merely because it is easily available to you.

19. Use-It-or-Lose-It Tendency

All skills attenuate with disuse. I was a whiz at calculus until age twenty, after which the skill was soon obliterated by total nonuse. The right antidote to such a loss is to make use of the functional equivalent of the aircraft simulator employed in pilot training. This allows a pilot to continuously practice all of the rarely used skills that he can't afford to lose.

Throughout his life, a wise man engages in practice of all his useful, rarely used skills, many of them outside his discipline, as a sort of duty to his better self. If he reduces the number of skills he practices and, therefore, the number of skills he retains, he will naturally drift into error from man with a hammer tendency. His learning capacity will also shrink as he creates gaps in the latticework of theory he needs as a framework for understanding new experience. It is also essential for a thinking man to assemble his skills into a checklist that he routinely uses. Any other mode of operation will cause him to miss much that is important.

Skills of a very high order can be maintained only with daily practice. The pianist Paderewski once said that if he failed to practice for a single day, he could notice his performance deterioration and that, after a week's gap in practice, the audience could notice it as well.

The hard rule of Use-It-or-Lose-It Tendency tempers its harshness for the diligent. If a skill is raised to fluency, instead of merely being crammed in briefly to enable one to pass some test, then the skill (1) will be lost more slowly and (2) will come back faster when refreshed with new learning. These are not minor advantages, and a wise man engaged in learning some important skill will not stop until he is really fluent in it.

20. Drug-Misinfluence Tendency

This tendency's destructive power is so widely known to be intense, with frequent tragic consequences for cognition and the outcome of life, that it needs no discussion here to supplement that previously given under "Simple, Pain-Avoiding Psychological Denial."

21. Senescence-Misinfluence Tendency

With advanced age, there comes a natural cognitive decay, differing among individuals in the earliness of its arrival and the speed of its progression. Practically no one is good at learning complex new skills when very old. But some people remain pretty good in maintaining intensely practiced old skills until late in life, as one can notice in many a bridge tournament.

Old people like me get pretty skilled, without working at it, at disguising age-related deterioration because social convention, like clothing, hides much decline.

Continuous thinking and learning, done with joy, can somewhat help delay what is inevitable.

22. Authority-Misinfluence Tendency

Living in dominance hierarchies as he does, like all his ancestors before him, man was born mostly to follow leaders, with only a few people doing the leading. And so, human society is formally organized into dominance hierarchies, with their culture augmenting the natural follow-the-leader tendency of man.

But automatic as most human reactions are, with the tendency to follow leaders being no exception, man is often destined to suffer greatly when the leader is wrong or when his leader's ideas don't get through properly in the bustle of life and are misunderstood. And so, we find much miscognition from man's Authority-Misinfluence Tendency.

Some of the misinfluences are amusing, as in a case described by Cialdini. A physician left a written order for a nurse treating an earache, as follows: "Two drops, twice a day, r. ear." The nurse then directed the patient to turn over and put the eardrops in his anus.

Other versions of confused instructions from authority figures are tragic. In World War II, a new pilot for a general, who sat beside him in the copilot's seat, was so anxious to please his boss that he misinterpreted some minor shift in the general's position as a direction to do some foolish thing. The pilot crashed the plane and became a paraplegic.

Well, naturally, cases like this one get the attention of careful thinkers like Boss Buffett, who always acts like an overquiet mouse around his pilots.

Such cases are also given attention in the simulator training of copilots who have to learn to ignore certain really foolish orders from boss pilots because boss pilots will sometimes err disastrously. Even after going through such a training regime, however, copilots in simulator exercises will too often allow the simulated plane to crash because of some extreme and perfectly obvious simulated error of the chief pilot.

After Corporal Hitler had risen to dominate Germany, leading a bunch of believing Lutherans and Catholics into orgies of genocide and other mass destruction, one clever psychology professor, Stanley Milgram, decided to do an experiment to determine exactly how far authority figures could lead ordinary people into gross misbehavior. In this experiment, a man posing as an authority figure, namely a professor governing a respectable experiment, was able to trick a great many ordinary people into giving what they had every reason to believe were massive electric shocks that inflicted heavy torture on innocent fellow citizens. This experiment did demonstrate a terrible result contributed to by Authority-Misinfluence Tendency, but it also demonstrated extreme ignorance in the psychology professoriate right after World War II.

Almost any intelligent person with my checklist of psychological tendencies in his hand would, by simply going down the checklist, have seen that Milgram's experiment involved about six powerful psychological tendencies acting in confluence to bring about his extreme experimental result. For instance, the person pushing Milgram's shock lever was given much social proof from presence of inactive bystanders whose silence communicated that his behavior was okay. Yet it took over a thousand psychological papers, published before I got to Milgram, for the professoriate to get his experiment only about ninety percent as well understood as it would have immediately been by any intelligent person who used (1) any sensible organization of psychology along the lines of this talk, plus (2) a checklist procedure. This outcome displaying the dysfunctional thinking of long-dead professors deserves a better explanation. I will later deal with the subject in a very hesitant fashion.

We can be pleased that the psychology professoriate of a former era wasn't quite as dysfunctional as the angler in my next-to-last illustration of Authority-Misinfluence Tendency.

When I once fished in the Rio Colorado in Costa Rica, my guide, in a state of shock, told me a story about an angler who'd earlier come to the river without ever having fished for tarpon. A fishing guide like the one I had runs the boat and gives fishing advice, establishing himself in this context as the ultimate authority figure. In the case of this guide, his native language was Spanish, while the angler's native language was English. The angler got a big tarpon on and began submitting to many directions from this authority figure called guide: tip up, tip down, reel in, etc. Finally, when it was necessary to put more pressure on the fish by causing more bending of the angler's rod, the guide said in English: "Give him the rod, give him the rod." Well, the angler threw his expensive rod at the fish, and when last seen, it was going down the Rio Colorado toward the ocean. This example shows how powerful is the tendency to go along with an authority figure and how it can turn ones brain into mush.

My final example comes from business. A psychology Ph.D. once became a CEO of a major company and went wild, creating an expensive headquarters, with a great wine cellar, at an isolated site. At some point, his underlings remonstrated that money was running short. "Take the money out of the depreciation reserves," said the CEO. Not too easy because a depreciation reserve is a liability account.

So strong is undue respect for authority that this CEO, and many even worse examples, have actually been allowed to remain in control of important business institutions for long periods after it was clear they should be removed. The obvious implication: be careful whom you appoint to power because a dominant authority figure will often be hard to remove, aided as he will be by Authority-Misinfluence Tendency.

23. Twaddle Tendency

Man, as a social animal who has the gift of language, is born to prattle and to pour out twaddle that does much damage when serious work is being attempted. Some people produce copious amounts of twaddle and others very little.

A trouble from the honeybee version of twaddle once demonstrated in an interesting experiment. A honeybee normally goes out and finds nectar and then comes back and does a dance that communicates to the other bees where the nectar is. The other bees then go out and get it. Well some scientist – clever, like B. F. Skinner – decided to see how well a honeybee would do with a handicap. He put the nectar straight up. Way up. Well, in a natural setting, there is no nectar a long way straight up, and the poor honeybee doesn't have a genetic program that is adequate to handle what she now as to communicate. You might guess that this honeybee would come back to the hive and slink into a corner, but she doesn't. She comes into the hive and does an incoherent dance. Well, all my life I've been dealing with the human equivalent of that honeybee. And it's a very important part of wise administration to keep prattling people, pouring out twaddle, far away from the serious work.

A rightly famous Caltech engineering professor, exhibiting more insight than tact, once expressed his version of this idea as follows: "The principal job of an academic administration is to keep the people who don't matter from interfering with the work of the people that do." I include this quotation partly because I long suffered from backlash caused by my version of this professor's conversational manner. After much effort, I was able to improve only slightly, so one of my reasons for supplying the quotation is my hope that, at least in comparison, I will appear tactful.

24. Reason-Respecting Tendency

There is in man, particularly one in an advanced culture, a natural love of accurate cognition and a joy in its exercise. This accounts for the widespread popularity of crossword puzzles, other puzzles, and bridge and chess columns, as well as all games requiring mental skill.

This tendency has an obvious implication. It makes man especially prone to learn well when a would-be teacher gives correct reasons for what is taught, instead of simply laying out the desired belief *ex cathedra* with no reasons given. Few practices, therefore, are wiser than not ouly thinking through reasons before giving orders but also communicating these reasons to the recipient of the order.

No one knew this better than Carl Braun, who designed oil refineries with spectacular skill and integrity.

He had a very simple rule, one of many in his large, Teutonic company: You had to tell Who was to do What, Where, When, and Why. And if you wrote a communication leaving out your explanation of why the addressee was to do what was ordered, Braun was likely to fire you because Braun well knew that ideas got through best when reasons for the ideas were meticulously laid out.

In general, learning is most easily assimilated and used when, life long, people consistently hang their experience, actual and vicarious, on a latticework of theory answering the question: Why? Indeed, the question "Why?" is a sort of Rosetta stone opening up the major potentiality of mental life.

Unfortunately, Reason-Respecting Tendency is so strong that even a person's giving of meaningless or incorrect reasons will increase compliance with his orders and requests. This has been demonstrated in psychology experiments wherein "compliance practitioners" successfully jump to the head of the lines in front of copying machines by explaining their reason: "I have to make some copies." This sort of unfortunate byproduct of Reason-Respecting Tendency is a conditioned reflex, based on a widespread appreciation of the importance of reasons. And, naturally, the practice of laying out various claptrap reasons is much used by commercial and cult "compliance practitioners" to help them get what they don't deserve.

25. Lollapalooza Tendency – The Tendency to Get Extreme Consequences from Confluences of Psychological Tendencies Acting in Favor of a Particular Outcome

This tendency was not in any of the psychology texts I once examined, at least in any coherent fashion, yet it dominates life. It accounts for the extreme result in the Milgram experiment and the extreme success of some cults that have stumbled through practice evolution into bringing pressure from many psychological tendencies to bear at the same time on conversion targets. The targets vary in susceptibility, like the dogs Pavlov worked with in his old age, but some of the minds that are targeted simply snap into zombiedom under cult pressure. Indeed, that is one cult's name for the conversion phenomenon: snapping.

What are we to make of the extreme ignorance of the psychology textbook writers of yesteryear? How could anyone who had taken a freshman course in physics or chemistry not be driven to consider, above all, how psychological tendencies combine and with what effects? Why would anyone think his study of psychology was adequate without his having endured the complexity involved in dealing with intertwined psychological tendencies? What could be more ironic than professors using oversimplified notions while studying bad cognitive effects grounded in the mind's tendency to use oversimplified algorithms?

I will make a few tentative suggestions. Maybe many of the long-dead professors wanted to create a whole science from one narrow type of repeatable psychology experiment that was conductible in a university setting and that aimed at one psychological tendency at a time. If so, these early psychology professors made a massive error in so restricting their approach to their subject. It would be like physics ignoring astrophysics because it couldn't happen in a physics lab, plus all compound effects. What psychological tendencies could account for early psychology professors adopting an over-restricted approach to their own subject matter? One candidate would be Availability-Misweighing Tendency grounded in a preference for easy-to-control data. And then the restrictions would eventually create an extreme case of man with a hammer tendency. Another candidate might be Envy/jealousy Tendency through which early psychology professors displayed some weird form of envy of a physics that was misunderstood. And this possibility tends to demonstrate that leaving envy/jealousy out of academic psychology was never a good idea. I now quit claim of all these historical mysteries to my betters.

Well, that ends my brief description of psychological tendencies.

QUESTIONS AND ANSWERS

Now, as promised, I will ask and answer a few general questions.

Q. Isn't this list of psychological tendencies tautological to some extent compared to the system of Euclid? That is, aren't there overlaps in the tendencies? And couldn't the system be laid out just as plausibly in a somewhat different way?

The answers are yes, yes, and yes, but this matters only moderately. Further refinement of these tendencies, while desirable, has a limited practical potential because a significant amount of messiness is unfixable in a soft science like psychology.

Q. Can you supply a real world model, instead of a Milgram-type controlled psychology experiment, that uses your system to illustrate multiple psychological tendencies interacting in a plausibly diagnosable way?

The answer is yes. One of my favorite cases involves the McDonnell Douglas airliner evacuation test. Before a new airliner can be sold, the government requires that it pass an evacuation test, during which a full load of passengers must get out in some short period of time. The government directs that the test be realistic. So you can't pass by evacuating only twenty-year-old athletes. So McDonnell Douglas scheduled such a test in a darkened hangar using a lot of old people as evacuees. The passenger cabin was, say, twenty feet above the concrete floor of the hangar and was to be evacuated through moderately flimsy rubber chutes. The first test was made in the morning. There were about twenty very serious injuries, and the evacuation took so long it flunked the time test. So what did McDonnell Douglas next do? It repeated the test in the afternoon, and this time there was another failure, with about twenty more serious injuries, including one case of permanent paralysis.

What psychological tendencies contributed to this terrible result? Well, using my, tendency list as a checklist, I come up with the following explanation. Reward-Superresponse Tendency drove McDonnell Douglas to act fast. It couldn't sell its airliner until it passed the test. Also pushing the company was Doubt-Avoidance Tendency with its natural drive to arrive at a decision and run with it. Then the government's direction that the test be realistic drove Authority-Misinfluence Tendency into the mischief of causing McDonnell Douglas to overreact by using what was obviously too dangerous a test method. By now the course of action had been decided, so Inconsistency Avoidance Tendency helped preserve the near idiotic plan. When all the old people got to the dark hangar, with its high airline cabin and concrete floor, the situation must have made McDonnell Douglas employees very queasy, but they saw other employees and supervisors not objecting. Social Proof Tendency, therefore, swamped the queasiness. And this allowed continued action as planned, a continuation that was aided by more Authority Overinfluence Tendency. Then came the disaster of the morning test with its failure, plus serious injuries. McDonnell Douglas ignored the strong disconfirming evidence from the failure of the first test because confirmation bias, aided by the triggering of strong Deprival Superreaction Tendency favored maintaining the original plan. McDonnell Douglas' Deprival Superreaction Tendency was now like that which causes a gambler, bent on getting even after a huge loss, to make his final big bet. After all, McDonnell Douglas was going to lose a lot if it didn't pass its test as scheduled. More psychology-based explanation can probably be made, but the foregoing discussion is complete enough to demonstrate the utility of my system when used in a checklist mode.

Q. In the practical world, what good is the thought system laid out in this list of tendencies? Isn't practical benefit prevented because these psychological tendencies are so thoroughly programmed into the human mind by broad evolution [the combination of genetic and cultural evolution] that we can't get rid of them?

Well, the answer is that the tendencies are probably much more good than bad. Otherwise, they wouldn't be there, working pretty well for man, given his condition and his limited brain capacity. So the tendencies can't be simply washed out automatically, and shouldn't be. Nevertheless, the psychological thought system described, when properly understood and used, enables the spread of wisdom and good conduct and facilitates the avoidance of disaster. Tendency is not always destiny, and knowing the tendencies and their antidotes can often help prevent trouble that would otherwise occur.

Here is a short list of examples reminding us of the great utility of elementary psychological knowledge:

1) Carl Braun's communication practices.
2) The use of simulators in pilot training.
3) The system of Alcoholics Anonymous.
4) Clinical training methods in medical schools.
5) The rules of the U.S. Constitutional Convention: totally secret meetings, no recorded vote by name until the final vote, votes reversible at any time before the end of the convention, then just one vote on the whole Constitution. These are very clever psychology-respecting rules. If the founders had used a different procedure, many people would have been pushed by various psychological tendencies into inconsistent, hardened positions. The elite founders got our Constitution through by a whisker only because they were psychologically acute.
6) The use of Granny's incentive-driven rule to manipulate oneself toward better performance of one's duties.
7) The Harvard Business School's emphasis on decision trees. When I was young and foolish I used to laugh at the Harvard Business School. I said, "They're teaching twenty-eight year-old people that high school algebra works in real life?" But later, I wised up and realized that it was very important that they do that to counter some bad effects from psychological tendencies. Better late than never.
8) The use of autopsy equivalents at Johnson & Johnson. At most corporations, if you make an acquisition and it turns out to be a disaster, all the people, paperwork, and presentations that caused the foolish acquisition are quickly forgotten. Nobody wants to be associated with the poor outcome by mentioning it. But at Johnson & Johnson, the rules make everybody revisit old acquisitions, comparing predictions with outcomes. That is a very smart thing to do.
9) The great example of Charles Darwin as he avoided confirmation bias, which has morphed into the extreme anti-confirmation-bias method of the "double blind" studies wisely required in drug research by the FDA.
10) The Warren Buffett rule for open-outcry auctions: Don't go.

Q. What special knowledge problems lie buried in the thought system demonstrated by your list?
Well, one answer is paradox. In social psychology, the more people learn about the system the less it is true, and this is what gives the system its great value as a preventer of bad outcomes and a driver of good outcomes. This result is paradoxical, and doesn't remind one of elementary physics, but so what. One can't get all the paradox out of pure math, so why should psychology be shocked by some paradox?

There is also some paradox in cognition change that works even when the manipulated person knows he is being manipulated. This creates a sort of paradox in a paradox, but, again, so what. I once much enjoyed an occasion of this sort. I drew this beautiful woman as my dinner partner many years ago. I'd never seen her before. She was married to a prominent Los Angeles man. She sat down next to me, turned her beautiful face up, and said, "Charlie, what one word accounts for your remarkable success in life?" I knew I was being manipulated by a practiced routine, and I just loved it. I never see this woman without a little lift in my spirits. And, by the way, I told her I was rational. You'll have to judge yourself whether that's true. I may be demonstrating some psychological tendency I hadn't planned on demonstrating.

Q. Don't we need more reconciliation of psychology and economics?
My answer is yes, and I suspect that some slight progress is being made. I have heard of one such example. Colin Camerer of Caltech, who works in "experimental economics," devised an interesting experiment in which he caused high I.Q. students, playing for real money, to pay price A+B for a "security" they knew would turn into A dollars at the end of the day. This foolish action occurred because the students were allowed to trade with each other in liquid market for the security. And some students then paid price A+B because they hoped to unload on other students at a higher price before the day was over. What I will now confidently predict is that, despite Camerer's experimental outcome, most economics and corporate finance professors who still believe in the "hard-form efficient market hypothesis" will retain their original belief. If so, this will be one more indication of how irrational smart people can be when influenced by psychological tendencies.

Q. Don't moral and prudential problems come with knowledge of these psychological tendencies?
The answer is yes. For instance, psychological knowledge improves persuasive power and, like other power, it can be used for good or ill. Captain Cook once played a psychology-based trick on his seamen to cause them to eat sauerkraut and avoid scurvy. In my opinion, this action was both ethical and wise under the circumstances, despite the deliberate manipulation involved. But ordinarily, when you try to use your knowledge of psychological tendencies in the artful manipulation of someone whose trust you need, you will be making both a moral and prudential error. The moral error is obvious. The prudential error comes because many intelligent people, targeted for conscious manipulation, are likely to figure out what you are trying to do and resent your action.

Q. Aren't there factual and reasoning errors in this talk?
The answer is yes, almost surely yes. The final revision was made from memory over about fifty hours by a man eighty-one years old, who never took a course in psychology and has read none of it, except one book on developmental psychology, for nearly fifteen years. Even so. I think the totality of my talk will stand up very well, and I hope all my descendants and friends will carefully consider what I have said. I even hope that more psychology professors will join me in:

1) making heavy use of inversion;
2) driving for a complete description of the psychological system so that it works better as a checklist; and
3) especially emphasizing effects from combinations of psychological tendencies.

Well that ends my talk. If in considering what I have said you had ten percent the fun I had saying it, you were lucky recipients.

Selections from three of Charlie Munger's talks, combined into one talk never made, after revisions by Charlie in 2005 that included considerable new material. The three talks were:

(1) The Bray Lecture at the Caltech Faculty Club, February 2, 1992;

(2) Talk under the Sponsorship of the Cambridge Center for Behavioral Studies at the Harvard Faculty Club, October 6, 1994; and the extensive revision by Charlie in 2005, made from memory unassisted by any research, occurred because Charlie thought he could do better at age eighty-one than he did more than ten years earlier when he knew less and was more harried by a crowded life and was speaking from rough notes instead of revising transcripts.

(3) Talk under the Sponsorship of the Cambridge Center for Behavioral Studies at the Boston Harbor Hotel, April 24, 1995.

WESCO FINANCIAL'S CHARLIE MUNGER

"A LESSON ON ELEMENTARY, WORLDLY WISDOM AS IT RELATES TO INVESTMENT MANAGEMENT & BUSINESS."

from a lecture to the students of Professor Guilford Babcock at the University of Southern California Marshall School of Business

from Outstanding Investor Digest's May 5, 1995 Edition

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A particularly astute student of human nature - particularly insofar as it relates to business and investing - Charlie Munger's counsel is highly prized and relied upon by friend and partner Warren Buffett. His insights are equally valued and sought after by more than a few OID subscribers and contributors (and editors).

Therefore, we were very pleased to be allowed to sit in on Munger's lecture at the University of Southern California last year on "investment expertise as a subdivision of elementary, worldly wisdom" and very gratefully acknowledge his generous permission to share it with you.

As always, we highly recommend a very careful reading (and re-reading) of his comments and insights and hope that you find them as valuable as we do:

ALL TOO LITTLE WORLDLY WISDOM
IS DELIVERED BY MODERN EDUCATION.

To be a great stock picker, you need some general education.

Charlie Munger: I'm going to play a minor trick on you today - because the subject of my talk is the art of stock picking as a subdivision of the art of worldly wisdom. That enables me to start talking about worldly wisdom - a much broader topic that interests me because I think all too little of it is delivered by modern educational systems, at least in an effective way.

And therefore, the talk is sort of along the lines that some behaviorist psychologists call Grandma's rule - after the wisdom of Grandma when she said that you have to eat the carrots before you get the dessert.

The carrot part of this talk is about the general subject of worldly wisdom which is a pretty good way to start. After all, the theory of modern education is that you need a general education before you specialize. And I think to some extent, before you're going to be a great stock picker, you need some general education.

So, emphasizing what I sometimes waggishly call remedial worldly wisdom, I'm going to start by waltzing you through a few basic notions.

WITHOUT MODELS FROM MULTIPLE DISCIPLINES,

YOU'LL FAIL IN BUSINESS AND IN LIFE.

Without a latticework of models, you'll fail in school and life.

Munger: What is elementary, worldly wisdom? Well, the first rule is that you can't really know anything if you just remember isolated facts and try and bang 'em back. If the facts don't hang together on a latticework of theory, you don't have them in a usable form.

You've got to have models in your head. And you've got to array your experience - both vicarious and direct - on this latticework of models. You may have noticed students who just try to remember and pound back what is remembered. Well, they fail in school and fail in life. You've got to hang experience on a latticework of models in your head.

Absent enough models, your brain will torture reality.

Munger: What are the models? Well, the first rule is that you've got to have multiple models - because if you just have one or two that you're using, the nature of human psychology is such that you'll torture reality so that it fits your models, or at least you'll think it does. You become the equivalent of a chiropractor who, of course, is the great boob in medicine.

It's like the old saying, "To the man with only a hammer, every problem looks like a nail." And of course, that's the way the chiropractor goes about practicing medicine. But that's a perfectly disastrous way to think and a perfectly disastrous way to operate in the world. So you've got to have multiple models.

And the models have to come from multiple disciplines - because all the wisdom of the world is not to be found in one little academic department. That's why poetry professors, by and large. are so unwise in a worldly sense. They don't have enough models in their heads. So you've got to have models across a fair array of disciplines.

Fortunately, it isn't all that tough....

Munger: You may say, "My God, this is already getting way too tough." But, fortunately, it isn't that tough - because 80 or 90 important models will carry about 90% of the freight in making you a worldly-wise person. And, of those, only a mere handful really carry very heavy freight.

So let's briefly review what kind of models and techniques constitute this basic knowledge that everybody has to have before they proceed to being really good at a narrow art like stock picking.

YOU'RE GIVING A HUGE ADVANTAGE TO OTHERS
IF YOU DON'T LEARN THIS SIMPLE TECHNIQUE.

The great useful model is permutations & combinations.

Munger: First there's mathematics. Obviously, you've got to he able to handle numbers and quantities - basic arithmetic.

And the great useful model, after compound interest, is the elementary math of permutations and combinations. And that was taught in my day in the sophomore year in high school. I suppose by now in great private schools, it's probably down to the eighth grade or so.

It's very simple algebra. And it was all worked out in the course of about one year in correspondence between Pascal and Fermat. They worked it out casually in a series of letters.

Your brain isn't designed to figure it out spontaneously.

Munger: It's not that hard to learn. What is hard is to get so you use it routinely almost everyday of your life. The Fermat/Pascal system is dramatically consonant with the way that the world works. And it's fundamental truth. So you simply have to have the technique.

Many educational institutions - although not nearly enough - have realized this. At Harvard Business School, the great quantitative thing that bonds the first-year class together is what they call decision tree theory. All they do is take high school algebra and apply it to real life problems. And the students love it. They're amazed to find that high school algebra works in life....

By and large. as it works out, people can't naturally and automatically do this. If you understand elementary psychology, the reason they can't is really quite simple: The basic neural network of the brain is there through broad genetic and cultural evolution. And it's not Fermat/Pascal. It uses a very crude, shortcut-type of approximation. It's got elements of Fermat/Pascal in it. However, it's not good.

Without it, you're giving a huge advantage to others....

Munger: So you have to learn in a very usable way this very elementary math and use it routinely in life - just the way if you want to become a golfer, you can't use the natural swing that broad evolution gave you. You have to learn to have a certain grip and swing in a different way to realize your full potential as a golfer.

If you don't get this elementary, but mildly unnatural, mathematics of elementary probability into your repertoire, then you go through a long life like a one-legged man in an ass-kicking contest. You're giving a huge advantage to everybody else.

One of the advantages of a fellow like Buffett, whom I've worked with all these years, is that he automatically thinks in terms of decision trees and the elementary math of permutations and combinations....

NEXT, YOU HAVE TO KNOW ACCOUNTING
- ALONG WITH ITS LIMITATIONS.

Double-entry bookkeeping was a hell of an invention.

Munger: Obviously, you have to know accounting. It's the language of practical business life. It was a very useful thing to deliver to civilization. I've heard it came to civilization through Venice which of course was once the great commercial power in the Mediterranean. However, double-entry bookkeeping was a hell of an invention.

And it's not that hard to understand.

But you have to know accounting's limitations....

Munger: But you have to know enough about it to understand its limitations - because although accounting is the starting place, it's only a crude approximation. And it's not very hard to understand its limitations. For example, everyone can see that you have to more or less just guess at the useful life of a jet airplane or anything like that. Just because you express the depreciation rate in neat numbers doesn't make it anything you really know.

In terms of the limitations of accounting, one of my favorite stories involves a very great businessman named Carl Braun who created the CF Braun Engineering Company. It designed and built oil refineries - which is very hard to do. And Braun would get them to come in on time and not blow up and have efficiencies and so forth. This is a major art.

And Braun, being the thorough Teutonic type that he was, had a number of quirks. And one of them was that he took a look at standard accounting and the way it was applied to building oil refineries and he said, "This is asinine."

So he threw all of his accountants out and he took his engineers and said "Now, we'll devise our own system of accounting to handle this process." And in due time, accounting adopted a lot of Carl Braun's notions. So he was a formidably willful and talented man who demonstrated both the importance of accounting and the importance of knowing its limitations.

AN IRON RULE OF WORLDLY WISDOM:
ALWAYS, ALWAYS, ALWAYS TELL PEOPLE WHY.

Braun's Five W's: Who, what, where, when and why.

Munger: He had another rule, from psychology, which, if you're interested in wisdom, ought to be part of your repertoire - like the elementary mathematics of permutations and combinations.

His rule for all the Braun Company's communications was called the five W's - you had to tell who was going to do what, where, when and why. And if you wrote a letter or directive in the Braun Company telling somebody to do something, and you didn't tell him why, you could get fired. In fact, you would get fired if you did it twice.

If you tell people why, they'll be much more likely to comply.

Munger: You might ask why that is so important? Well, again that's a rule of psychology. Just as you think better if you array knowledge on a bunch of models that are basically answers to the question, why, why, why, if you always tell people why, they'll understand it better, they'll consider it more important, and they'll be more likely to comply. Even if they don't understand your reason, they'll be more likely to comply.

So there's an iron rule that just as you want to start getting worldly wisdom by asking why, why, why in communicating with other people about everything, you want to include why, why, why. Even if it's obvious, it's wise to stick in the why.

ENGINEERING HAS MORE THAN ITS SHARE OF MODELS.
AND THEY'RE THE MOST RELIABLE ONES, AS WELL.

The most reliable models? Engineering models, of course.

Munger: Which models are the most reliable? Well, obviously, the models that come from hard science and engineering are the most reliable models on this Earth. And engineering quality control - at least the guts of it that matters to you and me and people who are not professional engineers - is very much based on the elementary mathematics of Fermat and Pascal:

It costs so much and you get so much less likelihood of it breaking if you spend this much. It's all elementary high school mathematics. And an elaboration of that is what Deming brought to Japan for all of that quality control stuff.

You have to understand normal occurrence distributions.

Munger: I don't think it's necessary for most people to be terribly facile in statistics. For example, I'm not sure that I can even pronounce the Poisson distribution, although I know what it looks like and I know that events and huge aspects of reality end up distributed that way. So I can do a rough calculation.

But if you ask me to work out something involving a Poisson distribution to ten decimal points, I can't sit down and do the math. I'm like a poker player who's learned to play pretty well without mastering Pascal.

And by the way, that works well enough. But you have to understand that bell-shaped curve at least roughly as well as I do.

Engineering has more than its share of powerful models....

Munger: And, of course, the engineering idea of a backup system is a very powerful idea. The engineering idea of breakpoints - that's a very powerful model, too. The notion of a critical mass - that comes out of physics - is a very powerful model.

All of these things have great utility in looking at ordinary reality. And all of this cost-benefit analysis - hell, that's all elementary high school algebra. too. It's just been dolled up a little bit with fancy lingo.

THE HUMAN MIND HAS ENORMOUS POWER,
BUT IT ALSO HAS STANDARD MISFUNCTIONS.

Our brains take shortcuts. So we're subject to manipulation.

Munger: I suppose the next most reliable models are from biology/physiology because, after all, all of us are programmed by our genetic makeup to be much the same.

And then when you get into psychology, of course, it gets very much more complicated. But it's an ungodly important subject if you're going to have any worldly wisdom.

And you can demonstrate that point quite simply: There's not a person in this room viewing the work of a very ordinary professional magician who doesn't see a lot of things happening that aren't happening and not see a lot of things happening that are happening.

And the reason why is that the perceptual apparatus of man has shortcuts in it. The brain cannot have unlimited circuitry. So someone who knows how to take advantage of those shortcuts and cause the brain to miscalculate in certain ways can cause you to see things that aren't there.

Therefore, you must know your brain's limitations.

Munger: Now you get into the cognitive function as distinguished from the perceptual function. And there, you are equally - more than equally in fact - likely to be misled. Again, your brain has a shortage of circuitry and so forth - and it's taking all kinds of little automatic shortcuts.

So when circumstances combine in certain ways - or more commonly, your fellow man starts acting like the magician and manipulates you on purpose by causing your cognitive dysfunction - you're a patsy.

And so just as a man working with a tool has to know its limitations, a man working with his cognitive apparatus has to know its limitations. And this knowledge, by the way, can be used to control and motivate other people....

Very eminent places miseducate people like you and me.

Munger: So the most useful and practical part of psychology - which I personally think can be taught to any intelligent person in a week - is ungodly important. And nobody taught it to me by the way. I had to learn it later in life, one piece at a time. And it was fairly laborious. It's so elementary though that, when it was all over, I just felt like a total horse's ass.

And yeah, I'd been educated at Cal Tech and the Harvard Law School and so forth. So very eminent places miseducated people like you and me.

Psychology of misjudgment is terribly important to learn.

Munger: The elementary part of psychology - the psychology of misjudgment, as I call it - is a terribly important thing to learn. There are about 20 little principles. And they interact, so it gets slightly complicated. But the guts of it is unbelievably important.

Terribly smart people make totally bonkers mistakes by failing to pay heed to it. In fact, I've done it several times during the last two or three years in a very important way. You never get totally over making silly mistakes.

Man's mind can be manipulated in amazing ways.

Munger: There's another saying that comes from Pascal which I've always considered one of the really accurate observations in the history of thought. Pascal said, "The mind of man at one and the same time is both the glory and the shame of the universe."

And that's exactly right. It has this enormous power. However, it also has these standard misfunctions that often cause it to reach wrong conclusions. It also makes man extraordinarily subject to manipulation by others. For example, roughly half of the army of Adolf Hitler was composed of believing Catholics. Given enough clever psychological manipulation, what human beings will do is quite interesting.

Consider the real interests and the psychological factors....

Munger: Personally, I've gotten so that I now use a kind of two-track analysis. First, what are the factors that really govern the interests involved, rationally considered? And second, what are the subconscious influences where the brain at a subconscious level is automatically doing these things - which by and large are useful, but which often misfunction.

One approach is rationality - the way you'd work out a bridge problem: by evaluating the real interests, the real probabilities and so forth. And the other is to evaluate the psychological factors that cause subconscious conclusions - many of which are wrong.

ORGANISMS, PEOPLE & COMPANIES WHO SPECIALIZE
CAN GET TERRIBLY GOOD IN THEIR LITTLE NICHE.

Like it or not, the economy is a lot like an ecosystem.

Munger: Now we come to another somewhat less reliable form of human wisdom - microeconomics. And here, I find it quite useful to think of a free market economy - or partly free market economy - as sort of the equivalent of an ecosystem....

This is a very unfashionable way of thinking because early in the days after Darwin came along, people like the robber barons assumed that the doctrine of the survival of the fittest authenticated them as deserving power - you know, "I'm the richest. Therefore, I'm the best. God's in his heaven, etc."

And that reaction of the robber barons was so irritating to people that it made it unfashionable to think of an economy as an ecosystem. But the truth is that it is a lot like an ecosystem. And you get many of the same results.

In nature and in business, specialization is key.

Munger: Just as in an ecosystem, people who narrowly specialize can get terribly good at occupying some little niche. Just as animals flourish in niches, similarly, people who specialize in the business world - and get very good because they specialize - frequently find good economics that they wouldn't get any other way.

Advantages of scale are ungodly important.

Munger: And once we get into microeconomics, we get into the concept of advantages of scale. Now we're getting closer to investment analysis - because in terms of which businesses succeed and which businesses fail, advantages of scale are ungodly important.

For example, one great advantage of scale taught in all of the business schools of the world is cost reductions along the so-called experience curve. Just doing something complicated in more and more volume enables human beings, who are trying to improve and are motivated by the incentives of capitalism, to do it more and more efficiently.

The very nature of things is that if you get a whole lot of volume through your joint, you get better at processing that volume. That's an enormous advantage. And it has a lot to do with which businesses succeed and fail....

AND THERE ARE OTHER ECONOMIES: GEOMETRIC, ADVERTISING, INFORMATION, EVEN PSYCHOLOGICAL.

There are even geometric economies of scale.

Munger: Let's go through a list - albeit an incomplete one of possible advantages of scale. Some come from simple geometry. If you're building a great circular tank, obviously as you build it bigger, the amount of steel you use in the surface goes up with the square and the cubic volume goes up with the cube. So as you increase the dimensions, you can hold a lot more volume per unit area of steel.

And there are all kinds of things like that where the simple geometry - the simple reality - gives you an advantage of scale.

For example, network TV advertising made the rich richer.

Munger: For example, you can get advantages of scale from TV advertising. When TV advertising first arrived - when talking color pictures first came into our living rooms - it was an unbelievably powerful thing. And in the early days, we had three networks that had whatever it was - say 90% of the audience.

Well, if you were Proctor & Gamble, you could afford to use this new method of advertising. You could afford the very expensive cost of network television because you were selling so damn many cans and bottles. Some little guy couldn't. And there was no way of buying it in part. Therefore, he couldn't use it. In effect, if you didn't have a big volume, you couldn't use network TV advertising - which was the most effective technique.

So when TV came in, the branded companies that were already big got a huge tail wind. Indeed, they prospered and prospered and prospered until some of them got fat and foolish. which happens with prosperity - at least to some people....

The informational advantage of brands is hard to beat.

Munger: And your advantage of scale can be an informational advantage. If I go to some remote place, I may see Wrigley chewing gum alongside Glotz's chewing gum. Well, I know that Wrigley is a satisfactory product, whereas I don't know anything about Glotz's. So if one is $.40 and the other is $.30, am I going to take something I don't know and put it in my mouth - which is a pretty personal place, after all - for a lousy dime?

So, in effect, Wrigley, simply by being so well known, has advantages of scale - what you might call an informational advantage.

Everyone is influenced by what others do and approve.

Munger: Another advantage of scale comes from psychology. The psychologists use the term "social proof". We are all influenced - subconsciously and to some extent consciously - by what we see others do and approve. Therefore, if everybody's buying something, we think it's better. We don't like to be the one guy who's out of step.

Again, some of this is at a subconscious level and some of it isn't. Sometimes, we consciously and rationally think, "Gee, I don't know much about this. They know more than I do. Therefore, why shouldn't I follow them?"

All told, your advantages can add up to one tough moat.

Munger: The social proof phenomenon which comes right out of psychology gives huge advantages to scale - for example, with very wide distribution, which of course is hard to get. One advantage of Coca-Cola is that it's available almost everywhere in the world.

Well, suppose you have a little soft drink. Exactly how do you make it available all over the Earth? The worldwide distribution setup - which is slowly won by a big enterprise - gets to be a huge advantage.... And if you think about it, once you get enough advantages of that type, it can become very hard for anybody to dislodge you.

THINGS TEND TOWARD WINNER TAKE ALL.
THEREFORE, IT PAYS TO BE #1, #2 OR OUT.

Things tend to cascade toward winner-take-all.

Munger: There's another kind of advantage to scale. In some businesses, the very nature of things is to sort of cascade toward the overwhelming dominance of one firm. The most obvious one is daily newspapers. There's practically no city left in the U.S., aside from a few very big ones, where there's more than one daily newspaper.

And again, that's a scale thing. Once I get most of the circulation, I get most of the advertising. And once I get most of the advertising and circulation, why would anyone want the thinner paper with less information in it? So it tends to cascade to a winner-take-all situation. And that's a separate form of the advantages of scale phenomenon.

Similarly, all these huge advantages of scale allow greater specialization within the firm. Therefore, each person can be better at what he does.

It's not irrational to insist on being #1 or #2 or out.

Munger: And these advantages of scale are so great, for example, that when Jack Welch came into General Electric, he just said, "To hell with it. We're either going to be #1 or #2 in every field we're in or we're going to be out. I don't care how many people I have to fire and what I have to sell. We're going to be #1 or #2 or out."

That was a very tough-minded thing to do, but I think it was a very correct decision if you're thinking about maximizing shareholder wealth. And I don't think it's a bad thing to do for a civilization either, because I think that General Electric is stronger for having Jack Welch there.

HOWEVER, BIGGER ISN'T ALWAYS BETTER -
THERE ARE ALSO DISADVANTAGES OF SCALE.

Bigger isn't always better. Sometimes, it's just the reverse....

Munger: And there are also disadvantages of scale. For example, we - by which I mean Berkshire Hathaway - are the largest shareholder in Capital Cities/ABC. And we had trade publications there that got murdered - where our competitors beat us. And the way they beat us was by going to a narrower specialization.

We'd have a travel magazine for business travel. So somebody would create one which was addressed solely at corporate travel departments. Like an ecosystem, you're getting a narrower and narrower specialization.

Well, they got much more efficient. They could tell more to the guys who ran corporate travel departments. Plus, they didn't have to waste the ink and paper mailing out stuff that corporate travel departments weren't interested in reading. It was a more efficient system. And they beat our brains out as we relied on our broader magazine.

That's what happened to The Saturday Evening Post and all those things. They're gone. What we have now is Motorcross - which is read by a bunch of nuts who like to participate in tournaments where they turn somersaults on their motorcycles. But they care about it. For them, it's the principal purpose of life. A magazine called Motorcross is a total necessity to those people. And its profit margins would make you salivate.

Just think of how narrowcast that kind of publishing is. So occasionally, scaling down and intensifying gives you the big advantage. Bigger is not always better.

Another defect of scale - flush, fat, stupid bureaucracy.

Munger: The great defect of scale, of course, which makes the game interesting - so that the big people don't always win - is that as you get big, you get the bureaucracy. And with the bureaucracy comes the territoriality - which is again grounded in human nature.

And the incentives are perverse. For example, if you worked for AT&T in my day, it was a great bureaucracy. Who in the hell was really thinking about the shareholder or anything else? And in a bureaucracy, you think the work is done when it goes out of your in-basket into somebody's else's in-basket. But, of course, it isn't. It's not done until AT&T delivers what it's supposed to deliver. So you get big, fat, dumb, unmotivated bureaucracies.

Bureaucracy's a terrible problem - especially in government.

Munger: They also tend to become somewhat corrupt. In other words, if I've got a department and you've got a department and we kind of share power running this thing, there's sort of an unwritten rule: "If you won't bother me, I won't bother you and we're both happy." So you get layers of management and associated costs that nobody needs. Then, while people are justifying all these layers. it takes forever to get anything done. They're too slow to make decisions and nimbler people run circles around them.

The constant curse of scale is that it leads to big, dumb bureaucracy - which, of course, reaches its highest and worst form in government where the incentives are really awful. That doesn't mean we don't need governments - because we do. But it's a terrible problem to get big bureaucracies to behave.

Some companies deal with bureaucracies well: e.g., GE.

Munger: So people go to stratagems. They create little decentralized units and fancy motivation and training programs. For example, for a big company, General Electric has fought bureaucracy with amazing skill. But that's because they have a combination of a genius and a fanatic running it. And they put him in young enough so he gets a long run. Of course, that's Jack Welch.

Others don't deal with it very well at all....

Munger: But bureaucracy is terrible.... And as things get very powerful and very big, you can get some really dysfunctional behavior. Look at Westinghouse. They blew billions of dollars on a bunch of dumb loans to real estate developers. They put some guy who'd come up by some career path - I don't know exactly what it was, but it could have been refrigerators or something - and all of a sudden, he's loaning money to real estate developers building hotels. It's a very unequal contest. And in due time, they lost all those billions of dollars.

You get a lot of dysfunction in a big, fat, happy place.

Munger: CBS provides an interesting example of another rule of psychology - namely, Pavlovian association. If people tell you what you really don't want to hear - what's unpleasant - there's an almost automatic reaction of antipathy. You have to train yourself out of it. It isn't foredestined that you have to be this way. But you will tend to be this way if you don't think about it.

Television was dominated by one network - CBS - in its early days. And Paley was a god. But he didn't like to hear what be didn't like to hear, And people soon learned that. So they told Paley only what he liked to hear, Therefore, he was soon living in a little cocoon of unreality and everything else was corrupt - although it was a great business,

So the idiocy that crept into the system was carried along by this huge tide. It was a Mad Hatter's tea party the last ten years under Bill Paley.

And that is not the only example by any means. You can get severe misfunction in the high ranks of business, And of course, if you're investing, it can make a hell of a lot of difference. If you take all the acquisitions that CBS made under Paley, after the acquisition of the network itself, with all his dumb advisors - his investment bankers, management consultants and so forth who were getting paid very handsomely - it was absolutely terrible.

For example, he gave something like 20% of CBS to the Dumont Company for a television set manufacturer which was destined to go broke. I think it lasted all of two or three years or something like that. So very soon after he'd issued all of that stock, Dumont was history. You get a lot of dysfunction in a big fat, powerful place where no one will bring unwelcome reality to the boss.

An everlasting battle between the pros and cons of size.

Munger: So life is an everlasting battle between those two forces - to get these advantages of scale on one side and a tendency to get a lot like the U.S. Agriculture Department on the other side - where they just sit around and so forth. I don't know exactly what they do. However, I do know that they do very little useful work,

A CASE STUDY IN ECONOMIES VS. DISECONOMICS
- WAL-MART VERSUS SEARS, ROEBUCK.

A chain store can be a fantastic enterprise.

Munger: On the subject of advantages of economies of scale, I find chain stores quite interesting. Just think about it. The concept of a chain store was a fascinating invention. You get this huge purchasing power - which means that you have lower merchandise costs. You get a whole bunch of little laboratories out there in which you can conduct experiments. And you get specialization.

If one little guy is trying to buy across 27 different merchandise categories influenced by traveling salesmen, he's going to make a lot of dumb decisions. But if your buying is done in headquarters for a huge bunch of stores, you can get very bright people that know a lot about refrigerators and so forth to do the buying.

The reverse is demonstrated by the little store where one guy is doing all the buying. It's like the old story about the little store with salt all over its walls. And a stranger comes in and says to the store owner, "You must sell a lot of salt." And he replies, "No, I don't. But you should see the guy who sells me salt."

So there are huge purchasing advantages. And then there are the slick systems of forcing everyone to do what works. So a chain store can be a fantastic enterprise.

Sam Walton played the game harder and better than anyone.

Munger: It's quite interesting to think about Wal-Mart starting from a single store in Bentonville, Arkansas - against Sears Roebuck with its name, reputation and all of its billions. How does a guy in Bentonville, Arkansas with no money blow right by Sears, Roebuck? And he does it in his own lifetime - in fact, during his own late lifetime because he was already pretty old by the time he started out with one little store....

He played the chain store game harder and better than anyone else. Walton invented practically nothing. But he copied everything anybody else ever did that was smart - and he did it with more fanaticism and better employee manipulation. So he just blew right by them all.

And he had a very shrewd strategy....

Munger: He also had a very interesting competitive strategy in the early days. He was like a prize fighter who wanted a great record so he could be in the finals and make a big TV hit. So what did he do? He went out and fought 42 palookas. Right? And the result was knockout, knockout, knockout - 42 times.

Walton, being as shrewd as he was, basically broke other small town merchants in the early days. With his more efficient system, he might not have been able to tackle some titan head-on at the time. But with his better system, he could sure as hell destroy those small town merchants. And he went around doing it time after time after time. Then, as he got bigger, he started destroying the big boys.

Well, that was a very, very shrewd strategy.

I believe that the world is better for having Wal-Mart.

Munger: You can say, "Is this a nice way to behave?" Well, capitalism is a pretty brutal place. But I personally think that the world is better for having Wal-Mart. I mean you can idealize small town life. But I've spent a fair amount of time in small towns. And let me tell you - you shouldn't get too idealistic about all those businesses he destroyed.

Plus, a lot of people who work at Wal-Mart are very high grade, bouncy people who are raising nice children. I have no feeling that an inferior culture destroyed a superior culture. I think that is nothing more than nostalgia and delusion. But, at any rate. it's an interesting model of how the scale of things and fanaticism combine to be very powerful.

Sears was a classic case study in diseconomics.

Munger: And it's also an interesting model on the other side - how with all its great advantages, the disadvantages of bureaucracy did such terrible damage to Sears, Roebuck. Sears had layers and layers of people it didn't need. It was very bureaucratic. It was slow to think. And there was an established way of thinking. If you poked your head up with a new thought, the system kind of turned against you. It was everything in the way of a dysfunctional big bureaucracy that you would expect.

In all fairness, there was also much that was good about it. But it just wasn't as lean and mean and shrewd and effective as Sam Walton. And, in due time, all their advantages of scale were not enough to prevent Sears from losing heavily to Wal-Mart and other similar retailers.

A MODEL WE'VE HAD TROUBLE WITH -
ANTICIPATING COMPETITION AND ITS EFFECTS.

In some markets, no one makes out. In others, everyone does.

Munger: Here's a model that we've had trouble with. Maybe you'll be able to figure it out better. Many markets get down to two or three big competitors - or five or six. And in some of those markets, nobody makes any money to speak of. But in others, everybody does very well.

Over the years, we've tried to figure out why the competition in some markets gets sort of rational from the investor's point of view so that the shareholders do well, and in other markets, there's destructive competition that destroys shareholder wealth.

It's easy to understand why air travel is so unprofitable....

Munger: If it's a pure commodity like airline seats, you can understand why no one makes any money. As we sit here, just think of what airlines have given to the world - safe travel. greater experience, time with your loved ones, you name it. Yet, the net amount of money that's been made by the shareholders of airlines since Kitty Hawk, is now a negative figure - a substantial negative figure. Competition was so intense that, once it was unleashed by deregulation, it ravaged shareholder wealth in the airline business.

But why is the cereal business so profitable?

Munger: Yet, in other fields - like cereals, for example - almost all the big boys make out. If you're some kind of a medium grade cereal maker, you might make 15% on your capital. And if you're really good. you might make 40%. But why are cereals so profitable - despite the fact that it looks to me like they're competing like crazy with promotions, coupons and everything else? I don't fully understand it.

Obviously, there's a brand identity factor in cereals that doesn't exist in airlines. That must be the main factor that accounts for it.

Maybe it boils down to individual psychology....

Munger: And maybe the cereal makers by and large have learned to be less crazy about fighting for market share - because if you get even one person who's hell-bent on gaining market share.... For example, if I were Kellogg and I decided that I had to have 60% of the market, I think I could take most of the profit out of cereals. I'd ruin Kellogg in the process. But I think I could do it.

In some businesses, the participants behave like a demented Kellogg. In other businesses, they don't. Unfortunately, I do not have a perfect model for predicting how that's going to happen.

For example, if you look around at bottler markets, you'll find many markets where bottlers of Pepsi and Coke both make a lot of money and many others where they destroy most of the profitability of the two franchises. That must get down to the peculiarities of individual adjustment to market capitalism. I think you'd have to know the people involved to fully understand what was happening.

A FEW WORDS ON PATENTS,

TRADEMARKS AND FRANCHISES.

Patents haven't made people much money - until recently.

Munger: In microeconomics, of course, you've got the concept of patents. trademarks, exclusive franchises and so forth. Patents are quite interesting. When I was young, I think more money went into patents than came out. Judges tended to throw them out - based on arguments about what was really invented and what relied on prior art. That isn't altogether clear.

But they changed that. They didn't change the laws. They just changed the administration - so that it all goes to one patent court. And that court is now very much more pro-patent. So I think people are now starting to make a lot of money out of owning patents.

But trademarks and franchises have always been great.

Munger: Trademarks, of course, have always made people a lot of money. A trademark system is a wonderful thing for a big operation if it's well known.

The exclusive franchise can also be wonderful. If there were only three television channels awarded in a big city and you owned one of them, there were only so many hours a day that you could be on. So you had a natural position in an oligopoly in the pre-cable days.

And if you get the franchise for the only food stand in an airport, you have a captive clientele and you have a small monopoly of a sort.

A BASIC LESSON OFTEN FORGOTTEN:
NEW TECHNOLOGY CAN KILL YOU.

You have to discern when technology will help and hurt.

Munger: The great lesson in microeconomics is to discriminate between when technology is going to help you and when it's going to kill you. And most people do not get this straight in their heads. But a fellow like Buffett does.

For example, when we were in the textile business, which is a terrible commodity business, we were making low-end textiles - which are a real commodity product. And one day, the people came to Warren and said, "They've invented a new loom that we think will do twice as much work as our old ones."

And Warren said, "Gee, I hope this doesn't work - because if it does, I'm going to close the mill." And he meant it.

Advances in commodity businesses go to buyers alone.

Munger: What was he thinking? He was thinking, "It's a lousy business. We're earning substandard returns and keeping it open just to be nice to the elderly workers. But we're not going to put huge amounts of new capital into a lousy business."

And he knew that the huge productivity increases that would come from a better machine introduced into the production of a commodity product would all go to the benefit of the buyers of the textiles. Nothing was going to stick to our ribs as owners.

That's such an obvious concept - that there are all kinds of wonderful new inventions that give you nothing as owners except the opportunity to spend a lot more money in a business that's still going to be lousy. The money still won't come to you. All of the advantages from great improvements are going to flow through to the customers.

The newspaper business is another matter altogether....

Munger: Conversely, if you own the only newspaper in Oshkosh and they were to invent more efficient ways of composing the whole newspaper, then when you got rid of the old technology and got new fancy computers and so forth, all of the savings would come right through to the bottom line.

A three-year payback often means a 4% per year return.

Munger: In all cases, the people who sell the machinery - and, by and large, even the internal bureaucrats urging you to buy the equipment - show you projections with the amount you'll save at current prices with the new technology. However, they don't do the second step of the analysis - which is to determine how much is going to stay home and how much is just going to flow through to the customer. I've never seen a single projection incorporating that second step in my life. And I see them all the time. Rather, they always read: "This capital outlay will save you so much money that it will pay for itself in three years."

So you keep buying things that will pay for themselves in three years. And after 20 years of doing it, somehow you've earned a return of only about 4% per annum. That's the textile business.

And it isn't that the machines weren't better. It's just that the savings didn't go to you. The cost reductions came through all right. But the benefit of the cost reductions didn't go to the guy who bought the equipment. It's such a simple idea. It's so basic. And yet it's so often forgotten.

THE NATIONAL CASH REGISTER MODEL
IS EXACTLY WHAT YOU'RE LOOKING FOR.

Early birds have huge advantages....

Munger: Then there's another model from microeconomics which I find very interesting. When technology moves as fast as it does in a civilization like ours, you get a phenomenon which I call competitive destruction. You know, you have the finest buggy whip factory and all of a sudden in comes this little horseless carriage. And before too many years go by, your buggy whip business is dead. You either get into a different business or you're dead - you're destroyed. It happens again and again and again.

And when these new businesses come in, there are huge advantages for the early birds. And when you're an early bird, there's a model that I call "surfing" - when a surfer gets up and catches the wave and just stays there, he can go a long, long time. But if he gets off the wave, he becomes mired in shallows....

But people get long runs when they're right on the edge of the wave whether it's Microsoft or Intel or all kinds of people, including National Cash Register in the early days.

National Cash Register was a lead pipe cinch....

Munger: The cash register was one of the great contributions to civilization. It's a wonderful story. Patterson was a small retail merchant who didn't make any money. One day, somebody sold him a crude cash register which he put into his retail operation. And it instantly changed from losing money to earning a profit because it made it so much harder for the employees to steal....

But Patterson, having the kind of mind that he did, didn't think, "Oh, good for my retail business." He thought, "I'm going into the cash register business." And, of course, he created National Cash Register.

And he "surfed". He got the best distribution system, the biggest collection of patents and the best of everything. He was a fanatic about everything important as the technology developed. I have in my files an early National Cash Register Company report in which Patterson described his methods and objectives. And a well-educated orangutan could see that buying into partnership with Patterson in those early days, given his notions about the cash register business, was a total 100% cinch.

And, of course, that's exactly what an investor should be looking for. In a long life, you can expect to profit heavily from at least a few of those opportunities if you develop the wisdom and will to seize them. At any rate, "surfing" is a very powerful model.

FIGURE OUT WHERE YOU HAVE AN EDGE
THEN, PLAY THERE AND ONLY THERE.

If we don't believe we have an advantage, we don't play.

Munger: However, Berkshire Hathaway, by and large, does not invest in these people that are "surfing" on complicated technology. After all, we're cranky and idiosyncratic - as you may have noticed.

And Warren and I don't feel like we have any great advantage in the high-tech sector. In fact, we feel like we're at a big disadvantage in trying to understand the nature of technical developments in software, computer chips or what have you. So we tend to avoid that stuff, based on our personal inadequacies.

Figure out where you have an edge - and stay there.

Munger: Again, that is a very, very powerful idea. Every person is going to have a circle of competence. And it's going to be very hard to advance that circle. If I had to make my living as a musician.... I can't even think of a level low enough to describe where I would be sorted out to if music were the measuring standard of the civilization.

So you have to figure out what your own aptitudes are. If you play games where other people have the aptitudes and you don't, you're going to lose. And that's as close to certain as any prediction that you can make. You have to figure out where you've got an edge. And you've got to play within your own circle of competence.

Life is much like trying to be a good plumbing contractor.

Munger: If you want to be the best tennis player in the world, you may start out trying and soon find out that it's hopeless - that other people blow right by you. However, if you want to become the best plumbing contractor in Bemidji, that is probably doable by two-thirds of you. It takes a will. It takes the intelligence. But after a while, you'd gradually know all about the plumbing business in Bemidji and master the art. That is an attainable objective, given enough discipline. And people who could never win a chess tournament or stand in center court in a respectable tennis tournament can rise quite high in life by slowly developing a circle of competence - which results partly from what they were born with and partly from what they slowly develop through work.

So some edges can be acquired. And the game of life to some extent for most of us is trying to be something like a good plumbing contractor in Bemidji. Very few of us are chosen to win the world's chess tournaments.

[Editor's note: Munger's comments remind your editor of Buffett's comments in John Train's The Money Masters. Buffett asks Train, "How do you beat Bobby Fisher?" Answer: "Play him in anything but chess."]

One person's garbage is another's treasure.

Munger: Some of you may find opportunities "surfing" along in the new high-tech fields - the Intels, the Microsofts and so on. The fact that we don't think we're very good at it and have pretty well stayed out of it doesn't mean that it's irrational for you to do it.

TO A MAN WITH PROFICIENCY IN MATH,
EFFICIENT MARKET THEORY LOOKS LIKE A NAIL.

On to dessert - the selection of common stocks....

Munger: Well, so much for the basic microeconomic models, a little bit of psychology, a little bit of mathematics, helping create what I call the general substructure of worldly wisdom. Now, if you want to go on from carrots to dessert, I'll turn to stock picking - trying to draw on this general worldly wisdom as we go.

I don't want to get into emerging markets, bond arbitrage and so forth. I'm talking about nothing but plain vanilla stock picking. That, believe me, is complicated enough. And I'm talking about common stock picking.

Do as I do, not as I say....

Munger: The first question is, "What is the nature of the stock market?" And that gets you directly to this efficient market theory that got to be the rage - a total rage - long after I graduated from law school.

And it's rather interesting because one of the greatest economists of the world is a substantial shareholder in Berkshire Hathaway and has been from the very early days after Buffett was in control. His textbook always taught that the stock market was perfectly efficient and that nobody could beat it. But his own money went into Berkshire and made him wealthy. So. like Pascal in his famous wager, he hedged his bet.

The iron rule of life: Only 20% of us can be in the top 5th.

Munger: Is the stock market so efficient that people can't beat it? Well, the efficient market theory is obviously roughly right - meaning that markets are quite efficient and it's quite hard for anybody to beat the market by significant margins as a stock picker by just being intelligent and working in a disciplined way.

Indeed, the average result has to be the average result. By definition, everybody can't beat the market. As I always say, the iron rule of life is that only 20% of the people can be in the top fifth. That's just the way it is. So the answer is that it's partly efficient and partly inefficient.

Efficient market theory is seductive. Only it's not true....

Munger: And, by the way, I have a name for people who went to the extreme efficient market theory - which is "bonkers". It was an intellectually consistent theory that enabled them to do pretty mathematics. So I understand its seductiveness to people with large mathematical gifts. It just had a difficulty in that the fundamental assumption did not tie properly to reality.

Again, to the man with a hammer, every problem looks like a nail. If you're good at manipulating higher mathematics in a consistent way, why not make an assumption which enables you to use your tool?

BETTING ON HORSES AND PICKING STOCKS
HAVE MORE THAN A LITTLE IN COMMON.

Odds on horses and stocks are set by the market.

Munger: The model I like - to sort of simplify the notion of what goes on in a market for common stocks - is the pari-mutuel system at the race track. If you stop to think about it, a pari-mutuel system is a market. Everybody goes there and bets and the odds change based on what's bet. That's what happens in the stock market.

Any damn fool can see that a horse carrying a light weight with a wonderful win rate and a good post position etc., etc. is way more likely to win than a horse with a terrible record and extra weight and so on and so on. But if you look at the damn odds. the bad horse pays 100 to 1, whereas the good horse pays 3 to 2. Then it's not clear which is statistically the best bet using the mathematics of Fermat and Pascal. The prices have changed in such a way that it's very hard to beat the system.

And then the track is taking 17% off the top. So not only do you have to outwit all the other betters, but you've got to outwit them by such a big margin that on average, you can afford to take 17% of your gross bets off the top and give it to the house before the rest of your money can be put to work.

Believe it or not, some people make money betting horses.

Munger: Given those mathematics, is it possible to beat the horses only using one's intelligence? Intelligence should give some edge, because lots of people who don't know anything go out and bet lucky numbers and so forth. Therefore, somebody who really thinks about nothing but horse performance and is shrewd and mathematical could have a very considerable edge, in the absence of the frictional cost caused by the house take.

Unfortunately, what a shrewd horseplayer's edge does in most cases is to reduce his average loss over a season of betting from the 17% that he would lose if he got the average result to maybe 10%. However, there are actually a few people who can beat the game after paying the full 17%.

I used to play poker when I was young with a guy who made a substantial living doing nothing but bet harness races.... Now. harness racing is a relatively inefficient market. You don't have the depth of intelligence betting on harness races that you do on regular races. What my poker pal would do was to think about harness races as his main profession. And he would bet only occasionally when he saw some mispriced bet available. And by doing that, after paying the full handle to the house - which I presume was around 17% - he made a substantial living.

You have to say that's rare. However, the market was not perfectly efficient. And if it weren't for that big 17% handle, lots of people would regularly be beating lots of other people at the horse races. It's efficient, yes. But it's not perfectly efficient. And with enough shrewdness and fanaticism, some people will get better results than others.

It ain't easy, but it's possible, to outperform in stocks, too.

Munger: The stock market is the same way - except that the house handle is so much lower. If you take transaction costs - the spread between the bid and the ask plus the commissions - and if you don't trade too actively, you're talking about fairly low transaction costs. So that with enough fanaticism and enough discipline, some of the shrewd people are going to get way better results than average in the nature of things.

It is not a bit easy. And, of course, 50% will end up in the bottom half and 70% will end up in the bottom 70%. But some people will have an advantage. And in a fairly low transaction cost operation, they will get better than average results in stock picking.

What works betting horses also works for stock picking.

Munger: How do you get to be one of those who is a winner - in a relative sense - instead of a loser?

Here again, look at the pari-mutuel system. I had dinner last night by absolute accident with the president of Santa Anita. He says that there are two or three betters who have a credit arrangement with them, now that they have off-track betting, who are actually beating the house. They're sending money out net after the full handle - a lot of it to Las Vegas, by the way - to people who are actually winning slightly, net, after paying the full handle. They're that shrewd about something with as much unpredictability as horse racing.

And the one thing that all those winning betters in the whole history of people who've beaten the pari-mutuel system have is quite simple. They bet very seldom.

Winners bet big when they have the odds - otherwise, never.

Munger: It's not given to human beings to have such talent that they can just know everything about everything all the time. But it is given to human beings who work hard at it - who look and sift the world for a mispriced bet - that they can occasionally find one.

And the wise ones bet heavily when the world offers them that opportunity. They bet big when they have the odds. And the rest of the time, they don't. It's just that simple.

AS USUAL, IN HUMAN AFFAIRS
WHAT WINS ARE INCENTIVES.

It's obvious to us. And yet nobody operates that way.

Munger: That is a very simple concept. And to me it's obviously right - based on experience not only from the pari-mutuel system, but everywhere else.

And yet, in investment management, practically nobody operates that way. We operate that way - I'm talking about Buffett and Munger. And we're not alone in the world. But a huge majority of people have some other crazy construct in their heads. And instead of waiting for a near cinch and loading up, they apparently ascribe to the theory that if they work a little harder or hire more business school students, they'll come to know everything about everything all the time.

To me, that's totally insane. The way to win is to work, work, work, work and hope to have a few insights.

Most of Berkshire's billions came from a handful of ideas.

Munger: How many insights do you need? Well, I'd argue that you don't need many in a lifetime. If you look at Berkshire Hathaway and all of its accumulated billions, the top ten insights account for most of it. And that's with a very brilliant man - Warren's a lot more able than I am and very disciplined - devoting his lifetime to it. I don't mean to say that he's only had ten insights. I'm just saying that most of the money came from ten insights.

So you can get very remarkable investment results if you think more like a winning pari-mutuel player. Just think of it as a heavy odds against game full of bullshit and craziness with an occasional mispriced something or other. And you're probably not going to be smart enough to find thousands in a lifetime. And when you get a few, you really load up. It's just that simple.

A simple but powerful way to improve your results....

Munger: When Warren lectures at business schools, he says, "I could improve your ultimate financial welfare by giving you a ticket with only 20 slots in it so that you had 20 punches - representing all the investments that you got to make in a lifetime. And once you'd punched through the card, you couldn't make any more investments at all."

He says, "Under those rules, you'd really think carefully about what you did and you'd be forced to load up on what you'd really thought about. So you'd do so much better."

As long as clients buy salt, investment managers will sell it.

Munger: Again, this is a concept that seems perfectly obvious to me. And to Warren, it seems perfectly obvious. But this is one of the very few business classes in the U.S. where anybody will be saying so. It just isn't the conventional wisdom.

To me, it's obvious that the winner has to bet very selectively. It's been obvious to me since very early in life. I don't know why its not obvious to very many other people.

I think the reason why we got into such idiocy in investment management is best illustrated by a story that I tell about the guy who sold fishing tackle. I asked him, "My God, they're purple and green. Do fish really take these lures?" And he said, "Mister, I don't sell to fish."

Investment managers are in the position of that fishing tackle salesman. They're like the guy who was selling salt to the guy who already had too much salt. And as long as the guy will buy salt, why they'll sell salt. But that isn't what ordinarily works for the buyer of investment advice.

As usual, in human affairs, what wins are incentives.

Munger: If you invested Berkshire Hathaway-style, it would be hard to get paid as an investment manager as well as they're currently paid - because you'd be holding a block of Wal-Mart and a block of Coca-Cola and a block of something else. You'd be sitting on your ass. And the client would be getting rich. And, after a while, the client would think, "Why am I paying this guy half a percent a year on my wonderful passive holdings?"

So what makes sense for the investor is different from what makes sense for the manager. And, as usual in human affairs, what determines the behavior are incentives for the decision maker,

Getting the incentives right is a very, very important lesson.

Munger: From all business, my favorite case on incentives is Federal Express. The heart and soul of their system - which creates the integrity of the product - is having all their airplanes come to one place in the middle of the night and shift all the packages from plane to plane. If there are delays, the whole operation can't deliver a product full of integrity to Federal Express customers.

And it was always screwed up. They could never get it done on time. They tried everything - moral suasion, threats, you name it. And nothing worked.

Finally, somebody got the idea to pay all these people not so much an hour, but so much a shift - and when it's all done, they can all go home. Well, their problems cleared up overnight.

So getting the incentives right is a very, very important lesson. It was not obvious to Federal Express what the solution was. But maybe now, it will hereafter more often be obvious to you.

IF SECTOR ROTATION IS VERY LUCRATIVE,
WE'VE NEVER SEEN THE EVIDENCE.

Once you factor in the odds, the market isn't easy to beat.

Munger: All right, we've now recognized that the market is efficient as a pari-mutuel system is efficient - with the favorite more likely than the long shot to do well in racing, but not necessarily give any betting advantage to those that bet on the favorite.

In the stock market, some railroad that's beset by better competitors and tough unions may be available at one-third of its book value. In contrast, IBM in its heyday might be selling at 6 times book value. So it's just like the pari-mutuel system. Any damn fool could plainly see that IBM had better business prospects than the railroad. But once you put the price into the formula, it wasn't so clear anymore what was going to work best for a buyer choosing between the stocks. So it's a lot like a pari-mutuel system. And, therefore, it gets very hard to beat.

I know of no really rich "sector rotators"....

Munger: What style should the investor use as a picker of common stocks in order to try to beat the market - in other words, to get an above average long-term result? A standard technique that appeals to a lot of people is called "sector rotation". You simply figure out when oils are going to outperform retailers, etc.. etc., etc. You just kind of flit around being in the hot sector of the market making better choices than other people. And presumably, over a long period of time, you get ahead.

However, I know of no really rich sector rotator. Maybe some people can do it. I'm not saying they can't. All I know is that all the people I know who got rich - and I know a lot of them - did not do it that way.

RICH OR POOR, IT'S GOOD TO HAVE
A HUGE MARGIN OF SAFETY.

A significant discount = more upside + a margin of safety.

Munger: The second basic approach is the one that Ben Graham used - much admired by Warren and me. As one factor, Graham had this concept of value to a private owner - what the whole enterprise would sell for if it were available. And that was calculable in many cases.

Then, if you could take the stock price and multiply it by the number of shares and get something that was one third or less of sellout value, he would say that you've got a lot of edge going for you. Even with an elderly alcoholic running a stodgy business, this significant excess of real value per share working for you means that all kinds of good things can happen to you. You had a huge margin of safety - as he put it - by having this big excess value going for you.

The aftermath of the 1930s was a bargain hunter's dream.

Munger: But he was, by and large, operating when the world was in shell-shock from the 1930s - which was the worst contraction in the English-speaking world in about 600 years. Wheat in Liverpool, I believe, got down to something like a 600-year low, adjusted for inflation. People were so shell-shocked for a long time thereafter that Ben Graham could run his Geiger counter over this detritus from the collapse of the 1930s and find things selling below their working capital per share and so on.

Today, stated assets evaporate at the first sign of trouble.

Munger: And in those days, working capital actually belonged to the shareholders, If the employees were no longer useful, you just sacked them all, took the working capital and stuck it in the owners' pockets. That was the way capitalism then worked.

Nowadays, of course, the accounting is not realistic - because the minute the business starts contracting, significant assets are not there. Under social norms and the new legal rules of the civilization, so much is owed to the employees, that the minute the enterprise goes into reverse, some of the assets on the balance sheet aren't there anymore.

Strange things can happen in the technology area.

Munger: Now, that might not be true if you run a little auto dealership yourself. You may be able to run it in a way that there's no health plan and this and that so that if the business gets lousy, you can take your working capital and go home. But IBM can't, or at least didn't. Just look at what disappeared from its balance sheet when it decided that it had to change size both because the world had changed technologically and because its market position had deteriorated.

And in terms of blowing it, IBM is some example. Those were brilliant, disciplined people. But there was enough turmoil in technological change that IBM got bounced off the wave after "surfing" successfully for 60 years. And that was some collapse - an object lesson in the difficulties of technology and one of the reasons why Buffett and Munger don't like technology very much. We don't think we're any good at it, and strange things can happen.

One way to keep finding "bargains" is to redefine the term.

Munger: At any rate, the trouble with what I call the classic Ben Graham concept is that gradually the world wised up and those real obvious bargains disappeared. You could run your Geiger counter over the rubble and it wouldn't click.

But such is the nature of people who have a hammer - to whom, as I mentioned, every problem looks like a nail - that the Ben Graham followers responded by changing the calibration on their Geiger counters. In effect, they started defining a bargain in a different way. And they kept changing the definition so that they could keep doing what they'd always done. And it still worked pretty well. So the Ben Graham intellectual system was a very good one.

Having an unstable business partner has its rewards.

Munger: Of course, the best part of it all was his concept of "Mr. Market". Instead of thinking the market was efficient, he treated it as a manic-depressive who comes by every day. And some days he says, "I'll sell you some of my interest for way less than you think it's worth." And other days, "Mr. Market" comes by and says, "I'll buy your interest at a price that's way higher than you think it's worth." And you get the option of deciding whether you want to buy more, sell part of what you already have or do nothing at all.

To Graham, it was a blessing to be in business with a manic-depressive who gave you this series of options all the time. That was a very significant mental construct. And it's been very useful to Buffett, for instance, over his whole adult lifetime.

GRAHAM WASN'T TRYING TO PLAY OUR GAME

- I.E., PAYING UP FOR BETTER BUSINESSES.

Ben Graham wasn't trying to do what we did.

Munger: However, if we'd stayed with classic Graham the way Ben Graham did it, we would never have had the record we have. And that's because Graham wasn't trying to do what we did.

For example, Graham didn't want to ever talk to management. And his reason was that, like the best sort of professor aiming his teaching at a mass audience, he was trying to invent a system that anybody could use. And he didn't feel that the man in the street could run around and talk to managements and learn things. He also had a concept that the management would often couch the information very shrewdly to mislead. Therefore, it was very difficult. And that is still true, of course - human nature being what it is.

Our leap - paying up for quality....

Munger: And so having started out as Grahamites - which, by the way, worked fine - we gradually got what I would call better insights. And we realized that some company that was selling at 2 or 3 times book value could still be a hell of a bargain because of momentums implicit in its position, sometimes combined with an unusual managerial skill plainly present in some individual or other, or some system or other.

And once we'd gotten over the hurdle of recognizing that a thing could be a bargain based on quantitative measures that would have horrified Graham, we started thinking about better businesses.

Bulk of Berkshire's billions brought by better businesses.

Munger: And, by the way, the bulk of the billions in Berkshire Hathaway have come from the better businesses. Much of the first $200 or $300 million came from scrambling around with our Geiger counter. But the great bulk of the money has come from the great businesses.

And even some of the early money was made by being temporarily present in great businesses, Buffett Partnership, for example, owned American Express and Disney when they got pounded down.

FROM THE VIEWPOINT OF A RATIONAL CLIENT,
INVESTMENT MANAGEMENT TODAY IS BONKERS.

A tremendous advantage at Berkshire - no clients.

Munger: [Most investment managers are] in a game where the clients expect them to know a lot about a lot of things. We didn't have any clients who could fire us at Berkshire Hathaway. So we didn't have to be governed by any such construct. And we came to this notion of finding a mispriced bet and loading up when we were very confident that we were right. So we're way less diversified. And I think our system is miles better.

However, in all fairness, I don't think [a lot of money managers] could successfully sell their services if they used our system. But if you're investing for 40 years in some pension fund, what difference does it make if the path from start to finish is a little more bumpy or a little different than everybody else's so long as it's all going to work out well in the end? So what if there's a little extra volatility.

Investment management today is really hobbling itself....

Munger: In investment management today, everybody wants not only to win, but to have the path never diverge very much from a standard path except on the upside. Well, that is a very artificial, crazy construct. That's the equivalent in investment management to the custom of binding the feet of the Chinese women. It's the equivalent of what Nietzsche meant when he criticized the man who had a lame leg and was proud of it.

That is really hobbling yourself. Now, investment managers would say. "We have to be that way. That's how we're measured". And they may be right in terms of the way the business is now constructed. But from the viewpoint of a rational consumer, the whole system's "bonkers" and draws a lot of talented people into socially useless activity.

IF YOU DON'T LOAD UP ON GREAT OPPORTUNITIES,
THEN YOU'RE MAKING A BIG MISTAKE.

It's much better to attempt something attainable.

Munger: And the Berkshire system is not "bonkers". It's so damned elementary that even bright people are going to have limited, really valuable insights in a very competitive world when they're fighting against other very bright, hardworking people.

And it makes sense to load up on the very few good insights you have instead of pretending to know everything about everything at all times. You're much more likely to do well if you start out to do something, feasible instead of something that isn't feasible. Isn't that perfectly obvious?

How many of you have 56 brilliant insights in which you have equal confidence? Raise your hands, please. How many of you have two or three insights that you have some confidence in? I rest my case.

I'd say that Berkshire Hathaway's system is adapting to the nature of the investment problem as it really is.

The trick is getting into better businesses.

Munger: We've really made the money out of high quality businesses. In some cases, we bought the whole business. And in some cases, we just bought a big block of stock. But when you analyze what happened, the big money's been made in the high quality businesses. And most of the other people who've made a lot of money have done so in high quality businesses.

Over the long term, it's hard for a stock to earn a much better return than the business which underlies it earns. If the business earns 6% on capital over 40 years and you hold it for that 40 years, you're not going to make much different than a 6% return - even if you originally buy it at a huge discount. Conversely, if a business earns 18% on capital over 20 or 30 years, even if you pay an expensive looking price, you'll end up with one hell of a result.

Finding 'em small is a very beguiling idea....

Munger: So the trick is getting into better businesses. And that involves all of these advantages of scale that you could consider momentum effects.

How do you get into these great companies? One method is what I'd call the method of finding them small - get 'em when they're little. For example, buy Wal-Mart when Sam Walton first goes public and so forth. And a lot of people try to do just that. And it's a very beguiling idea. If I were a young man, I might actually go into it.

We have to buy 'em big. And it gets harder all the time.

Munger: But it doesn't work for Berkshire Hathaway anymore because we've got too much money. We can't find anything that fits our size parameter that way. Besides, we're set in our ways. But I regard finding them small as a perfectly intelligent approach for somebody to try with discipline. It's just not something that I've done.

Finding 'em big obviously is very hard because of the competition. So far, Berkshire's managed to do it. But can we continue to do it? What's the next Coca-Cola investment for us? Well, the answer to that is I don't know. I think it gets harder for us all the time....

Not loading up on great opportunities is a big mistake.

Munger: And ideally - and we've done a lot of this - you get into a great business which also has a great manager because management matters. For example, it's made a hell of a difference to General Electric that Jack Welch came in instead of the guy who took over Westinghouse - one hell of a difference. So management matters, too.

And some of it is predictable. I do not think it takes a genius to understand that Jack Welch was a more insightful person and a better manager than his peers in other companies. Nor do I think it took tremendous genius to understand that Disney had basic momentums in place which are very powerful and that Eisner and Wells were very unusual managers.

So you do get an occasional opportunity to get into a wonderful business that's being run by a wonderful manager. And, of course, that's hog heaven day. If you don't load up when you get those opportunities, it's a big mistake.

It's usually better to bet on the business than the manager....

Munger: Occasionally, you'll find a human being who's so talented that he can do things that ordinary skilled mortals can't. I would argue that Simon Marks - who was second generation in Marks & Spencer of England - was such a man. Patterson was such a man at National Cash Register. And Sam Walton was such a man,

These people do come along - and in many cases, they're not all that hard to identity. If they've got a reasonable hand - with the fanaticism and intelligence and so on that these people generally bring to the party - then management can matter much.

However, averaged out, betting on the quality of a business is better than betting on the quality of management. In other words, if you have to choose one, bet on the business momentum, not the brilliance of the manager.

But, very rarely, you find a manager who's so good that you're wise to follow him into what looks like a mediocre business.

MAKE A FEW GREAT INVESTMENTS
AND SIT ON YOUR ASSETS....

There are huge mathematical advantages to doing nothing.

Munger: Another very simple effect I very seldom see discussed either by investment managers or anybody else is the effect of taxes. If you're going to buy something which compounds for 30 years at 15% per annum and you pay one 35% tax at the very end, the way that works out is that after taxes, you keep 13.3% per annum,

In contrast, if you bought the same investment, but had to pay taxes every year of 35% out of the 15% that you earned, then your return would be 15% minus 35% of 15% - or only 9.75% per year compounded. So the difference there is over 3.5%. And what 3.5% does to the numbers over long holding periods like 30 years is truly eye-opening. If you sit on your ass for long, long stretches in great companies, you can get a huge edge from nothing but the way income taxes work.

Even with a 10% per annum investment, paying a 35% tax at the end gives you 8.3% after taxes as an annual compounded result after 30 years. In contrast, if you pay the 35% each year instead of at the end, your annual result goes down to 6.5%. So you add nearly 2% of after-tax return per annum if you only achieve an average return by historical standards from common stock investments in companies with low dividend payout ratios.

Tax-related motivations have led to many big boners.

Munger: But in terms of business mistakes that I've seen over a long lifetime, I would say that trying to minimize taxes too much is one of the great standard causes of really dumb mistakes. I see terrible mistakes from people being overly motivated by tax considerations.

Warren and I personally don't drill oil wells. We pay our taxes. And we've done pretty well, so far. Anytime somebody offers you a tax shelter from here on in life, my advice would be don't buy it.

In fact, any time anybody offers you anything with a big commission and a 200-page prospectus. don't buy it. Occasionally, you'll be wrong if you adopt "Munger's Rule". However, over a lifetime, you'll be a long way ahead - and you will miss a lot of unhappy experiences that might otherwise reduce your love for your fellow man.

Make a few great investments and sit on your assets....

Munger: There are huge advantages for an individual to get into a position where you make a few great investments and just sit on your ass: You're paying less to brokers. You're listening to less nonsense. And if it works, the governmental tax system gives you an extra 1, 2 or 3 percentage points per annum compounded.

And you think that most of you are going to get that much advantage by hiring investment counselors and paying them 1% to run around, incurring a lot of taxes on your behalf? Lots of luck.

Great companies' stock prices often reflect their quality.

Munger: Are there any dangers in this philosophy? Yes. Everything in life has dangers. Since it's so obvious that investing in great companies works, it gets horribly overdone from time to time. In the Nifty-Fifty days, everybody could tell which companies were the great ones. So they got up to 50, 60 and 70 times earnings. And just as IBM fell off the wave, other companies did, too. Thus, a large investment disaster resulted from too high prices. And you've got to be aware of that danger....

So there are risks. Nothing is automatic and easy. But if you can find some fairly-priced great company and buy it and sit, that tends to work out very, very well indeed - especially for an individual.

AND THERE'S THE ULTIMATE NO-BRAINER
- LIKE FINDING MONEY IN THE STREET.

The ultimate no-brainer....

Munger: Within the growth stock model, there's a sub-position: There are actually businesses. that you will find a few times in a lifetime, where any manager could raise the return enormously just by raising prices - and yet they haven't done it. So they have huge untapped pricing power that they're not using. That is the ultimate no-brainer.

That existed in Disney. It's such a unique experience to take your grandchild to Disneyland. You're not doing it that often. And there are lots of people in the country. And Disney found that it could raise those prices a lot and the attendance stayed right up.

So a lot of the great record of Eisner and Wells was utter brilliance but the rest came from just raising prices at Disneyland and Disneyworld and through video cassette sales of classic animated movies.

Coca-Cola had it all. It was perfect....

Munger: At Berkshire Hathaway, Warren and I raised the prices of See's Candy a little faster than others might have. And, of course, we invested in Coca-Cola - which had some untapped pricing power. And it also had brilliant management. So a Goizueta and Keough could do much more than raise prices. It was perfect.

You will occasionally find money in the street.

Munger: You will get a few opportunities to profit from finding underpricing. There are actually people out there who don't price everything as high as the market will easily stand. And once you figure that out, it's like finding money in the street - if you have the courage of your convictions.

MODELS FROM BERKSHIRE HATHAWAY INVESTMENTS:
COKE, GILLETTE, GEICO & THE WASHINGTON POST

Model #1: Betting on newspapers in two newspaper towns.

Munger: If you look at Berkshire's investments where a lot of the money's been made and you look for the models, you can see that we twice bought into two-newspaper towns which have since become one-newspaper towns. So we made a bet to some extent....

The Washington Post was a rare opportunity indeed.

Munger: In one of those - The Washington Post - we bought it at about 20% of the value to a private owner. So we bought it on a Ben Graham-style basis - at one-fifth of obvious value - and, in addition, we faced a situation where you had both the top hand in a game that was clearly going to end up with one winner and a management with a lot of integrity and intelligence. That one was a real dream. They're very high class people - the Katharine Graham family. That's why it was a dream - an absolute, damn dream.

Of course, that came about back in '73-'74. And that was almost like 1932. That was probably a once-in-40- years-type denouement in the markets. That investment's up about 50 times over our cost. If I were you, I wouldn't count on getting any investment in your lifetime quite as good as The Washington Post was in '73 and '74.

But it doesn't have to be that good to take care of you.

Model #2: A low-priced item + a global marketing advantage.

Munger: Let me mention another model. Of course, Gillette and Coke make fairly low-priced items and have a tremendous marketing advantage all over the world. And in Gillette's case, they keep surfing along new technology which is fairly simple by the standards of microchips. But it's hard for competitors to do.

So they've been able to stay constantly near the edge of improvements in shaving. There are whole countries where Gillette has more than 90% of the shaving market.

Model #3: The cancer surgery formula - a la GEICO.

Munger: GEICO is a very interesting model. It's another one of the 100 or so models you ought to have in your head. I've had many friends in the sick-business-fix- game over a long lifetime. And they practically all use the following formula - I call it the cancer surgery formula:

They look at this mess. And they figure out if there's anything sound left that can live on its own if they cut away everything else. And if they find anything sound, they just cut away everything else. Of course, if that doesn't work, they liquidate the business. But it frequently does work.

And GEICO had a perfectly magnificent business - submerged in a mess, but still working. Misled by success, GEICO had done some foolish things. They got to thinking that, because they were making a lot of money, they knew everything. And they suffered huge losses.

All they had to do was to cut out all the folly and go back to the perfectly wonderful business that was lying there. And when you think about it, that's a very simple model. And it's repeated over and over again.

And, in GEICO's case, think about all the money we passively made.... It was a wonderful business combined with a bunch of foolishness that could easily he cut out. And people were coming in who were temperamentally and intellectually designed so they were going to cut it out. That is a model you want to look for.

And you may find one or two or three in a long lifetime that are very good. And you may find 20 or 30 that are good enough to be quite useful.

THE INVESTMENT MANAGEMENT BUSINESS:
DON'T PRACTICE PSYCHOLOGICAL DENIAL

Investment managers as a whole don't add any value....

Munger: Finally, I'd like to once again talk about investment management. That is a funny business - because on a net basis, the whole investment management business together gives no value added to all buyers combined. That's the way it has to work.

Of course, that isn't true of plumbing and it isn't true of medicine. If you're going to make your careers in the investment management business, you face a very peculiar situation. And most investment managers handle it with psychological denial -just like a chiropractor. That is the standard method of handling the limitations of the investment management process. But if you want to live the best sort of life, I would urge each of you not to use the psychological denial mode.

However, it's not impossible to add value.

Munger: I think a select few - a small percentage of the investment managers - can deliver value added. But I don't think brilliance alone is enough to do it. I think that you have to have a little of this discipline of calling your shots and loading up - if you want to maximize your chances of becoming one who provides above average real returns for clients over the long pull.

But I'm just talking about investment managers engaged in common stock picking. I am agnostic elsewhere. I think there may well be people who are so shrewd about currencies and this, that and the other thing that they can achieve good long-term records operating on a pretty big scale in that way. But that doesn't happen to be my milieu. I'm talking about stock picking in American stocks.

I think it's hard to provide a lot of value added to the investment management client, but it's not impossible.

--OID

Investment Practices of Leading Charitable Foundations

Speech of Charles T. Munger, Vice Chair, Berkshire Hathaway, at Miramar Sheraton Hotel, Santa Monica, CA, on October 14, 1998, to a meeting of the Foundation Financial Officers Group sponsored by The Conrad Hilton Foundation, The Amateur Athletic Foundation, The J. Paul Getty Trust, and Rio Hondo Memorial Foundation. The speech is reproduced here (http://www.tiff.org/pub/library/Other_Resources/Munger_Speech.html) with Mr. Munger's permission.

I am speaking here today because my friend, John Argue, asked me. And John well knew that I, who, unlike many other speakers on your agenda, have nothing to sell any of you, would be irreverent about much current investment practice in large institutions, including charitable foundations. Therefore any hostility my talk will cause should be directed at John Argue who comes from the legal profession and may even enjoy it.

It was long the norm at large charitable foundations to invest mostly in unleveraged, marketable, domestic securities, mostly equities. The equities were selected by one or a very few investment counselling organizations. But in recent years there has been a drift toward more complexity. Some foundations, following the lead of institutions like Yale, have tried to become much better versions of Bernie Cornfeld's "fund of funds." This is an amazing development. Few would have predicted that, long after Cornfeld's fall into disgrace, leading universities would be leading foundations into Cornfeld's system.

Now, in some foundations, there are not few but many investment counselors, chosen by an additional layer of consultants who are hired to decide which investment counselors are best, help in allocating funds to various categories, make sure that foreign securities are not neglected in favor of domestic securities, check validity of claimed investment records, insure that claimed investment styles are scrupulously followed, and help augment an already large diversification in a way that conforms to the latest notions of corporate finance professors about volatility and "beta."

But even with this amazingly active, would-be-polymathic new layer of consultant-choosing consultants, the individual investment counselors, in picking common stocks, still rely to a considerable extent on a third layer of consultants. The third layer consists of the security analysts employed by investment banks. These security analysts receive enormous salaries, sometimes set in seven figures after bidding wars. The hiring investment banks recoup these salaries from two sources: (1) commissions and trading spreads born by security buyers (some of which are rebated as "soft dollars" to money managers), plus (2) investment banking charges paid by corporations which appreciate the enthusiastic way their securities are being recommended by the security analysts.

There is one thing sure about all this complexity including its touches of behavior lacking the full punctilio of honor. Even when nothing but unleveraged stock-picking is involved, the total cost of all the investment management, plus the frictional costs of fairly often getting in and out of many large investment positions, can easily reach 3% of foundation net worth per annum if foundations, urged on by consultants, add new activity, year after year. This full cost doesn't show up in conventional accounting. But that is because accounting has limitations and not because the full cost isn't present.

Next, we come to time for a little arithmetic: it is one thing each year to pay the croupiers 3% of starting wealth when the average foundation is enjoying a real return, say, of 17% before the croupiers' take. But it is not written in the stars that foundations will always gain 17% gross, a common result in recent years. And if the average annual gross real return from indexed investment in equities goes back, say, to 5% over some long future period, and the croupiers' take turns out to remain the waste it has always been, even for the average intelligent player, then the average intelligent foundation will be in a prolonged, uncomfortable, shrinking mode. After all, 5% minus 3% minus 5% in donations leaves an annual shrinkage of 3%.

All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers' costs they have jointly elected to bear. This is an unescapable fact of life. And it is also unescapable that exactly half of the investors will get a result below the median result after the croupiers' take, which median result may well be somewhere between unexciting and lousy.

Human nature being what it is, most people assume away worries like those I raise. After all, five centuries before Christ Demosthenes noted that: "What a man wishes, he will believe." And in self appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90% of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert's public assessment is that he is above average, no matter what is the evidence to the contrary.

But, you may think, my foundation, at least, will be above average. It is well endowed, hires the best, and considers all investment issues at length and with objective professionalism. And to this I respond that an excess of what seems like professionalism will often hurt you horribly — precisely because the careful procedures themselves often lead to overconfidence in their outcome.

General Motors recently made just such a mistake, and it was a lollapalooza. Using fancy consumer surveys, its excess of professionalism, it concluded not to put a fourth door in a truck designed to serve also as the equivalent of a comfortable five-passenger car. Its competitors, more basic, had actually seen five people enter and exit cars. Moreover they had noticed that people were used to four doors in a comfortable five-passenger car and that biological creatures ordinarily prefer effort minimization in routine activies and don't like removals of long-enjoyed benefits. There are only two words that come instantly to mind in reviewing General Motors horrible decision, which has blown many hundreds of millions of dollars. And one of those words is: "oops."

Similarly, the hedge fund known as "Long Term Capital Management" recently collapsed, through overconfidence in its highly leveraged methods, despite I.Qs. of its principals that must have averaged 160. Smart, hard-working people aren't exempted from professional disasters from overconfidence. Often, they just go around in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.

It is, of course, irritating that extra care in thinking is not all good but also introduces extra error. But most good things have undesired "side effects," and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel Laureate Richard Feynman as follows: "The first principle is that you must not fool yourself and you're the easiest person to fool."

But suppose that an abnormally realistic foundation, thinking like Feynman, fears a poor future investment outcome because it is unwilling to assume that its unleveraged equities will outperform equity indexes, minus all investment costs, merely because the foundation has adopted the approach of becoming a "fund of funds," with much investment turnover and layers of consultants that consider themselves above average. What are this fearful foundation's options as it seeks improved prospects?

There are at least three modern choices:

1. The foundation can both dispense with its consultants and reduce its investment turnover as it changes to indexed investment in equities.

2. The foundation can follow the example of Berkshire Hathaway, and thus get total annual croupier costs below 1/10 of 1% of principal per annum, by investing with virtually total passivity in a very few much-admired domestic corporations. And there is no reason why some outside advice can't be used in this process. All the fee payor has to do is suitably control the high talent in investment counseling organizations so that the servant becomes the useful tool of its master, instead of serving itself under the perverse incentives of a sort of Mad Hatter's tea party.

3. The foundation can supplement unleveraged investment in marketable equities with investment in limited partnerships that do some combination of the following: unleveraged investment in high-tech corporations in their infancy; leveraged investments in corporate buy-outs, leveraged relative value trades in equities, and leveraged convergence trades and other exotic trades in all kinds of securities and derivatives.

For the obvious reasons given by purveyors of indexed equities, I think choice (1), indexing, is a wiser choice for the average foundation than what it is now doing in unleveraged equity investment. And particularly so as its present total croupier costs exceed 1% of principal per annum. Indexing can't work well forever if almost everybody turns to it. But it will work all right for a long time.

Choice (3), investment in fancy limited partnerships, is largely beyond the scope of this talk. I will only say that the Munger Foundation does not so invest, and briefly mention two considerations bearing on "LBO" funds.

The first consideration bearing on LBO funds is that buying 100% of corporations with much financial leverage and two layers of promotional carry (one for the management and one for the general partners in the LBO fund) is no sure thing to outperform equity indexes in the future if equity indexes perform poorly in the future. In substance, a LBO fund is a better way of buying equivalents of marketable equities on margin, and the debt could prove disastrous if future marketable equity performance is bad. And particularly so if the bad performance comes from generally bad business conditions.

The second consideration is increasing competition for LBO candidates. For instance, if the LBO candidates are good service corporations, General Electric can now buy more than $10 billion worth per year in GE's credit corporation, with 100% debt financing at an interest rate only slightly higher than the U.S. Government is paying. This sort of thing is not ordinary competition, but supercompetition. And there are now very many LBO funds, both large and small, mostly awash in money and with general partners highly incentivized to buy something. In addition there is increased buying competition from corporations other than GE, using some combination of debt and equity.

In short, in the LBO field, there is a buried covariance with marketable equities — toward disaster in generally bad business conditions — and competition is now extreme.

Given time limitation, I can say no more about limited partnerships, one of which I once ran. This leaves for extensive discussion only foundation choice (2), more imitation of the investment practices of Berkshire Hathaway in maintaining marketable equity portfolios with virtually zero turnover and with only a very few stocks chosen. This brings us to the question of how much investment diversification is desirable at foundations.

I have more than skepticism regarding the orthodox view that huge diversification is a must for those wise enough so that indexation is not the logical mode for equity investment. I think the orthodox view is grossly mistaken.

In the United States, a person or institution with almost all wealth invested, long term, in just three fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse. And particularly so when he rationally believes, like Berkshire, that his long-term results will be superior by reason of his lower costs, required emphasis on long-term effects, and concentration in his most preferred choices.

I go even further. I think it can be a rational choice, in some situations, for a family or a foundation to remain 90% concentrated in one equity. Indeed, I hope the Mungers follow roughly this course. And I note that the Woodruff foundations have, so far, proven extremely wise to retain an approximately 90% concentration in the founder's Coca-Cola stock. It would be interesting to calculate just how all American foundations would have fared if they had never sold a share of founder's stock. Very many, I think, would now be much better off. But, you may say, the diversifiers simply took out insurance against a catastrophe that didn't occur. And I reply: there are worse things than some foundation's losing relative clout in the world, and rich institutions, like rich individuals, should do a lot of self insurance if they want to maximize long-term results.

Furthermore, all the good in the world is not done by foundation donations. Much more good is done through the ordinary business operations of the corporations in which the foundations invest. And some corporations do much more good than others in a way that gives investors therein better than average long-term prospects do. And I don't consider it foolish, stupid, evil, or illegal for a foundation to greatly concentrate investment in what it admires or even loves. Indeed, Ben

Franklin required just such an investment practice for the charitable endowment created by his will.

One other aspect of Berkshire’s equity investment practice deserves comparative mention. So far, there has been almost no direct foreign investment at Berkshire and much foreign investment at foundations.

Regarding this divergent history, I wish to say that I agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. This factor, I think is underweighed at many investment institutions, probably because it does not easily lead to quantitative thinking using modern financial technique. But some important factor doesn’t lose share of force just because some "expert" can better measure other types of force. Generally, I tend to prefer over direct foreign investment Berkshire’s practice of participating in foreign economies through the likes of Coca-Cola and Gillette.

To conclude, I will make one controversial prediction and one controversial argument.

The controversial prediction is that, if some of you make your investment style more like Berkshire Hathaway’s, in a long-term retrospect you will be unlikely to have cause for regret, even if you can’t get Warren Buffett to work for nothing. Instead, Berkshire will have cause for regret as it faces more intelligent investment competition. But Berkshire won’t actually regret any disadvantage from your enlightenment. We only want what success we can get despite encouraging others to share our general views about reality.

My controversial argument is an additional consideration weighing against the complex, high-cost investment modalities becoming ever more popular at foundations. Even if, contrary to my suspicions, such modalities should turn out to work pretty well, most of the money-making activity would contain profoundly antisocial effects. This would be so because the activity would exacerbate the current, harmful trend in which ever more of the nation’s ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others. Money management does not create the right examples. Early Charlie Munger is a horrible career model for the young, because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.

Rather than encourage such models, a more constructive choice at foundations is long-term investment concentration in a few domestic corporations that are wisely admired.

Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a pretty good investor, too. Better his model, I think, than Bernie Cornfeld’s. The choice is plainly yours to make.

Master's Class

Berkshire Hathaway's vice chairman shreds the conventional wisdom on foundation investing

By Charles Munger, 1999

It was long the norm at large charitable foundations to invest mostly in unleveraged, marketable, domestic securities, mostly equities. The equities were selected by one or a very few investment counseling organizations. But in recent years there has been a drift toward more complexity. Some foundations, following the lead of institutions like Yale, have tried to become much better versions of Bernie Cornfeld's "fund of funds." This is an amazing development. Few would have predicted that, decades after his fall into disgrace, leading universities would be leading foundations into Cornfeld's system.

Now, in some foundations, there are not few but many investment counselors, chosen by an additional layer of consultants who are hired to decide which investment counselors are best, help in allocating funds to various categories, make sure that foreign securities are not neglected in favor of domestic securities, check validity of claimed investment records, ensure that claimed investment styles are scrupulously followed, and help augment an already large diversification in a way that conforms to the latest notions of corporate finance professors about measures of volatility.

But even with this amazingly active, would-be-polymathic new layer of consultant-choosing consultants, in picking common stocks the individual investment counselors still rely to a considerable extent on a third layer of consultants. The third layer consists of the security analysts employed by investment banks. These security analysts receive enormous salaries, sometimes set in seven figures after bidding wars. The hiring investment banks recoup these salaries from two sources: First, from commissions and trading spreads borne by securities buyers; and second, from investment banking charges paid by corporations which appreciate the enthusiastic way their securities are being recommended by the security analysts.

There is one sure thing about all this complexity, including its touches of behavior lacking the full punctilio of honor. Even when nothing but unleveraged stock-picking is involved, the total cost of all the investment management, plus the frictional costs of fairly often getting in and out of many large investment positions, can easily reach 3 percent of foundation net worth per annum if foundations, urged by consultants, add new activity year after year. This full cost doesn't show up in conventional accounting. But that is because accounting has limitations and not because the full cost isn't present.

Where Every Investment Advisor Is Above-Average

Now is time for a little arithmetic: It is one thing each year to pay the croupiers 3 percent of starting wealth when the average foundation is enjoying a real return, say, of 17 percent before the croupiers' take. But it is not written in the stars that foundations will always gain 17 percent gross, a common result in recent years. And if the average annual gross real return from indexed investment in equities goes back, say, to 5 percent over some long future period, and the croupiers' take turns out to remain the waste it has always been, even for the average intelligent players, then the average intelligent foundation will be in a prolonged, uncomfortable, shrinking mode. After all, 5 percent minus 3 percent minus 5 percent in donations leaves an annual shrink of 3 percent.

All the equity investors, in total, will surely bear a performance disadvantage per annum equal to the total croupiers' costs they have jointly elected to bear. This is an inescapable fact of life. And it is also inescapable that exactly half of the investors will get a result below the median result after the croupiers' take, which median result may well be somewhere between unexciting and lousy.

Human nature being what it is, most people assume away worries like those I raise. After all, in the 5th century B. C. Demosthenes noted that: "What a man wishes, he will believe." And in self-appraisals of prospects and talents it is the norm, as Demosthenes predicted, for people to be ridiculously over-optimistic. For instance, a careful survey in Sweden showed that 90 percent of automobile drivers considered themselves above average. And people who are successfully selling something, as investment counselors do, make Swedish drivers sound like depressives. Virtually every investment expert's public assessment is that he is above average, no matter what is the evidence to the contrary.

"But," some will say, "my foundation, at least, will be above average. It is well-endowed, hires the best, and considers all investment issues at length and with objective professionalism." And to this I respond that an excess of what seems like professionalism will often hurt you horribly—precisely because the careful procedures themselves often lead to overconfidence in their outcome.

Not long ago, General Motors made just such a mistake, and it was a lollapalooza. Using fancy consumer surveys, its excess of professionalism, it decided not to put a fourth door in a truck designed to serve also as the equivalent of a comfortable five-passenger car. Its competitors, more basic, had actually seen five people enter and exit cars. Moreover they had noticed that people were used to four doors in a comfortable five-passenger car and that biological creatures ordinarily prefer effort minimization in routine activities and don't like removals of long-enjoyed benefits. There are only two words that come instantly to mind in reviewing General Motors horrible decision, which has blown many hundreds of millions of dollars. And one of those words is: "Oops."

Similarly, the hedge fund known as "Long Term Capital Management" collapsed last fall through overconfidence in its highly leveraged methods, despite I.Q.'s of its principals that must have averaged 160. Smart people aren't exempt from professional disasters from overconfidence. Often, they just run aground in the more difficult voyages they choose, relying on their self-appraisals that they have superior talents and methods.

Investment Secrets of Richard Feynman

It is, of course, irritating that extra care in thinking is not all good but actually introduces extra error. But most good things have undesired "side effects," and thinking is no exception. The best defense is that of the best physicists, who systematically criticize themselves to an extreme degree, using a mindset described by Nobel laureate Richard Feynman as follows: "The first principle is that you must not fool yourself and you're the easiest person to fool."

But suppose that an abnormally realistic foundation, thinking like Feynman, fears a poor future investment outcome because it is unwilling to assume that its unleveraged equities, after deducting all investment costs, will outperform equity indexes, merely because the foundation has adopted the approach of becoming a "fund of funds" with much investment turnover and layers of consultants that consider themselves above average. What are this fearful foundation's options as it seeks improved prospects? There are at least three modern choices:

• The foundation can both dispense with its consultants and reduce its investment turnover as it changes to indexed investment in equities.

• The foundation can follow the example of Berkshire Hathaway, and thus get total annual croupier costs below 0.1 percent of principal per annum, by investing with virtually total passivity in a very few much-admired domestic corporations. And there is no reason why some outside advice can't be used in this process. All the fee payer has to do is suitably control the high talent in investment counseling organizations so that the servant becomes the useful tool of its master, instead of serving itself under the perverse incentives of a sort of mad hatter's tea party.

• The foundation can supplement unleveraged investment in marketable equities with investment in limited partnerships that do some combination of the following: Unleveraged investment in high-tech corporations in their infancy, leveraged investments in corporate buy-outs, leveraged relative value trades in equities, and leveraged convergence trades and other exotic trades in all kinds of securities and derivatives.

For the obvious reasons given by purveyors of indexed equities, I think choice #1, indexing, is a wiser choice for the average foundation than what it is now doing in unleveraged equity investment. And particularly so as its present total croupier costs exceed 1 percent of principal per annum. Indexing can't work well forever if almost everybody turns to it. But it will work alright for a long time.

Contending with Supercompetitors

Choice #3, investment in fancy limited partnerships, is largely beyond the scope of this article. I will only note that the Munger Foundation does not so invest and briefly mention two considerations bearing on leveraged buyout (LBO) funds.

The first consideration bearing on LBO funds is that buying 100 percent of corporations with much financial leverage and two layers of promotional carry (one for the management and one for the general partners in the LBO fund) is no sure thing to outperform equity indexes in the future if equity indexes perform poorly in the future. In substance, an LBO fund is a better way of buying equivalents of marketable equities on margin, and the debt could prove disastrous if future marketable equity performance is bad. And particularly so if the bad performance comes from generally bad business conditions.

The second consideration is increasing competition for LBO candidates. For instance, if the LBO candidates are good service corporations, General Electric can now buy more than $10 billion worth per year in GE's credit corporation, with 100 percent debt financing at an interest rate only slightly higher than the U.S. government is paying. This is not ordinary competition, but supercompetition. And there are now very many LBO funds, both large and small, mostly awash in money and with general partners highly incentivized to buy something. In addition, there is increased buying competition from corporations other than GE, using come combination of debt and equity.

In short, in the LBO field there is a buried "covariance" with marketable equities, toward disaster in generally bad business conditions, and competition is now extremely intense.

This brings us to foundation choice #2—more imitation of the investment practices of Berkshire Hathaway in maintaining marketable equity portfolios with virtually zero turnover and with only a very few stocks chosen. And that in turn raises the question of how much investment diversification is desirable for foundations.

I am more than skeptical of the orthodox view that huge diversification is a must for those wise enough that indexation is not the logical mode for equity investment. I think the orthodox view is grossly mistaken.

In the United States, a person or institution with almost all wealth invested long-term in just three fine domestic corporations is securely rich. And why should such an owner care if at any time most other investors are faring somewhat better or worse? And particularly so when he rationally believes, like Berkshire, that his long-term results will be superior by reason of his lower costs, required emphasis on long-term effects, and concentration in his most-preferred choices.

I would go even further. I think it can be a rational choice, in some situations, for a family or a foundation to remain 90 percent concentrated in one equity. Indeed, I hope the Mungers follow roughly this course. And I note that the Robert Woodruff Foundations have, so far, proven extremely wise to retain an approximately 90 percent concentration in the founder's Coca-Cola stock. It would be interesting to calculate just how all American foundations would have fared if they had never sold a share of the founder's stock. Very many, I think, would now be much better off. But, some would say, the diversifiers simply took out insurance against a catastrophe that didn't occur. And I reply: There are worse things than a foundation's losing relative clout in the world, and rich institutions, like rich individuals, should do a lot of self-insurance if they want to maximize long-term results.

Furthermore, all the good in the world is not done by foundation donations. Much more good is done through the ordinary business operations of the corporations in which the foundations invest. And some corporations do much more good than others in a way that gives investors therein better than average long-term prospects. And I don't consider it foolish, stupid, evil, or illegal for a foundation to greatly concentrate investment in what it admires or even loves. Indeed, Ben Franklin required just such an investment practice for the charitable endowment created by his will.

Investing Abroad—at Home

So far, there has been almost no direct foreign investment at Berkshire and much foreign investment at foundations.

Regarding this divergent history, I have to agree with Peter Drucker that the culture and legal systems of the United States are especially favorable to shareholder interests, compared to other interests and compared to most other countries. Indeed, there are many other countries where any good going to public shareholders has a very low priority and almost every other constituency stands higher in line. This factor, I think is underweighed at many investment institutions, probably because it does not easily lead to quantitative thinking using modern financial techniques. But some important factor doesn't lose its "share of force" just because some "expert" can better measure other types of force. Generally, I tend to prefer over direct foreign investment Berkshire's practice of participating in foreign economies through the likes of Coca-Cola and Gillette.

To conclude, I will make one controversial prediction and one controversial argument.

The one controversial prediction is that, if some foundations make their investment style more like Berkshire Hathaway's, in a long-term retrospect they will be unlikely to have cause for regret, even if they can't get Warren Buffett to work for nothing. Instead, Berkshire will have cause for regret as it faces more intelligent investment competition. But Berkshire won't actually regret any disadvantage from their enlightenment.

My controversial argument is an additional consideration weighing against the complex, high-cost investment modalities becoming ever more popular at foundations. Even if, contrary to my suspicions, such modalities should turn out to work pretty well, most of the money-making activity would contain profoundly antisocial effects. This, because the activity would exacerbate the current harmful trend in which ever more of the nation's ethical young brainpower is attracted into lucrative money-management and its attendant modern frictions, as distinguished from work providing much more value to others. Money management simply does not create the right examples. Early Charlie Munger is a horrible career model for the young because not enough was delivered to civilization in return for what was wrested from capitalism. And other similar career models are even worse.

Rather than encourage such models, a more constructive choice at foundations is long-term investment concentration in a few domestic corporations that are wisely admired.

Why not thus imitate Ben Franklin? After all, old Ben was very effective in doing public good. And he was a pretty good investor, too. Better his model, I think, than Bernie Cornfeld's.

Charles T. Munger is vice chairman of Berkshire Hathaway Inc., and president of the Los Angeles-based Alfred C. Munger Foundation. This article is adapted from Mr. Munger's recent speech at a meeting of the Foundation Financial Officers Group.

11/10/00 TALK OF CHARLES T. MUNGER TO BREAKFAST MEETING OF THE PHILANTHROPY ROUND TABLE

I am here today to talk about so-called “wealth effects” from rising prices for U.S. Common stocks.

I should concede, at the outset, that “wealth effects” are part of the academic discipline of economics and that I have never taken a single course in economics, nor tried to make a single dollar, ever, from foreseeing macroeconomic changes.

Nonetheless, I have concluded that most PhD economists under appraise the power of the common-stock-based “wealth effect”, under current extreme conditions.

Everyone now agrees on two things. First, spending proclivity is influenced in an upward direction when stock prices go up and in a downward direction when stock prices go down. And, second, the proclivity to spend is terribly important in macroeconomics. However, the professionals disagree about size and timing of “wealth effects”, and how they interact with other effects, including the obvious complication that increased spending tends to drive up stock prices while stock prices are concurrently driving up spending. Also, of course, rising stock prices increase corporate earnings, even when spending is static, for instance, by reducing pension cost accruals after which stock prices tend to rise more. Thus “wealth effects” involve mathematical puzzles that are not nearly so well worked out as physics theories and never can be.

The “wealth effect” from rising U.S. stock prices is particularly interesting right now for two reasons. First, there has never been an advance so extreme in the price of widespread stock holdings and, with stock prices going up so much faster than GNP, the related “wealth effect” must now be bigger than was common before. And second, what has happened in Japan over roughly the last ten years has shaken up academic economics, as it obviously should, creating strong worries about recession from “wealth effects” in reverse.

In Japan, with much financial corruption, there was an extreme rise in stock and real estate prices for a very long time, accompanied by extreme real economic growth, compared to the U.S. Then asset values crashed and the Japanese economy stalled out at a very suboptimal level. After this Japan, a modem economy that had learned all the would-be-corrective Keynesian and monetary tricks, pushed these tricks hard and long. Japan, for many years, not only ran an immense government deficit but also reduced interest rates to a place within hailing distance of zero, and kept them there. Nonetheless, the Japanese economy year after year, stays stalled, as Japanese proclivity to spend stubbornly resists all the tricks of the economists. And Japanese stock prices stay down. This Japanese experience is a disturbing example for everyone, and, if something like it happened here, would leave shrunken charitable foundations feeling clobbered by fate. Let us hope, as is probably the case, that the sad situation in Japan is caused in some large part by social psychological effects and corruption peculiar to Japan. In such case our country may be at least half as safe as is widely assumed.

Well, grant that spending proclivity, as influenced by stock prices, is now an important subject, and that the long Japanese recession is disturbing. How big are the economic influences of U.S.

stock prices? A median conclusion of the economics professionals, based mostly on data collected by the Federal Reserve System, would probably be that the “wealth effect” on spending from stock prices is not all that big. After all, even now, real household net worth, excluding pensions, is probably up by less than 100% over the last ten years and remains a pretty modest figure per household while market value of common stock is probably not yet one third of aggregate household net worth, excluding pensions. Moreover, such household wealth in common stocks is almost incredibly concentrated, and the super-rich don’t consume in proportion to their wealth. Leaving out pensions, the top 1% of households probably hold about 50% of common stock value and the bottom 80% probably hold about 4%.

Based, on such data, plus unexciting past correlation between stock prices and spending, it is easy for a professional economist to conclude, say, that, even if the average household spends incrementally at a rate of 3% of asset values in stock, consumer spending would have risen less than ½% per year over the last ten years as a consequence of the huge, unprecedented, long lasting, consistent boom is stock prices.

I believe that such economic thinking widely misses underlying reality right now. To me, such thinking looks at the wrong numbers and asks the wrong questions. Let me, the ultimate amateur, boldly try to do a little better, or at least a little differently.

For one thing, I have been told, probably correctly, that Federal Reserve data collection, due to practical obstacles, doesn’t properly take into account pension effects, including effects from 401(k) and similar plans. Assume some 63-year-old dentist has $1 million in GE stock in a private pension plan. The stock goes up in value to $2 million, and the dentist, feeling flush, trades in his very old Chevrolet and leases a new Cadillac at the give-away rate now common. To me this is an obvious large “wealth effect” in the dentist’s spending. To many economists, using Federal Reserve data, I suspect the occasion looks like profligate dissaving by the dentist. To me the dentist, and many others like him, seem to be spending a lot more because of a very strong pension-related “wealth effect”. Accordingly, I believe that present day “wealth effect” from pension plans is far from trivial and much larger than it was in the past.

For another thing, the traditional thinking of economists often does not take into account implications from the idea of “bezzle”. Let me repeat: “bezzle”, B-E-Z-Z-L-E.

The word “bezzle” is a contraction of the word “embezzle”, and it was coined by Harvard Economics Professor John Kenneth Galbraith to stand for the increase in any period of undisclosed embezzlement. Galbraith coined the “bezzle” word because he saw that undisclosed embezzlement, per dollar, had a very powerful stimulating effect on spending. After all, the embezzler spends more because he has more income, and his employer spends as before because he doesn’t know any of his assets are gone.

But Galbraith did not push his insight on. He was content to stop with being a stimulating gadfly. So I will now try to push Galbraith’s “bezzle” concept on to the next logical level. As Keynes showed, in a naive economy relying on earned income, when the seamstress sells a coat to the shoemaker for $20, the shoemaker has $20 more to spend and the seamstress has $20 less to spend. There is lalapaloose effect on aggregate spending. But when the government prints another $20 bill and uses it to buy pair of shoes, the shoemaker has another $20 and no one feels poorer. And when the shoemaker next buys a coat, - the process goes on and on, not to an infinite increase, but with what is now called the Keynesian multiplier effect, a sort of lalapaloosa effect on spending. Similarly, an undisclosed embezzlement has stronger stimulative effects per dollar on spending than a same-sized honest exchange of goods. Galbraith, being Scottish, liked the bleakness of life demonstrated by his insight. After all, the Scottish enthusiastically accepted the idea of pre-ordained, unfixable infant damnation. But the rest of us don't like Galbraith's insight. Nevertheless, we have to recognize that Galbraith was roughly right.

No doubt Galbraith saw the Keynesian-multiplier-type economic effects promised by increases in "bezzle". But he stopped there. After all, "bezzle" could not grow very big, because discovery of massive theft was nearly inevitable and sure to have reverse effects in due course. Thus, increase in private "bezzle" could not drive economies up and up, and on and on, at least for a considerable time, like government spending.

Deterred by the apparent smallness of economic effects from his insight, Galbraith did not ask the next logical question: Are there important functional equivalents of "bezzle" that are large and not promptly self-destructive? My answer to this question is yes. I will next describe only one. I will join Galbraith in coining new words, first, "febezzle", to stand for the functional equivalent of "bezzle" and, second, "febezzlement", to describe the process of creating "febezzle", and third "febezzlers" to describe persons engaged in "febezzlement". Then I will identify an important source of "febezzle" right in this room. You people, I think, have created a lot of "febezzle" through your foolish investment management practices in dealing with your large holdings of common stock.

If a foundation, or other investor, wastes 3% of assets per year in unnecessary, nonproductive investment costs in managing a strongly rising stock portfolio, it still feels richer, despite the waste, while the people getting the wasted 3%, "febezzelers" though they are, think they are virtuously earning income. The situation is functioning like undisclosed embezzlement without being self-limited. Indeed, the process can expand for a long while by feeding on itself. And all the while what looks like spending from earned income of the receivers of the wasted 3% is, in substance, spending from a disguised "wealth effect" from rising stock prices.

This room contains many people pretty well stricken by expired years --- in my generation or the one following. We tend to believe in thrift and avoiding waste as good things, a process that has worked well for us. It is paradoxical and disturbing to us that economists have long praised foolish spending as a necessary ingredient of a successful economy. Let us call foolish expenditures "foolexures". And now you holders of old values are hearing one of you own add to the case for "foolexures" the case for "febezzlements" --- the functional equivalent of embezzlements. This may not seem like a nice way to start a new day. Please be assured that I don't like "febezzlements". It is just that I think "febezzlements" are widespread and have powerful economic effects. And I also think that one should recognize reality even when one doesn't like it, indeed especially when one doesn't like it. Also, I think one should cheerfully endure paradox that one can't remove by good thinking. Even in pure mathematics they can't remove all paradox, and the rest of us should also recognize we are going to have to endure a lot of paradox, like it or not.

Let me also take this occasion to state that my previous notion of 3% of assets per annum in waste in much institutional investment management related to stocks is quite likely too low in a great many cases. A friend, after my talk to foundation financial officers, sent me a summary of a study about mutual fund investors. The study concluded that the typical mutual fund investor gained at 7.25% per year in a 15-year period when the average stock fund gained at 12.8% per year (presumably after expenses). Thus the real performance lag for investors was over 5% of assets per year in addition to whatever percentage per year the mutual funds, after expenses, lagged behind stock market averages. If this mutual fund study is roughly right, it raises huge questions about foundation wisdom in changing investment managers all the time as mutual fund investors do. If the extra lag reported in the mutual fund study exists, it is probably caused in considerable measure by folly in constant removal of assets from lagging portfolio managers being forced to liquidate stockholdings, followed by placement of removed assets with new investment managers that have high-pressure, asset-gaining hoses in their mouths and clients whose investment results will not be improved by the super-rapid injection of new funds. I am always having trouble like that caused by this new mutual fund study. I describe something realistically that looks so awful that my description is disregarded as extreme satire instead of reality. Next, new reality tops the horror of my disbelieved description by some large amount. No wonder Munger notions of reality are not widely welcome. This may be my last talk to charitable foundations.

Now toss in with "febezzlement" in investment management about $750 billion in floating, ever-growing, ever-renewing wealth from employee stock options and you get lot more common-stock-related "wealth effect", driving consumption, with some of the "wealth effect" from employee stock options being, in substance, "febezzle" effect, facilitated by the corrupt accounting practice now required by law.

Next consider that each 100-point advance in the S&P adds about $1 trillion in stock market value, and throw in some sort of Keynesian-type multiplier effect related to all "febezzlement". The related macro-economic "wealth effects", I believe, become much larger than is conventionally supposed.

And aggregate "wealth effect" from stock prices can get very large indeed. It is an unfortunate fact that great and foolish excess can come into prices of common stocks in the aggregate. They are valued partly like bonds, based on roughly rational projections of use value in producing future cash. But they are also valued partly like Rembrandt paintings, purchased mostly because their prices have gone up, so far. This situation, combined with big "wealth effects", at first up and later down, can conceivably produce much mischief. Let us try to investigate this by a "thought experiment". One of the big British pension funds once bought a lot of ancient art, planning to sell it ten years later, which it did, at a modest profit. Suppose all pension funds purchased ancient art, and only ancient art, with all their assets. Wouldn't we eventually have a terrible mess on our hands, with great and undesirable macroeconomic consequences? And wouldn't the mess be bad if only half of all pension funds were invested in ancient art? And if half of all stock value became a consequence of mania, isn't the situation much like the case wherein half of pension assets are ancient art?

My foregoing acceptance of the possibility that stock value in aggregate can become irrationally high is contrary to the hard-form "efficient market" theory that many of you once learned as gospel from your mistaken professors of yore. Your mistaken professors were too much influenced by "rational man" models of human behavior from economics and too little by "foolish man" models from psychology and real-world experience. "Crowd folly", the tendency of humans, under some circumstances, to resemble lemmings, explains much foolish thinking of brilliant men and much foolish behavior --- like investment management practices of many foundations represented here today. It is sad that today each institutional investor apparently fears most of all that its investment practices will be different from practices of the rest of the crowd.

Well, this is enough uncredentialed musing for one breakfast meeting. If I am at all right, our -present prosperity has had a stronger boost from common-stock-price-related "wealth effects", some of them disgusting, than has been the case in many former booms. If so, what was greater on the upside in the recent boom could also be greater on the downside at some time of future stock price decline. Incidentally, the economists may well conclude, eventually, that, when stock market advances and declines are regarded as long lasting, there is more downside force on optional consumption per dollar of stock market decline than there is upside force per dollar of stock market rise. I suspect that economists would believe this already if they were more willing to take assistance from the best ideas outside their own discipline, or even to look harder at Japan.

Remembering Japan, I also want to raise the possibility that there are, in the very long term, "virtue effects" in economics--- for instance that widespread corrupt accounting will eventually create bad long term consequences as a sort of obverse effect from the virtue-based boost double-entry book-keeping gave to the heyday of Venice. I suggest that when the financial scene starts reminding you of Sodom and Gomorrah, you should fear practical consequences even if you like to participate in what is going on.

Finally, I believe that implications for charitable foundations of my conclusions today, combined with conclusions in my former talk to foundation financial officers, go way beyond implications for investment techniques. If I am right, almost all U.S. foundations are unwise through failure to understand their own investment operations, related to the larger system. If so, this is not good. A rough rule in life is that an organization foolish in one way in dealing with a complex system is all too likely to be foolish in another. So the wisdom of foundation donations may need as much improvement as investment practices of foundations. And here we have two more old rules to guide us. One rule is ethical and the other is prudential.

The ethical rule is from Samuel Johnson who believed that maintenance of easily removable ignorance by a responsible office holder was treacherous malfeasance in meeting moral obligation. The prudential rule is that underlying the old Warner & Swasey advertisement for machine tools: "The man who needs a new machine tool, and hasn't bought it, is already paying for it". The Warner & Swasey rule also applies, I believe, to thinking tools. If you don't have the right thinking tools, you, and the people you seek to help, are already suffering from your easily removable ignorance.

The Great Financial Scandal of 2003
(An Account by Charles T. Munger)

The great financial scandal erupted in 2003 with the sudden, deserved disgrace of Quant Technical Corporation, always called “Quant Tech”. By this time Quant Tech was the country’s largest pure engineering firm, having become so as a consequence of the contributions of its legendary founder, engineer Albert Berzog Quant.

After 2003, people came to see the Quant Tech story as a sort of morality play, divided into two acts. Act One, the era of the great founding engineer, was seen as a golden age of sound values. Act Two, the era of the founder’s immediate successors, was seen as the age of false values with Quant Tech becoming, in the end, a sort of latter day Sodom or Gomorrah.

In fact, as this account will make clear, the change from good to evil did not occur all at once when Quant Tech’s founder died in 1982. Much good continued after 1982, and serious evil had existed for many years prior to 1982 in the financial culture in which Quant Tech had to operate.

The Quant Tech story is best understood as a classic sort of tragedy in which a single flaw is inexorably punished by remorseless Fate. The flaw was the country’s amazingly peculiar accounting treatment for employee stock options. The victims were Quant Tech and its country. The history of the Great Financial Scandal, as it actually happened, could have been written by Sophocles.

As his life ended in 1982, Albert Berzog Quant delivered to his successors and his Maker a wonderfully prosperous and useful company. The sole business of Quant Tech was designing, for fees, all over the world, a novel type of super-clean and super-efficient small power plant that improved electricity generation.

By 1982 Quant Tech had a dominant market share in its business and was earning $100 million on revenues of $1 billion. It’s costs were virtually all costs to compensate technical employees engaged in design work. Direct employee compensation cost amounted to 70% of revenues. Of this 70%, 30% was base salaries and 40% was incentive bonuses being paid out under an elaborate system designed by the founder. All compensation was paid in cash. There were no stock options because the old man had considered the accounting treatment required for stock options to be “weak, corrupt and contemptible,” and he no more wanted bad accounting in his business than he wanted bad engineering. Moreover, the old man believed in tailoring his huge incentive bonuses to precise performance standards established for individuals or small groups, instead of allowing what he considered undesirable compensation outcomes, both high and low, such as he believed occurred under other companies’ stock option plans.

Yet, even under the old man’s system, most of Quant Tech’s devoted longtime employees were becoming rich, or sure to get rich. This was happening because the employees were buying Quant Tech stock in the market, just like non-employee shareholders. The old man had always figured that people smart enough, and self-disciplined enough, to design power plants could reasonably be expected to take care of their own financial affairs in this way. He would sometimes advise an employee to buy Quant Tech stock, but more paternalistic than that he would not become.

By the time the founder died in 1982, Quant Tech was debt free and, except as a reputation-enhancer, really didn't need any shareholders' equity to run its business, no matter how fast revenues grew. However, the old man believed with Ben Franklin that "it is hard for an empty sack to stand upright," and he wanted Quant Tech to stand upright. Moreover, he loved his business and his coworkers and always wanted to have on hand large amounts of cash equivalents so as to be able to maximize work-out or work-up chances if an unexpected adversity or opportunity came along. And so in 1982 Quant Tech had on hand $500 million in cash equivalents, amounting to 50% of revenues.

Possessing a strong balance sheet and a productive culture and also holding a critical mass of expertise in a rapidly changing and rapidly growing business, Quant Tech, using the old man's methods, by 1982 was destined for 20 years ahead to maintain profits at 10% of revenues while revenues increased at 20% per year. After this 20 years, commencing in 2003, Quant Tech's profit margin would hold for a very long time at 10% while revenue growth would slow down to 4% per year. But no one at Quant Tech knew precisely when its inevitable period of slow revenue growth would begin.

The old man's dividend policy for Quant Tech was simplicity itself: He never paid a dividend. Instead, all earnings simply piled up in cash equivalents.

Every truly sophisticated investor in common stocks could see that the stock of cash-rich Quant Tech provided a splendid investment opportunity in 1982 when it sold at a mere 15 times earnings and, despite its brilliant prospects, had a market capitalization of only $1.5 billion. This low market capitalization, despite brilliant prospects, existed in 1982 because other wonderful common stocks were also then selling at 15 times earnings, or less, as a natural consequence of high interest rates then prevailing plus disappointing investment returns that had occurred over many previous years for holders of typical diversified portfolios of common stocks.

One result of Quant Tech's low market capitalization in 1982 was that it made Quant Tech's directors uneasy and dissatisfied right after the old man's death. A wiser board would then have bought in Quant Tech's stock very aggressively, using up all cash on hand and also borrowing funds to use in the same way. However, such a decision was not in accord with conventional corporate wisdom in 1982. And so the directors made a conventional decision. They recruited a new CEO and CFO from outside Quant Tech, in particular from a company that then had a conventional stock option plan for employees and also possessed a market capitalization at 20 times reported earnings, even though its balance sheet was weaker than Quant Tech's and its earnings were growing more slowly than earnings at Quant Tech. Incident to the recruitment of the new executives, it was made plain that Quant Tech's directors wanted a higher market capitalization, as soon as feasible.

The newly installed Quant Tech officers quickly realized that the company could not wisely either drive its revenues up at an annual rate higher than the rate in place or increase Quant Tech profit margin. The founder had plainly achieved an optimum in each case. Nor did the new officers dare tinker with an engineering culture that was working so well. Therefore, the new officers were attracted to employing what they called "modern financial engineering" which required prompt use of any and all arguably lawful methods for driving up reported earnings, with big, simple changes to be made first.

By a strange irony of fate, the accounting convention for stock options that had so displeased Quant Tech's founder now made the new officers' job very easy and would ultimately ruin Quant Tech's reputation. There was now an accounting convention in the United States that, provided employees were first given options, required that when easily marketable stock was issued to employees at a below-market price, the bargain element for the employees, although roughly equivalent to cash, could not count as compensation expense in determining a company's reported profits. This amazingly peculiar accounting convention had been selected by the accounting profession, over the objection of some of its wisest and most ethical members, because corporate managers, by and large, preferred that their gains from exercising options covering their employers' stock not be counted as expense in determining their employers' earnings. The accounting profession, in making its amazingly peculiar decision, had simply followed the injunction so often followed by persons quite different from prosperous, entrenched accountants. The injunction was that normally followed by insecure and powerless people: "His bread I eat, his song I sing." Fortunately, the income tax authorities did not have the same amazingly peculiar accounting idea as the accounting profession. Elementary common sense prevailed, and the bargain element in stock option exercises was treated as an obvious compensation expense, deductible in determining income for tax purposes.

Quant Tech's new officers, financially shrewd as they were, could see at a glance that , given the amazingly peculiar accounting convention and the sound income-tax rules in place, Quant Tech had a breathtakingly large opportunity to increase its reported profits by taking very simple action. The fact that so large a share of Quant Tech's annual expense was incentive bonus expense provided a "modern financial engineering" opportunity second to none.

For instance, it was mere child's play for the executives to realize that if in 1982 Quant Tech had substituted employee stock option exercise profits for all its incentive bonus expense of $400 million, while using bonus money saved, plus option prices paid, to buy back all shares issued in option exercises and keeping all else the same, the result would have been to drive Quant Tech 1982 reported earnings up by 400% to $500 million from $100 million while shares outstanding remained exactly the same! And so it seemed that the obviously correct ploy for the officers was to start substituting employee stock option exercise profits for incentive bonuses. Why should a group of numerate engineers care whether their bonuses were in cash of virtually perfect equivalents of cash? Arranging such substitutions, on any schedule desired, seemed like no difficult chore.

However, it was also mere child's play for the new officers to realize that a certain amount of caution and restraint would be desirable in pushing their new ploy. Obviously, if they pushed their new ploy too hard in any single year there might be rebellion from Quant Tech's accountants or undesirable hostility from other sources. This, in turn, would risk killing a goose with a vast ability to deliver golden eggs, at least to the officers. After all, it was quite clear that their ploy would be increasing reported earnings only by adding to real earnings an element of phony earnings – phony in the sense that Quant Tech would enjoy no true favorable economic effect (except temporary fraud-type effect similar to that from overcounting closing inventory) from that part of reported earnings increases attributable to use of the ploy. The new CEO privately called the desirable, cautious approach "wisely restrained falsehood".

Plainly, the new officers saw, it would be prudent to shift bonus payments to employee stock option exercise profits in only a moderate amount per year over many years ahead. They privately called the prudent plan they adopted their "dollop by dollop system" which they believed had four obvious advantages:

> First, a moderate dollop of phony earnings in any single year would be less likely to be noticed than a large dollop.
>
> Second, the large long-term effect from accumulating many moderate dollops of phony earnings over the years would also tend to be obscured in the "dollop by dollop system." As the CFO pithily and privately said: "If we mix only a moderate minority share of turds with the raisins each year, probably no one will recognize what will ultimately become a very large collection of turds."
>
> Third, the outside accountants, once they had blessed a few financial statements containing earnings increases only a minority share of which were phony, would probably find it unendurably embarrassing not to bless new financial statements containing only the same phony proportion of reported earnings increase.
>
> Fourth, the "dollop by dollop system" would tend to prevent disgrace, or something more seriously harmful, for Quant Tech's officers. With virtually all corporations except Quant Tech having ever-more-liberal stock option plans, the officers could always explain that a moderate dollop of shift toward compensation in option-exercise form was needed to help attract or retain employees. Indeed, given corporate culture and stock market enthusiasm likely to exist as a consequence of the strange accounting convention for stock options, this claim would often be true.

With these four advantages, the "dollop by dollop system" seemed so clearly desirable that it only remained for Quant Tech's officers to decide how big to make their annual dollops of phony earnings. This decision, too, turned out to be easy. The officers first decided upon three reasonable conditions they wanted satisfied:

> First, they wanted to be able to continue their "dollop by dollop system" without major discontinuities for 20 years.
>
> Second, they wanted Quant Tech's reported earnings to go up by roughly the same percentage each year throughout the whole 20 years because they believed that financial analysts, representing institutional investors, would value Quant Tech's stock higher if reported annual earnings growth never significantly varied.
>
> Third, to protect credibility for reported earnings, they never wanted to strain credulity of investors by reporting, even in their 20th year, that Quant Tech was earning more than 40% of revenues from designing power plants.

With these requirements, the math was easy, given the officers assumption that Quant Tech's non-phony earnings and revenues were both going to grow at 20% per year for 20 years. The officers quickly decided to use their "dollop by dollop system" to make Quant Tech's reported earnings increase by 28% per year instead of the 20% that would have been reported by the founder.

And so the great scheme of "modern financial engineering" went forward toward tragedy at Quant Tech. And few disreputable schemes of man have ever worked better in achieving what was attempted. Quant Tech's reported earnings, certified by its accountants, increased regularly at 28% per year. No one criticized Quant Tech's financial reporting except a few people widely regarded as impractical, overly theoretical, misanthropic cranks. It turned out that the founder's policy of never paying dividends, which was continued, greatly helped in preserving credibility for Quant Tech's reports that its earnings were rising steadily at 28% per year. With cash equivalents on hand so remarkably high, the Pavlovian mere-association effects that so often impair reality recognition served well to prevent detection of the phony element in reported earnings.

It was therefore natural, after the "dollop by dollop system" had been in place for a few years, for Quant Tech's officers to yearn to have Quant Tech's reported earnings per share keep going up at 28% per year while cash equivalents grew much faster than they were then growing. This turned out to be a snap. By this time, Quant Tech's stock was selling at a huge multiple of reported earnings, and the officers simply started causing some incremental stock-option exercises that were not matched either by reductions in cash bonuses paid or by repurchases of Quant Tech's stock. This change, the officers easily recognized, was a very helpful revision of their original plan. Not only was detection of the phony element in reported earnings made much more difficult as cash accumulation greatly accelerated, but also a significant amount of Ponzi-scheme or chain-letter effect was being introduced into Quant Tech, with real benefits for present shareholders, including the officers.

At this time the officers also fixed another flaw in their original plan. They saw that as Quant Tech's reported earnings, containing an increasing phony element, kept rising at 28%, Quant Tech's income taxes as a percentage of reported pre-tax earnings kept going lower and lower. This plainly increased chances for causing undesired questions and criticism. This problem was soon eliminated. Many power plants in foreign nations were built and owned by governments, and it proved easy to get some foreign governments to raise Quant Tech's design fees, provided that in each case slightly more than the fee increase was paid back in additional income taxes to the foreign government concerned.

Finally, for 2002, Quant Tech reported $16 billion in earnings on $47 billion of revenues that now included a lot more revenue from interest on cash equivalents than would have been present without net issuances of new stock over the years. Cash equivalents on hand now amounted to an astounding $85 billion, and somehow it didn't seem impossible to most investors that a company virtually drowning in so much cash could be earning the $16 billion it was reporting. The market capitalization of Quant Tech at its peak early in 2003 became $1.4 trillion, about 90 times earnings reported for 2002.

However, all man's desired geometric progressions, if a high rate of growth is chosen, at last come to grief on a finite earth. And the social system for man on earth is fair enough, eventually, that almost all massive cheating ends in disgrace. And in 2003 Quant Tech failed in both ways.

By 2003, Quant Tech's real earning power was growing at only 4% per year after sales growth had slowed to 4%. There was now no way for Quant Tech to escape causing a big disappointment for its shareholders, now largely consisting of institutional investors. This disappointment triggered a shocking decline in the price of Quant Tech stock which went down suddenly by 50%. This price decline, in turn, triggered a careful examination of Quant Tech's financial reporting practices which, at long last, convinced nearly everyone that a very large majority of Quant Tech's reported earnings had long been phony earnings and that massive and deliberate misreporting had gone on for a great many years. This triggered even more price decline for Quant Tech stock until in mid-2003 the market capitalization of Quant Tech was only $140 billion, down 90% from its peak only six months earlier.

A quick 90% decline in the price of the stock of such an important company, that was previously so widely owned and admired, caused immense human suffering, considering the $1.3 trillion in market value that had disappeared. And naturally, with Quant Tech's deserved disgrace, the public and political reaction included intense hatred and revulsion directed at Quant Tech, even though its admirable engineers were still designing the nation's best power plants.

Moreover, the hatred and revulsion did not stop with Quant Tech. It soon spread to other corporations, some of which plainly had undesirable financial cultures different from Quant Tech's only in degree. The public and political hatred, like the behavior that had caused it, soon went to gross excess and fed upon itself. Financial misery spread far beyond investors into a serious recession like that of Japan in the 1990s following the long period of false Japanese accounting.

There was huge public antipathy to professions following the Great Scandal. The accounting profession, of course, got the most blame. The rule-making body for accountants had long borne the acronym "F.A.S.B." And now nearly everyone said this stood for "Financial Accounts Still Bogus".

Economics professors likewise drew much criticism for failing to blow the whistle on false accounting and for not sufficiently warning about eventual bad macroeconomic effects of widespread false accounting. So great was the disappointment with conventional economists that Harvard's John Kenneth Galbraith received the Nobel Prize in economics. After all, he had once predicted that massive, undetected corporate embezzlement would have a wonderfully stimulating effect on the economy. And people could now see that something very close to what Galbraith had predicted had actually happened in the years preceding 2003 and had thereafter helped create a big, reactive recession.

With Congress and the S.E.C. so heavily peopled by lawyers, and with lawyers having been so heavily involved in drafting financial disclosure documents now seen as bogus, there was a new "lawyer" joke every week. One such was: "The butcher says 'the reputation of lawyers has fallen dramatically', and the check-out clerk replies: "How do you fall dramatically off a pancake?'"

But the hostility to established professions did not stop with accountants, economists and lawyers. There were many adverse "rub-off" effects on reputations of professionals that had always performed well, like engineers who did not understand the financial fraud that their country had made not a permissible option but a legal requirement.

In the end, much that was good about the country, and needed for its future felicity, was widely and unwisely hated.

At this point, action came from a Higher Realm. God himself, who reviews all, changed His decision schedule to bring to the fore the sad case of the Great Financial Scandal of 2003. He called in his chief detective and said, "Smith, bring in for harsh but fair judgment the most depraved of those responsible for this horrible outcome."

But when Smith brought in a group of security analysts who had long and uncritically touted the stock of Quant Tech, the Great Judge was displeased. "Smith," he said, "I can't come down hardest on low-level cognitive error, much of it subconsciously caused by the standard incentive systems of the world."

Next, Smith brought in a group of S.E.C. Commissioners and powerful politicians. "No, no," said the Great Judge, "These people operate in a virtual maelstrom of regrettable forces and can't reasonably be expected to meet the behavioral standard you seek to impose."

Now the chief detective thought he had gotten the point. He next brought in the corporate officers who had practiced their version of "modern financial engineering" at Quant Tech. "You are getting close," said the Great Judge, "but I told you to bring in the most depraved. These officers will, of course, get strong punishment for their massive fraud and disgusting stewardship of the great engineer's legacy. But I want you to bring in the miscreants who will soon be in the lowest circle in Hell, the ones who so easily could have prevented all this calamity."

At last the chief detective truly understood. He remembered that the lowest circle of Hell was reserved for traitors. And so he now brought in from Purgatory a group of elderly persons who, in their days on earth, had been prominent partners in major accounting firms. "Here are your traitors," said the chief detective. "They adopted the false accounting convention for employee stock options. They occupied high positions in one of the noblest professions, which, like Yours, helps make society work right by laying down the right rules. They were very smart and securely placed, and it is inexcusable that they deliberately caused all this lying and cheating that was so obviously predictable. They well knew what they were doing was disastrously wrong, yet they did it anyway. Owing to press of business in Your Judicial System, you made a mistake at first in punishing them so lightly. But now you can send them into the lowest circle in Hell."

Startled by the vehemence and presumption, the Great Judge paused. Then He quietly said: "Well done, my good and faithful servant."

This account is not an implied prediction about 2003. It is a work of fiction. Except in the case of Professor Galbraith, any resemblances to real persons or companies is accidental. It was written in an attempt to focus possibly useful attention on certain modern behaviors and belief systems.

Munger Goes Mental

Charlie Munger, the famed right-hand man of Warren Buffett, gave a brilliant speech last October at the University of California, Santa Barbara. With Munger's permission, Whitney Tilson is publishing a transcript for the first time -- a Motley Fool exclusive! -- and shares the highlights in this column.

By Whitney Tilson
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Berkshire Hathaway's (NYSE: BRK.A)(NYSE: BRK.B) Warren Buffett and Charlie Munger are undoubtedly the greatest investment duo ever, so I think any sensible investor should try to learn as much as possible about these two men and how they achieved their success. In the case of Buffett, it's not hard -- there are many books about him, he's published lengthy annual letters for decades (you can read the last 27 of them for free on Berkshire's website), and he gives speeches and makes public appearances regularly. But Munger is more private; there are only two books about him, he is a far less prolific writer, and rarely gives speeches.

Thus, my heart skipped a beat when a friend gave me a recording of a speech Munger gave to the economics department at the University of California, Santa Barbara last Oct. 3. It's 85 minutes long and entitled, "Academic Economics: Strengths and Faults After Considering Interdisciplinary Needs."

With that kind of title, it sounds like a real snoozer, eh? But it's not. In this speech, Munger applies his famous mental models approach to critiquing how economics is taught and practiced, and I think the lessons he teaches are profound -- both for investors as well as anyone who seeks to be a better, clearer thinker.

I transcribed the speech for my own benefit, but after making such an effort (it took forever, as it's 21 single-spaced pages), I thought that others might be interested in Munger's wisdom, so I sent him a copy and asked if I could publish it. He asked me not to until he'd had a chance to review it and make some edits. He has now done so, so I'm delighted to share it with you: Click here to read it.

In this column, I will share some of the highlights of the speech.

Berkshire's success
Munger started his speech by highlighting his credentials to talk about economics -- namely the extraordinary success of Berkshire Hathaway over the years he and Buffett have been running it (Buffett ran it for a few years before Munger joined him):

> When Warren took over Berkshire, the market capitalization was about ten million dollars. And forty something years later, there are not many more shares outstanding now than there were then, and the market capitalization is about a hundred billion dollars, ten thousand for one. And since that has happened, year

> after year, in kind of a grind-ahead fashion, with very few failures, it eventually drew some attention, indicating that maybe Warren and I knew something useful in microeconomics.

Efficient market theory
Buffett and Munger have always heaped scorn upon the academics who cling to the efficient market theory, unable to distinguish between an obvious truth -- that the market is mostly efficient most of the time -- and obvious nonsense -- that the market is always perfectly efficient all of the time:

> Berkshire's whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you'd have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks. Yet…many people still believe it. But Berkshire never paid any attention to it.

Multidisciplinary education and "man with a hammer syndrome"
Over the years, Munger has always preached the importance of learning -- and then using -- all of the big disciplines, such as math, science, psychology, etc. To him, this just came naturally:

> For some odd reason, I had an early and extreme multidisciplinary cast of mind. I couldn't stand reaching for a small idea in my own discipline when there was a big idea right over the fence in somebody else's discipline. So I just grabbed in all directions for the big ideas that would really work. Nobody taught me to do that; I was just born with that yen.

If one doesn't embrace all multidisciplinary thinking, Munger argues, then one is likely to fall into the trap of:

> "man with a hammer syndrome." And that's taken from the folk saying: To the man with only a hammer, every problem looks pretty much like a nail. And that works marvelously to gum up all professions, and all departments of academia, and indeed most practical life. The only antidote for being an absolute klutz due to the presence of a man with a hammer syndrome is to have a full kit of tools. You don't have just a hammer. You've got all the tools. And you've got to have one more trick. You've got to use those tools checklist-style, because you'll miss a lot if you just hope that the right tool is going to pop up unaided whenever you need it.

Problems to solve
During his speech, to illustrate the types of questions his ways of thinking will help answer, Munger posed a number of problems to solve:

1. There's an activity in America, with one-on-one contests, and a national championship. The same person won the championship on two occasions about 65 years apart. Name the activity.

2. You have studied supply and demand curves. You have learned that when you raise the price, ordinarily the volume you can sell goes down, and when you reduce the price, the volume you can sell goes up. Now tell me several instances when, if you want the physical volume to go up, the correct answer is to increase the price?

3. You own a small casino in Las Vegas. It has 50 standard slot machines. Identical in appearance, they're identical in the function. They have exactly the same payout ratios. The things that cause the payouts are exactly the same. They occur in the same percentages. But there's one machine in this group of slot machines that, no matter where you put it among the 50, in fairly short order, when you go to the machines at the end of the day, there will be 25% more winnings from this one machine than from any other machine. What is different about that heavy-winning machine?

For the answers to these questions, you'll have to read the transcript.

Second- and third-order consequences and free trade

Munger gave a number of examples of how often people only look at immediate consequences of certain actions and fail to consider second- and third-order consequences. For example:

> Everybody in economics understands that comparative advantage is a big deal, when one considers first-order advantages in trade from the Ricardo effect. But suppose you've got a very talented ethnic group, like the Chinese, and they're very poor and backward, and you're an advanced nation, and you create free trade with China, and it goes on for a long time.
>
> Now let's follow and second- and third-order consequences: You are more prosperous than you would have been if you hadn't traded with China in terms of average well-being in the U.S., right? Ricardo proved it. But which nation is going to be growing faster in economic terms? It's obviously China. They're absorbing all the modern technology of the world through this great facilitator in free trade and, like the Asian Tigers have proved, they will get ahead fast. Look at Hong Kong. Look at Taiwan. Look at early Japan. So, you start in a place where you've got a weak nation of backward peasants, a billion and a quarter of them, and in the end they're going to be a much bigger, stronger nation than you are, maybe even having more and better atomic bombs. Well, Ricardo did not prove that that's a wonderful outcome for the former leading nation. He didn't try to determine second-order and higher-order effects.
>
> If you try and talk like this to an economics professor, and I've done this three times, they shrink in horror and offense because they don't like this kind of talk. It really gums up this nice discipline of theirs, which is so much simpler when you ignore second- and third-order consequences.

Open-mindedness
How many people do you know who actively seek out opinions contrary to their own? Munger certainly does. For example, he said:

> …take Paul Krugman and read his essays, you will be impressed by his fluency. I can't stand his politics; I'm on the other side. [Krugman constantly bashes Republicans and the Bush administration on the Op Ed page of *The New York Times*.] But I love this man's essays. I think Paul Krugman is one of the best essayists alive.

Destroying your own best-loved ideas
Munger believes that it's absolutely critical not to "cling to failed ideas." You must become good, he argues, "at destroying your own best-loved and hardest-won ideas. If you can get really good at destroying your own wrong ideas, that is a great gift."

How important this is when it comes to investing! Not long ago, I publicly recommended a stock, yet a few weeks later, based on new information, I came to the conclusion that it was no longer a good idea. A natural tendency would have been to hold on to the stock and refuse to admit to my readers that I might have been mistaken. Making it even harder to sell was the fact that the stock had declined - why not wait until it rebounded to the price at which I had bought it, right? (This is a deadly error, as I've discussed in previous columns.) Fortunately, I did sell, refusing to "cling to failed ideas."

Chutzpah
I'll conclude this column with a bit of classic Munger humor: While Buffett bends over backward to appear humble, Munger's the opposite -- he jokes about his big ego. In his opening remarks, he said:

> As I talk about strengths and weaknesses in academic economics, one interesting fact you are entitled to know is that I never took a course in economics. And with this striking lack of credentials, you may wonder why I have the chutzpah to be up here giving this talk. The answer is I have a black belt in chutzpah. I was born with it.

Contributor Whitney Tilson is a longtime guest columnist for The Motley Fool. He owned shares of Berkshire Hathaway at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback. To read his previous columns for The Motley Fool and other writings, visit www.tilsonfunds.com. The Motley Fool is investors writing for investors.

"Academic Economics: Strengths and Faults After Considering Interdisciplinary Needs"

Herb Kay Undergraduate Lecture
University of California, Santa Barbara
Economics Department

By Charles T. Munger

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Introduction by Rajnish Mehra

Music. Good afternoon. I am Rajnish Mehra, chair of the Economics Department [www.econ.ucsb.edu/~mehra/], and on behalf of the entire department it is my pleasure to welcome you to our annual Herb Kay Undergraduate Lecture, underwritten by the generosity of Herb Kay. Herb was on our faculty in the '60s and has remained a friend and benefactor of the Department. We are very fortunate to have Herb here in the audience today. So please join me in giving him a very warm welcome. (Applause).

Mr. Munger's achievements are very great. They are too numerous for me to detail here. He attended Caltech and Harvard, and in addition to being Vice Chair at Berkshire Hathaway, he's the chair of a major legal newspaper corporation and also Wesco Financial Corporation. He's the President of the Alfred C. Munger Foundation, a philanthropic foundation named after his father. He's on the Forbes 400 list – and what makes that achievement remarkable is that he got there the old fashioned way: He earned it. (Laughter).

He's – after Warren Buffett – the largest shareholder in Berkshire Hathaway. And as you can see he's a fan of Coke, both of the stock and the drink. (Laughter).

It's a personal privilege to introduce Mr. Munger to the UCSB community. I have long been a fan of his Mungerisms. And to quote a particular favorite one that has served me in good stead: Never wrestle with a pig, for if you do, you will both get dirty, but the pig will enjoy it. (Laughter).

Ladies and gentlemen, please join me in welcoming Charles Munger. He will speak to us today on Interdisciplinary Wisdom Involving Economics.

Munger's Opening Remarks:

I've outlined some remarks in a rough way, and after I'm finished talking from that outline, I'll take questions as long as anybody can endure listening, until they drag me away to wherever else I'm supposed to go.

As you might guess, I agreed to do this because the subject of getting the soft sciences so they talked better to each other has been one that has interested me for decades. And, of course, economics is in many respects the queen of the soft sciences. It's expected to be better than the rest. It's my view that economics is better at the multi-disciplinary stuff than the rest of the soft science. And it's also my view that it's still lousy, and I'd like to discuss this failure in this talk.

As I talk about strengths and weaknesses in academic economics, one interesting fact you are entitled to know is that I never took a course in economics. And with this striking lack of credentials, you may wonder why I have the chutzpah to be up here giving this talk. The answer is I have a black belt in chutzpah. I was born with it. Some people, like some of the women I know, have a black belt in spending. They were born with that. But what they gave me was a black belt in chutzpah.

But I come from two peculiar strands of experience that may have given me some useful economic insights. One is Berkshire Hathaway and the other is my personal educational history.

Berkshire, of course, has finally gotten interesting. When Warren took over Berkshire, the market capitalization was about ten million dollars. And forty something years later, there are not many more shares outstanding now than there were then, and the market capitalization is about a hundred billion dollars, ten thousand for one. And since that has happened, year after year, in kind of a grind-ahead fashion, with very few failures, it eventually drew some attention, indicating that maybe Warren and I knew something useful in microeconomics.

Non-use of Efficient Market Theory at Berkshire

For a long time there was a Nobel Prize-winning economist who explained Berkshire Hathaway's success as follows:

First, he said Berkshire beat the market in common stock investing through one sigma of luck, because nobody could beat the market except by luck. This hard-form version of efficient market theory was taught in most schools of economics at the time. People were taught that nobody could beat the market. Next the professor went to two sigmas, and three sigmas, and four sigmas, and when he finally got to six sigmas of luck, people were laughing so hard he stopped doing it.

Then he reversed the explanation 180 degrees. He said, "No, it was still six sigmas, but is was six sigmas of skill." Well this very sad history demonstrates the truth of Benjamin Franklin's observation in Poor Richard's Almanac. If you would persuade, appeal to interest and not to reason. The man changed his view when his incentives made him change it, and not before.

I watched the same thing happen at the Jules Stein Eye Institute at UCLA. I asked at one point, why are you treating cataracts only with a totally obsolete cataract operation? And the man said to me, "Charlie, it's such a wonderful operation to teach." (Laughter). When he stopped using that operation, it was because almost all the patients had voted with their feet. Again, appeal to interest and not to reason if you want to change conclusions.

Well, Berkshire's whole record has been achieved without paying one ounce of attention to the efficient market theory in its hard form. And not one ounce of attention to the descendants of that idea, which came out of academic economics and went into corporate finance and morphed into such obscenities as the capital asset pricing model, which we also paid no attention to. I think you'd have to believe in the tooth fairy to believe that you could easily outperform the market by seven-percentage points per annum just by investing in high volatility stocks.

Yet, believe it or not, like the Jules Stein doctor, people once believed this stuff. And the belief was rewarded. And it spread. And many people still believe it. But Berkshire never paid any attention to it. And now I think the world is coming our way and the idea of perfection in all market outcomes is going the way of the DoDo.

It was always clear to me that the stock market couldn't be perfectly efficient, because as a teenager, I'd been to the racetrack in Omaha where they had the parimutuel system. And it was quite obvious to me that if the house takes the croupier's take, was 17%, some people consistently lost a lot less then 17% of all their bets, and other people consistently lost more than 17% of all their bets. So the parimutuel system in Omaha had no perfect efficiency. And so I didn't accept the argument that the stock market was always perfectly efficient in creating rational prices.

Indeed, there's been some documented cases since, of people getting so good at understanding horses and odds, that they actually are able to beat the house in off-track betting. There aren't many people who can do that, but there are a few people in America who can.

Personal Multidisciplinary Education

Next, my personal education history is interesting because its deficiencies and my peculiarities eventually created advantages. For some odd reason, I had an early and extreme multidisciplinary cast of mind. I couldn't stand reaching for a small idea in my own discipline when there was a big idea right over the fence in somebody else's discipline. So I just grabbed in all directions for the big ideas that would really work. Nobody taught me to do that; I was just born with that yen. I also was born with a huge craving for synthesis. And when it didn't come easily, which was often, I would rag the problem, and then when I failed I would put it aside and I'd come back to it and rag it again. It took me 20 years to figure out how and why the Reverend Moon's conversion methods worked. But the psychology departments haven't figured it out yet, so I'm ahead of them.

But anyway, I have this tendency to want to rag the problems. Because WW II caught me. I drifted into some physics, and the Air Corps sent me to Caltech where I did a little more physics as part of being made into a meteorologist. And there, at a very young age, I absorbed what I call the fundamental full attribution ethos of hard science. And that was enormously useful to me. Let me explain that ethos.

Under this ethos, you've got to know all the big ideas in all the disciplines less fundamental than your own. You can never make any explanation, which can be made in a more fundamental way, in any other way than the most fundamental way. And you always take with full attribution to the most fundamental ideas that you are required to use. When you're using physics, you say you're using physics. When you're using biology, you say you're using biology. And so on and so on. I could early see that that ethos would act as a fine organizing system for my thought. And I strongly suspected that it would work really well in the soft sciences as well as the hard sciences, so I just grabbed it and used it all through my life in soft science as well as hard science. That was a very lucky idea for me.

Let me explain how extreme that ethos is in hard science. There is a constant, one of the fundamental constants in physics, known as Boltzmann's constant. You probably all know it very well. And the interesting thing about Boltzmann's constant is that Boltzmann didn't discover it. So why is Boltzmann's constant now named for Boltzmann? Well, the answer was that Boltzmann derived that constant from basic physics in a more fundamental way than the poor forgotten fellow who found the constant in the first place in some less fundamental way. The ethos of hard science is so strong in favor of reductionism to the more fundamental body of knowledge that you can wash the discoverer right out of history when somebody else handles his discovery in a more fundamental way. I think that is correct. I think Boltzmann's constant should be named for Boltzmann.

At any rate, in my history and Berkshire's history Berkshire went on and on into considerable economic success, while ignoring the hard form efficient markets doctrine once very popular in academic economics and ignoring the descendants of that doctrine in corporate finance, where the results became even sillier than they were in the economics. This naturally encouraged me.

Finally, with my peculiar history, I'm also bold enough to be here today, because at least when I was young I wasn't a total klutz. For one year at the Harvard Law School, I was ranked second in my group of about a thousand, and I always figured that, while there were always a lot of people much smarter than I was, I didn't have to hang back totally in the thinking game.

The Obvious Strengths of Academic Economics

Let me begin by discussing the obvious strengths of academic economics. The first obvious strength, and this is true of lot of places that get repute, is that it was in the right place at the right time. Two hundred years ago, aided by the growth of technology and the growth of other developments in the civilization, the real output per capita of the civilized world started going up at about 2% per annum, compounded. And before that, for the previous thousands of years, it had gone up at a rate that hovered just a hair's breadth above zero. And, of course, economics grew up amid this huge success. Partly it helped the success, and partly it explained it. So, naturally, academic economics grew. And lately with the collapse of all the communist economies, as the free market economies or partially free market economies flourished, that added to the reputation of economics. Economics has been a very favorable place to be if you're in academia.

Economics was always more multidisciplinary than the rest of soft science. It just reached out and grabbed things as it needed to. And that tendency to just grab whatever you need from the rest of knowledge if you're an economist has reached a fairly high point in Mankiw's [post.economics.harvard.edu/faculty/mankiw/mankiw.html] new textbook [Principles of Economics, www.amazon.com/exec/obidos/ASIN/0324168624/tilsoncapitalpar]. I checked out that textbook. I must have been one of the few businessmen in America that bought it immediately when it came out because it had gotten such a big advance. I wanted to figure out what the guy was doing where he could get an advance that great. So this is how I happened to riffle through Mankiw's freshman textbook. And there I found laid out as principles of economics: opportunity cost is a superpower, to be used by all people who have any hope of getting the right answer. Also, incentives are superpowers.

And lastly, the tragedy of the commons model, popularized by UCSB's Garrett Hardin [www.es.ucsb.edu/faculty/hardin.php; died 9/03]. Hardin caused the delightful introduction into economics – alongside Smith's beneficent invisible hand – of Hardin's wicked evildoing invisible foot. Well, I thought that the Hardin model made economics more complete, and I knew when Hardin introduced me to his model, the Tragedy of the Commons [www.garretthardinsociety.org/articles/art_tragedy_of_the_commons.html], that it would be in the economics textbooks eventually. And, low and behold, it finally made it about 20 years later. And it's right for Mankiw to reach out into other disciplines and grab Hardin's model and anything else that works well.

Another thing that helped economics is that from the beginning it attracted the best brains in soft science. Its denizens also interacted more with the practical world than was at all common in soft science and the rest of academia, and that resulted in very creditable outcomes like the three cabinet appointments of economics PhD George Schultz and the cabinet appointment of Larry Summers. So this has been a very favored part of academia.

Also, economics early on attracted some of the best writers of language in the history of the earth. You start out with Adam Smith. Adam Smith was so good a thinker, and so good a writer, that in his own time, Emmanuel Kant, then the greatest intellectual in Germany, simply announced that there was nobody in Germany to equal Adam Smith. Well Voltaire, being an even more pithy speaker than Kant, which wouldn't be that hard, immediately said, "Oh well, France doesn't have anybody who can even be compared to Adam Smith." So economics started with some very great men and great writers.

And then there have been later great writers like John Maynard Keynes, whom I quote all the time, and who has added a great amount of illumination to my life. And finally, even in the present era, if you take Paul Krugman [www.nytimes.com/top/opinion/editorialsandoped/oped/columnists/paulkrugman/index.html] and read his essays, you will be impressed by his fluency. I can't stand his politics; I'm on the other side. But I love this man's essays. I think Paul Krugman is one of the best essayists alive. And so economics has constantly attracted these fabulous writers. And they are so good that they have this enormous influence far outside their economic discipline, and that's very uncommon in other academic departments.

Okay, now it's time to extend criticism, instead of praise. We've recognized that economics is better than other soft-science academic departments in many ways. And one of the glories of civilization. Now it's only fair that we outline a few things that are wrong with academic economics.

What's Wrong with Economics

1) Fatal Unconnectedness, Leading To "Man With A Hammer Syndrome," Often Causing Overweighing What Can Be Counted

I think I've got eight, no nine objections, some being logical subdivisions of a big general objection. The big general objection to economics was the one early described by Alfred North Whitehead when he spoke of the fatal unconnectedness of academic disciplines, wherein each professor didn't even know the models of the other disciplines, much less try to synthesize those disciplines with his own.

I think there's a modern name for this approach that Whitehead didn't like, and that name is bonkers. This is a perfectly crazy way to behave. Yet economics, like much else in academia, is too insular.

The nature of this failure is that it creates what I always call, "man with a hammer syndrome." And that's taken from the folk saying: To the man with only a hammer, every problem looks pretty much like a nail. And that works marvelously to gum up all professions, and all departments of academia, and indeed most practical life. The only antidote for being an absolute klutz due to the presence of a man with a hammer syndrome is to have a full kit of tools. You don't have just a hammer. You've got all the tools. And you've got to have one more trick. You've got to use those tools checklist-style, because you'll miss a lot if you just hope that the right tool is going to pop up unaided whenever you need it. But if you've got a full list of tools, and go through them in your mind, checklist-style, you will find a lot of answers that you won't find any other way. So limiting this big general objection that so disturbed Alfred North Whitehead is very important, and there are mental tricks that help do the job.

Overweighing what can be counted

A special version of this "man with a hammer syndrome" is terrible, not only in economics but practically everywhere else, including business. It's really terrible in business. You've got a complex system and it spews out a lot of wonderful numbers that enable you to measure some factors. But there are other factors that are terribly important, [yet] there's no precise numbering you can put to these factors. You know they're important, but you don't have the numbers. Well practically everybody (1) overweighs the stuff that can be numbered, because it yields to the statistical techniques they're taught in academia, and (2) doesn't mix in the hard-to-measure stuff that may be more important. That is a mistake I've tried all my life to avoid, and I have no regrets for having done that.

The late, great, Thomas Hunt Morgan [www.nobel.se/medicine/articles/lewis/], who was one of greatest biologists who ever lived, when he got to Caltech, had a very interesting, extreme way of avoiding some mistakes from overcounting what could be measured, and undercounting what couldn't. At that time there were no computers and the computer substitute then available to science and engineering was the Frieden calculator, and Caltech was full of Frieden calculators. And Thomas Hunt Morgan banned the Frieden calculator from the biology department. And when they said, "What the hell are you doing, Mr. Morgan?," He said, "Well, I am like a guy who is prospecting for gold along the banks of the Sacramento River in 1849. With a little intelligence, I can reach down and pick up big nuggets of gold. And as long as I can do that, I'm not going to let any people in my department waste scarce resources in placer mining." And that's the way Thomas Hunt Morgan got through life.

I've adopted the same technique, and here I am in my 80th year. I haven't had to do any placer mining yet. And it begins to look like I'm going to get all the way through, as I'd always hoped, without doing any of that damned placer mining. Of course if I were a physician, particularly an academic physician, I'd have to do the statistics, do the placer mining. But it's amazing what you can do in life without the placer mining if you've got a few good mental tricks and just keep ragging the problems the way Thomas Hunt Morgan did.

2) Failure To Follow The Fundamental Full Attribution Ethos of Hard Science

What's wrong with the way Mankiw does economics is that he grabs from other disciplines without attribution. He doesn't label the grabbed items as physics or biology or psychology, or game theory, or whatever they really are, fully attributing the concept to the basic knowledge from which it came. If you don't do that, it's like running a business with a sloppy filing system. It reduces your power to be as good as you can be. Now Mankiw is so smart he does pretty well even when his technique is imperfect. He got the largest advance any textbook writer ever got.

But, nonetheless he'd be better if he had absorbed this hard science ethos that I say has been so helpful to me.

I have names for Mankiw's approach, grabbing whatever you need without attribution. Sometimes I call it "take what you wish," and sometimes I call it "Kipplingism." And when I call it Kipplingism, I'm reminding you of Kippling's stanza of poetry, which went something like this: "When Homer smote his blooming lyre, he'd heard men sing by land and sea, and what he thought he might require, he went and took, the same as me." Well that's the way Mankiw does it. He just grabs. This is much better than not grabbing. But it is much worse than grabbing with full attribution and full discipline, using all knowledge plus extreme reductionism where feasible.

3) Physics Envy

The third weakness that I find in economics is what I call physics envy. And of course, that term has been borrowed from penis envy as described by one of the world's great idiots, Sigmund Freud. But he was very popular in his time, and the concept got a wide vogue.

Washington Post case study

One of the worst examples of what physics envy did to economics was cause adaptation and hard-form efficient market theory. And then when you logically derived consequences from this wrong theory, you would get conclusions such as: it can never be correct for any corporation to buy its own stock. Because the price by definition is totally efficient, there could never be any advantage. QED. And they taught this theory to some partner at McKinsey when he was at some school of business that had adopted this crazy line of reasoning from economics, and the partner became a paid consultant for the Washington Post. And Washington Post stock was selling at a fifth of what an orangutan could figure was the plain value per share by just counting up the values and dividing. But he so believed what he'd been taught in graduate school that he told the Washington Post they shouldn't buy their own stock. Well, fortunately, they put Warren Buffett on the Board, and he convinced them to buy back more than half of the outstanding stock, which enriched the remaining shareholders by much more than a billion dollars. So, there was at least one instance of a place that quickly killed a wrong academic theory.

It's my view that economics could avoid a lot of this trouble that comes from physics envy. I want economics to pick up the basic ethos of hard science, the full attribution habit, but not the craving for an unattainable precision that comes from physics envy. The sort of precise reliable formula that includes Boltzmann's constant is not going to happen, by and large, in economics. Economics involves too complex a system. And the craving for that physics-style precision does little but get you in terrible trouble, like the poor fool from McKinsey.

Einstein and Sharon Stone

I think that economists would be way better off if they paid more attention to Einstein and Sharon Stone. Well, Einstein is easy because Einstein is famous for saying, "Everything should be made as simple as possible, but no more simple." Now, the saying is a tautology, but it's very useful, and some economist – it may have been Herb Stein – had a similar tautological saying that I dearly love: "If a thing can't go on forever, it will eventually stop."

Sharon Stone contributed to the subject because someone once asked her if she was bothered by penis envy. And she said, "absolutely not, I have more trouble than I can handle with what I've got." (Laughter).

When I talk about this false precision, this great hope for reliable, precise formulas, I am reminded of Arthur Laffer, who's in my political party, and who is one of the all-time horses' asses when it comes to doing economics. His trouble is his craving for false precision, which is not an adult way of dealing with his subject matter.

The situation of people like Laffer reminds me of a rustic legislator – and this really happened in America. I don't invent these stories. Reality is always more ridiculous than what I'm going to tell you. At any rate, this rustic legislator proposed a new law in his state. He wanted to pass a law rounding Pi to an even 3.2 so it would be easier for the school children to make the computations. Well, you can say that this is too ridiculous, and it can't be fair to liken economics professors like Laffer to a rustic legislator like this. I say I'm under-criticizing the professors. At least when this rustic legislature rounded Pi to an even number, the error was relatively small. But once you try to put a lot of false precision into a complex system like economics, the errors can compound to the point where they're worse than those of the McKinsey partner when he was incompetently advising the Washington Post. So, economics should emulate physics' basic ethos, but its search for precision in physics–like formulas is almost always wrong in economics.

4) Too Much Emphasis on Macroeconomics

My fourth criticism is that there's too much emphasis on macroeconomics and not enough on microeconomics. I think this is wrong. It's like trying to master medicine without knowing anatomy and chemistry. Also, the discipline of microeconomics is a lot of fun. It helps you correctly understand macroeconomics. And it's a perfect circus to do. In contrast, I don't think macroeconomics people have all that much fun. For one thing they are often wrong because of extreme complexity in the system they wish to understand.

Case study: Nebraska Furniture Mart's new store in Kansas City

Let me demonstrate the power of microeconomics by solving two microeconomic problems. One simple and one a little harder. The first problem is this: Berkshire Hathaway just opened a furniture and appliance store in Kansas City [www.nfm.com/store_kansascity.asp]. At the time Berkshire opened it, the largest selling furniture and appliance store in the world was another Berkshire Hathaway store, selling $350 million worth of goods per year. The new store in a strange city opened up selling at the rate of more than $500 million a year. From the day it opened, the 3,200 spaces in the parking lot were full. The women had to wait outside the ladies restroom because the architects didn't understand biology. (Laughter). It's hugely successful.

Well, I've given you the problem. Now, tell me what explains the runaway success of this new furniture and appliance store, which is outselling everything else in the world? (Pause). Well, let me do it for you. Is this a low-priced store or a high-priced store? (Laughter). It's not going to have a runaway success in a strange city as a high-priced store. That would take time. Number two, if it's moving $500 million worth of furniture through it, it's one hell of a big store, furniture being as bulky as it is. And what does a big store do? It provides a big selection. So what could this possibly be except a low-priced store with a big selection?

But, you may wonder, why wasn't it done before, preventing its being done first now? Again, the answer just pops into your head: it costs a fortune to open a store this big. So, nobody's done it before. So, you quickly know the answer. With a few basic concepts, these microeconomic problems that seem hard can be solved much as you put a hot knife through butter. I like such easy ways of thought that are very remunerative. And I suggest that you people should also learn to do microeconomics better.

Case study: Les Schwab Tires

Now I'll give you a harder problem. There's a tire store chain in the Northwest, which has slowly succeeded over 50 years, the Les Schwab tire store chain [www.lesschwab.com/]. It just ground ahead. It started competing with the stores that were owned by the big tire companies that made all the tires, the Goodyears and so forth. And, of course, the manufacturers favored their own stores. Their "tied stores" had a big cost advantage. Later, Les Schwab rose in competition with the huge price discounters like Costco and Sam's Club and before that Sears Roebuck and so forth. And yet here is Schwab now, with hundreds of millions of dollars in sales. And here's Les Schwab in his 80s, with no education, having done the whole thing. How did he do it? (Pause). I don't see a whole lot of people looking like a light bulb has come on. Well, let's think about it with some microeconomic fluency.

Is there some wave that Schwab could have caught? The minute you ask the question, the answer pops in. The Japanese had a zero position in tires and they got big. So this guy must have ridden that wave some in the early times. Then the slow following success has to have some other causes. And what probably happened here, obviously, is this guy did one hell of a lot of things right. And among the things that he must have done right is he must have harnessed what Mankiw calls the superpower of incentives. He must have a very clever incentive structure driving his people. And a clever personnel selection system, etc. And he must be pretty good at advertising. Which he is. He's an artist. So, he had to get a wave in Japanese tire invasion, the Japanese being as successful as they were. And then a talented fanatic had to get a hell of a lot of things right, and keep them right with clever systems. Again, not that hard of an answer. But what else would be a likely cause of the peculiar success?

We hire business school graduates and they're no better at these problems than you were. Maybe that's the reason we hire so few of them.

Causes of problem-solving success

Well, how did I solve those problems? Obviously I was using a simple search engine in my mind to go through checklist-style, and I was using some rough algorithms that work pretty well in a great many complex systems, and those algorithms run something like this: Extreme success is likely to be caused by some combination of the following factors:

A) Extreme maximization or minimization of one or two variables. Example, Costco or our furniture and appliance store.

B) Adding success factors so that a bigger combination drives success, often in non-linear fashion, as one is reminded by the concept of breakpoint and the concept of critical mass in physics. Often results are not linear. You get a little bit more mass, and you get a lollapalooza result. And of course I've been searching for lollapalooza results all my life, so I'm very interested in models that explain their occurrence.

C) An extreme of good performance over many factors. Example, Toyota or Les Schwab.

D) Catching and riding some sort of big wave. Example, Oracle. By the way, I put down Oracle before I knew that the Oracle CFO was a big part of the proceedings here today.

Generally I recommend and use in problem solving cut-to-the quick algorithms, and I find you have to use them both forward and backward. Let me give you an example. I irritate my family by giving them little puzzles, and one of the puzzles that I gave my family not very long ago was when I said, "There's an activity in America, with one-on-one contests, and a national championship. The same person won the championship on two occasions about 65 years apart." "Now," I said, "name the activity," (Pause). Again, I don't see a lot of light bulbs going on. And in my family not lot of light bulbs were flashing. But I have a physicist son who has been trained more in the type of thinking I like. And he immediately got the right answer, and here's the way he reasoned:

> It can't be anything requiring a lot of hand-eye coordination. Nobody 85 years of age is going to win a national billiards tournament, much less a national tennis tournament. It just can't be. Then he figured it couldn't be chess, which this physicist plays very well, because it's too hard. The complexity of the system, the stamina required are too great. But that led into checkers. And he thought, "Ah ha! There's a game where vast experience might guide you to be the best even though you're 85 years of age."

And sure enough that was the right answer.

Anyway, I recommend that sort of mental trickery to all of you, flipping one's thinking both backward and forward. And I recommend that academic economics get better at very small scale microeconomics as demonstrated here.

5) Too Little Synthesis in Economics

My fifth criticism is there is too little synthesis in economics. Not only with matter outside traditional economics, but also within economics. I have posed at two different business schools the following problem. I say, "You have studied supply and demand curves. You have learned that when you raise the price, ordinarily the volume you can sell goes down, and when you reduce the price, the volume you can sell goes up. Is that right? That's what you've learned?" They all nod yes. And I say, "Now tell me several instances when, if you want the physical volume to go up, the correct answer is to increase the price?" And there's this long and ghastly pause. And finally, in each of the two business schools in which I've tried this, maybe one person in fifty could name one instance. They come up with the idea that occasionally a higher price acts as a rough indicator of quality and thereby increases sales volumes.

This happened in the case of my friend Bill Ballhaus. When he was head of Beckman Instruments it produced some complicated product where if it failed it caused enormous damage to the purchaser. It wasn't a pump at the bottom of an oil well, but that's a good mental example. And he realized that the reason this thing was selling so poorly, even though it was better than anybody else's product, was because it was priced lower. It made people think it was a low quality gizmo. So he raised the price by 20% or so and the volume went way up.

But only one in fifty can come up with this sole instance in a modern business school – one of the business schools being Stanford, which is hard to get into. And nobody has yet come up with the main answer that I like. Suppose you raise that price, and use the extra money to bribe the other guy's purchasing agent? (Laughter). Is that going to work? And are there functional equivalents in economics – microeconomics – of raising the price and using the extra sales proceeds to drive sales higher? And of course there are zillion, once you've made that mental jump. It's so simple.

One of the most extreme examples is in the investment management field. Suppose you're the manager of a mutual fund, and you want to sell more. People commonly come to the following answer: You raise the commissions, which of course reduces the number of units of real investments delivered to the ultimate buyer, so you're increasing the price per unit of real investment that you're selling the ultimate customer. And you're using that extra commission to bribe the customer's purchasing agent. You're bribing the broker to betray his client and put the client's money into the high-commission product. This has worked to produce at least a trillion dollars of mutual fund sales.

This tactic is not an attractive part of human nature, and I want to tell you that I pretty completely avoided it in my life. I don't think it's necessary to spend your life selling what you would never buy. Even though it's legal, I don't think it's a good idea. But you shouldn't accept all my notions because you'll risk becoming unemployable. You shouldn't take my notions unless you're willing to risk being unemployable by all but a few.

I think my experience with my simple question is an example of how little synthesis people get, even in advanced academic settings, considering economic questions. Obvious questions, with such obvious answers. Yet people take four courses in economics, go to business school, have all these IQ points and write all these essays, but they can't synthesize worth a damn. This failure is not because the professors know all this stuff and they're deliberately withholding it from the students. This failure happens because the professors aren't all that good at this kind of synthesis. They were trained in a different way. I can't remember if it was Keynes or Galbraith who said that economics professors are most economical with ideas. They make a few they learned in graduate school last a lifetime. (Laughter).

The second problem with synthesis

The second interesting problem with synthesis involves two of the most famous examples in the economics. Number one is Ricardo's principle of comparative advantage in trade, and the other is Adam Smith's pin factory. And both of these, of course, work to vastly increase economic output per person, and they're similar in that each somehow directs functions into the hands of people who are very good at doing the functions. Yet they're radically different examples in that one of them is the ultimate example of central planning, the pin factory, where the whole system was planned by somebody, while the other example, Ricardo's, happens automatically as a natural consequence of trade.

And, of course, once you get into the joys of synthesis, you immediately think. "Do these things interact?" Of course they interact. Beautifully. And that's one of the causes of the power of a modern economic system. I saw an example of that kind of interaction years ago. Berkshire had this former savings and loan company, and it had made this loan on a hotel right opposite the Hollywood Park Racetrack. In due time the neighborhood changed and it was full of gangs, pimps, and dope dealers. They tore copper pipe out of the wall for dope fixes, and there were people hanging around the hotel with guns, and nobody would come. We foreclosed on it two or three times, and the loan value went down to nothing. We seemed to have an insolvable economic problem -- a microeconomic problem.

Now we could have gone to McKinsey, or maybe a bunch of professors from Harvard, and we would have gotten a report about 10 inches thick about the ways we could approach this failing hotel in this terrible neighborhood. But instead, we put a sign on the property that said: "For sale or rent." And in came, in response to that sign, a man who said, "I'll spend $200,000 fixing up your hotel, and buy it at a high price on credit, if you can get zoning so I can turn the parking lot into a putting green." "You've got to have a parking lot in a hotel," we said. "What do you have in mind?" He said. "No, my business is flying seniors in from Florida, putting them near the airport, and then letting them go out to Disneyland and various places by bus and coming back. And I don't care how bad the neighborhood is going to be because my people are self-contained behind walls. All they have to do is get on the bus in the morning and come home in the evening, and they don't need a parking lot; they need a putting green." So we made the deal with the guy. The whole thing worked beautifully, and the loan got paid off, and it all worked out.

Obviously that's an interaction of Ricardo and the pin factory examples. The odd system that this guy had designed to amuse seniors was pure pin factory, and finding the guy with this system was pure Ricardo. So these things are interacting.

Well, I've taken you part way through the synthesis. It gets harder when you want to figure out how much activity should be within private firms, and how much should be within the government, and what are the factors that determine which functions are where, and why do the failures occur, and so on and so on.

It's my opinion that anybody with a high IQ who graduated in economics ought to be able to sit down and write a ten-page synthesis of all these ideas that's quite persuasive. And I would bet a lot of money that I could give this test in practically every economics department in the country, and get a perfectly lousy bunch of synthesis. They'd give me Ronald Coase [www.coase.org/aboutronaldcoase.htm]. They'd talk about transaction costs. They'd click off a little something that their professors gave them and spit it back. But in terms of really understanding how it all fits together, I would confidently predict that most people couldn't do it very well.

By the way, if any of you want to try and do this, go ahead. I think you'll find it hard. In this connection, one of the interesting things that I want to mention is that Max Planck [www-gap.dcs.st-and.ac.uk/~history/Mathematicians/Planck.html], the great Nobel laureate who found Planck's Constant, tried once to do economics. He gave it up. Now why did Max Planck, one of the smartest people who ever lived, give up economics? The answer is, he said, "It's too hard. The best solution you can get is messy and uncertain." It didn't satisfy Planck's craving for order, and so he gave it up. And if Max Planck early on realized he was never going to get perfect order, I will confidently predict that all of the rest of you are going to have exactly the same result.

By the way there's a famous story about Max Planck which is apocryphal: After he won his prize, he was invited to lecture everywhere, and he had this chauffeur that drove him around to give public lectures all through Germany. And the chauffeur memorized the lecture, and so one day he said, "Gee Professor Planck, why don't you let me try it as we switch places?" And so he got up and gave the lecture. At the end of it some physicist stood up and posed a question of extreme difficulty. But the chauffeur was up to it. "Well," he said, "I'm surprised that a citizen of an advanced city like Munich is asking so elementary a question, so I'm going to ask my chauffeur to respond." (Laughter).

6) Extreme and Counterproductive Psychological Ignorance

All right, I'm down to the sixth main defect, and this is a subdivision of the lack of adequate multidisciplinarity: Extreme and counterproductive psychological ignorance in economics. Here I want to give you a very simple problem. I specialize in simple problems.

You own a small casino in Las Vegas. It has fifty standard slot machines. Identical in appearance, they're identical in the function. They have exactly the same payout ratios. The things that cause the payouts are exactly the same. They occur in the same percentages. But there's one machine in this group of slot machines that, no matter where you put it among the fifty, in fairly short order, when you go to the machines at the end of the day, there will be 25% more winnings from this one machine than from any other machine. Now surely I'm not going to have a failure here. What is different about that heavy winning machine? (Silence) Can anybody do it?

Male: More people play it.

Charles Munger: No, no, I want to know why more people play it. What's different about that machine is people have used modern electronics to give a higher ratio of near misses. That machine is going bar, bar, lemon. Bar, bar, grapefruit, way more often than normal machines, and that will cause heavier play. How do you get an answer like that? Easy. Obviously, there's a psychological cause: That machine is doing something to trigger some basic psychological response.

If you know the psychological factors, if you've got them on a checklist in your head, you just run down the factors, and, boom!, you get to one that must explain this occurrence. There isn't any other way to do it effectively. These answers are not going to come to people who don't learn these mental tricks. If you want to go through life like a one legged man in an ass-kicking contest, why be my guest. But if you want to succeed, like a strong man with two legs, you have to pick up these tricks, including doing economics while knowing psychology.

In this vein, I next want to mention a strange Latin American case of a dysfunctional economy that got fixed. In this little subdivision of Latin America, a culture had arisen wherein everybody stole everything. They embezzled from the company, they stole everything that was loose in the community. And of course, the economy came practically to a halt. And this thing got fixed. Now where did I read about this case? I'll give you a hint. It wasn't in the annals of economics. I found this case in the annals of psychology. Clever people went down and used a bunch of psychological tricks. And they fixed it.

Well, I think there's no excuse if you're an economist, when there are wonderful cases like that of the dysfunctional economy becoming fixed, and these simple tricks that solve so many problems, and you don't know how to do the fixes and understand the problems. Why be so ignorant about psychology that you don't even know psychology's tricks that will fix your own dysfunctional economic systems?

Here I want to give you an extreme injunction. This is even tougher than the fundamental organizing ethos of hard science. This has been attributed to Samuel Johnson [justus.anglican.org/resources/bio/20.html]. He said in substance that if an academic maintains in place an ignorance that can be easily removed with a little work, the conduct of the academic amounts to treachery. That was his word, "treachery." You can see why I love this stuff. He says you have a duty if you're an academic to be as little of a klutz as you can possibly be, and therefore you have got to keep grinding out of your system as much removable ignorance as you can remove.

7) Too Little Attention to Second and Higher Order Effects

On to the next one the seventh defect: Too little attention in economics to second order and even higher order effects. This defect is quite understandable, because the consequences have consequences, and the consequences of the consequences have consequences, and so on. It gets very complicated. When I was a meteorologist I found this stuff very irritating. And economics makes meteorology look like a tea party.

Mispredicting Medicare costs

Extreme economic ignorance was displayed when various experts, including Ph D. economists, forecast the cost of the original Medicare law. They did simple extrapolations of past costs.

Well the cost forecast was off by a factor of more than 1000%. The cost they projected was less than 10% of the cost that happened. Once they put in place all these new incentives, the behavior changed in response to the incentives, and the numbers became quite different from their projection. And medicine invented new and expensive remedies, as it was sure to do. How could a great group of experts make such a silly forecast? Answer: They over simplified to get easy figures, like the rube rounding Pi to 3.2! They chose not to consider effects of effects on effects, and so on.

Investing in textile looms

One good thing about this common form of misthinking from the viewpoint of academia, is that business people are even more foolish about microeconomics. The business version of the Medicare-type insanity is when you own a textile plant and a guy comes in and says, "Oh, isn't this wonderful? They invented a new loom. It'll pay for itself in three years at current prices because it adds so much efficiency to the production of textiles." And you keep buying these looms for 20 years, and their equivalent, and you keep making 4% on capital, you never go anywhere. And the answer is, it wasn't that technology didn't work, it's that the laws of economics caused the benefit from the new looms to go to the people that bought the textiles, not the guy that owned the textile plant. How could anybody not know that if he'd taken freshmen economics or been through business school? I think the schools are doing a lousy job. Otherwise such insanities wouldn't happen so often.

Usually, I don't use formal projections. I don't let people do them for me because I don't like throwing up on the desk (laughter), but I see them made in a very foolish way all the time, and many people believe in them, no matter how foolish they are. It's an effective sales technique in America to put a foolish projection on a desk.

And if you're an investment banker, it's an art form. I don't read their projections either. Once Warren and I bought a company and the seller had a big study done by an investment banker, it was about this thick. We just turned it over as if it were a diseased carcass. He said, "We paid $2 million for that." I said, "We don't use them. Never look at them."

Workman's comp madness

Anyway, as the Medicare example showed, all human systems are gamed, for reasons rooted deeply in psychology, and great skill is displayed in the gaming because game theory has so much potential. That's what's wrong with the workman's comp system in California. Gaming has been raised to an art form. In the course of gaming the system, people learn to be crooked. Is this good for civilization? Is it good for economic performance? Hell no. The people who design easily–gameable systems belong in the lowest circle of hell.

I've got a friend whose family controls about 8% of the truck trailer market. He just closed his last factory in California and he had one in Texas that was even worse. The workman's comp cost in his Texas plant got to be about 30% of payroll. Well, there's no such profit in making truck trailers. He closed his plant and moved it to Ogden, Utah, where a bunch of believing Mormons are raising big families and don't game the workman's comp system. The workman's comp expense is 2% of payroll.

Are the Latinos who were peopling his plant in Texas intrinsically dishonest or bad compared to the Mormons? No. It's just the incentive structure that so rewards all this fraud is put in place by these ignorant legislatures, many members of which have been to law school, and they just don't think about what terrible things they're doing to the civilization because they don't take into account the second order effects and the third order effects in lying and cheating. So, this happens everywhere, and when economics is full of it, it is just like the rest of life.

Niederhoffering the curriculum

There was a wonderful example of gaming a human system in the career of Victor Niederhoffer [www.squashtalk.com/profiles/niederhoffer.htm] in the Economics Department of Harvard. Victor Niederhoffer was the son of a police lieutenant, and he needed to get A's at Harvard. But he didn't want to do any serious work at Harvard, because what he really liked doing was, one, playing world-class checkers; two, gambling in high-stakes card games, at which he was very good, all hours of the day and night; three, being the squash champion of the United States, which he was for years; and, four, being about as good a tennis player as a part-time tennis player could be.

This did not leave much time for getting A's at Harvard so he went into the Economics Department. You'd think he would have chosen French poetry. But remember, this was a guy who could play championship checkers. He thought he was up to outsmarting the Harvard Economics Department. And he was. He noticed that the graduate students did most of the boring work that would otherwise go to the professors, and he noticed that because it was so hard to get to be a graduate student at Harvard, they were all very brilliant and organized and hard working, as well as much needed by grateful professors.

And therefore, by custom, and as would be predicted from the psychological force called reciprocity tendency, in a really advanced graduate course, the professors always gave an A. So Victor Niederhoffer signed up for nothing but the most advanced graduate courses in the Harvard Economics Department, and of course, he got A, after A, after A, after A, and was hardly ever near a class. And for a while, some people at Harvard may have thought it had a new prodigy on its hands. That's a ridiculous story, but the scheme will work still. And Niederhoffer is famous: they call his style "Niederhoffering the curriculum." (Laughter).

This shows how all-human systems are gamed. Another example of not thinking through the consequences of the consequences is the standard reaction in economics to Ricardo's law of comparative advantage giving benefit on both sides of trade. Ricardo came up with a wonderful, non-obvious explanation that was so powerful that people were charmed with it, and they still are, because it's a very useful idea. Everybody in economics understands that comparative advantage is a big deal, when one considers first order advantages in trade from the Ricardo effect. But suppose you've got a very talented ethnic group, like the Chinese, and they're very poor and backward, and you're an advanced nation, and you create free trade with China, and it goes on for a long time.

Now let's follow and second and third order consequences: You are more prosperous than you would have been if you hadn't traded with China in terms of average well-being in the United States, right? Ricardo proved it. But which nation is going to be growing faster in economic terms? It's obviously China. They're absorbing all the modern technology of the world through this great facilitator in free trade, and, like the Asian Tigers have proved, they will get ahead fast. Look at Hong Kong. Look at Taiwan. Look at early Japan. So, you start in a place where you've got a weak nation of backward peasants, a billion and a quarter of them, and in the end they're going to be a much bigger, stronger nation than you are, maybe even having more and better atomic bombs. Well, Ricardo did not prove that that's a wonderful outcome for the former leading nation. He didn't try to determine second order and higher order effects.

If you try and talk like this to an economics professor, and I've done this three times, they shrink in horror and offense because they don't like this kind of talk. It really gums up this nice discipline of theirs, which is so much simpler when you ignore second and third order consequences.

The best answer I ever got on that subject – in three tries – was from George Schultz. He said, "Charlie, the way I figure it is if we stop trading with China, the other advanced nations will do it anyway, and we wouldn't stop the ascent of China compared to us, and we'd lose the Ricardo-diagnosed advantages of trade." Which is obviously correct. And I said, "Well George, you've just invented a new form of the tragedy of the commons. You're locked in this system and you can't fix it. You're going to go to a tragic hell in a handbasket, if going to hell involves being once the great leader of the world and finally going to the shallows in terms of leadership." And he said, "Charlie, I do not want to think about this." I think he's wise. He's even older than I am, and maybe I should learn from him.

8) Not Enough Attention to the Concept of Febezzlement

Okay, I'm now down to my eighth objection: Too little attention within economics to the simplest and most fundamental principle of algebra. Now this sounds outrageous, that economics doesn't do algebra, right? Well, I want to try an example – I may be wrong on this. I'm old and I'm iconoclastic – but I throw it out anyway. I say that economics doesn't pay enough attention to the concept of febezzlement. And that I derive from Galbraith's idea. Galbraith's idea was that, if you have an undisclosed embezzlement, it has a wonderful Keynesian stimulating effect on the economy because the guy who's been embezzled thinks he is as rich as he always was and spends accordingly, and the guy that had stolen the money gets all this new purchasing power. I think that's correct analysis on Galbraith's part. The trouble with his notion is that he's described a minor phenomenon. Because when the embezzlement is discovered, as it almost surely will be, the effect will quickly reverse. So the effect quickly cancels out.

But suppose you paid a lot of attention to algebra, which I guess Galbraith didn't, and you think, "Well, the fundamental principle of algebra is, 'If A is equal to B and B is equal to C, then A is equal to C.'" You've then got a fundamental principle that demands that you look for functional equivalents, all you can find. So suppose you ask the question, "Is there such a thing in economics as a febezzlement?" By the way, Galbraith invented the word "bezzle" to describe the amount of undisclosed embezzlement, so I invented the word "febezzlement": the functional equivalent of embezzlement.

This happened after I asked the question "Is there a functional equivalent of embezzlement?" I came up with a lot of wonderful affirmative answers. Some were in investment management. After all I'm near investment management. I considered the billions of dollars totally wasted in the course of investing common stock portfolios for American owners. As long as the market keep going up, the guy who's wasting all this money doesn't feel it, because he's looking at these steadily rising values. And to the guy who is getting the money for investment advice, the money looks like well earned income, when he's really selling detriment for money, surely the functional equivalent of undisclosed embezzlement. You can see why I don't get invited to many lectures.

So I say, if you look in the economy for febezzlement, the functional equivalent of embezzlement, you'll find some enormously powerful factors. They create some "wealth effect" that is on steroids, compared to the old "wealth effect." But practically nobody thinks as I do, and I quitclaim my idea to any hungry graduate student who has independent means, which he will need before his thesis topic is approved.

9) Not Enough Attention to Virtue and Vice Effects

Okay, my ninth objection: Not enough attention to virtue and vice effects in economics. It has been plain to me since early life that there are enormous virtue effects in economics, and also enormous vice effects. But economists get very uncomfortable when you talk about virtue and vice. It doesn't lend itself to a lot of columns of numbers. But I would argue that there are big virtue effects in economics. I would say that the spreading of double-entry bookkeeping by the Monk, Fra Luca de Pacioli [www-gap.dcs.st-and.ac.uk/~history/Mathematicians/Pacioli.html], was a big virtue effect in economics. It made business more controllable, and it made it more honest. Then the cash register. The cash register did more for human morality than the congregational church. It was a really powerful phenomenon to make an economic system work better, just as, in reverse, system that can be easily defrauded ruins a civilization. A system that's very hard to defraud, like a cash register, helps the economic performance of a civilization by reducing vice, but very few people within economics talk about it in those terms.

Religion

I'll go further: I say economic systems work better when there's an extreme reliability ethos. And the traditional way to get a reliability ethos, at least in past generations in America, was through religion. The religions instilled guilt. We have a charming Irish Catholic priest in our neighborhood and he loves to say, "Those old Jews may have invented guilt, but we perfected it." (Laughter). And this guilt, derived from religion, has been a huge driver of a reliability ethos, which has been very helpful to economic outcomes for man.

Pay for directors and judges

Many bad effects from vice are clear. You've got the crazy booms and crooked promotions – all you have to do is read the paper over the last six months. There's enough vice to make us all choke. And, by the way, everybody's angry about unfair compensation at the top of American corporations, and people should be. We now face various crazy nostrums invented by lawyers which won't give us a fix for unfair compensation, yet a good partial solution is obvious: If directors were significant shareholders who got a pay of zero, you'd be amazed what would happen to unfair compensation of corporate executives as we dampened effects from reciprocity tendency.

A roughly similar equivalent of this no-pay system has been tried in a strange place. In England the lower criminal courts which can send you to prison for a year or fine you substantially, are staffed by lay magistrates. You've got three judges sitting up there, and they all get a pay of zero. Their expenses are reimbursed, but not too liberally. And they work about 40 half-days a year, as volunteers. It's worked beautifully for about 700 years. Able and honest people compete to become magistrates, to perform the duty and get the significance, but no pay.

This is the system Benjamin Franklin, near the end of his life, wanted for U.S. government. He didn't want the high executives of government to be paid, but to be like himself or the entirely unpaid, well-off ministers and rulers of the Mormon Church. And when I see what's happened in California, I'm not sure he wasn't right. At any rate, no one now drifts in Franklin's direction. For one thing, professors – and most of them need money – get appointed directors.

Not a vice that some systems are deliberately made unfair

It is not always recognized that, to function best, morality should sometimes appear unfair, like most worldly outcomes. The craving for perfect fairness causes a lot of terrible problems in system function. Some systems should be made deliberately unfair to individuals because they'll be fairer on average for all of us. I frequently cite the example of having your career over, in the Navy, if your ship goes aground, even if it wasn't your fault. I say the lack of justice for the one guy that wasn't at fault is way more than made up by a greater justice for everybody when every captain of a ship always sweats blood to make sure the ship doesn't go aground. Tolerating a little unfairness to some to get a greater fairness for all is a model I recommend to all of you. But again, I wouldn't put it in your assigned college work if you want to be graded well, particularly in a modern law school wherein there is usually an over-love of fairness-seeking process.

Contributions of vice to bubbles

There are, of course, enormous vice effects in economics. You have these bubbles with so much fraud and folly. The aftermath is frequently very unpleasant, and we've had some of that lately. One of the first big bubbles, of course, was the huge and horrible South Sea bubble in England. And the aftermath was interesting. Many of you probably don't remember what happened after the South Sea Bubble, which caused an enormous financial contraction, and a lot of pain. They banned publicly traded stock in England for decades. Parliament passed a law that said you can have a partnership with a few partners, but you can't have publicly traded stock. And, by the way, England continued to grow without publicly traded stock. The people who are in the business of prospering because there's a lot of stock being traded in casino-like frenzy wouldn't like this example if they studied it enough. It didn't ruin England to have a long period when they didn't have publicly traded shares.

Just as in real estate. We had all the shopping centers and auto dealerships, and so on, we needed for years when we didn't have publicly traded real estate shares. It's a myth that once you've got some capital market, economic considerations demand that it has to be as fast and efficient as a casino. It doesn't.

Paradoxical good contributions from vice; the irremovability of paradox

Another interesting problem is raised by vice effects involving envy. Envy wisely got a very strong condemnation in the laws of Moses. You remember how they laid it on with a trowel: You couldn't covet thy neighbor's ass, you couldn't covet thy neighbor's servant girl, you couldn't covet…--Those old Jews knew how envious people are and how much trouble it caused. They really laid it on hard, and they were right. But Mandeville, [htpp://cepa.newschool.edu/het/profiles/mandev.htm], remember his fable of bees? He demonstrated convincingly – to me, anyway – that envy was a great driver of proclivity to spend. And so here's this terrible vice, which is forbidden in the Ten Commandments, and here it's driving all these favorable results in economics. There's some paradox in economics that nobody's going to get out.

When I was young, everybody was excited by Godel [www.gap.dcs.st-and.ac.uk/~history/Mathematicians/Godel.html] who came up with proof that you couldn't have a mathematical system without a lot of irritating incompleteness in it. Well, since then my betters tell me that they've come up with more irremovable defects in mathematics and have decided that you're never going to get mathematics without some paradox in it. No matter how hard you work, you're going to have to live with some paradox if you're a mathematician.

Well, if the mathematicians can't get the paradox out of their system when they're creating it themselves, the poor economists are never going to get rid of paradoxes, nor are any of the rest of us. It doesn't matter. Life is interesting with some paradox. When I run into a paradox I think either I'm a total horse's ass to have gotten to this point, or I'm fruitfully near the edge of my discipline. It adds excitement to life to wonder which it is.

Conclusion

Clinging to failed ideas – a horror story

As I conclude, I want to tell one more story demonstrating how awful it is to get a wrong idea from a limited repertoire and just stick to it. And this is the story of Hyman Liebowitz who came to America from the old country. In the new country, as in the old, he tried to make his way in the family trade, which was manufacturing nails. And he struggled and he struggled, and finally his little nail business got to vast prosperity, and his wife said to him, "You are old, Hyman, it's time to go to Florida and turn the business over to our son."

So down he went to Florida, turning his business over to the son, but he got weekly financial reports. And he hadn't been in Florida very long before they turned sharply negative. In fact, they were terrible. So he got on an airplane and he went back to New Jersey, where the factory was. As he left the airport on the way to the factory he saw this enormous outdoor advertising sign lighted up. And there was Jesus, spread out on the cross. And under it was a big legend, "They Used Liebowitz's Nails." So he stormed into the factory and said, "You dumb son! What do you think you're doing? It took me 50 years to create this business!" "Papa," he said, "trust me. I will fix it."

So back he went to Florida, and while he was in Florida he got more reports, and the results kept getting worse. So he got on the airplane again. Left the airport, drove by the sign, looked up at this big lighted sign, and now there's a vacant cross. And, low and behold, Jesus is crumpled on the ground under the cross, and the sign said, "They Didn't Use Liebowitz's Nails." (Laugher).

Well, you can laugh at that. It is ridiculous but it's no more ridiculous than the way a lot of people cling to failed ideas. Keynes said "It's not bringing in the new ideas that's so hard. It's getting rid of the old ones." And Einstein said it better, attributing his mental success to "curiosity, concentration, perseverance and self-criticism." By self-criticism he meant becoming good at destroying your own best-loved and hardest-won ideas. If you can get really good at destroying your own wrong ideas, that is a great gift.

Repeating the big lesson

Well, it's time to repeat the big lesson in this little talk. What I've urged is the use of a bigger multidisciplinary bag of tricks, mastered to fluency, to help economics and everything else. And I also urged that people not be discouraged by irremovable complexity and paradox. It just adds more fun to the problems. My inspiration again is Keynes: Better roughly right than precisely wrong.

And so I end by repeating what I said once before on a similar occasion. If you skillfully follow the multidisciplinary path, you will never wish to come back. It would be like cutting off your hands.

Well, that's the end. I'll take questions as long as people can endure me.

(Applause)

Q & A

Male: …financial destruction from trading of derivative contracts. Buffett said that the genie's out of the bottle and the hangover may be proportionate to the binge. Would you speculate for us how that scenario can play out? [The question was garbled, but the person asked about derivatives, which Buffett has called "financial weapons of mass destruction."]

Munger: Well, of course, catastrophe predictions have always been quite difficult to make with success. But I confidently predict that there are big troubles to come. The system is almost insanely irresponsible. And what people think are fixes aren't really fixes. It's so complicated I can't do it justice here – but you can't believe the trillions of dollars involved. You can't believe the complexity. You can't believe how difficult it is to do the accounting. You can't believe how big the incentives are to have wishful thinking about values, and wishful thinking about ability to clear.

Running off derivative book is agony and takes time. And you saw what happened when they tried to run off the derivative books at Enron. Its certified net worth vanished. In the derivative books of America there are a lot of reported profits that were never earned and assets that never existed.

And there are large febezzlement effects and some ordinary embezzlement effects that come from derivative activity. And the reversal of these is going to cause pain. How big the pain will be and how well it will be handled, I can't tell you. But you would be disgusted if you had a fair mind and spent a month really delving into a big derivative operation. You would think it was Lewis Carroll [author of <u>Alice in Wonderland</u>]. You would think it was the Mad Hatter's Tea Party. And the false precision of these people is just unbelievable. They make the worst economics professors look like gods. Moreover, there is depravity augmenting the folly. Read the book "F.I.A.S.C.O.", by law professor and former derivatives trader Frank Partnoy, an insider account of depravity in derivative trading at one of the biggest and best regarded Wall

Street firms. The book will turn your stomach. [F.I.A.S.C.O.: The Inside Story of a Wall Street Trader]

Rajneesh Mehta: We'll take one more question. There's a class outside that has to come in. So one more question.

Male: Could you describe Warren's reactions to the advice about the negative reaction that he got from musing about defects of California's Prop 13? Was he shocked, surprised?

Munger: It's hard to shock Warren. He's past 70, he's seen a lot. And his brain works quickly. He generally avoids certain subjects before elections and that is what I am going to do here. (Laughter).

Sacrificing To Restore Market Confidence

By Charles T. Munger

Wednesday, February 11, 2009

Our situation is dire. Moderate booms and busts are inevitable in free-market capitalism. But a boom-bust cycle as gross as the one that caused our present misery is dangerous, and recurrences should be prevented. The country is understandably depressed -- mired in issues involving fiscal stimulus, which is needed, and improvements in bank strength. A key question: Should we opt for even more pain now to gain a better future? For instance, should we create new controls to stamp out much sin and folly and thus dampen future booms? The answer is yes.

Sensible reform cannot avoid causing significant pain, which is worth enduring to gain extra safety and more exemplary conduct. And only when there is strong public revulsion, such as exists today, can legislators minimize the influence of powerful special interests enough to bring about needed revisions in law.

Many contributors to our over-the-top boom, which led to the gross bust, are known. They include insufficient controls over morality and prudence in banks and investment banks; undesirable conduct among investment banks; greatly expanded financial leverage, aided by direct or implied use of government credit; and extreme excess, sometimes amounting to fraud, in the promotion of consumer credit. Unsound accounting was widespread.

There was also great excess in highly leveraged speculation of all kinds. Perhaps real estate speculation did the most damage. But the new trading in derivative contracts involving corporate bonds took the prize. This system, in which completely unrelated entities bet trillions with virtually no regulation, created two things: a gambling facility that mimicked the 1920s "bucket shops" wherein bookie-customer types could bet on security prices, instead of horse races, with almost no one owning any securities, and, second, a large group of entities that had an intense desire that certain companies should fail. Croupier types pushed this system, assisted by academics who should have known better. Unfortunately, they convinced regulators that denizens of our financial system would use the new speculative opportunities without causing more harm than benefit.

Considering the huge profit potential of these activities, it may seem unlikely that any important opposition to reform would come from parties other than conventional, moneyed special interests. But many in academia, too, will resist. It is important that reform plans mix moral and accounting concepts with traditional economic concepts. Many economists take fierce pride in opposing that sort of mixed reasoning. But what these economists like to think about is functionally intertwined, in complex ways, with what they don't like to think about. Those who resist the wider thinking are acting as engineers would if they rounded pi from 3.14 to an even 3 to simplify their calculations. The result is a kind of willful ignorance that fails to understand much that is important.

Moreover, rationality in the current situation requires even more stretch in economic thinking. Public deliberations should include not only private morality and accounting issues but also issues of public morality, particularly with regard to taxation. The United States has long run large, concurrent trade and fiscal deficits while, to its own great advantage, issuing the main reserve currency of a deeply troubled and deeply interdependent world. That world now faces new risks from an expanding group of nations possessing nuclear weapons. And so the United States may now have a duty similar to the one that, in the danger that followed World War II, caused the Marshall Plan to be approved in a bipartisan consensus and rebuild a devastated Europe.

The consensus was grounded in Secretary of State George Marshall's concept of moral duty, supplemented by prudential considerations. The modern form of this duty would demand at least some increase in conventional taxes or the imposition of some new consumption taxes. In so doing, the needed and cheering economic message, "We will do what it takes," would get a corollary: "and without unacceptably devaluing our money." Surely the more complex message is more responsible, considering that, first, our practices of running twin deficits depend on drawing from reserves of trust that are not infinite and, second, the message of the corollary would not be widely believed unless it was accompanied by some new taxes.

Moreover, increasing taxes in some instances might easily gain bipartisan approval. Surely both political parties can now join in taxing the "carry" part of the compensation of hedge fund managers as if it was more constructively earned in, say, cab driving.

Much has been said and written recently about bipartisanship, and success in a bipartisan approach might provide great advantage here. Indeed, it is conceivable that, if legislation were adopted in a bipartisan way, instead of as a consequence of partisan hatred, the solutions that curbed excess and improved safeguards in our financial system could reduce national pain instead of increasing it. After the failure of so much that was assumed, the public needs a restoration of confidence. And the surest way to gain the confidence of others is to deserve the confidence of others, as Marshall did when he helped cause passage of some of the best legislation ever enacted.

Creating in a bipartisan manner a legislative package that covers many subjects will be difficult. As they work together in the coming weeks, officials might want to consider a precedent that helped establish our republic. The deliberative rules of the Constitutional Convention of 1787 worked wonders in fruitful compromise and eventually produced the U.S. Constitution. With no Marshall figure, trusted by all, amid today's legislators, perhaps the Founding Fathers can once more serve us.

The writer, a Republican, is vice chairman of Berkshire Hathaway Inc., which owns 21 percent of The Washington Post Co.'s common stock.

Wantmore, Tweakmore, Totalscum, and the Tragedy of Boneheadia

A Parody about the Great Recession.

By Charles Munger

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A Parody Describing the Contributions of Wantmore, Tweakmore, Totalscum, Countwrong, and Oblivious to the Tragic "Great Recession" in Boneheadia and the Thoughts of Some People Relating to This Disaster.

In the country of Boneheadia there was a man, Wantmore, who earned his income as a home mortgage loan originator. Wantmore operated conservatively. All his home loans bore interest rates of 6 percent or less, and he demanded of all borrowers large down payments, documented proof of adequate income, and an immaculate credit-using history. Wantmore sold all his loans to life insurance companies that, before closing purchases, checked loan quality with rigor—then held all loans to maturity.

As Wantmore prospered, he eventually attracted the attention of Tweakmore, a very bold and ingenious investment banker. There was no other investment banker quite like Tweakmore, even in the United States.

Tweakmore had become the richest person in Boneheadia, driven by an insight that had come to him when, as a college student, he had visited a collection of hotels that contained gambling casinos located in a desert.

As Tweakmore saw immense amounts of cash pouring into cashiers' cages surrounded by endless sand, in business operations that did not tie up any capital in inventories, receivables, or manufacturing equipment, he realized immediately that he was looking at the best business model in the world, provided one could also eliminate commitment of any capital or expense to hotel rooms, restaurants, or facilities providing parking or entertainment.

Tweakmore also saw exactly how he could create for himself an operation that possessed all the characteristics of his ideal business. All he had to do was add to investment banking a lot of activities that were the functional equivalent of casino gambling, with the bank having the traditional "house advantage." Such casino-type activities, masked by respectable-sounding labels, Tweakmore foresaw, could easily grow to dwarf all the action in ordinary casinos.

Determined to create and own his ideal business as fast as possible, Tweakmore quit college and entered investment banking. Within 12 years, Tweakmore was the most important investment banker in Boneheadia. Tweakmore rose so rapidly because he was very successful in convincing regulators and legislators to enlarge what was permissible.

Indeed, by the time Tweakmore called on Wantmore, any investment bank in Boneheadia could invent and trade in any bets it wished, provided they were called "derivatives," designed to make counterparties feel better about total financial risks in their lives, outcomes that automatically happened. Moreover, an investment bank faced no limit on the amount of financial leverage it employed in trading or investing in derivatives or anything else. Also, Tweakmore had obtained permission to use "Mark-To-Model" accounting that enabled each bank to report in its derivative book whatever profit it desired to report. As a result, almost every investment bank claimed ever-growing profits and had ownership of assets totaling at least 30 times an ever-swelling reported net worth. And despite a vast expansion of transaction-clearance risk, no big mess had so far occurred.

Tweakmore was pleased, but not satisfied, by what he had accomplished. And he now planned to revolutionize Boneheadia's home-mortgage loan business in a manner that would make Tweakmore a national hero.

In his first proposal to Wantmore, Tweakmore held much of his ingenuity in reserve. All he proposed was that Wantmore hereafter sell all his home loans to Tweakmore at a higher price than life insurers would pay. Tweakmore said that he planned to put all loans into trusts with no other assets. Each trust would be divided into five "tranches" with different priorities in use of loan payments. Four tranches would use their shares of loan payments to pay off complex new fixed-interest-bearing, freely tradable debt instruments, called CDOs. The fifth tranche got a tiny residue in case all home loan payments were received as due. The CDOs would be sold by Tweakmore, using a highly paid sales force, to anyone who could be induced to buy, even highly leveraged speculators and small Scandinavian cities near the Arctic.

To Wantmore, Tweakmore's proposal at first appeared unfeasible. The planned operation seemed to resemble the operation of a meat vendor who routinely bought 1,000 pounds of chuck roast, sliced it up, and then sold 950 pounds as filet mignon and the balance as dog food.

But Wantmore's doubts melted away when Tweakmore revealed how much he would pay. Under the offered terms, Wantmore would double his income, something Tweakmore could easily afford because his own income was going to be three times that of Wantmore. After Wantmore accepted Tweakmore's proposal, everything worked out exactly as Tweakmore had planned, because buyers of CDOs in aggregate paid much more than the life insurers had formerly paid.

Even so, Wantmore, as he became familiar with Tweakmore's prosperity, was soon dissatisfied with a merely doubled income. With Wantmore restive, Tweakmore now displayed the full range of his ingenuity.

What Tweakmore next proposed was that Wantmore add to his product line a new class of "Subprime, pay-what-you-wish" home-mortgage loans. All loans would bear interest at 7½ percent or more, and borrowers would not be allowed to state anything except that they wanted the money. There would be no down payments and no credit checks or the like. Also, each loan would be very user-friendly in its first three years, during which the borrower could make only tiny payments with all unpaid interest being added to principal. After three years, very onerous loan service was required, designed to pay off the greatly swollen principal, plus all interest, over the next five years.

This proposal would have seemed preposterous, even hilariously satirical, if it had been presented to Wantmore when Tweakmore had first called. But by now Wantmore had doubled his income by going along with a peculiar idea of Tweakmore's. So Wantmore's credulity was easily stretched to allow acceptance of the new loan product, which Tweakmore projected would triple Wantmore's already doubled income.

It is easy to see why Wantmore became a "true believer" in the new loan product. But why did the already super-rich, prominent, and sophisticated Tweakmore believe his revised scheme would work safely and well for him?

Well, we know the answer. As Tweakmore revealed in his prideful autobiography, his thought process was as follows:

1. There would be no significant troubles during the first three years. Under the accounting standards of Boneheadia, all its accountants would be required for a long time to reserve no loan-loss provision at all against unpaid principal and unpaid interest on the new loans. And CDOs would be valued highly in traditional markets because underlying loans were booked at unreasonably high value. It wouldn't matter that homebuyers were making no down payments, had no personal liability at any time, and paid only a tiny portion of interest accrued for three years. It also wouldn't matter that any competent inquiry would have revealed extreme past improvidence on the part of most borrowers.
2. House prices in Boneheadia would not merely rise as they had done before. Prices would rise much faster as more and more people learned they could bid to acquire homes without using any of their own money, no matter how poor were their credit-using histories.
3. All the buyers of new CDOs would have a near-perfect investment experience. Ever-rising house prices would cause full payment of all mortgage debt as due. The market for the new CDOs would expand and expand as investors reliably earned much more and faster as the scheme fed on itself in a runaway feedback mode.
4. True, after the first three years many overstretched homebuyers were sure to suffer somewhat as they were forced, by threats of foreclosure, to sell their homes. This would often cost them their credit and the respect of their children, friends, and employers, but

that would be the only trouble, and it would prove endurable by Tweakmore and everyone else, except the people forced out of their homes.

5. The runaway feedback mode that drove up house prices would cause no significant trouble for decades, as had happened in Japan, where a big bust in real estate prices occurred only after the Imperial Palace grounds in Tokyo were apparently worth more than the market value of the entire state of California.
6. The principles of economics would give the scheme a large tailwind and considerable popularity. As Tweakmore, a former student in elementary economics, knew from studying Galbraith, a large undisclosed embezzlement strongly stimulates spending because the perpetrator is much richer and the victim spends as before because he does not yet feel poorer. And what Tweakmore was creating was the functional equivalent of a long-running undisclosed embezzlement on steroids. The perpetrators would not be the only ones to spend more, as typically occurs during ordinary embezzlements. The CDO-buying victims also would spend more as they believed they were getting richer and richer from ever-growing paper gains embodied in accrual of interest at above normal rates.
7. To be sure, the scheme looked a little like a chain-letter scheme, and such schemes were usually ill-regarded by prospective users, partly because the schemes were criminal and partly because the schemes always blew up so quickly, bringing criminal troubles so soon. Tweakmore's scheme, in contrast, would, by design, be lawful and benevolent, and recognized as such, because it would create big macroeconomic stimulus as a public good.
8. And should the scheme eventually blow up after decades, like the land-price bubble in Japan, who could fairly blame Tweakmore? Nothing lasts forever. Besides, the blowup might be lost in a miasma of other blowups like those sure to come in many irresponsible countries and subdivisions of countries.

Tweakmore's revised scheme worked fantastically well for a considerable period. Naturally, there were some glitches, but Tweakmore turned each glitch into an opportunity to boost profit. For instance, when Wantmore was made nervous as hordes of scumball-salesmen were drawn into his business by rich commissions paid for production of easy-to-sell "subprime" pay-what-you-wish home loans, Tweakmore responded by buying Wantmore's business. Then Tweakmore replaced Wantmore with a new CEO, Totalscum, who did not consider any business practice optimal unless it was depraved. Totalscum soon increased loan production by 400 percent and his success caused Tweakmore to buy five additional loan businesses and replace their CEOs with people like Totalscum, causing profits to soar and soar, even though Tweakmore never again found anyone else whose depraved operations could produce results that matched those of Totalscum.

As Tweakmore's scheme went on, it was necessary for its continuing success that the accountants of Boneheadia never stop treating as trustworthy a lot of hugely important loan-payment promises that any sensible person would deem unreliable. However, there was almost no risk that accountants would act otherwise than as Tweakmore desired. The accountants of Boneheadia were not allowed to be sensible. They had to use rote "rules-based" accounting standards set by a dominating man, Countwrong, who was head of Boneheadia's Accounting Standards Setting Board. And Countwrong had ordained, in effect, that all loss provisions on the new loans must remain based on the zero-loss record that had existed before Wantmore met Tweakmore. And, so long as Countwrong was in charge, no one was going to use in accounting an understanding of runaway feedback modes, instead of Countwrong's rules.

Of course, if Totalscum or Tweakmore ever started to have loan losses, he would have to start making loan-loss provisions against new loans. But there weren't any meaningful loan losses for anyone for a very long time.

Countwrong was so habit-bound as a thinker that he never recognized that his cognition was anti-social. He had always sought simplicity of process for accountants at the expense of "principles-based" rigor and thought that would better serve his country. He had been rewarded in his life for his convictions, and he was now proud of his conclusions, even as they were contributing mightily to the super-catastrophe sure to come eventually from Tweakmore's scheme.

A large economic boom occurred in Boneheadia just as Tweakmore had expected. The boom made the regulators of Boneheadia feel extremely good about themselves as they passively watched the ever-enlarging operations of Tweakmore and Totalscum.

A famous regulator named Oblivious was particularly approving. He had been over-influenced in early life by classical economics. So influenced, Oblivious loved all the new derivatives, even those based on outcomes of parts of complex CDOs composed of parts of other complex CDOs. And he did not believe the government should rein in any investment banker until the banker's behavior was very much worse than Tweakmore's.

The boom initiated by Tweakmore lasted only three years. He had underestimated the boom's strength and the power of people to understand, in due course, super-sized folly. These factors had helped shorten the boom's duration. Also, Boneheadia had proved less like Japan than had been hoped.

When the boom-ending bust came, it was a doozy. Almost every investment bank had been made collapse-prone by Tweakmore's innovations before he became interested in home loans. And now, in a huge bust, most big financial institutions were sure to disappear, causing total chaos and another "Great Depression" unless there was super-massive intervention by the government, financed by printing money.

Fortunately, Boneheadia did so intervene, guided by effective leaders who somehow obtained support from politicians in both political parties. And, after this massive intervention, Boneheadia, with doubled unemployment, is enormously worse off than if the boom and bust had never happened. And its options in case of future trouble are greatly reduced because, after its money-printing spree, it is nearer to facing general distrust of its money and credit.

Boneheadia's bust is now called the "Great Recession." Yet, even so, not much has been learned by the elite in Boneheadia. Among the protagonists and too-passive types who contributed so much to the mess, only one has expressed significant contrition. To his great credit, Oblivious has recognized that he was grossly wrong.

The accounting profession remains unaware of its large contribution to public woe. And it does not recognize the cognitive defects of Countwrong, which are still believed to be virtuous qualities that reduce accountants' litigation risks and their duty to cause antagonism by opposing the wishes of some of their best-paying clients.

The professoriate in economics has barely budged toward recognition of the importance of optimized, more conservative accounting in both macroeconomics and microeconomics. And economics professors, even now, do not recognize what was so easily recognized by Tweakmore: The functional equivalent of undisclosed embezzlement can be magnified and have massive macroeconomic consequences when the victims, as well as the perpetrators are led to believe they are getting richer under conditions that are going to last for a long time.

How about the legislators in Boneheadia? Well, most are confused by what has happened to their most powerful friends and draw no useful implications from the outcome of Canadia, a country just north of Boneheadia that had no "Great Recession" because its simple laws and regulations kept in place home loan operations much like those of Wantmore before he embraced modern finance in the state preferred by Tweakmore.

How about the regulators? Well, very few important regulators or former regulators in all Boneheadia have expressed really serious doubts about the status quo and interest in really serious re-regulation of investment banking. One the doubters is Follyseer, a long-retired former minister of finance. Follyseer has argued that all contributions of Tweakmore to investment banking should be removed and banned, because it is now obvious that (1) augmenting casino-type activities in investment banks was never a good idea, and (2) investment banks are less likely to cause vast public damage when they are forbidden to use much financial leverage and are limited to few long-traditional activities.

Regarding accounting, no regulator now in power seems to understand, in a way that has any chance of causing effective remedial action, that the disaster triggered by Tweakmore couldn't have happened if Boneheadia's system of accounting regulation had been more "principles-based," with a different and less tradition-bound group creating accounting standards that were less easy to game.

The former regulator and lifelong professor who seemed extra wise after the Great Recession was England's John Maynard Keynes, dead for more than half a century. Keynes had predicted, correctly, that "When the capital development of a country is a by-product of the operations of a casino, the job is likely to be ill-done."

Afterword*: The foregoing attempt is* not *an attempt to describe in a fair way real contributions to the "Great Recession" in the United States. Certain characters and industries, for instance, Tweakmore and investment banking, are grossly overdrawn as contributors to sin and mayhem, while other contributors are not discussed at all. The whole idea was to draw attention to certain issues in accounting, academic economics, and conceivable over-development of finance as a percentage of the entire economy, by making the characters and the story line extreme enough to be memorable.*

1999 Wesco Shareholder Meeting, Pasadena CA 1999

By simpleinvestor posted on www.fool.com | about stocks: BRK.A / BRK.B / WSC

Following note was found on Motley Food (www.fool.com) website, posted by user name "simpleinvestor"

FREE INVESTMENT SEMINAR

The last time I visited Pasadena in 1977, Michigan lost the Rose Bowl to USC. My team got a football lesson then and when I returned last week a lucky few got a world class investment lesson.

The Wesco annual meeting in Pasadena, California is more of a free investment seminar held in a classroom for 200 students. The Omaha meeting is more of a spectacle of financial advice staged in an arena of 15,000 participants. In the future plan to attend both but my preference is Pasadena. In Omaha you meet fellow shareholders in an arena. In Pasadena you learn in a classroom (University Club).

Charlie Munger was a different advisor. Never once did he say, "I have nothing further to add." He spoke like a college professor with candor and experience. With such a small audience it was easy to ask questions. Some even had the opportunity to ask more than once. It's an open meeting. No ticket required.

Lou Simpson was in attendance (his first) and answered some GEICO questions. The tables were turned and Mr. Munger asked Alice Schroeder from PaineWebber some questions.

The entire meeting lasted 3 hours and I was able to take as many notes as the Omaha meeting. The most significant thing that I learned was a better comprehension of technology and the Internet. And an unexpected surprise tour the next day.

When you turn off the noise coming at you from all angles in the investment world, you need to know when to turn your senses back on. In Pasadena you could open your eyes and ears and listen to every question and remember every answer.

Here's a summary of my notes and observations.

1. GOOD IDEAS CAN HURT YOU. For as much as Mr. Munger and Mr. Buffett claim to not consider technology in their circle of competence, I learned a new way of looking at tech. When you come across a bad idea you and everyone else know it's bad, so it can't hurt you. On the other hand when you come across a good idea it's easy to over do it. Mr. Munger liken the Internet to railroads, refrigeration, radio, television and air conditioning. Great technological advances for mankind but not necessarily great investments. Ben Graham said it's not the bad ideas that do you in. It's the good ideas that get you. You can't ignore it and it's easy to over do it. Mr. Munger stressed that technology has opportunities but it's potentially way over done.

2. THERE'S ALWAYS SOMETHING THAT PEOPLE GO CRAZY OVER. In the 1920's it was the over-leveraged stock market and the Florida land speculation. In the 60's it was junk stocks, overvaluations and efficient market theorists. EMT reached insanity levels. Buffett closed his partnership in the 60's because of too much speculation. Which led to junk bonds of the 80's. Today it's the Internet stocks. Mr. Munger's prediction: immense losses will be realized with Internet investments. This is a major reason to have experienced money managers making decisions for you.

3. LESSONS FROM JAPAN. Looked what happened to Japan. A clannish people, smart, hard working and prosperous society. They were led into excessive land speculation, bank fictional accounting, and stock market excesses. The so called 'wealth effect' became a narcotic that eventually crashed. Mr. Munger told the story of Bank of America selling their modest Tokyo executive house for $55 million cash during the height of Japans over-exuberance. Japan attempted to fix their economy with classic Keyesian economic theory; interest rates to zero and high debt but still suffers from a long lasting depression.

4. TELEVISION COMPARED TO THE INTERNET. Mr. Munger considers the invention of the television more impactful than the Internet. Instant color pictures brought into the home could be captured by a few broadcasting networks, which led to good investment returns. Any single provider will soon wire the Internet into the home with unlimited bandwidth but no monopoly.

5. HOT STOCK TIPS VERSUS INVESTMENT LESSONS. One former stockbroker in attendance walked away from the annual meeting (free investment seminar) with a hot stock tip. Lou Simpson and Mr. Munger talked about Mercury Insurance and their respect for the fellow running it. Some took that as a stock tip. I interpreted it as something that I didn't understand and was glad to have experts in charge of making investment decisions for me. If Charlie or Lou thought Mercury was a great investment I am confident they would buy it on my behalf. We're partners in business not competitors.

6. CONCENTRATED PORTFOLIO. Mr. Munger, Mr. Simpson and Mr. Buffett's investments all have one thing in common. They believe in concentrating their portfolios. If you are confident enough to select 3 to 10 common stocks for the long term you too can compete against this distinguished group. If you need to diversify out of ignorance its best to own a low cost and tax efficient index fund. Mr. Munger took a poll of the audience and 90 percent owned fewer than 12 common stocks. Berkshire has 60 percent of its common stock holdings in 3 stocks. Wesco has 95 percent of its common stock holdings in just 3 stocks.

7. DON'T BELIEVE THE BERKSHIRE RUMORS. Mr. Munger said that Berkshire Hathaway is not buying REITS but Mr. Buffett was personally buying some. REITs are more suitable for personal investment because of the dividends. Munger teased Buffett saying that buying REITs was resorting to cigar butt investing and a need to support the lifestyle of his globetrotting wife.

8. GEN RE. Very happy with the way things are going with General Re. Cologne Re charge against earnings was a surprise and not an intentional deception by management.

9. STOCK OPTIONS. Berkshire handles executive compensation the honest way by declaring it as an expense on the earnings statement. When Berkshire acquired Gen Re it declared upfront $63 million of compensation expenses to inform shareholders as to the true costs against earnings. Mr. Munger considers himself the sole voice against a widely used practice of deceiving the shareholders with stock options. The typical stock option program is corrupt accounting and is like a Ponzi scheme. An investment farce where high profits are promised from fictitious sources and early investors are paid off with funds raised from later ones. The average stock option program bleeds 12 –14 percent of profits from shareholders. Mr. Munger thinks the accounting profession bends too much and should have higher standards like the engineering profession. Better standards are needed.

10. YEAR-END CASH. Berkshire loves companies that have earnings at the end of the year in cash. Mr. Munger compared this desire with a friend who had a construction equipment firm that had all his annual earnings in accounts receivable and equipment in the yard at the end of the year.

11. FOUNDATION MANAGEMENT. One word for it – preposterous. Mr. Munger likens it to a mad hatter's tea party. Too many layers. Consultants hired to hire more consultants. No value added.

12. ANALYST COVERAGE. Welcomed Alice Schroeder of PaineWebber and took the opportunity to ask her some questions. She reassured shareholders that she wasn't given any special treatment. Information that Alice used in her writings is available to all owners in the annual reports. Berkshire releases all public information on the Internet after market hours for all interested parties so no one has inside information.

13. CASUALTY BUSINESS. It's going to get more competitive. Mr. Munger compared the casualty insurance business to rowing against a strong current but Berkshire has a very large well-equipped boat.

14. GEICO COMPETION. Mr. Munger called on Lou Simpson to explain GEICO's competition. He said in Southern California its 20th Century and Mercury. Elsewhere its Progressive and potentially AIG, and GE (Colonial Penn), State Farm, and Allstate. Business will be tougher in the next 5 years, but Mr. Munger likes what's happening at GEICO. It's the biggest advertiser on cable.

15. ERRORS OF OMISSION. Mr. Munger said they should have bought more Coke. Once you know it's a good idea you don't need to talk about it. Berkshire's success is measured by how successful they were buying Coke but should be measured by how much more successful they would have been if they bought more. No other management team would be so candid to talk about their errors of omission.

16. CONTRIBUTION TO SEE'S. Berkshire's contribution to See's Candies has been to leave it alone. Often Headquarters screws it up by thinking it knows best. Berkshire doesn't like to micro manage.

17. DIFFICULTY OF ACHIEVING 15% RETURNS IN THE FUTURE. Because of its size Berkshire will have a difficult time achieving market-beating returns in the future. But Mr. Munger said that if you understand the difficulty of something you have a better chance.

18. S&P INDEX ADDITION. Just a matter of time before Berkshire is added and figuring out how to add a stock that has little shareholder turnover.

19. INVESTMENT SUCCESS. To win at investing you need to know and understand many main models of the world e.g. Ponzi scheme. Find an investment manager who is concerned about disappointing you, the customer. Evaluating human beings is important in management and investing.

20. BUSINESS SCHOOLS SHOULD TEACH RETAILING FIRST. Mr. Munger thinks a business education should start first with retailing. When Charlie and Warren walk into a retail business, like a car dealership, they immediately begin to analyze it. Its how they're wired.

21. HOW TO MAKE YOUR LIFE BETTER. Mr. Munger believes in his latticework of models. And he believes that the best thing you can do to make your life better is to master life's models.

22. BUFFETT FOUNDATION. Mr. Munger said that the 5% annual payout required after both Mr. and Mrs. Buffett deaths will not affect the normal operations of Berkshire Hathaway and will be insignificant. No need to worry about future family influences of the Buffett's or Munger's.

23. GREAT STORIES. Mr. Munger told many great stories. A few about Wrigley Chewing Gum and an entertaining one about silver mining companies that made money on silver and by shareholder fraud. Another great story of an investment manager who recently made $100 million for himself by selling his firm but had not served his customers well.

All in all it was one of the best free investment seminars that I have ever attended. Honest. Straightforward. Unrehearsed. Unedited. Nothing to sell. Nothing to buy. Just a great way to size up management.

You can read the transcript but you won't be able to see and hear the tap dancing. This is a great mind available to us all. Next year by popular demand, Mr. Munger plans to expand the meeting.

A SIDE NOTE: Okay I have to admit that I did something after the Wesco Financial annual meeting that may rank higher than learning from one of the best minds in the investment business. In fact this may be the most fun of any business/manufacturing tour I have ever taken and hope to take again. I got a tour of See's Candy factory in Los Angeles.

Jesus Soria, production manager, said there were only a few rules on the chocolate factory tour. One, you can taste anything while inside the factory. Two, you can't take anything with you. Wow. Talk about a kid in a candy store. If you see a noticeable dip in next quarters See's candy profits you can attribute the loss to me.

Being the loyal shareholder I am, I taste tested just about everything. What a tour. And Jesus (a.k.a. Chewy) was able to answer just about every question; including competition, distribution, synergies with other subsidiaries, production before Berkshire, expansion plans, employee relations, spoilage, shrinkage, the manufacturing process, shelf life, and seasonal workloads.

An annual tour of this production facility is a must for any shareholder attending the Wesco annual meeting. An extraordinary investment (and life) seminar followed by a gastronomic delight.

Hope to see you next year.
Willy Wonka

Charlie Munger Speaks

Notes from the Wesco Annual Meeting

By Whitney Tilson
May 15, 2000

As an admirer of Warren Buffett and a **Berkshire Hathaway** (NYSE: BRK.A) shareholder, I make a point of attending the company's annual meetings so I can learn from the answers to dozens of questions from his shareholders. Sharing the stage with him is Charlie Munger, Berkshire Hathaway's Vice Chairman and Buffett's long-time partner.

The dynamic is pretty funny to watch: Buffett generally takes the first stab at answering a question, but after giving his answer turns and says, "Charlie?" Munger, immobile and expressionless throughout the day (they could easily substitute a mannequin for quite a while and no-one would notice), typically replies, "I have nothing to add."

But as you can see from my notes from this year's meeting (summarized in my previous column), Munger often does have something to add, and it is invariably sharp and insightful. In many ways, he's more entertaining than Buffett because he doesn't pull any punches (I think his "mixing raisins and turds" line will go down in Berkshire history).

Over time, I have come to realize that Munger is a genius in his own right, and has had a profound effect on Buffett's thinking (which Buffett freely acknowledges). So who is this "cranky, old fashioned" man (to use his words)? I think many of the answers will be revealed in Janet Lowe's upcoming book, *Damn Right*, which she tells me will be available in October. But I wanted to find out for myself, so I recently attended **Wesco Financial's** (AMEX: WSC) annual meeting, where Munger, the company's long-time Chairman, took questions from shareholders for two hours. (Since 1973, Berkshire Hathaway has owned 80.1% of Wesco. I am a Wesco shareholder and plan to write a future column about the company and why I believe it's attractively priced.)

As I did in my last column, I will try to distill my notes down to the most important things I heard. Note that in some cases I am paraphrasing because I couldn't write quickly enough.

Opening Statement

"This only masquerades as a shareholder's meeting. It's really a gathering to hear the thoughts of the assistant headmaster of a cult."

Comments on Berkshire Hathaway and Wesco

Making the Right Personnel Decisions

"It's amazing how few times over the decades we've have to remove a person -- far less than other companies. It's not that we're soft or foolish, it's that we're wiser and luckier. Most people would look back and say their worst mistake was not firing someone soon enough. [We don't say that.] Our record is fabulous. We're old-fashioned. For example, in the case of CORT Business Services [a furniture rental business that Wesco acquired this year], Warren said to me, 'You're going to love Paul Arnold [CORT's CEO].' And he was right. Paul's been running the business since he was in law school and loves it.

Berkshire Hathaway's Culture

"There are certain virtues that are common in all of Berkshire's subsidiaries. We don't create them -- we select companies that have them already. We just don't screw it up."

Writing More Insurance

"Both Berkshire Hathaway and Wesco write amazingly low amounts of insurance relative to our surplus. It gives us investment flexibility. We just don't find enough insurance to write -- we'd do more if we could. Writing insurance equal to 10% of surplus for Berkshire Hathaway would be hog heaven -- we don't come close to that. Wesco didn't either, but we took on one big policy this year."

Lumpy Results

"That is one of our advantages as an insurer -- we don't give a damn about lumpy results. Everyone else is trying to please Wall Street. This is not a small advantage."

Risks to Berkshire Hathaway from Large Super Cat Losses

"We don't write big super cat contracts where there's no upper limit [cat means catastrophe; for example, insuring against a large earthquake in California]. It's inconceivable that we'd lose more than 6-7% of the company's assets after tax in one event. The real risk is borne by insurers who write, for example, basic homeowner's policies against a storm or earthquake and don't lay off some of that risk. That's roughly what happened to 20th Century, where they lost 100% of their capital in the Northridge (CA) Earthquake due to writing lots of little policies concentrated in an earthquake area."

Buffett's Successors
A shareholder noted that Berkshire Hathaway's succession plan calls for two people to replace Buffett: one to make the investments and one to oversee the operating companies. Lou Simpson of GEICO has been designated (at least unofficially) for the former position, so the shareholder asked, "Could you share with us who has been designated for the latter role?" Munger's succinct reply, "I could but I won't." [In the past, Buffett has defended his decision not to reveal this person because he might change his mind and wants to avoid the media circus that would invariably occur were this to happen.]

Why Not Use Wesco to Make Smaller Investments?
A shareholder noted that Buffett and Munger have long maintained that Berkshire Hathaway's size makes finding attractive investments difficult. Why then, he asked, don't they use Wesco to make smaller investments? Munger replied, "Lou Simpson will occasionally do smaller investments. But we're not set up to do small investments. Also, Warren and I are idiosyncratic and are unlikely to change our spots."

Berkshire Hathaway Repurchasing Shares
"In the past, when Berkshire has gotten cheap, we've found other even cheaper stocks to buy. I'd always prefer this. It's no fun to have the company so lacking in repute that we can make money for some shareholders by buying out others."

Why Don't More Companies and Investors Copy Berkshire Hathaway?
"It's a good question. Our approach has worked for us. Look at the fun we, our managers, and our shareholders are having. More people *should* copy us. It's not difficult, but it looks difficult because it's unconventional -- it isn't the way things are normally done. We have low overhead, don't have quarterly goals and budgets or a standard personnel system, and our investing is much more concentrated than average. It's simple and common sense.

"Our investment style has been given a name -- focus investing -- which implies 10 holdings, not 100 or 400. Focus investing is growing somewhat, but what's really growing is the unlimited use of consultants to advise on asset allocation, to analyze other consultants, etc.

"I was recently speaking with Jack McDonald, who teaches a course on investing rooted in our principles at Stanford Business School. He said it's lonely -- like he's the Maytag repairman.

"I was in the ROTC for six years and saw a very limited culture [in the military] with few new ideas. It's the same elsewhere"

Future Outlook for Berkshire Hathaway
"The future will be harder for Berkshire Hathaway for two reasons:

1) We're so big. It limits our investment options to more competitive areas that are examined by very smart people like Alice Schroeder [Paine Webber's insurance analyst, who was sitting in the audience].
2) The current climate offers prospects in common stocks over the next 15-20 years that are *way* less than we've experienced over the past 15-20 years. Read Warren's *Fortune* article -- I totally agree with it.

"But this is not a tragedy. We're content. Berkshire Hathaway and Wesco will accumulate cash every year, and we have a structure that gives us enormous flexibility. While we're too big to buy the stock of a small company, we have the advantage of having entire companies offered to us. Something has always turned up for us. I'm not discouraged, but I don't think your money here is going to do anything like what you're used to."

Charlie Munger Speaks - Part 2

Notes from the Wesco Annual Meeting

By Whitney Tilson
May 15, 2000

Comments on Businesses
Coca Cola
"Over the next 20-30 years, Coke will be selling more soda and other drinks. They will also be able to raise prices moderately and increase margins. Therefore, if you own Coke, you'll do all right. [Regarding the stock's high valuation,] if you project growth long enough into the future, you can get high current valuations. So what you're seeing in Coke's stock price is the residual prediction that despite its recent stumbles, they'll be coloring a lot more water 20 years from now."

The Furniture Business

"Berkshire Hathaway now owns the leading furniture retailer in six states and, through CORT, has a substantial position in the rent-to-rent [as opposed to rent-to-own] furniture business. This all came about by accident. The furniture business is generally not a good one, but if you own the best companies, it's a fine business for us. It seems like CORT's business wouldn't be a good one, but it is."

MidAmerican Energy
"Who would have thought we'd buy an electric company in Iowa? But this is a perfectly decent investment. It also gives us a window into a field where a lot of crazy things are going on, which may give us other opportunities [see the discussion of the real options that MidAmerican has in my recent column]."

Net Jets' Expansion into Europe
"Europe is a bitch of a place to get into, with all its countries and rules. We are losing money and expect that this will continue for a while. But look at the situation faced by the 2nd mover: all the same troubles and we're already there. Coke has done this all over the world and look how it's paid off."

The Newspaper Business
"It is way less certain to be a wonderful business in the future. The threat is alternative mediums of information. Every newspaper is scrambling to parlay their existing advantage into dominance on the Internet. But it is way less sure [that this will occur] than the certainty 20 years ago that the basic business would grow steadily, so there's more downside risk. The perfectly fabulous economics of this business could become grievously impaired."

General Comments
Earnings Manipulation and Accounting Shenanigans
"With so much money riding on reported numbers, human nature is to manipulate them. And with so many doing it, you get Serpico effects, where everyone rationalizes that it's okay because everyone else is doing it. It is always thus.

"Now, it's chain letter mechanics. Because it's mixed with legitimate activities like venture capital, it looks respectable. But we're mixing respectable activity with disrespectable activity -- hence my comment at the Berkshire Hathaway annual meeting about if you mix raisins with turds, you've still got turds. There is nothing in accounting that can prevent unscrupulous managers from engaging in a chain-letter-type fraud.

"I hate with a passion GAAP [Generally Accepted Accounting Principles] as applied to derivatives and swaps. JP Morgan sold out to this type of accounting to front-end revenues. I think it's a disgrace."

Interest Rates

"Neither Warren nor I have any record of making large profits from interest rate bets. That being said, all intelligent citizens of this republic think a bit about this. In my lifetime, I've seen interest rates range from 1% to 20%. We try to operate so that really extreme interest rates in either direction wouldn't be too bad for us. When interest rates are in a middle range, as they are now, we're agnostic."

Japan's Recession

"Anyone has to be flabbergasted by Japan's recession, which has endured for 10 years, despite interest rates below 1%. The government is playing all the monetary games, but it's not working. If you had described this situation to Harvard economists, they would have said it's impossible. Yet at the same time, there's an asset bubble in Hong Kong. Why? Because Japan and China are two vastly different cultures. The Chinese are gamblers.

"This is a classic example of why, to be a successful investor, one must draw from many disciplines. Imagine an economist standing up at a meeting of economists and giving my explanation. It wouldn't be politically correct! But the tools of economics don't explain what's going on."

Advice to Other Investors

Opportunities for Small Investors

"If you have only a little capital and are young today, there are fewer opportunities than when I was young. Back then, we had just come out of a depression. Capitalism was a bad word. There had been abuses in the 1920s. A joke going around then was the guy who said, 'I bought stock for my old age and it worked -- in six months, I feel like an old man!'

"It's tougher for you, but that doesn't mean you won't do well -- it just may take more time. But what the heck, you may live longer."

Practice Evolution

"This is really important. For example, Hertz and Enterprise Rent-a-Car through practice evolution have developed personnel systems, etc. that work for them. They are like different species in similar ecological niches.

"Common stock investors can make money by predicting the outcomes of practice evolution. You can't derive this by fundamental analysis -- you must think biologically.

"Another example is Tupperware, which developed what I believe to be a corrupt system of psychological manipulation. But the practice evolution worked and had legs. Tupperware parties sold billions of dollars of merchandise for decades.

"We wouldn't have bought CORT if we didn't like the culture, which resulted from long practice evolution."

Mental Models for Investing

"You must know the big ideas in the big disciplines, and use them routinely -- all of them, not just a few. Most people are trained in one model -- economics, for example -- and try to solve all problems in one way. You know the old saying: to the man with a hammer, the world looks like a nail. This is a dumb way of handling problems."

Be Satisfied with What You Have

"Here's one truth that perhaps your typical investment counselor would disagree with: if you're comfortably rich and someone else is getting richer faster than you by, for example, investing in risky stocks, *so what*?! Someone will *always* be getting richer faster than you. This is not a tragedy.

"Look at Stanley Druckenmiller [who ran one of George Soros' funds, which is essentially being shut down due to large losses in speculative tech and biotech stocks]: he always had to be the best and couldn't stand that others were beating him by investing in these sectors.

"A lot of success in life and business comes from knowing what you want to avoid: early death, a bad marriage, etc."

Recommended Books and Comments on Silicon Valley

Munger was asked to name his favorite books of all time. He replied, "That's hard because I mix ideas from so many books. One fabulous book is The Selfish Gene, which provides basic insights on human conditions. [In the past, Munger has strongly recommended Influence: The

Psychology of Persuasion, which I just read and liked enough to add it to my list of all-time favorite books related to investing.]

Later, Alice Schroeder, who covers the insurance industry for Paine Webber, asked if he'd read The New New Thing, Wall Street On Sale or the new translation of Beowulf. He had only read the former, and commented: "It was interesting enough for me to finish it. In some respects it describes an appalling culture. While Silicon Valley has made great contributions to society, some things come pretty close to 'the unacceptable face of capitalism.'"

EVA

Asked to elaborate on his comments at the Berkshire Hathaway meeting on Stern Stewart and their concept of Economic Value Added, Munger said:

"It's obvious that if a company generates high returns on capital and reinvests at high returns, it will do well. But this wouldn't sell books, so there's a lot of twaddle and fuzzy concepts that have been introduced that don't add much -- like cost of capital. It's accepted because some of it is right, but like psychoanalysis, I don't think it's an admirable system in its totality."

A number of people have asked whether I agree with Munger's dismissal of EVA. Sort of. I agree with his comment about the "twaddle," but fear that he may have deterred people from studying and understanding return on invested capital -- the single most important metric I consider when evaluating a company. Sure, Bennett Stewart's book, The Quest for Value, is unbearably dense, but ROIC is *not* a difficult concept nor is it difficult to calculate. For an understandable (not to mention free) take on ROIC, I recommend the Fool's School, A Look at ROIC, and Paul Johnson's Introducing ROIC as an Economic Measure (focus on pages 1-9 and 35-37). Johnson is one of the authors of The Gorilla Game, my favorite book on tech investing.

-- Whitney Tilson

Charlie Munger Holds Court

Charlie Munger, who runs Wesco Financial, is the famed right-hand-man of Warren Buffett -- but is also a master investor in his own right. At Wesco's annual meeting last week, he shared his always-blunt opinions on the expected returns from Berkshire Hathaway and Wesco stocks as well as equities in general, the scandalous state of pension fund accounting, the decline of public schools, and more.

By Whitney Tilson
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Given that more than 10,000 people attend **Berkshire Hathaway's** (NYSE: BRK.A) annual meeting each year, I'm always surprised by the paltry attendance -- maybe a couple hundred people -- at the annual meeting of **Wesco Financial** (AMEX: WSC), which is 80.1%-owned by Berkshire and whose CEO is Berkshire Vice Chairman Charlie Munger. One needn't even be a Wesco shareholder to attend.

While Buffett gets all the attention -- and is, according to Munger, the superior investor -- Munger is himself an investment genius and, were it not for Buffett, might well be acclaimed the world's greatest investor. Before Munger joined forces with Buffett in the mid-1970s, his investment partnership compounded at an average rate of 24.3% annually -- vs. only 6.4% for the Dow -- between 1962 and 1975.

As I did in last week's column on the Berkshire Hathaway annual meeting, I will try to distill more than 20 pages of notes down to the most important things I heard. (My notes can be seen in their entirety at my website.) I've added a little commentary, but will generally let Munger speak for himself. Recording devices were not allowed in the meeting, so in many cases I am paraphrasing because I couldn't write quickly enough.

Future returns from equities: stocks and Rembrandts

"If I'm wrong [about future stock market returns being in the mid-single digits], it could be for a bad reason. Stocks partly sell like bonds, based on expectations of future cash streams, and partly like Rembrandts, based on the fact that they've gone up in the past and are fashionable. If they trade more like Rembrandts in the future, then stocks will rise, but they will have no anchors. In this case, it's hard to predict how far, how high, and how long it will last.

"If stocks compound at 15% going forward, then it will be due to a big 'Rembrandt effect.' This is not good. Look at what happened in Japan, where stocks traded at 50 to 60 times earnings.

This led to a 10-year depression. I think that was a special situation, though. My guess is that we won't get extreme 'Rembrandtization' and the returns will be 6%."

Berkshire's past returns

"Berkshire's past record has been almost ridiculous. If Berkshire had used even half the leverage of, say, Rupert Murdoch, it would be five times its current size."

Future returns on Berkshire Hathaway and Wesco

"The future returns of Berkshire and Wesco won't be as good in the future as they have been in the past. The only difference is that we'll tell you. Today, it seems to be regarded as the duty of CEOs to make the stock go up. This leads to all sorts of foolish behavior. We want to tell it like it is.

"I'm happy having 90% of my net worth in Berkshire stock. We're going to try to compound it at a reasonable rate without taking unreasonable risk or using leverage. If we can't do this, then that's just too damn bad."

Berkshire is "a hell of a business"

"The businesses that Berkshire has acquired will return 13% pre-tax on what we paid for them, maybe more. With a cost of capital of 3% -- generated via other peoples' money in the form of float -- that's a hell of a business. That's the reason Berkshire shareholders needn't totally despair. Berkshire is not as good as it was in terms of percentage compounding [going forward], but it's still a hell of a business."

Wesco vs. Berkshire Hathaway

"You shouldn't buy Wesco stock instead of Berkshire's."

Conservative nature

"This is an amazingly sound place. We are more disaster-resistant than most other places. We haven't pushed it as hard as other people would have pushed it. I don't want to go back to Go.

I've been to Go. A lot of our shareholders have a majority of their net worth in Berkshire, and they don't want to go back to Go either."

Synergies

"The reason we avoid the word 'synergy' is because people generally claim more synergistic benefits than will come. Yes, it exists, but there are so many false promises. Berkshire is full of synergies -- we don't avoid synergies, just claims of synergies."

The scandal of American pension fund accounting

"**IBM** (NYSE: IBM) just raised its return expectations for its pension fund to 10%. [Editor's note: Companies can make adjustments to the assumptions that make up the value of their pension funds, which can affect reported earnings.] Most companies are at 9%. We think 6% is more realistic. They may believe it -- they're honest people -- but subconsciously they believe it because they WANT to believe it. It makes earnings good so they can promote the stock.

"The reason accountants don't say anything is best summed up by the saying, 'Whose bread I eat, his song I sing.' I think you're getting very foolish numbers in American accounting. I don't think it's willful dishonesty, but it might as well be."

Corporate America's addiction to "extraordinary" charges

"If it happens every year like clockwork, what's so extraordinary about it?"
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Freddie Mac

"We're exceptionally goosey of leveraged financial institutions. If they start talking about risk management [e.g., how good it is], it makes us nervous. We fret way earlier than other people.

We left a lot of money on the table through early fretting. It's the way we are -- you'll just have to live with it."

"I don't want to be in the position of criticizing **Freddie Mac** (NYSE: FRE). It's had a wonderful record so far and for all I know, its risk management is perfect."

The decline of public schools
"You could argue that [the decline of public schools] is one of the major disasters in our lifetimes. We took one of the greatest successes in the history of the earth and turned it into one of the greatest disasters in the history of the earth."

Cheerful pessimism
I asked a tongue-in-cheek question: "Mr. Munger, I recently read about a Mayo Clinic study that showed that optimists live 20% longer than pessimists. I'm concerned because in the Berkshire Hathaway movie last weekend, you were referred to as the 'No-Man.' Is it too late for you to turn over a new leaf, so that we can benefit from your investing prowess as long as possible?" He laughed and said, "Is there such thing as a cheerful pessimist? That's what I am."

Munger's writings
At the meeting, Munger passed out a booklet with six of his writings and speeches that he used in a course he taught recently at Stanford Law School. To my knowledge, one of the essays,

"The Great Financial Scandal of 2003," has never been released to the public. (More details regarding the contents of this booklet are available on my website.)

I will write Munger shortly and ask for permission to post on the Web the first three articles in the booklet (the other three are copyrighted). If he says yes, I will include a link in a future column.

-- Whitney Tilson

Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owned shares of Berkshire Hathaway and Wesco at the time of publication. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit http://www.tilsonfunds.com/.
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Whitney Tilson's Notes from the 2001 Wesco Annual Meeting

Note: This is not a transcript. No recording devices were allowed at the meeting, so this has been reconstructed from 21 pages of frantic scribbles. I did not take notes on certain questions and answers that I felt weren't very interesting or that repeated what Munger has said many times in the past (or maybe my mind and/or wrist just needed to rest periodically).

Wesco and Berkshire Hathaway

Using Wesco as a vehicle for small investments

I asked Munger the following question: "Mr. Munger, an hour ago someone asked me what Wesco was worth. I threw up my hands and said, 'I don't know. With $1 billion in cash and a $2 billion market cap, Wesco's future returns will be largely dependent on how that cash is allocated.' Can you tell us how you plan to invest that money? In particular, you and Mr. Buffett have been saying for a long time that Berkshire Hathaway's increasing size is an anchor on the percentage rate of return it will be able to generate in the future. You have also said that certain investors with smaller pools of capital could generate very high rates of return. So why don't you use Wesco as your vehicle to do smaller investments, such as those that Mr. Buffett sometimes does in his personal portfolio?"

Munger replied, "Warren spends 70 hours a week thinking about investing, and we're not talking about large sums [in his personal portfolio]. He does these investments to amuse himself when he's not playing bridge."

"Even with the amount of money that Wesco has makes it very hard to play this game. You just have to have a prepared mind and be able to move rapidly."

" It took us months of buying all the Coke stock we could to accumulate $1 billion worth -- equal to 7% of the company. It's very hard to accumulate major positions."

Competitive advantages

"We don't have automatic competitive advantages. We're seeing some more insurance volume, mainly from General Re, and Cort and Precision Steel have momentum, but we have to find future advantages through our own intellect. We don't have enough critical mass and momentum in place at Wesco, so investors are betting on management."

"We have one slight edge that helps us: there's a lot of human love in building at least some businesses and some people who own businesses love them. They don't want to sell to a financial buyer who will dress it up and strip it down. When we buy a company, we don't tinker with winning businesses. So, for some sellers such as Justin, Berkshire Hathaway was the only acceptable buyer."

"If you want a culture like ours, I don't know anywhere to get it if not here. In that sense, we're stronger than we were years ago because we're better known. I don't think GE is going to catch us in this area."

"So, we may well have a competitive advantage buying decent businesses at decent prices. But they won't be fabulous businesses and fabulous prices. There's too much competition and money out there, with many buyout specialists. Debt is tight right now, which helps us. Berkshire wouldn't have been able to buy Johns Manville were it not for this."

Wesco's history
"Wesco had a market capitalization of $40 million when we bought it [in the early 1970s]. It's $2 billion now. It's been a long slog to a perfectly respectable outcome -- not as good as Berkshire Hathaway or Microsoft, but there's always someone in life who's done better."

Berkshire buying Wesco outright
"It's a historical accident [that Wesco is only 80.1% owned by Berkshire and that its stock continues to trade], due to complicated tax reasons. I suspect that it will eventually become wholly owned by Berkshire, but it's hard to do when you people maintain this enthusiasm [for the stock]."

Berkshire's future returns
"Warren said [at the Berkshire annual meeting] that he hoped to do modestly better than the market. 15% would be a hell of a number, so the target is the 6-15% range."

"You're in the same boat we are."

Buffett's decision making
"Warren is amazingly quick to say both yes and no."

Cort
"Cort will keep growing, both via acquisitions and expanding in its current markets. It will do pretty well. It's like Enterprise Rent-A-Car. They both have a terrific culture, service and incentive system."

"Cort has good relationships with its suppliers. Capitalism works better when there's trust in the system."

General Re
"It's one of the best reinsurance operations in the world. It has a strong distribution network and culture -- a culture of intelligence and discipline. It sees reinsurance opportunities that Berkshire doesn't. They have a huge advantage being there for so long. Gen Re's competitive advantage is that it's smarter and sees more opportunities."

"I don't think its returns in the future will be as good, but a 2-3%/year advantage is a lot over time."

"Reinsurance is interesting. A lot of people get into the business because of the money. Then, reinsurance brokers -- who are very well paid and can make dumb ideas look good

-- pitch them business. Boy, is this dangerous! Very smart people can make very dumb investments. Even GEICO and Gen Re get caught sometimes."

Insurance reserves
"In the past, we've under-reserved, but more often been overly conservative. Consequently, Berkshire and especially Wesco have been reversing some reserves."

Insuring against natural disasters
"No-one wanted to write California earthquake coverage [as Berkshire did]. We're like that."

"We don't think because it's never happened that it won't. There's no actuarial science, it's rough judgment. We just try to be conservative."

Wesco's and Berkshire's inefficient tax structure
"We don't have any miraculous way of avoiding taxes at Wesco and Berkshire. With float, we get some tax benefit."

[Munger said something about some of the most foolish behavior he's ever seen was a result of trying to avoid paying taxes.]

"What a terrible, inefficient thing it is to own real estate and securities in a Section C Corporation [like Wesco and Berkshire]. The enormous taxes we paid when we sold Freddie Mac last year is an example of this. If we were a partnership, you wouldn't have had to pay this. It's very hard."

"We drifted into this structure by accident. We bought a doomed textile mill [Berkshire Hathaway] and a California S&L [Savings & Loan; Wesco] just before a calamity. Both were bought at a discount to liquidation value. It turned out wonderful for many people in this room -- Wesco's market cap has grown from $40 million to $2 billion -- but it was dumb. The structure is terribly inefficient and bad. It's much better when we buy wholly owned businesses like Precision Steel."

Why not franchise See's candy stores?
"It takes almost no capital to open a new See's candy store. We're drowning in capital of our own that has almost no cost. It would be crazy to franchise stores like some capital-starved pancake house. We like owning our own stores as a matter of quality control."

Walter Scott, Level 3 Communications, and Berkshire's investment in electricity
"Walter Scott has one of the best business records ever. People put a lot of money in new fiber optic networks, and now there is a bloodbath that has driven Level 3 stock down. I don't think it means that Walter Scott is any less of a businessman."

"Berkshire's electricity investment [in Mid-American Energy] was in a total system in Iowa and a distribution system in Britain. It's doing perfectly fine. I would not extrapolate these results to new capacity in a new field [such as Level 3]. Ours is a much more conservative investment."

"Electricity is a HUGE field. It's enormously stupid to run short of electricity. There's an opportunity to make reasonable returns and we're going to try."

Finova
"We're never done anything like this before, so there's no model. We think our offer is a good example for the creditors of Finova -- an honorable, intelligent transaction. It's fair to bondholders -- we're the largest -- and leaves some room for the stock to come back. It brings in good management with the right incentives. Of course there will be some complaints, but I'd be surprised if someone else comes in with the same offer."

"I wish every place in which we had a junk bond investment, someone came forward with an offer like ours."

Auto insurance pricing
"I think auto insurance is getting some rate increases. It was almost too good a business over the last 6-7 years."

Conservative nature
"We don't feel some compulsion to swing. We're perfectly willing to wait for something decent to come along."

"We're rich in relation to the business that we're doing."

Future returns from equities
"In certain periods, we have a hell of a time finding places to invest our money. We are in such a period."

"In Warren's *Fortune* article [11/22/99], he described the last two 18-year periods. During the first period, the market was essentially flat. The most recent one has been a marvelous period. Warren said that in the nature of things, double-digit returns couldn't go on and on and on. Therefore, individual shareholders and pension funds should reduce their expectations. My guess is that he'll be right for a long period ahead. There will be way lower returns over the next 15-18 years."

"The normal expectancy of the average investor -- for example, the pension funds of AT&T or IBM -- is 6% for a long time."

"With stocks yielding 1.5% and trading at 4-5x book value, it's not as much fun as it was buying Coke and Gillette at much lower prices relative to their valuations."

Recent stock market decline

"What you've recently seen is just a tea party. If you, like me, lived through 1973-74 or even the early 1990s… There was a waiting list to get OUT of the country club -- that's when you know things are tough. If you live long enough, you'll see it."

Purchase vs. pooling for acquisitions
"The problem is that the exact same transaction is treated differently. That's crazy. The proposal to require that all acquisitions be done using purchase accounting is perfectly reasonable. Berkshire made a mistake buying Dexter Shoes. When we found out, we wrote it down and took a charge against earnings. The difference is that we didn't say it was a one-time or unusual charge -- we just took it against earnings."

Retailing and Costco
"If I were teaching at business school, I'd take people through retailing because it's easy to understand. Retailing is pretty simple. There are four or five strategies."

"I'm a director of Costco. It's easy to understand. In the history of the world, few companies have succeeded on a 12% mark-up. They make it up with high volume. Costco has the right culture. They promote from within. It's a wonderful place to work."

"I think that Costco is a better operator in the warehouse club format than Sam's. Both companies will do well in the future, but I predict that Costco will do better."

"I don't know why schools don't teach this, but I'd teach a lot of things differently."

State Farm
"State Farm is one of the very richest insurance companies in the world. It's an honorable, old fashioned, high-grade place. They have integrity and skill. In condominium insurance, for example, they're the best. They're in Indiana, don't have elaborate compensation schemes, no stock options, and no high-falutin' advisors -- and they've blown by competitors. We admire them."

"They're enormously rich, so if they decide to keep a lid on auto insurance, I can't predict when they might stop. We [at GEICO] have a better model though."

Demutualization
"Are policy holders treated fairly [when an insurance company demutualizes]? The ordinary answer is 'No.' What a surprise."

How to detect bad reserving
"If [an insurance company's] combined ratio is wonderfully regular, then it's probably crooked. It's also a bad sign if a company is consistently under-reserving."

"Sometimes you can tell by the people that the numbers are good. For example, George Joseph of Mercury General is a genius and you know his numbers are right."

Wrigley

"Wrigley is a great business, but that doesn't solve the problem. Buying great businesses at advantageous prices is very tough."

Financial industry
"The financial industry has become so big. We keep pushing it further and further and further. For example, we now lease new autos for 36 months and guarantee a high residual value. How much further can you push consumer credit? We don't like it. We don’t like pushing credit to extremes. We don't like daisy chain stock promotion. However, one of Berkshire's largest holdings is American Express, so we think it has a great future."

Medicare and HMOs
"The cost was projected to be X, but was actually 10X. People forgot that effects have effects. Incentives have super-effects. [Notes are sketchy here.] The original system was on a cost-plus basis. For example, a test was not reimbursed in a doctor's office, but was at a hospital, so doctors referred patients to the hospital to have the test. It was great for doctors and hospitals, but bad for patients and taxpayers."

"So then the system switched to DRGs [whereby providers were reimbursed a fixed amount for a certain disease/problem], which controlled costs somewhat. Then, there was a switch to HMOs, which did control costs. People who hate HMOs should realize that it was a needed response to a totally out of control system."

"Yes, HMOs have an incentive to deny needed care -- this kind of behavior is just unspeakable -- but no-one ever gives HMOs credit for preventing unnecessary, harmful procedures that doctors would otherwise do."

The decline of family-controlled businesses when family foundations take over
"Don't confuse correlation and causation. Almost all great records eventually dwindle. Those you mention [Reader's Digest, Kellogg] would have dwindled, even without family ownership."

"I think the foundation at Berkshire [Buffett's stake in Berkshire will pass to the Buffett Foundation upon his death] will be a plus because there will be a continuation of the culture. We'd still take in fine businesses run by people who love them."

Money managers
"We have a number of high-IQ individuals -- an enormous group compared to the past, 4-5 times as many -- devoting extraordinary time to beating the market. They have new vehicles: hedge funds, LBO funds, venture capital, international investing, etc. In the nature of things, some will succeed. But I don't think the mass of people's results, even pretty sound, glued-together people, will be very high."

"It's natural that you'd have more brains going into money management. There are so many huge incomes in money management and investment banking -- it's like ants to sugar. There are huge incentives for a man to take up money management as opposed to, say, physics, and it's a lot easier."

"I think it's inevitable but terrible -- a disaster for the wider civilization. I'm somewhat ashamed… That I've profited from being shrewd with money is not by itself satisfying to me. To atone, I teach and try to set an example. I would hate it if the example of my life caused people to pursue the passive ownership of pieces of paper. I think lives so spent are disastrous lives. I think it's a better career if you help build something. I wish I'd built more, but I was cursed at being so good at stock picking. 'The man is the prisoner of his talents.' You can laugh, but I'll bet this room is full of people who are prisoners of their talents. It tends to be the human condition."

Asbestos litigation
"This is one of the most interesting things on the current scene. It affects you as both citizens and investors."

"Asbestos had many wonderful qualities. But when the health risks became clear, the companies that were major users of asbestos such as Johns Manville covered it up and were rightly hit with damages through the tort system. But other companies only used small amounts -- for example, in brake pads or a bit in USG's paste. Because of a tiny bit of asbestos in brake pads, Ford has set aside $1.7 billion to pay claims. There was a gain to society and the risk was low. It's not clear to me the damage from these uses."

"The claims bar quickly drove into bankruptcy anyone who behaved like Johns Manville, and then went after companies that didn't know they did anything wrong."

"The tobacco companies caused almost all of this."

"Now there is a whole class of people filing claims who have no symptoms. This accounts for way more than half the money being paid out. You could argue that it was a mistake to pay these claimants."

"It's coming from companies on an extortion basis. There are judges in Texas who are in the pockets of the plaintiff's bar, and there are compliant juries. It's turning the courts into an extortion system."

"Isn't it interesting that the only brand names that plaintiffs can remember are the brands of the only two solvent companies?"

"Is it good for society that lawyers, workmen, etc. are lying, that junk science is accepted? It's a national disgrace. I don't know where it will stop."

"I regard what's happening to USG as a dishonorable mugging of an honorable place. I don't think they should be driven out of business, but I don't want to make predictions about this."

"Is the system sound when obvious fraud goes on a massive scale? I would say no. And it spreads. You get what you reward for. That's why the claims keep coming and coming and coming. If you want ants, put sugar on the floor."

Later, another shareholder asked if he'd been too harsh on this topic. That set Munger off again:

"I wasn't harsh enough! Once you've got people benefiting from the system and use the money to influence judges and politicians [you've got a real mess]. It creates a situation that's very hard to fix. It would have been relatively easy to prevent if we'd had the will, but now it will be hell to fix. As Ben Franklin once said, 'An ounce of prevention is worth a pound of cure.'"

The decline of public schools
"There's a similar situation with schools. In Omaha years ago, there was an influx of poor minorities and white flight. It was obvious that Omaha Central High School was tipping toward 100% low-income minority students. If this happened, there would be no good high school in Omaha for minorities. This happened everywhere else. But in Omaha, a group of blacks demanded that there be an anti-black quota at Omaha Central, which passed and saved the school. It's a wonderful story, but the tragedy is that it only happened in Omaha."

"If you let it go, I don't see how you can reverse a lot of this stuff."

Estate tax
"Personally, I'm against the estate tax at its current rate, with its rapid rise to 55%. It hits owners of auto dealers, plumbers, etc. I think the exemption should be raised. [Since this appears likely to happen,] out of our crazy democratic system, we're going to get a reasonable outcome.

"I have no problem with this rate [for estates] in the hundreds of millions of dollars. I have no problem personally with the estate tax."

California energy crisis
"The California energy crisis is a disgrace -- to schools, executives, both political parties. There's enough disgrace to go around. We richly deserve this miserable result, which is due to extreme stupidity and indifference. [Quit beating around the bush, Mr. Munger. Tell us what you really think!] We are like the canary in a coal mine for other states, which are saying, 'Boy, have these guys done us a favor!' It's ABC basic what needs to be done: decrease pollution, increase conservation, and have the right incentives in the rates."

"In modern academia, there's no shame. People are taught Beowolf, but can't think their way out of a paper sack."

Investing abroad

"We don't feel any compulsion to go abroad because of any strategic considerations. We haven't taken the advice of any financial planner that I'm aware of. We have more comparative advantage buying in the U.S. because we're well known. There's no master plan. We're individual opportunity driven."

Mental models
"If you have the right mental equipment from the right education, you know it. We [at Berkshire and Wesco] have experienced people with the right models. You don't want to be the patient of a surgeon who's doing his first complicated procedure."

"My speech about mental models using Coke as an example was a failure. People had to read it two or three times before it sunk in, and even then it only sunk in if people already half knew it."

Prediction of interest rates
"Neither Warren nor I has ever made a dime in this area."

John Train
Asked to comment on John Train's books (The Money Masters, etc.), Munger said, "He's a gifted writer with moderate insights into the investment process."

Damn Right (biography of Munger by Janet Lowe)
"I didn't want it done. I felt that the disadvantages outweighed the advantages. I like to keep private. But once it became clear that she would write it with or without me, it was obviously the right decision to cooperate. I got to like Janet Lowe -- she's a very high-grade person. The book gave me the chance to spread some of my ideas without having to do the work. One idea is that whenever you think something or some person is ruining your life, it's you. A victimization mentality is so debilitating. I love spreading this stuff around. Just because it's trite doesn't mean it isn't right. In fact, I like to say, 'If it's trite, it's right.'"

Munger's writings
"For you masochists, I taught a course at Stanford Law School recently and compiled some readings. Copies are available in boxes at the front of the room."

The booklet, privately printed by Munger, is entitled "Some Investment-Related Talks and Writings Made or Selected by Charles T. Munger." In it is:

1) "The Great Financial Scandal of 2003, An Account by Charles T. Munger." Unlike the other readings in this booklet, I don't believe this has ever been published before. It details a hypothetical financial scandal in 2003, triggered by dishonest accounting, especially for options, at an imaginary tech company called Quant Tech (which appears to be a bit of Cisco, IBM and the like).
2) "11/10/00 Talk of Charles T. Munger to Breakfast Meeting of the Philanthropy Round Table." Munger rails against --among other things -- "common-stock-price-

related 'wealth effects'" and foundations and other investors "wasting 3% of assets per year in unnecessary, nonproductive investment costs."

3) "Investment Practices of Leading Charitable Foundations, Speech of Charles T. Munger on October 14, 1998 to a meeting of the foundation financial officers group." Munger continues railing against the investment practices of foundations -- lessons that apply to nearly all investors. You can read it at http://www.tiff.org/pub/pages/othres.html?body=Munger_Speech.html.
4) "Mr. Buffett on the Stock Market," 11/22/99. A reprint of Buffett's *Fortune* magazine article, in which Buffett presciently warns investors about the tech bubble and argues that stock market returns for the foreseeable will be in the mid-single digits. You can read it at http://w3.res.ulaval.ca/cours-gsf-60808/buffet.html.
5) Munger's 1994 presentation to the USC Business School on "Investment Expertise as a Subdivision of Elementary, Worldly Wisdom." The transcript is from the 5/5/95 Outstanding Investor Digest. In this speech, Munger talks about the importance of mental models and argues that "you're got to hang experience on a latticework of models in your head" to be a successful investor and thinker.
6) A transcript of last year's Wesco annual meeting, published in the 12/18/00 edition of Outstanding Investor Digest. My notes from that meeting are available at http://www.fool.com/boringport/2000/boringport00051500.htm.

The Best of Charlie Munger

Charlie Munger, who runs Wesco Financial, is the famed right-hand man of Warren Buffett.
He is also a master investor in his own right. At Wesco's annual meeting a week ago, he shared his always-blunt opinions on Berkshire Hathaway, the scandalous ethics in the accounting, law, and investment banking professions, and more.
By Whitney Tilson

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(http://www.fool.com/news/foth/2002/foth020515.htm)

Warren Buffett is generally acknowledged to be the greatest investor ever -- one of the reasons why 13,000 people flocked to the recent annual meeting of his investment vehicle, **Berkshire Hathaway** (NYSE: BRK.A). But closely following Buffett are a handful of other legendary investors, including his long-time partner, Charlie Munger.

While Buffett gets all the attention -- and is, according to Munger, the superior investor – Munger is himself an investment genius and, were it not for Buffett, might well be acclaimed the world's greatest investor. Before Munger joined forces with Buffett in the mid-1970s, his investment partnership compounded at an average rate of 24.3% annually from 1962 to 1975 (vs. only 6.4% for the Dow over the same period).

In addition to his role as vice chairman of Berkshire Hathaway, Munger is chairman of **Wesco Financial** (AMEX: WSC), which is 80.1%-owned by Berkshire. In a similar open-mike format as the Berkshire meeting, Munger answers shareholder questions for a couple of hours at the Wesco meeting. Since Buffett does most of the talking at the Berkshire meeting, I always like to attend the Wesco meeting to hear Munger's in-depth thinking. I wasn't disappointed this year. As I did in last week's column on Berkshire's annual meeting, I will try to distill many pages of notes down to the most important things I heard. (My notes can be seen in their entirety at my website.) I've added a little commentary, but will generally let Munger speak for himself. Recording devices were not allowed in the meeting, so in many cases I am paraphrasing because I couldn't write quickly enough.

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

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

"The overall result is that we're going to do pretty well -- meaning in the top 10% [of the industry]

-- because we do different things....We're willing to do some unpleasant things.

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

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

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

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

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

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

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

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

Circle of competence
"There are a lot of things we pass on. We have three baskets: in, out, and too tough...We have to have a special insight, or we'll put it in the 'too tough' basket. All of you have to look for a special area of competency and focus on that."

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

Wall Street's ethics (or lack thereof)
"The ethics of Wall Street will always average out to mediocre at best.... This doesn't mean there aren't some wonderful, intelligent people on Wall Street -- there are, like those in this room – but everyone I know has to fight their own firm [to do the right thing]."

Critique of legal and accounting firms
"Too many law and accounting firms get roped into shady things. For example, tax shelters, with their contingency fees and secrecy, are a total abomination.... I never have the least interest in defending miscreants and helping them misbehave. But the general view is that it's wonderful what Johnny Cochran did."

Derivatives
"Everyone caved, adopted loose [accounting] standards, and created exotic derivatives linked to theoretical models. As a result, all kinds of earnings, blessed by accountants, are not really being earned. When you reach for the money, it melts away. It was never there.

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

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

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

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

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

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

Guest columnist Whitney Tilson is Managing Partner of Tilson Capital Partners, LLC, a New York City-based money management firm. He owned shares of Berkshire Hathaway at the time of
publication. Mr. Tilson appreciates your feedback at Tilson@Tilsonfunds.com. To read his previous columns for The Motley Fool and other writings, visit http://www.tilsonfunds.com/.

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

By Whitney Tilson

COMMENTS ON BERKSHIRE HATHAWAY AND WESCO

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

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

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

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

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

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

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

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

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

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

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

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

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

Bonds
"Berkshire owns bonds in two ways:

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

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

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

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

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

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

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

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

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

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

Differences between Buffett, Munger and Simpson
"Not very much."

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

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

COMMENTS ON BERKSHIRE HATHAWAY HOLDINGS

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

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

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

Munger's role in the purchase of Gen Re
"That thing was very far along before I ever heard of it. There will be more of this as the years go on."

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

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

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

INVESTMENT ADVICE

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

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

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

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

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

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

COMMENTS ON VARIOUS COMPANIES, INDUSTRIES AND OTHER ECONOMIC MATTERS

Freddie Mac

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

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

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

Lloyd's

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

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

Moody's

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

Influence of board members (or lack thereof)

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

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

Risks of financial institutions

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

Consumer credit

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

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

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

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

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

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

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

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

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

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

Expect the unexpected (Japan example)
"Warren has said that over 40 years, a lot of surprising things will happen."

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

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

CRITIQUES OF ACCOUNTANTS AND INVESTMENT BANKERS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

COMMENTS ON EDUCATION AND PROPER THINKING

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

ADVICE ON LIFE AND OTHER

Terrorism risk and immigration policy

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

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

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

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

Books

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

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

Charlie Munger's Worldly Wisdom

Charlie Munger, who runs Wesco Financial, is the famed right-hand man of Warren Buffett. He is also a master investor in his own right. At Wesco's annual meeting on Wednesday, he shared his always-blunt opinions on Berkshire Hathaway, the danger of derivatives, how to get rich, and more.
By Whitney Tilson

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(http://www.fool.com/news/commentary/2003/commentary030509wt.htm)
While Warren Buffett gets most of the attention, Charlie Munger, his partner in managing **Berkshire Hathaway** (NYSE: BRK.A), is an investment genius in his own right. In fact, I suspect that were it not for Buffett -- who Munger freely acknowledges is the superior investor – Munger might well be acclaimed the world's greatest investor. Before Munger joined forces with Buffett in the mid-1970s, his investment partnership compounded at an average rate of 24.3% annually from 1962 to 1975 (vs. only 6.4% for the Dow over the same period).

In addition to his role as vice chairman of Berkshire Hathaway, Munger is chairman of **Wesco Financial** (AMEX: WSC), which is 80.1%-owned by Berkshire. In an open-mike format similar to that of the Berkshire meeting, Munger answers shareholder questions for a couple of hours at the Wesco meeting. Since Buffett does most of the talking at the Berkshire meeting, I always like to attend the Wesco meeting to hear Munger's in-depth thinking. I wasn't disappointed this year. As I did in Monday's column on Berkshire's annual meeting, I will try to distill extensive notes down to the most important things I heard. (My notes can be seen in their entirety at my website.)

I've added a little commentary, but will generally let Munger speak for himself. Recording devices were not allowed in the meeting, so in many cases I am paraphrasing because I couldn't type quickly enough.

Thoughts on Buffett
While Buffett is now 71 years old, Munger raved, "It's hard to believe that he's getting better with each passing year. It won't go on forever, but Warren is actually improving. It's remarkable: Most almost-72-year-old men are not improving, but Warren is."

Berkshire without Buffett
The most common concern investors seem to have about Berkshire is, "What happens when Buffett dies?" Munger acknowledged that "if he were gone, we couldn't invest the money as well as Warren," but noted that "the place is drowning in money -- we have great business pounding out money. If the stock went down, Berkshire could buy it back. There's no reason to think it will go to hell in a bucket, and I think there's reason to believe it could go on quite well. I'd be horrified if it isn't bigger and better over time, even after Warren dies."

Berkshire's acquisition strategy
Berkshire continues to have spectacular success on the acquisition front. According to Munger,

there's no secret: "We've bought business after business because we admire the founders and what they've done with their lives. In almost all cases, they've stayed on and our expectations have not been disappointed."

Berkshire and Wesco's stock prices relative to intrinsic value
Unlike so many corporate managers who seem to believe that it's their #1 duty to inflate their stock price -- often by unethical or illegal means -- Buffett and Munger "like the stocks of both Berkshire and Wesco to trade within hailing distance of what we think of as intrinsic value. When it runs up, we try to talk it down. That's not at all common in Corporate America, but that's the way we act."

As for Berkshire's current share price (it closed yesterday at $72,600 per A share), Munger said "there's been a deafening silence [on what we think of the stock price]. Berkshire is trading in a reasonable way given our environment and opportunities, which is why we've been silent. We are in no distress at all about the current value of the stock." When was the last time you heard a senior manager of a company say that?!

Derivatives
Munger, like Buffett, has long warned about the dangers of derivatives, and did so again this week: "It's easy to see [the dangers] when you talk about [what happened with] the energy derivatives -- they were kerflooey. When they [the companies] reached for the assets that were on their books, the money wasn't there. When it comes to financial assets, we haven't had any such denouement and the accounting hasn't changed, so the denouement is ahead of us.
"We tried to sell Gen Re's derivatives operation and couldn't, so we started liquidating it. We had to take big markdowns. I would confidently predict that most of the derivative books of [this country's] major banks cannot be liquidated for anything like what they're carried on the books at.

When the denouement will happen and how severe it will be, I don't know. But I fear the consequences could be fearsome. I think there are *major* problems, worse than in the energy field, and look at the destruction there." Alan Greenspan is apparently listening and singing a different tune than he was only a short while ago. Just yesterday, he expressed concern about derivatives and **J.P. Morgan** (NYSE: JPM) in particular.

Attractive investment opportunities tend to be ephemeral
The dates stick in my mind: July 23rd and October 9th last year and March 11th this year -- all days in which the market bottomed amidst panicked selling, when bargains abounded. But if you weren't ready to buy, stocks snapped back quickly. Munger noted that "a lot of opportunities in life tend to last a short while, due to some temporary inefficiency... For each of us, really good investment opportunities aren't going to come along too often and won't last too long, so you've got to be ready to act and have a prepared mind."

Views on Ben Graham's ideas
While Munger largely rejects Ben Graham's cigar-butt style of investing, he embraces the core principles: "The idea of a margin of safety, a Graham precept, will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and

dispassionate will never be obsolete. So Graham had a lot of wonderful ideas."

Stock valuations

Munger continues to report difficulty finding good stocks to buy: "In terms of the general climate, I think it's pretty miserable for anyone who likes easy, sure money. Common stocks may be reasonably fairly valued, but they are not overwhelming bargains."

The importance of reading

"In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time -- none, zero... You'd be amazed at how much Warren reads -- at how much I read.
My children laugh at me. They think I'm a book with a couple of legs sticking out."

How to get rich

A young shareholder asked Munger how to follow in his footsteps, and Munger brought down the house by saying, "We get these questions a lot from the enterprising young. It's a very intelligent question: You look at some old guy who's rich and you ask, 'How can I become like you, except faster?'"

Munger's reply was: "Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts... Slug it out one inch at a time, day by day, at the end of the day -- if you live long enough -- most people get what they deserve."

Humor

Munger has an acerbic, dry wit and he was in rare form this week. Here were my favorites:

"If you rise in life, you have to behave in a certain way. You can go to a strip club if you're a beer-swilling sand shoveler, but if you're the Bishop of Boston, you shouldn't go."

"The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it's the only one you could never possibly have any fun at. There's a lot of pain and no fun. Why would you want to get on that trolley?"

"What's the best way to get a good spouse? The best single way is to *deserve* a good spouse because a good spouse is by definition not nuts."

"I think liberal art faculties at major universities have views that are not very sound, at least on public policy issues -- they may know a lot of French [however]."

Ben Franklin "was a very good ambassador and whatever was wrong with him from John Adams's point of view [I'm sure] helped him with the French."

Whitney Tilson is a longtime guest columnist for The Motley Fool. He owned shares of Berkshire

Hathaway at press time, though positions may change at any time. Under no circumstances does this information represent a recommendation to buy, sell, or hold any security. Mr. Tilson appreciates your feedback on the Fool on the Hill discussion board or at Tilson@Tilsonfunds.com. The Motley Fool is investors writing for investors.

Notes from the 2003 Wesco Annual Meeting, 5/7/03

By Whitney Tilson (WTilson@Tilsonfunds.com)

Note: This is not a transcript. No recording devices were allowed at the meeting, so this is based on 2 1/2 hours of rapid typing, combined with my memory (egads!). Other than the opening statement, I have reorganized the content of the meeting by subject area. Words in [brackets] are my comments or edits.

For more on this meeting, see my 5/9/03 column, Charlie Munger's Worldly Wisdom. For my columns and notes on previous Berkshire and Wesco meetings, click here.

To learn more about Munger, I recommend the book Damn Right: Behind the Scenes with Berkshire Hathaway Billionaire Charlie Munger. I also recommend reading my column and transcript of Munger's speech, "24 Standard Causes of Human Misjudgment," which has powerful implications for investors.

OPENING COMMENTS

This group is the hard core cultists. Most have actually been to the Berkshire meeting [last Saturday], sat through hours and hours of questions, and now here they are again. Some are doing it with other people's money, but many are doing it with their own money. If you've traveled this far, you're hard core.

Why do people come? Partly, I'm sure out of respect for the long-term record of compounding money at high rates. But also there's the cast of mind that helped create the record. I'm very sympathetic to people who share our twists of mind. If you're Warren Buffett and Charlie Munger, you're lonely. The whole of academia, business and economics believe a lot of things we don't believe at all, and conversely don't believe a lot of things we do believe.

Critique of the Efficient Market Theory and Institutional Money Managers

They used to criticize us bitterly, but stopped doing that when criticized by their heirs[?]. There's a world in academia where markets are perfectly efficient, where nobody knows if one company is better than another at any time, where value is dictated based on price. Then, it can never make any sense for a company to buy back its own stock. But if you say, "I can point to you many situations in which a stock was selling for 1/5th of its value, so why shouldn't a company buy it back?", some purists still won't change their minds. A corollary of this says that you can never find a price that is rational to buy a stock that you know a lot about.

It makes it hard for Warren and I to go on every year. We don't really care actually. [Laughter] In what other profession do the leading practitioners differ so much from the leading theorists? [Laughter] Hopefully this is not true in surgery, engineering and so forth.

Institutional money managers hire consultants who hire other consultants. They put money in venture capital, little companies, big ones, growth, value, etc. One thing that's sure is that at the end of the year, you've spent a lot on the consultants and frictional costs. Berkshire and Wesco never have and never will [behave this way].

20 Punches
Warren said at the Berkshire meeting (or maybe it was to the press afterward?), that he often tells business school students that if he gave them a card that only had 20 punches for a lifetime, and each time they made an investment they would use up one punch, and that after 20 punches there would be no more, then on average, with those rules, you'll die a lot richer. But people can't grasp this; they don't know what to make of it. But I believe it's true -- you'll do better over a lifetime [following the 20-punch way of thinking], assuming you're a smart, disciplined person. This room is filled with people who followed that advice. But that is absolute apostasy in academia.

How many different things has Wesco done since Blue Chip Stamps? [A major acquisition that Wesco made under Munger and Buffett's leadership in the 1970s.] We've only bought two or three companies and made a few big stock purchases. We've probably made a significant decision every two years. But nobody manages money this way. For one thing, clients won't want to pay you. [Laughter]

But our theory is that getting a real chance to invest at rates way better than average is not all that easy. I'm not saying it's not moderately easy to beat the indices by half a percentage point every year, but the moment you seek higher returns, is a very rarified achievement. The only way we know how to do this is to make relatively few investments of size.

What you can know if that if you spread your capital over a large number of securities, this will lead to average returns. Why anyone would pay a lot of money to learn what is so obvious is beyond me. [Laughter] I'm serious, people get paid to teach this! [Laughter]

It's not so bad to have one's money scattered over three wonderful investments. Suppose you were a real estate investor with a 1/3 interest in the best apartment complex in town, the best mall, and the best [I missed what he said -- another type of real estate investment]. Would you feel like a poor, undiversified investor? No! But as soon as you get into stocks, people feel this way. Partly, people need to justify their fees.

Envy is a Really Stupid Sin
Then there's the chasing of the investment return rabbit. What if you had an investment that you were confident would return 12% per annum. A lot of you wouldn't like that -- especially if you've done better -- but many would say, "I don't care if someone else makes money faster." The idea of caring that someone is making money faster [than you are] is one of the deadly sins. Envy is a really stupid sin because it's the only one you could never possibly have any fun at. [Laughter] There's a lot of pain and no fun. Why would you want to get on that trolley? [Laughter]

Options and Circle of Competency
We have a theory that you go through life in an orderly way. It gives us extra options. There's an obvious doctrine in life that all individuals and companies have to make decisions based on opportunity costs -- that's how all people make decisions. If you're married, you can keep [your spouse] but you always have the option to say, "I can do better elsewhere." Now you don't say this… [Laughter]

Most people have options: what job to take, school to go to, and so forth. One should measure investment opportunities this way. The more attractive things are, the higher the bar is. Berkshire has raised the opportunity bar by looking at stocks, bonds, private companies, public companies, etc. We have more opportunities by operating in a wider range.

The danger is that you have more risk of operating outside of your circle of competency. I don't think we're ever gone outside our circle of competency. We find things across a fairly wide range that we think is within our circle of competency. If you can widen your range and broaden your circle of competency, then you'll be a better investor.

Focus Investing
I remember when Warren was buying American Express when the company was suffering from a scandal [the 1963 Salad Oil Scandal]. Warren said to me, "I can't find anything else that's nearly as attractive." So, he asked his partners [this was before Berkshire, when he was managing the Buffett Partnership] to change the partnership agreement [which, I assume, prevented him from putting too much of the partnership into one position] and put 40% of his capital into American Express. When was the last time you saw a mutual fund do this [I'm not sure if he meant investing so heavily in one stock, or changing the contract with investors to take advantage of an opportunity]? It happens, but it's rare. To me, it's the most ordinary common sense, but it's not the most conventional wisdom of the time.

I know value investors who [I missed this]. There's a graduate of Stanford Business School who can compound money at 25% per annum so why does he need to invest other people's money, and he's now a very rich man. Warren operated out of a sun porch [in his house] for years.

Unattractive Investment Environment
At Wesco, we're in a state of arrest. We have way more capital than we're using. We have some investments in bonds that went up $20 or $30 million [over the past year], but this is not fun, watching and waiting, for people who have an action bias. Too much action bias is dangerous [however], especially if you're already rich.

In terms of the general climate, I think it's pretty miserable for anyone who likes easy, sure money. Common stocks may be reasonably fairly valued, but they are not overwhelming bargains. Interest rates are really low. When you get five-year rates under 3%, it starts getting really unpleasant for people who are used to better results. But I don't think this is a tragedy. If things get really bad, like Japan, then things will be very unpleasant. Think of how you'd like to run a big university under those circumstances. I don't think that will happen here -- I think we're a better place in terms of investing.

But the world can throw you a lot of surprises. Who would have predicted the World Trade Center, interest rates where they are, life insurers in Japan insolvent because they agreed to pay 3% interest per annum.

A New Way to Measure Returns
Think of professional money management. A typical fund might do well, the money comes in, and then there's a big collapse. If you took into account the negative results at the end, with the big money in the fund, the overall result would be negative. If I were running the world, I'd require all people running mutual funds and investment funds to report results in two ways: the

current way and per dollar year. The big funds would really look terrible because they took in really a lot of money and then collapsed. If you took venture capital, which did well with a small amount of capital, and then took in a huge amount of capital [and lost most of it], they'd have trouble shaving in the morning.

[To understand what Munger is talking about, consider a fund with $100 that has a spectacular year and doubles to $200, a 100% return. Money of course pours in (let's say $800), chasing this performance, such that the fund grows from $200 to $1,000. Then, the fund falls by 50% the next year to $500. The fund's IRR (internal rate of return) is 0% (a +100% year followed by a -50% year), yet investors have lost a massive amount of capital: a $100 gain in the first year, followed by a $500 loss in the second year.]

COMMENTS ON BERKSHIRE HATHAWAY

Berkshire Without Buffett

I said to my fellow directors of Berkshire quite recently, when we were discussing Berkshire in his [Buffett's] absence, "It's hard to believe that he's getting better with each passing year." It won't go on forever, but Warren is actually improving. It's remarkable: most almost-72-year-old men are not improving, but Warren is.

If he were gone, we couldn't invest the money as well as Warren, but the place is drowning in money -- we have great business pounding out money. If the stock went down, Berkshire could buy it back. There's no reason to think it will go to hell in a bucket, and I think there's reason to believe it could go on quite well. The people at MidAmerican Energy are quite formidable. I'd be horrified if it isn't bigger and better over time, even after Warren dies. And I can't imagine Ajit not being one of the jewels of the insurance business in the world as far as the eye can see.

If your problem is that eventually all things crest, then you're right. The loss of dominance rate is 100%. Every great civilization that was dominant eventually passed the baton. Similarly, the greatest companies of yore are not the great companies of hence. I like looking back and seeing who would have predicted what happened to [formerly great companies like] Kodak, Sears and General Motors.

Sure, vicissitudes come to all places, but I think Berkshire is structured so that it's unlikely to fall back the way GM has. GM basically transferred the enterprise value to the employees instead of the shareholders. That is not the Berkshire culture. We want employees to be esteemed, get rich and enjoy life, but we're not in business of deliberately transferring the company from shareholders to employees.

At GM, they tried to get by each year without a calamity [e.g., a strike] by giving [whichever union whose contract was due for renegotiation] a lot, which they then had to give to the other unions. Do this over 40 years and at the end there's nothing left for shareholders. That's not the culture at Berkshire.

Will it ever fail? I suppose it will. [I believe he was referring to Berkshire, not GM, in the context of his earlier comment, "Every great civilization that was dominant eventually passed the baton."]

Berkshire and Wesco's Stock Prices Relative to Intrinsic Value
We like the stocks of both Berkshire and Wesco to trade within hailing distance of what we think of as intrinsic value. When it runs up, we try to talk it down. That's not at all common in Corporate America, but that's the way we act.

At Berkshire, there's been a deafening silence [on what we think of the stock price]. Berkshire is trading in a reasonable way given our environment and opportunities, which is why we've been silent. We are in no distress at all about the current value of the stock, and we're the type who feel uncomfortable if the stock gets too high or too low.

I have yet to see a shareholder who needs to get out not be able to sell it. So far, we haven't had any crisis of liquidity. If there were a crisis of liquidity, there's someone around who has plenty of liquidity. [E.g., Buffett/Berkshire] [Laughter]

There have been two times that my Berkshire stock holdings have fallen by more than 50%. So what? Warren has always said that if you're not prepared to experience a 50% quotational loss, you shouldn't be in stocks.

Intrinsic Value of Berkshire vs. Wesco
[He gave two explanations -- I missed them -- and concluded:] Either way you calculate it, Berkshire has way more value per dollar of book value [than Wesco].

Berkshire's Advantages in Super Cat Insurance Underwriting
If it could easily be done, just by manipulating rules of statistics, like life insurance, then everyone would have done it and there wouldn't be much profit in it. But what you point out -- what everyone doesn't like about it -- is what we like about it. For example, there have been lots of earthquakes but the average actuary says that after 50 years without an earthquake, it means that one is now less likely. But we think that maybe pressure is building up, making it more likely not less. We try to take into account all of these factors.

There is a close collaboration between Warren and Ajit Jain. I've known both a long long time and if there are two better people on this earth to do this [super cat underwriting], I don't know who they are. We can't guarantee results, but they've done fine -- in fact, more than fine.

Sometimes they will do things where it's a straight Pascalian calculation -- the odds are x and we get paid at a rate that give us better odds than Las Vegas. The reason other people won't do it is because if they're wrong, it'll be a big money loss, but Berkshire can handle a big number loss. I'm quite comfortable watching those two people do it. I wish I could do it, but I can't. It's reasonable heuristics by two tough, sharp-minded men.

Event Arbitrage Investing and Berkshire's Junk Bond Investments in 2002
We haven't been doing much event arbitrage in recent years. In earlier years we did a fair amount, but now it's rare. The equivalent is we bought something around $10 billion of junk bonds last year, and $7 billion are left around. It's sort of similar to event arbitrage that Warren used to do in his earlier days. I don't think you'd find the recent records in event arbitrage are very good compared to the results we've had.

Warren calculated that over the past 60 years, if you combined Ben Graham's record and his, they generated returns of 20% per annum on event arbitrage. Ben Graham called them "Jewish Treasury Bills."

[Graham was Jewish. Here's the full story: When Buffett graduated from Columbia Business School, he offered to work for Graham at his investment firm, Graham-Newman, for free. Graham turned him down, even though Buffett was his only student to ever receive an A+ grade, because he only hired Jews. (This was not unusual at the time, as Wall Street had a number of all-Jewish firms to balance the many all-white, male, Christian firms.) Buffett returned to Omaha and worked as a stock broker (and occasionally wrote research reports on companies like GEICO) until Graham contacted him years later in 1954, after he had decided to open up the firm to non-Jews. Buffett took the job for two years, until Graham shuttered the firm in 1956, and then went back home to Omaha to open his own partnership. Incidentally, it was at Graham-Newman that Buffett met another legendary investor, Walter Schloss, who was also a junior analyst there.]

Now, that way of investing [event arbitrage] has gotten fashionable [today] because some money will be coming in even if world goes to hell in a hand basket. You can amuse yourself with that calculation as much as you want, but we tend not to do that. I suppose we could if the right opportunity came along. For one thing, its hard to do with a lot of capital.

The junk bonds are an interesting case. When we were buying [last year], the mutual [bond] funds were getting net redemptions and had to sell. Even under those conditions, we only got $8 or $10 billion invested. Now, the mutual funds have net inflows and you can't buy anything.

[I share Munger's bearish on bonds, as I argued in Don't Chase Performance.]

More on Bonds
Warren's doing most of the work on Berkshire's bond portfolio. I scarcely look at them.

We normally don't talk about what we are or aren't investing in, but I can't help saying that we don't own tobacco bonds. As for the WPPSS bonds, we bought every bond that traded, but we could only buy $300 million. It's hard to invest large sums of money.

[According to Of Permanent Value: The Story of Warren Buffett (a wonderful 1,490 page tome for true Berkshire junkies), "Buffett quietly bought $139 million worth of Projects 1, 2, and 3 of Washington Public Power Supply System bonds in 1983 and 1984…Buffett explained how WPPSS had defaulted on $2.2 billion worth of bonds issued to help finance Projects 4 and 5. That stigma stained other projects and Buffett was able to buy the bonds at a steep discount."]

Berkshire's SQUARZ deal in 2002
Warren has a big motor and there isn't enough going on at Berkshire with a tiny pile of assets and an insufficient number of large businesses [laughter] so when he sees a mispriced security, so he's willing to issue it. Personally, I wouldn't issue it. But it's one of Warren quirks. Remember the LIONS [a security Berkshire issued long ago]? We only have to put up with this every 20 years. To Warren, the appeal is that it could be done. I think the mere fact of borrowing money at a negative interest rate turned him on [because] not many people are able to do that. Just call it an intellectual quirk.

[For more on the SQAURZ deal, see my column, Berkshire's Unusual Security.]

Berkshire's Acquisition Strategy
We've bought business after business because we admire the founders and what they've done with their lives. In almost all cases, they've stayed on and our expectations have not been disappointed.

Buying Stock vs. Entire Companies
We do both, but we get tax advantages by buying whole companies rather than stocks -- very significant ones. Also, if we buy a company, we can change management, dividend policy, etc. if we need to.

We'll pay more per share for 100% of a company than 3%, but practically everyone else will too.

Why Did Berkshire Bid for Burlington Industries?
That's very easy: Burlington has a segment that relates to Shaw. Shaw does flooring and carpets [so there's a part of Burlington that] would fit in nicely with Shaw. What wouldn't fit in, we were will to buy for the price we offered. It was a peculiar add-on thing. We haven't suddenly decided that textiles are the thing.

The judge was willing to have us give the company a put [for an inadequate fee]. In our world, puts are worth a lot of money. There was a perfectly reasonable judge, but we're perfectly reasonable too, so we walked.

A Change in Dividend Tax Policy Wouldn't Change Us
[At the Berkshire meeting, Warren did talk about dividends. It [making dividends tax-free] wouldn't change us. Our long-stated policy is that as long as we think that, over an extended period of time, we think we can create more than $1 of value for every $1 retained, then we'll retain it. If that changes, we'll shell it out.

Would Corporate America change if dividends could be distributed tax free? Sure. For one thing, people would think the law might change [and therefore rush to pay out dividends before they became taxable again].

Failing to Buy Wal-Mart Stock
Wal-Mart was an $8 billion sin. What happened is that we started to buy it and the price started to go up and we're naturally so cheap that we stopped buying. It's not $8 billion we lost, but $8 billion we didn't gain. We keep doing this. We haven't done this hundreds of times, but our sins of omission have cost us a lot in terms of opportunity. I wish I could tell you we won't do this again. We do find things to actually do and they tend to work out well. If we only could have been 5% smarter, our shareholders would be a lot better off.

Costco and Wal-Mart
Costco [Munger is on the Board] and Wal-Mart are two of the most admirable retailing operations in the history of the world. In fact, Wal-Mart has the best retailing record in the history of the world. It was started by a guy in his 40s and he hasn't been dead that long. There's a similar story at Costco. Costco would be worth a lot more money if there weren't any

Wal-Mart [Laughter]. Sam Walton talked to Sol Price about buying what is now Costco, but those two titans never got together. We screwed up by not buying Wal-Mart stock, and Wal-Mart screwed up by not paying whatever price Sol Price wanted.

Future Relationship With Wal-Mart
Obviously based on past history, with Garan and McLane, we trust Wal-Mart. [Wal-Mart accounts for more than 85% of Garan's sales.] We admire Wal-Mart. How could you have a good value system and not admire Wal-Mart?

[When asked about Berkshire expanding its relationship with Wal-Mart to put Dairy Queens in Wal-Mart, sell GEICO insurance, knives, etc. through Wal-Mart, Munger replied:] I wouldn't get carried away with two transactions. Wal-Mart has perhaps the best buying systems on earth. They won't be buying from us because they like us. We wouldn't want it any other way. I wouldn't expect any fast flood of products into Wal-Mart.

COMMENTS ON BERKSHIRE HATHAWAY AND WESCO HOLDINGS

McLane
Obviously we like the manager [of McLane, Grady Rosier] a great deal, and obviously we trust Wal-Mart to stay with us as a major customer. Obviously we think it's a good buy at the price we paid. What more can I say? It's not some business that's going to grow at fantastic rates forever and ever, partly because one of its main products is tobacco. But we didn't pay for a business that's going to grow forever and ever. We like buying decent businesses at fair prices.

You should think of a business like McLane not as a normal merchandising business -- it's a logistics business like FedEx or UPS. It's a super-slick, super-efficient system for carrying out a logistics function. I think Wal-Mart sold it because they're the best in the world at retailing and they want to concentrate at what they're best at. I would too.

Clayton Homes
We wouldn't have bought Clayton Homes if the family members weren't there and weren't planning to remain. With reference to the price, the entire industry worked itself into a disastrous collapse with vast oversupply of used units, big financial losses, etc. Even Clayton has felt the effects of this calamity. We think Berkshire will help make Clayton stronger. We agree that Clayton is the jewel of the industry. We're buying at period of maximum distress. We think it's okay for Berkshire and okay for Clayton shareholders.

A lot of people wouldn't be interested because they can't stand taint. There's nothing wrong with Clayton, but the whole industry is tainted. We're willing to do things like that all of the time. Our triple A credit rating won't hurt Clayton [Laughter]. Everything you like about Clayton's culture -- does it seem that inconsistent with Berkshire's culture?

I've always felt that manufactured housing should have a bigger place in our society. It might morph into something different. Houses are built in many places in a very inefficient way.

CORT Business Services
CORT [which Wesco acquired in January 2000] has been clobbered by the big dot-com decline. The whole temporary office business in the country had a huge boom. Law firms, accounting

firms, venture capital firms, etc. all expanded. When they went bust, rental firms went bust. In that business, we caught a big recession.

We're having a similar recession in NetJets in that used jets have gone down in price. CORT and NetJets are losing a lot of money. Do I think CORT is going to fail? No. Net Jets? No. There are vicissitudes in life. In fact, we're buying other furniture rental companies. Some people vote with their feet; we vote with our wallets. Was our timing great in buying CORT? No, it was terrible.

Asbestos and Berkshire's Investment in USG
Obviously, so far at least, USG has not been one of our happiest moments. Everyone in American has underestimated how much asbestos could cost. One reason is that an awful lot of money goes to people who haven't been hurt -- way more than half goes to lawyers and experts and those who haven't been hurt. They [the country] did it a lot better when they had [a settlement] for black lung [disease] for coal miners. They simply put a tax on coal and all the money didn't go to lawyers and people who weren't sick.

In my judgment, the common stock of USG won't go to zero, but how well it will work out on the plus side, from zero to infinity, I'll leave you to figure out.

Won't Talk About Investments
[When asked to comment on Berkshire's investment in Mueller Industries (NYSE: MLI; a manufacturer of brass, copper, plastic and aluminum products; Mueller also owns a short-line railroad and various natural resource properties in the western United States), Munger replied:] We ordinarily don't talk about the reasons for making particular investments. We don't want people following us into particular stocks. It's sort of like asking, "What are you buying tomorrow?" We tend not to answer those questions.

INVESTMENT ADVICE

Attractive Investment Opportunities Tend to Be Ephemeral
A lot of opportunities in life tend to last a short while, due to some temporary inefficiency. If you're Berkshire, you can get a few billion dollars out, but most institutions would miss it -- they would have to meet with trustees, lawyers, etc. By the time they were done, they'd have missed it. In this environment, you have to be present and ready to act. Look at some of our recent acquisitions. They faced default and needed money by Monday, and it was Friday afternoon. It was an ephemeral opportunity. For each of us, really good investment opportunities aren't going to come along too often and won't last too long, so you've got to be ready to act and have a prepared mind.

Cigar-Butt Investing and the Value of Meeting With Management
I don't think Warren would think it [cigar-butt investing] was useless -- he just doesn't want to do it. [Laughter] And he trained under Ben Graham, who said, "Just look at the facts. You might lose an occasional valuable insight, but you won't get misled." If you sit down and talk to the key manager for an hour and you're a smart person, I think that could be a significant plus. But a smart person might be right 60% of the time and, for the balance, be misled. If you have some specific questions that the management is going to answer, obviously that would be helpful.

Warren reads a lot of what people have written. He just doesn't want to do it [spend a lot of time talking to managements]. There's a good argument that at a certain level of skill, you're better off without it, especially if you're Warren Buffett. But even he finds it helpful.

I remember a few years ago, Warren met with a CEO and afterward said he thought the CEO wasn't very shareholder friendly and was the biggest horse's ass. So we didn't invest and the stock compounded at 15% per annum for 20 years.

Views on Ben Graham's Ideas
The idea of a margin of safety, a Graham precept, will never be obsolete. The idea of making the market your servant will never be obsolete. The idea of being objective and dispassionate will never be obsolete. So Graham had a lot of wonderful ideas. Warren worshipped Graham. He got rich, starting essentially from zero, following in the footsteps of Graham.

I liked Graham, and he always interested and amused me. But I never had the worship for buying the stocks he did. So I don't have the worship for that Warren does. I picked up the ideas, but discarded the practices that didn't suit me. I don't want to own bad businesses run by people I don't like and say, "no matter how horrible this is to watch, it [the stock] will bounce by 25%." I'm not temperamentally attracted to it.

[For more on Graham, read his classics: The Intelligent Investor [the single greatest book on investing, in my opinion] and Security Analysis. Another book I recommend on Graham is The Rediscovered Benjamin Graham. Finally, my friend Rich Rockwood wrote a nice piece on Graham's thinking recently, Invest the Buffett Way.]

Diversification and Circle of Competence
95% of American managements, the minute they get out of their chosen activities, why shouldn't they just slaughter themselves? I think most managements are nice people, but their general powers of capital allocation are inadequate. And the people advising them, the investment bankers, etc., they will mislead you 95% of the time. The consequences for the utilities that tried to diversity were lethal.

Why are we different? We're working harder at trying to be rational. If you don't work hard at it, and just float along, you will fall victim to the folly of the crowd -- and there will always be folly of the crowd. I wish people would learn more from this than I think they will.

A Shareholder Case Study
[A shareholder stood up and said he first discovered Buffett and Munger and bought Wesco stock in 1984, and kept buying more -- and also added Berkshire stock -- despite Munger talking down Wesco all the time. Munger replied:] If I was steering you toward Berkshire rather than Wesco, then I hope I didn't hurt you. [Laughter]

The man who just spoke is teaching by providing an example of what I was talking about earlier. Here's a guy who is acting like he has 20 punches in life. He likes these guys [Buffett and Munger], gets to know them better, doesn't ask a consultant if he should buy a burlap bag manufacturer in India -- he just kept buying what he knows and has confidence in.

[Munger then asked the shareholder:] How many investments have you made in which you had as much confidence as you had in us?

Shareholder: "Maybe 10."

Munger: "A typical rich shareholder, which means he probably doesn't have a chauffer."

Shareholder: "I drive a '94 Buick."

Munger: "They won't teach this in all of the finance departments. Maybe you should give all of the money back." [Laughter]

Investing Taught at Business Schools
There are a handful of business school professors who teach investing properly. Jack McDonald of Stanford Business School, for one. He comes to the Berkshire meetings. I've taught in his class and Warren has come to his class. There are others.

Reforming academia, except accidentally by having a view that catches on, isn't something I try. It's amazing how difficult it is to change ideas, no matter how wrong they are.

Neither Warren nor I has ever thought for two seconds about beta. But every business school teaches this [concept]. Maybe if we had a few more hundreds of billions of dollars, people would pay attention to us. [Laughter]

Competitive Threat from China
If you're in any business of a manufacturing nature that China can do well, after you consider transport, then you're in the crosshairs of a very formidable opponent.

Why didn't we recognize this with the shoe business? Well, as a German philosopher once said, "Too soon old and too late smart."

Comments on Philip Fisher
Phil Fisher believed in concentrated investing and knowing a lot about your companies -- it's in our playbook, which is partly because we learned from him.

[For more on Fisher, I recommend his books: Common Stocks and Uncommon Profits [one of the all-time great books on investing, in my opinion], Conservative Investors Sleep Well, and Developing an Investment Philosophy.]

Recommended Reading for Investors
I think the business publications, because they digest so much so well, are a good resource. There's a lot of brainpower on the staffs of Fortune, Forbes and The Wall Street Journal.

RISKS IN THE FINANCIAL SYSTEM

Derivatives
It's easy to see [the dangers] when you talk about [what happened with] the energy derivatives -- they were kerflooey. When they [the companies] reached for the assets that were on their books,

the money wasn't there. When it comes to financial assets, we haven't had any such denouement and the accounting hasn't changed, so the denouement is ahead of us.

We tried to sell Gen Re's derivatives operation and couldn't, so we started liquidating it. We had to take big markdowns. I would confidently predict that most of the derivative books of [this country's] major banks cannot be liquidated for anything like what they're carried on the books at. When the denouement will happen and how severe it will be, I don't know. But I fear the consequences could be fearsome. I think there are *major* problems, worse than in the energy field, and look at the destruction there.

Consumer Credit
Consumer credit has been a gold mine -- it's like selling heroin to addicts. There are a lot of fiscalaholics [a new Mungerism] who will probably find some way to pay their bills. Some banks understood this and made a great deal of money.

What I said last year was that it made me nervous, that constant pushing of consumer credit. I didn't say when [a blow-up might occur], but it still makes me nervous.

COMMENTS ON OTHER ECONOMIC MATTERS

The Banking Industry, Past and Future
The banking industry has been a gold mine. I think Warren and I blew it -- we should have invested a lot of money in banks. While we did well in it, we should have been heavier in it. The amount of money made in banking has been awesome. And [this despite the fact that] the people who made the money -- how shall I say it -- have been moderately skillful. [Laughter] [I think he said something here about one being able to make a lot of money in banking even if one is "a perfect ass."] [Bankers have been like] a duck sitting on a pond and they raised the pond. By borrowing short and lending long, one can make a lot of money. It's so easy that people are tempted to do more and more.

Can it go on forever? A wise economist once said, "If a thing can't go on forever, it will eventually stop." My guess is that the extremes are over. Banking has been a marvelous business, but I wouldn't think it would continue to get better and better and it might even get a lot worse.

Pension Fund Consultants
I'm glad you asked, as it gives me a chance to talk about a deeper reality. [Laughter] Let's compare pension fund consulting with bass fishing. You can go on the bass fish tour and catch bass and get prizes. Or you can go into the business of selling tackle and giving advice to bass fisherman. They are two different businesses. The people who choose the latter wouldn't be very good at catching bass. That's how Warren and I view things. We want to win the bass fishing tour, whereas pension fund consultants sell tackle. We're not interested in selling tackle, we're interested in catching bass.

Housing Boom
We've had a boom in housing that has been almost unprecedented in the country, and it keeps going on despite setbacks in certain places. It's partly due to interest rates being so low, and partly because everyone who previously bought [houses] did so well. But in some places, like

Silicon Valley, prices got so high that they've come down. I don't know a lot about the housing price market. I wouldn't have predicted that a little house in Palo Alto would be worth $3.5 million. It took a good educational system and being amidst the Silicon Valley boom.

Having failed to predict accurately [what would happen in the housing industry] in the past, I don't know why, based on a clear lack of competency, why I should predict anything now. Ordinarily, [my advice is to] buy housing when you need it, and don't try to time the market.

ADVICE ON LIFE AND OTHER (MUNGER'S WORLDLY WISDOM)

Approach to Life

We've tried to do that [convey our philosophy] in everything we've ever done and said. But you can't say: "Please dispense all wisdom in one sentence." We're just not up to it. Other people have tried. If you want it short, try Buddha, who said: "I only teach one thing: I teach the cause of human sorrow and how to avoid some of it." (This isn't word for word, but some of it.)

That's my approach: Go around figuring out what doesn't work and then avoid it -- and when you get the sorrow, how to handle it. I think this is a very rational approach to the human condition. If you want to avoid sorrow, you gotta know the cause of sorrow. There are certain ways of improving life that have a certain outcome.

If it's trite, it's right. That's not totally true, but mostly true.

How to Get Rich

We get these questions a lot from the enterprising young. It's a very intelligent question: you look at some old guy who's rich and you ask, "how can I become like you, except faster?" [Laugher] My answer is that I did it slowly, inch by inch, taking losses mentally when they occurred. If you want to do it with fast rapidity, then you're talking to the wrong man, but I know my way works.

If you don't just want to play tiddlywinks, I say welcome to the pool. Spend each day trying to be a little wiser than you were when you woke up. Discharge your duties faithfully and well. Step by step you get ahead, but not necessarily in fast spurts. But you build discipline by preparing for fast spurts. You may not need Zsa Zsa Gabor or a Lamborghini or a lot of other things you think you need now. Slug it out one inch at a time, day by day, at the end of the day -- if you live long enough -- most people get what they deserve.

It's so simple. What's the best way to get a good spouse? The best single way is to *deserve* a good spouse because a good spouse is by definition not nuts. [Laughter] It's the same with the responsibilities in life.

Iraq and Afghanistan

As for Iraq and Afghanistan, your guess is as good as mine. But I will say that it's very easy to shrink from something unpleasant and conclude we don't really need it. At least I admire the ability to suffer now in the hopes of making something better. I'm skeptical of the approach that never finds it necessary to suffer now to make it better. There's a lot to be said to seeking ways to suffer now to make things better. That's the way it is in investing -- sacrifice now in the hopes of something better. Now whether it will actually turn out better [in the Middle East], your guess is as good as mine, but I kind of like the fact that we tried.

[For more on this, see my two columns, Iraq and Investing and Weathering Iraq's Storm.]

Don't Change the Dividend Tax Policy
I think in a democracy, you have to kind of work to keep appearances not too unfair. The way to do this is to keep the reality not too unfair. I think that to some cab driver working seven days a week and paying taxes at a 40% rate, that someone at the country club paying zero tax would be unacceptable. Look what happened when American Airlines executives took part of their compensation and made it secure. The resentment among the workers, who were being asked to sacrifice, was overwhelming -- and I think rightly so.

I think if you make it [e.g., become wealthy], then you have a duty not to mess up the system. I think Corporate American has been terrible at setting an example. If you rise in life, you have to behave in certain way. You can go to a strip club if you're a beer-swilling sand shoveler, but if you're the Bishop of Boston, you shouldn't go. [Laughter]

Opinion on a Temporary Wealth Tax
The wealth tax has existed in the past. For example, immediately after WW II, to recover from the war, Germany instituted a temporary wealth tax and people cheerfully paid it. In this country, I think that once people got accustomed to it, it would stay [e.g., politicians would make it permanent].

Estate Taxes
I like the idea of retaining gift and death taxes, but as for the guy who builds up a good business worth $5 million and wants to pass it to his children, I think the death tax should be zero. But for people who really strike it big, I think there should be an intergenerational tax.

Intergenerational Tensions
If the growth rate of the country goes to zero, then of course we'll have intergenerational tensions. If it continues to grow at 2% -- per capita real growth of 2% per annum -- then we won't, and Social Security will be okay.

Don't Invest Part of Social Security in Stocks
People grew accustomed to stocks doing well. A lot of people behind these schemes thought stocks would yield very high returns over a long period of time. I don't have any gospel from god that stocks will yield 8-10% real returns over a long period. But I do have faith that if government gets involved, it will gum it up. I don't want trustees appointed by the government voting shares of the common stocks in America. Leave it well enough alone.

Common stocks are valued in 2 ways: 1) rational estimates based on future use value [e.g., as Buffett has said in the past: future cash flows that the underlying businesses will generate from now until kingdom come, discounted back to the present at an appropriate rate]; 2) in the hopes that they will go up because people want to buy them. Like bonds and Rembrandts. Once you have government buying stocks every year like [they are] Rembrandts, God knows what would happen. This doesn't appeal to me at all. I'm afraid of it, afraid of the politics, and I don't believe the numbers of those projecting them. By the way, the numbers of those proposing this idea three years ago now look silly. What would happen to the morale of this country if [we invested Social Security into stocks and then what's happened over the past 20+ years in Japan happened here? Imagine that the] government of Japan had put [their] Social Security into common stocks. For a while, stock prices went up and everyone felt good, consumers and politicians spent more, etc., and then stocks declined by 80%. I think they'd be in even worse shape. The more anything sounds like easy free money, the less I tend to believe it.

Giving Money Away
I don't like to think of bequests, not because it reminds me that I'm going to die, but because I find it very hard to figure out what to do with money. Some people like to have people come up to them asking for money, but I don't.

I know a lot of people who like to remain anonymous when they give away money, and you may think that this is a becoming modestly, but mostly it's because they're afraid someone else will ask them for more money.

Charities Cooperating More
In terms of getting all charities in the world to act together, I can't get all of my children to act together, and they've been in my house and under my control.

View of Liberal Art Faculties
[Every year, Munger takes a shot at what he believes are clueless, disconnected-from-reality liberal art faculties at major universities. This year was no exception:]
I think liberal art faculties at major universities have views that are not very sound, at least on public policy issues -- they may know a lot of French [however]. [Laughter]

The Importance of Reading
In my whole life, I have known no wise people (over a broad subject matter area) who didn't read all the time -- none, zero. Now I know all kinds of shrewd people who have done well by staying in a narrow area. But investing requires broad knowledge.

You'd be amazed at how much Warren reads -- at how much I read. My children laugh at me. They think I'm a book with a couple of legs sticking out. [Laughter]

Recommended Reading
A Matter of Degrees, by physicist named Segre, is a perfectly marvelous book. Not a book you can go through at 90 mph, but if you parse through it slowly, you'll get a lot out of it. You'll get a lot of hours per dollar if you use it right.

How much GNP per capita there is really matters. It multiplied by seven times in a single century [in the U.S.] -- a lot by previous history of man. I certainly recommend the Carnegie biography by the Grinnell guy -- I forget his name [he was referring to Andrew Carnegie by Joseph Frazier Wall], but it's the definitive biography. It's a very interesting story. Carnegie started in absolute poverty and had only 4 1/2 years of grade school in a one-room schoolhouse with only one teacher for 170 or 180 students. From this beginning came Carnegie Steel and all of his eccentricities. He was married at 51 and was a virgin -- it was a different world. [Laughter]

It's very interesting -- the past is strange. People behave differently there. [Laughter] The way labor was treated was really something. People did dangerous work, had no Workman's Comp, insurance or pensions, companies could arbitrarily slash their pay by 40%, etc. And that was only 100 years ago. It makes you think how different the world will be 100 years from now.

Johnson, Adams and Franklin Biographies

Yes, I've read the whole Johnson biographies [Robert Caro's trilogy: The Path to Power, Means of Ascent, and Master of the Senate] and I've read the Adams biography [John Adams by David McCullough] and the various Franklin biographies.

Sure, Franklin was quite old when he was ambassador to France. This was after he was world famous and rich, and he was more self-indulgent than when he was young and making his way in the world. But he was a very good ambassador and whatever was wrong with him from John Adams's point of view [I'm sure] helped him with the French. [Laughter] I think Franklin was a marvelous steward. I'm willing to take the fellow as he averaged out. And certainly I'm in favor of old people having a little enjoyment. [Laughter]

Notes from the 2004 Wesco Annual Meeting

May 5, 2004
Pasadena, CA

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

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

OFFICAL MEETING

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

OPENING SPEECH

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Berkshire has never believed in extreme diversification.

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

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

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

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

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

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

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

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

Master Plans

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

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

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

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

Outlook

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

Scandals

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

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

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

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

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

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

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

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

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

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

I do think we're coming back from that. When the guys went to the penitentiary to pound rocks for price fixing, I think it changed [that type of behavior]. I think a goodly number of people going to prison will help things. But there are enormous pressures. There's so much money [at stake], and it's easy to report a little more [in earnings, to keep the stock price up]. I don't think we've seen the last person to succumb to the temptations.

Impact of Sarbanes-Oxley

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

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

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

Signs of Hope – New Zealand Example

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

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

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

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

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

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

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

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

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

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

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

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

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

Bad Behavior in the Money Management Industry
I feel obligated to ramble a bit when people have traveled so far. [Laughter]

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

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

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

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

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

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

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

QUESTION & ANSWER PERIOD

COMMENTS ON WESCO

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

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

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

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

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

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

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

COMMENTS ON BERKSHIRE HATHAWAY & ITS SUBSIDIARIES

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

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

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

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

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

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

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

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

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

I don't know where we'd get a Gen Re now, like the Gen Re we have, if we wanted one, so I'm not gnashing my teeth. We bought at the peak of the market, sold everything [Gen Re's stock holding], took losses, and we now we have the capital asset. So it made us look silly for a while, but in the long game for Berkshire, the bad part was a blip and the long-term looks quite favorable.

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

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

Impact of Judge's Ruling on How Much Insurers Have to Pay Larry Silverstein, the Developer of the World Trade Center Site
[Missed this – it was a quick answer; something about multiple verdicts expected and that based on the first verdict, Gen Re's share was $109 million.]

Gen Re's Declining Volumes and Loss of Market Share
[Munger asked Gen Re's CEO, Joe Brandon, to answer this question. Brandon said:]

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

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

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

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

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

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

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

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

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

Do You Have Thoughts on How to Calculate the Intrinsic Value of Commodities Like Silver
No.

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

HOW TO BECOME A BETTER INVESTOR

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

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

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

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

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

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

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

BUSINESS AND INVESTING TOPICS

Are Any Asset Classes Undervalued?
Our cash is speaking for itself. If we had a lot of wonderful ideas, we wouldn't have so much cash.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

It's incredible the reciprocity that happens when CEOs keep recommending that directors get paid more, and then the directors raise the CEO's pay – it's a big game of pitty pat. And then they hire compensation consultants to make sure no-one else is getting paid more. This is true even is the CEO a klutz and a little dishonorable.

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

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

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

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

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

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

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

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

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

Today, there are 8,000 hedge funds and the number is growing rapidly. There are hundreds of billions of dollars in them. Every university has to have hedge fund investments, and there are funds of hedge funds and layers upon layers of fees. There are hedge funds giving layers of incentive fees to operating businesses beneath them. [I think he's referring to fund of funds charging fees on top of the already-high fees charged by the underlying hedge funds.]

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

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

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

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

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

COMMENTS ON GOVERNMENT, REGULATORY & POLITICAL MATTERS

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

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

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

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

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

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

Congress Recent Relaxing Rules Requiring Companies to Set Aside Enough Money to Meet Pension Obligations
You had some very important institutions like airlines that couldn't pay their pension obligations, so Congress just papered it over by saying they didn't have to pay. Whether that's a good idea, I'll leave that up to you. It can't be a good sign for the civilization.

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

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

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

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

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

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

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

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

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

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

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

My views would make me anathema in both parties.

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

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

ADVICE ON LIFE AND OTHER

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

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

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

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

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

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

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

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

Deterioration in Union and Political Structure

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

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

Book Recommendations

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

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

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

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

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

Notes from 2005 Wesco Financial Annual Meeting

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 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. (Laugher)

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 <u>FIASCO</u> [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, <u>Conspiracy of Fools</u> [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 *under*paid 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. (Laugher)

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.

I will miss Hank Greenberg dearly in areas like tort reform. He was always honest with us. He invited us or we invited him in the deal to buy the assets of Long Term Capital Management. There's a lot that was strong and good at AIG.

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.

There's a lot of leverage in those carry-trade games. Other people are more certain than I am that aircraft can always be leased.

I Would Never Dream of Shorting GM

I would never short a company that was doing $180 billion [in sales] per year with a market cap of $15 billion that was such an iconic part of America. I would never dream of making that short.

What happened was that a lot of very decent people running GM basically blew it. They were facing a very serious competitive challenge and they set up a [lifetime healthcare and pension] system that will grow and grow and grow and they are paying one hell of a penalty.

Employees have 5-6 times the value in their pension plan than all of the stockholders combined. [At the time, GM had a market cap slightly above $15 billion vs. approximately $90 billion set aside for pension liabilities.] GM gave all of the value of the company to employees and left shareholders with almost nothing. They didn't observe the maxim that a small leak can sink a great ship. They never should have allowed the unions to bargain with each company and shut one company down and let the other two take share. They should have bargained as a unit. The result today is a combination of what they gave away one year at a time.

I regard GM as such a marvel of human achievement, but also an example of massive management failure. I can't be criticized if I eventually die – I delayed it as long as I could. GM delayed it as long as they could. They had a very tough hand to play, but I would argue that they blew it.

I don't think Berkshire Hathaway will blow its hand in this way. It would never do that. We would do some very unpleasant things to prevent something that would have very bad consequences far into the future.

Nuclear weapons are a very serious problem. [It's so awful to contemplate that] people use gallows humor. What would you do if you were told a nuclear bomb would be detonated over Pasadena right now? The answer: you'd crawl under the table and kiss your ass goodbye. (Nervous laughter)

Comments on Leucadia and Its Investments in Telecom

We regard the Leucadia people as very smart. Is it conceivable that the Leucadia people could have one outcome that didn't work very well? Sure, it's possible.

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.

Social Security Is Amazing

I'm not so sure that common stocks will do wonders. In England, where they tried to create a scheme like this, they let the brokers and salespeople loose on the people and it was a disaster. So they [those in the U.S. who are pushing to allow people to invest their Social Security savings themselves] said, "We won't do that. We'll just package them in index funds." But the way it's set up, it's like an arbitrage. A guy gives up the promise of Social Security to take the promise of an index fund.

Social Security is amazing how we've run it. It's inflation protected. It's easy to sneer at it, but it's one of the most successful government programs ever. It's low cost and encourages work.

People say if you never change the revenue base, it'll run out of money. But if 10 years from now, the country is 30-40% richer, why not use a higher percentage of GDP to pay people? Young people benefit too – the money is paid to people who might be moving in with them. (Laughter) Everybody's going to get older, but also richer, so why wouldn't you spend a higher percentage of GDP on them? Why is that so unthinkable? I'll tell you what's unthinkable: that so many people are that stupid! (Laughter)

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.

ADVICE ON LIFE AND OTHER

Have Realistic Expectations

People need to ask, "How do I play the hand that has been dealt me?" The world is not going to give you extra return just because you want it. You have to be very shrewd and hard working to get a little extra. It's so much easier to reduce your wants. There are a lot of smart people and a lot of them cheat, so it's not easy to win. (Nervous laughter)

Keys to Success in Life

Never abuse current clients by trying to get new ones. Think how this would work with matrimony – if you ignore your current wife while you pursue another one. (Laughter) The old attitudes will work fine. If you live long enough and act well, and have some intelligence, you'll do fine.

Future of the United States

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.

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.

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.

I will miss Hank Greenberg dearly in areas like tort reform. He was always honest with us. He invited us or we invited him in the deal to buy the assets of Long Term Capital Management. There's a lot that was strong and good at AIG.

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.

There's a lot of leverage in those carry-trade games. Other people are more certain than I am that aircraft can always be leased.

I Would Never Dream of Shorting GM

I would never short a company that was doing $180 billion [in sales] per year with a market cap of $15 billion that was such an iconic part of America. I would never dream of making that short.

What happened was that a lot of very decent people running GM basically blew it. They were facing a very serious competitive challenge and they set up a [lifetime healthcare and pension] system that will grow and grow and grow and they are paying one hell of a penalty.

Employees have 5-6 times the value in their pension plan than all of the stockholders combined. [At the time, GM had a market cap slightly above $15 billion vs. approximately $90 billion set aside for pension liabilities.] GM gave all of the value of the company to employees and left shareholders with almost nothing. They didn't observe the maxim that a small leak can sink a great ship. They never should have allowed the unions to bargain with each company and shut one company down and let the other two take share. They should have bargained as a unit. The result today is a combination of what they gave away one year at a time.

I regard GM as such a marvel of human achievement, but also an example of massive management failure. I can't be criticized if I eventually die – I delayed it as long as I could. GM delayed it as long as they could. They had a very tough hand to play, but I would argue that they blew it.

I don't think Berkshire Hathaway will blow its hand in this way. It would never do that. We would do some very unpleasant things to prevent something that would have very bad consequences far into the future.

Nuclear weapons are a very serious problem. [It's so awful to contemplate that] people use gallows humor. What would you do if you were told a nuclear bomb would be detonated over Pasadena right now? The answer: you'd crawl under the table and kiss your ass goodbye. (Nervous laughter)

Comments on Leucadia and Its Investments in Telecom

We regard the Leucadia people as very smart. Is it conceivable that the Leucadia people could have one outcome that didn't work very well? Sure, it's possible.

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.

Social Security Is Amazing

I'm not so sure that common stocks will do wonders. In England, where they tried to create a scheme like this, they let the brokers and salespeople loose on the people and it was a disaster. So they [those in the U.S. who are pushing to allow people to invest their Social Security savings themselves] said, "We won't do that. We'll just package them in index funds." But the way it's set up, it's like an arbitrage. A guy gives up the promise of Social Security to take the promise of an index fund.

Social Security is amazing how we've run it. It's inflation protected. It's easy to sneer at it, but it's one of the most successful government programs ever. It's low cost and encourages work.

People say if you never change the revenue base, it'll run out of money. But if 10 years from now, the country is 30-40% richer, why not use a higher percentage of GDP to pay people? Young people benefit too – the money is paid to people who might be moving in with them. (Laughter) Everybody's going to get older, but also richer, so why wouldn't you spend a higher percentage of GDP on them? Why is that so unthinkable? I'll tell you what's unthinkable: that so many people are that stupid! (Laughter)

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.

ADVICE ON LIFE AND OTHER

Have Realistic Expectations

People need to ask, "How do I play the hand that has been dealt me?" The world is not going to give you extra return just because you want it. You have to be very shrewd and hard working to get a little extra. It's so much easier to reduce your wants. There are a lot of smart people and a lot of them cheat, so it's not easy to win. (Nervous laughter)

Keys to Success in Life

Never abuse current clients by trying to get new ones. Think how this would work with matrimony – if you ignore your current wife while you pursue another one. (Laughter) The old attitudes will work fine. If you live long enough and act well, and have some intelligence, you'll do fine.

Future of the United States

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*.

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Whitney Tilson's 2006 Wesco Annual Meeting Notes:
Part 1, Charlie Munger's Opening Remarks

May 11, 2006

This is an advance copy intended only for subscribers of *Value Investor Insight*. To subscribe, please go to www.valueinvestorinsight.com/subscribe

***Note**: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what was said. Part 2 of these notes, from the Q&A session with Mr. Munger, will be completed soon.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

OPENING REMARKS

Welcome to the Wesco annual meeting for the die-hard groupies of Berkshire Hathaway. [Laughter]

[Munger briefly went through the official business of the annual meeting, introducing the directors, etc. At one point, he said that there are 7,119,807 shares of Wesco outstanding, and commented: "That has not changed since I was first affiliated in any way with Wesco. We must be the only corporation in America with that attribute." He then concluded the annual meeting and, as he's done in past years, began with some remarks, after which he took questions for roughly two hours.]

Now we will begin our question-and-answer session, preceded by extended comments … by me. [Laughter]

The reason I'm making these extended comments is that so many of you have come from so far and so many of you are devotees of the same approach to life as is demonstrated around Berkshire and Wesco. Under these circumstances, I feel obliged to do it as an unfortunate aspect of my duties. It's not entirely an unpleasant duty because I like people to think the way I do.

The Money Management Fad

One unfortunate aspect of my practice is that I talk to a great many money managers who want to do better – do their function in life way better than other people do. I have very mixed feelings on this subject because I regard the amount of brainpower going into money management as a national scandal. We have armies of people with advanced degrees in physics and math in various hedge funds and private-equity funds trying to outsmart the market. A lot of you older people in the room can remember when none of these people existed. There used to be very few people in the business, who were not very intelligent. This was a great help to me. [Laughter]

Now we have armies of very talented people working with great diligence to be the best they can be. I think this is good for the people in it because if you know enough about money management to be good at it, you will know a lot about life. That part is good.

But it's been carried to an extreme. I see prospectuses for businesses with 40-50 people with PhDs, and they have back tested systems and formulas and they want to raise $100 billion. [Munger is referring to Jim Simons, who has compiled one of the best investment records of all time with Renaissance Technologies, compounding net to investors at roughly 35% annually since 1982.] And they will take a very substantial override for providing this wonderful system. The guy who runs it has a wonderful investment record and his system is a lot of high mathematics and algorithms with data from the past.

Rationality is a High Moral Duty

What is the central theme that the people in this room represent? I'd argue that it's rationality rather than to make more money than other people. I'd argue that rationality is a high moral duty. It's the idea the binds us all together. I think that is a *really* good idea. It requires that you avoid taking in a lot of the nonsense that's conventional in your time. There's always a lot of nonsense in anyone's time. It requires gradually developing systems of thought that improve your batting average and thinking correctly.

Regarding Wesco, there's not much to say beyond what's in the annual report, so I won't talk about it unless I'm asked a question.

Regarding money management, I'll talk at some length because we're in quite a period. When I was young, professional money management consisted of owning some mixture of stocks and bonds. Early on, bonds were respected and stocks were regarded with some fear, thanks to the early 1930s and the behavior of the capitalists in the robber-baron days. For a long time, stocks yielded dividends that were twice as much as the interest rates on bonds. It was a wonderful period to be buying stocks. We profited from others' demoralization from the previous generation.

Today's System of Institutional Money Management is Nuts

It used to be that if you owned stocks, you could get an extra 7-8 points of return per annum, but if you think that's true today, you probably believe in the tooth fairy. If there's any efficiency at all in markets, all of these professionals will have asset-class [returns] converge.

As this convergence became obvious to a lot of people at foundations and pension funds, they basically said "It won't work very well for me if I get lower returns, because I need and want [higher returns]." So they reasoned as follows: "I need it and I want it and therefore I should have it." [Laughter] My father used to have contempt for this attitude.

So institutional investors have decided that they want way more than the result that can be achieved from the standard mix of stocks and bonds. So the system morphed into a series of consultants. The consultancy system works as follows. It's like a gigantic farm, stretching as far as the eye can see. They decided to manage this farm in an intelligent way and somebody had to decide how much soybeans to have, how much corn, wheat, pigs, chickens, etc. Once we decided to do that, then we decided to subdivide responsibilities by having a competition. Those who think they're excellent chicken raisers will compete for the job of raising chickens. All the guys who think they know how to grow soybeans will compete for the job of growing soybeans, etc. And then they have these beauty contests judged by the consultants. Those of you in money management are no doubt familiar with this process.

The interesting thing about this, the reasons that it spread so mightily, is because it coincided with a time when stocks and bonds were collapsing and disappointing, so a lot of the people who'd gone to this system profited. The truth of the matter is that there were remarkable opportunities from taking leveraged positions. There was a time when junk bonds, purchased with reasonable care, produced enormous returns [he's referring to the collapse and near paralysis in the junk-bond market in late 2002]. And the same thing in different forms also generated big returns.

I recently met a man with more than $5 billion under management. Institutions found him via consultants, incidentally, even though he's not that hard to find. [Laughter] What he does is buy participations in first-lien bank loans, probably $50 million a pop, and he selects the ones he thinks won't default, and he gets 250 [basis points] over LIBOR. Then he issues bonds against his purchases until he's leveraged about 6x. These are 10-year bonds that can be prepaid at will but can't be called. The bonds yield a little bit over LIBOR, so maybe he's getting a two [percentage] point override. You don't have to know very much about mathematics to know that this yields a very handsome return on the equity of the people who put it up. So the institutions put up the equity and this man takes a nice fee and 20% of the profit. So far, there have been no defaults and the institutions have gotten over 10% per annum – and the guy's gotten rich.

I see this repeated over and over and over again. So why don't we all leverage someone's high-yielding loans and make our own 12 or 13 or 20% with our own money.

In the first place, it's inconvenient to do. You have to work at it, understand the covenants. I regard what this man is doing as pretty intelligent. Taking first-lien positions, it's not totally crazy. My guess is that investing with this man is not the dumbest thing these institutions are doing. It has some elements of rationality. It's worked very well, but it's created a lot of leverage in the system. If there was a real convulsion of some kind, all of these things would encounter trouble. But short of a convulsion, everything would be okay. It's sort of like earthquake insurance. Most years when you write earthquake insurance, you pocket the premiums and look very intelligent. If you do that with someone else's capital under a profit-sharing formula, it would *really* be intelligent.

All of this stuff that people are investing in – it's like the man who promises you an extra yield on a bond, provided there's no major earthquake (earthquake in some general sense). The investment world is just chock full of this stuff and it's worked very well so far. Everyone's made a lot of money. The people like Harvard, who got into fixed-income arbitrage *really* made a lot of money. The rest of us were asleep when Harvard was doing this. It wasn't that hard when they told us that interest rates were going down, down, down for a long time. There was an easy, idiot-proof way to take advantage of this, with very little risk, but it involved using unconventional techniques, using the [bond] repo system to go long 2-year Treasuries and go short 1-year Treasuries on a highly leveraged basis. People got very rich on carry trades like that. They not only made a lot of money on the interest, but also on the valuation as the interest rates kept coming down. These unconventional people suddenly got very good investment records, partly by accident.

The Early-Stage Venture Capital Fad

Take the world of venture capital. A few people like Harvard and Yale concentrated their investments with the four or five early-stage venture capital firms that had a real edge because they were the best known, attracted the best brainpower, and got the first calls from the companies. If you look at the history of start-up venture capital, you will find that a very few firms made most of the money, and they made it in just a couple of boom periods. Practically everyone else in a different period made mediocre or lousy returns.

Of course what happened was that when the huge returns were made by the clients of these few firms, envy rippled through the world of institutional money management and everyone set out to enter the business and firms started up to meet this demand for early-stage venture capital investment. In 1999 and early 2000, the amount invested was up about 10x. A lot of money was lost and I think something like this will happen again with these latest fads.

Many of you are on investment committees and I don't know anybody who has successfully resisted this. There's a new orthodoxy: you take all of the different fields of investment and somebody decides how much money is going into each field. And then you have these beauty contests, deciding who's going to manage the money in the distressed debt, early-stage venture capital, small caps, developing countries, etc., etc., etc. The people feel so busy and so virtuous, particularly after they've been successful for a while and other people who led them into it were also successful. You can put me down as an enormous skeptic to this whole process, even though it's worked so far.

I don't see anything automatically wrong with doing some fixed-income arbitrage at selected times just because it was unconventional for some institutions to do it. I don't think it's wrong to engage in some activities in foreign countries or emerging markets or a lot of other places.

But this idea that you have these categories and then look for the right masters of the category – that is nuts by the standards of Berkshire Hathaway and Wesco.

Opportunity Costs

The introductory text in economics, the best-selling one by [Harvard Professor Gregory] Mankiw, says that all intelligent people make decisions based on their own personal opportunity costs. So, when someone presented a company in an emerging market to Warren Buffett, Warren said, "I don't feel more comfortable [buying this] than I feel about adding to our position in Wells Fargo." He thinks highly of the company and the managers and the position they were in. He was using this as his opportunity cost. He was saying, "Don't talk about anything unless it's better than buying more Wells Fargo." It doesn't matter to Warren where the opportunity is. He has no preconceived ideas about whether Berkshire's money ought to be in this or that. He's scanning the world trying to get his opportunity cost as high as he can so his individual decisions would be better.

Why is it that the prevalent investment course in economics, what this Harvard professor [Mankiw] says, is so inconsistent with what *all* of these experts are doing? I have difficulty understanding it. It's because of crazy waves of mental conformity and based on social approval. I believe in it the way I believe in baptism, because I've seen it done. [Laughter]

It's hard for me to think that this many smart people can be so extremely irrational. This worshipping at the altar of diversification, I think that is really crazy. The idea that 10 different securities might not make an institution or a family securely rich? Yet instead they listen to the professionals recommend having 300 securities in separate accounts, with cadres of experts and battalions of consultants, all charging them money and that is going to make them safe?! How can people be so uncynical about human nature?

Some of you may remember when a group of experts developed the idea of portfolio insurance. They created this trip hammer system and that gave us Black Monday and the market fell 20%+ in one day. Of course the idea just died with this one denouement.

If you listen to the presentations of the people who are selling these various forms of expertise, they seem like reasonable people and you listen to their presentation and you walk away wanting to invest money with all of them. These people are selected because they know how to tell a beguiling story.

This system, with all the costs of getting in and out, with all these layers and experts and so forth, in many cases exceeds 3% per annum in costs. In a world when government bonds yield 5% and when returns from other assets are very likely to be converging toward 5%, that's likely to eat up more than half of the expected return. You could have a lot of disappointment in America.

Everyone thinks they've found a way to rig the game. After all, Harvard doubled and tripled its endowment. So people say, I've seen the excellence at Harvard, so I want to get a high return, and there are these other people who tell them they know how to do it. And if you look at the last four or five years, they've done it. They are in for quite a ride I think.

A Different Construct

Let me give you a different example, a different construct. I know a man, John Arrillaga [#346 on the Forbes 400], who was a star athlete at Stanford in a different generation. He got out of Stanford and started building little buildings around Stanford. He kept doing it and was good at it and of course there was no better market. In due time, he and his family had 15 million square feet, and the rents had gone up and up and up.

The interesting thing was that instead of doing the normal thing real estate developers do, which is borrow, borrow, borrow, so that money earned goes up and up and up, John gradually paid off 100% of the debt on his buildings so that when the great Silicon Valley crash hit and three million square feet of his buildings went vacant, it was a total non-event – and, in fact, he could start buying buildings from others [who were distressed]. He now likes to build buildings for Stanford – and doesn't take any compensation for it; he takes a loss. This has been a wonderful thing.

Here's a man who deliberately took some risk out of his life. He has no regrets in his life. He was damn glad. I think there's a lot to be said when the world is going a little crazy around you, to at least put yourself in a position that if something really unpleasant happens, that it might be unpleasant but will be a non-event in terms of changing your life. We all might consider imitating John Arrillaga as things get crazier and crazier.

How Crazy Are Things?

Well, how crazy are things? Let's look at the obvious bubbles. Saudi Arabia had a huge bubble; it was the South Sea bubble all over again. People bought into things just because they were going up, and the market is down 50%. Kuwait did the same a few years ago. There was just an orgy like the South Sea bubble. But Kuwait is so rich that when it happened, they just bailed everybody out.

The wealth of some of these oil countries is amazing. Qatar decided it wanted a medical school and 300-bed hospital. It cost $9 billion and it was like taking it out of petty cash. In the history of the earth, I don't think there's ever been so much wealth per capita – and it's only about 60 miles square. The world is not entirely a fair place when it leads to these ridiculous bonanzas.

I remember a story they used to tell in Texas when I was young. When some idiot got rich, they'd say, "Well, old Charlie was out in the field playing the big brass tuba on the day it rained gold." A lot of people have become rich lately who were playing the tuba on the day it rained gold.

If you get capital gains taxed at 15% and you get stock options in something that goes crazy or a hedge fund that has a great year…There's many a man that decides he wants three Chagalls and a $15 million apartment very fast…

The world has signs now that are somewhat disturbing. The way things are going is that every asset class I see is priced on a fairly rich basis.

If you buy a really nice apartment house, with the costs of running it and replacing carpets, etc., it yields less than 5% if you buy it outright. In Europe, you can find office buildings that are yielding 3%.

There are very liberally valued assets in practically every asset class. Junk bonds seem to be pretty junky. Whatever premium they're providing in terms of yield seems to me to be offset by the increased risk of not getting your principal back.

The markets are picked over. Part of the reason they're picked over is because so many people like you can afford to come so far and think about value investing.

Even Obscure Markets Are Picked Over

Little obscure markets are picked over too; it isn't just the big ones. I heard of a money manager who made a presentation to a major university the other day. Guess where he'd generated a successful investment record? Sub-Saharan Africa! There is a specialist in investing in sub-Saharan Africa. And, by the way, he's done very well. It's kind of like Ben Graham – he just picks some field that nobody else is interested in.

The headlines are so awful in sub-Saharan Africa. He just went into these relatively illiquid securities and dominated every little pocket and made $500 million. It's quite rational. If a thing is despised enough and ignored enough, you can run a Geiger counter over it and find a few things that make it go click. But he had no illusion that he could make another $500 million in sub-Saharan Africa. He'd accomplished what he was trying to do for a while in the field he'd chosen.

I think that's what you find around the world. Even if you did go into sub-Saharan Africa, which not many people are likely to do, you'd find the field pretty well occupied. And this is a guy who thinks a lot the way you do and he knows everybody and that's pretty much the way you'll find the world.

The World Has Changed (Buffett's Investment in South Korea Notwithstanding)

Warren, liking examples that markets are not all that efficient, is now telling business school classes and others that a few years ago he looked at the Moody's manual for South Korea [and found a lot to invest in]. There's a nuclear North Korea to the north, huge scandals at home, chaebols that didn't seem to care about the shareholders, a huge consumer credit boomlet that led to a huge collapse. And in the middle of that, Warren found a flour mill trading for two times earnings and he thought he was young again. [Laughter]. So he bought a lot of these securities right out of the manual and made a lot of money. So [he concluded], the world hasn't changed.

Well, the world *has* changed. If you're Warren Buffett, maybe you can find the one place where that still works, but I don't think many ordinary people can find a great many pockets as crazy as South Korea [was].

Macro Problems – Consumer Credit

Now you have the problems of the macro scene. Let's take credit expansion. Consumer credit has expanded to levels that nobody's ever seen before. All of these credit cards and all of these algorithms… people [meaning lenders] really want that particular customer that's just crazy enough to overspend but not so crazy that he goes bankrupt. [Laughter] They have computer algorithms to identify these people – they seek them out with clever marketing techniques. I always say it's like having serfs when you finally get them. They while away at their job and you're the lord of the manor and at the end of the month they send you [the money they make]. They've gotten so rich that [the lenders] keep surfing for more serfs with ever more liberal credit, and so forth. That is the world of consumer credit.

Mortgage Credit

Now you get into mortgage credit. Again, to the people in this room, this is a new world. Warren sold that house in Laguna that he'd owned for many years. He asked the buyer how much he'd borrowed for the $3.5 million or whatever the house cost, and he said 100%. He got an 80% loan and then got an equity line and with a little manipulation, he could borrow 100%. Now you have all these mortgages that say that if it's inconvenient to pay the interest, it's no big deal, just add it to the principal and you can get to it later.   [Laughter] You not only don't have to pay the principal, you don't have to pay the interest! Of course, with this arrangement, you can buy a lovely spread.

And the accountants let people write mortgages like that and let you accrue substantially all of the income even though the credit risk has obviously gone up.

And they do that because they can't see any difference in the credit losses yet. That is not the way I would do accounting – but a lot that I see is not the way I would do accounting.

It was quite logical for people to gamble that with interest rates going down, housing prices would go up. And if you really took advantage of the low interest rates and really laid it on and took on a lot of leverage, I think that was very clever and you could even argue it was totally sound. People did it big time and made *enormous* amounts of money – *unbelievable* amounts of money. The rest of us were really dumb. It was a very logical thing to do if you stop to think about it: as interest rates were sure to go down, the value of property was sure to go up. The rest of us were stupid. It looked risky, but really wasn't. It was a pretty smart thing for these people to do.

Whether it's smart to continue it now from our present level is a very interesting question. I would think no. There are many instances of collapse after liberal mortgage lending. England had a tremendous collapse maybe 10 or 15 years ago.

A combination of very extreme extra leverage in mortgage lending, combined with the leverage in consumer lending…

Commercial Real Estate Lending

Let's talk about commercial lending to real estate developers. A good friend of mine just invested in a very intelligent real estate development project, with a good developer. The total development is going to cost $140 million. And guess how much non-recourse equity the developer put up? $8 million! I don't care how promising the real estate market is – if you leverage something that much, there could be a lot of pain for the real estate lenders.

We are in a weird period. I think it's extra dangerous because it's worked so marvelously well for everybody who did these loony things in the past. Everything's worked.

Silicon Valley Bubble

People really got creamed who were the marginal players in the early stage venture capital business. Some of them have not recovered and have even disappeared in the collapse in Silicon Valley. But that was an unbelievable bubble.

I negotiated with a young woman at the height of that, thinking she should come work for us. She was 23 years old and in her second job and had Silicon Valley stock options. She said, "My stock options are now vesting at the rate of $40,000 a week," so we'd have to start compensation to offset that before she'd consider changing employment. [Laughter] By the way, her brother was a Ph.D economist at some reputable university and he was looking at his sister earning $40,000 per week and thinking this was not part of economics when he was learning it. [Laughter] But at any rate, that's the weird situation we're now in.

Wesco and Berkshire Still Holding and Occasionally Buying Stocks

Obviously, since Wesco and Berkshire are still holding stocks and occasionally adding to something, we'd rather own selected common stocks at these prices rather than own, say, municipal bonds long term – we're at least that optimistic. And we think we'll find occasional things to do where we'll earn returns at least moderately approaching some of the things we did in the past. That's my role as a director, to orient you to the way the world looks to me.

How Stupid We Were

The proper thing to do looking back is to realize how stupid we all were. We all blow a fair amount of obvious opportunity. By the way, Berkshire did do some fixed-income arbitrage and distressed debt. It's not like nothing at all has gone on in recent years. But looking back, I would say that we were all a little bit brain blocked – we could have done better in recent years. The right way to do it, of course, is to scan a broad area until you find something you understand and that you're sure will work and then load up hugely, after properly considering other opportunities. Most of us, including the one speaking, didn't scan enough. I didn't try as hard as I did when I was young. We should have scanned a little more intelligently and been a little more ambitious in the things we did.

I don't think it's a game that everybody will win at. The mistakes we all made were pretty much standard in human nature. Most people are way worse at making decisions than the people in this room.

I said at the Berkshire meeting that the money managers and stock brokers – it's not a class where everybody's wonderful and angels – but those who tend to come to our meetings I always feel are the class in their group. I think Berkshire and Wesco, in their meetings, attract a very good class of money managers who try to be rational and do a good job and not go crazy. I think that's why you're here. It's kind of like a reaffirmation of the faith.

Well, with those preliminary remarks, I will now open the field for questions.

[*Part 2 of these notes, from the Q&A session with Mr. Munger, will be made available soon.*]

Whitney Tilson's 2006 Wesco Annual Meeting Notes
Part 2, Question and Answer Period

May 11, 2006

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***Note**: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what Mr. Munger said. Part 1 of my notes, from Mr. Munger's opening remarks, were sent out earlier.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

MY QUESTION

[I asked the second question of the meeting and Mr. Munger gave a lengthy answer, touching on many of his favorite topics: the failure of corporate governance, the importance of good accounting – and the failure of accountants to uphold this, etc.]

My question: Hello Mr. Munger, I'm Whitney Tilson, a shareholder from New York. [Mr. Munger: "I know you well."] Thank you. My question relates to something you and Mr. Buffett said at the annual meeting last Saturday. Mr. Buffett spoke at length about the need for improved corporate governance and that large shareholders really need to step up and start behaving like owners rather than renters. I forget whether it was in the context of that question that you said something along the lines of activist hedge funds being a mixed bag.

It struck me that there might be some inconsistency in those statements because in the past two or three years, virtually every case in which I can think of in which a large shareholder acted like an owner – the only exception I can think of is in the case of Hollinger and Chris Browne and the Tweedy Browne folks, but even that was an accident and they hope never to be activists again – the only people who are behaving as you are calling on shareholders to behave are, in fact, these hedge funds. I know what you think about hedge fund fees and that they're likely to underperform as an asset class – and I wholeheartedly agree, despite running one of these creatures – but my question is: at least in the area of corporate governance, shouldn't you and Mr. Buffett be applauding this kind of behavior (while perhaps holding your nose about the fees these funds charge) and encouraging institutional investors and mutual funds to behave in this fashion.

Munger's reply: The reason I said it was a mixed bag is because I regard it as a mixed bag. Obviously, since Hollinger was a total kleptocracy [laughter] – I mean *total*; it was the most god-awful example of corporate misbehavior that you could imagine – and it was contrary to Tweedy Browne's interests to do what it did, when they cleaned up that mess by wading in big-time, they did the rest of us a favor. So that's the part of the mixed bag that's weighted toward the favorable side.

But if you take Carl Icahn's assault on Time Warner – if you think Carl Icahn really gives a damn about the shareholders of Time Warner… Tweedy Browne was revolted by the behavior and so they got on a real moral crusade. And they were right, and I applaud that. But a lot of other people just want to raise hell and they don't care if they're raising hell with admirable people or knaves – they're just trying to make money. That second class is I think a mixed bag that we don't need.

I don't think every corporation in America that could be, on a short-term basis, made to give shareholders a little jump in value…I don't think every single instance like that ought to be seized by the management or whether shareholders ought to have the power to run around and do it, particularly if they're the [wrong kind of people?].

I think I said on a previous occasion that some of these assaults remind me of Oscar Wilde's definition of fox hunting: he said it's the pursuit of the uneatable by the unspeakable. [Laughter] In other words, I think some of the hedge fund types are the unspeakable and even when they're on the right side, the other people are uneatable. But still it's not an elegant view. The Tweedy Browne thing was a huge blessing – I'd agree with that.

Corporate Management and Governance
Governance is a very tough subject and the truth of the matter is that corporate managements, from shareholders' point of view, run the gamut from being very valuable, so they add to the asset value of the business they supervise, to very negative, so that the asset value of the business should have a big discount. You know that perfectly well in your own life. One of our fellow value investors said the other day, considering the self-interested way that most corporate managers behave, you *ought* to get 30-40% more assets than you pay for to allow for the depravations of the people who are running the corporation. [Laughter] That's a very harsh thing to say, but it's true in many cases.

Compensation and Stock Option Abuse
There were *lots* of companies that had something like 50% of all of the outstanding stock subject to options. They couldn't help it. They were in the high-tech game, everybody else was paying in options, and they needed people like this woman who was making $40,000 per week in options, so they paid in this currency and were just swept along by these crazy practices. Corporate compensation is a weird subject.

Stock Option Accounting: The Accountants Failed Us
Again, the accountants failed the rest of us. Never, ever should the accountants have allowed any stock option compensation not to go through the income statement, 100%, all of it. The Washington Post has a subsidiary where they created a phantom stock option plan in which somebody valued the subsidiary as a public company and the employees get options. But they account for that on a full-cost basis, not the way people are now accounting for the cost of stock options, which is to hire phony experts to come up with low values. They resented the fact that options had to be expensed, so they made very foolish assumptions so they could get the charges as low as possible. And they're

still lobbying to try to get Congress in some way to change the accounting back to its former knavish state.

Accounting Has Huge Consequences
Accounting has *huge* consequences because given the competitive pressures in life, you have enormous incentives to report every damn item of income they possibly can. People who are subjected to that kind of temptation need a disciplined supervisory structure, which accounting provides. I feel sorry for my individual friends in the accounting profession who haven't produced any income for years because of the malpractice fines, but the profession as a whole richly deserves the amount of trouble that it's had. It's *such* a thankless job to want to pull the plug. How many people are volunteering for that? It reminds me of the saying, "Whose bread I eat, his song I sing."

Sarbanes-Oxley
The Sarbanes-Oxley stuff did give us a little bit of supervision over accountants but what they're doing mostly is running around improving internal controls, which is a gold mine for the accounting firms. Companies need bodies and the accounting firms are billing those bodies at very high rates (despite the quality of some of them), so it's been a bonanza for the accounting profession. And I think better internal controls are ultimately good.

Implications of Bad Accounting: The Enron Disaster
But some of the big stuff is being ignored. I had fun once at the Stanford Directors' College [a program at Stanford University to train corporate directors on how to be good directors] – I asked them, "Name the time when that whole Enron thing could have easily been stopped?" People utterly failed – they should have done better. A whole bunch of experts paid thousands of dollars to come to the college, but not one person stood up with the correct answer, which is: that when Skilling got to SEC and talked them into allowing them to front-end all future profits from long-term arrangements to deliver natural gas and the income immediately went to the trading desk. This triggered a whole daisy chain, with all of its misery and terrible example. And all they had to do is make that one decision right instead of wrong. What I've said is totally obvious, but I don't know how many other people realize it – and this is a smart bunch. It's so *easy* to realize how all of this sin and error could be fixed by proper accounting. Yet the skilled people like Skilling and Arthur Andersen went to talk to the skilled regulators who are the accountants at the SEC and they made the exact wrong calls.

There's a lot to be fixed in the world. To the extent that this is an educational meeting, I think the story I've told you is giving you a real educational lesson. It would have been *so* easy…yet the method they chose was so insane. I'll give anybody with any understanding of traders and trading culture and management consulting and management consulting culture, how could *anyone* believe that that kind of accounting would be anything but a disaster?!

There's so much skill in exposition in this stuff. Look at Johnnie Cochran. There's just a huge amount of skill in exposition. And part of being a wise person is resisting the other person's expository – to know nonsense when you see it. If you're like me, you can conceal your contempt for the person even as they speak. [Laughter]

I think we can offer a certain forgiveness. It reminds me of the [?] who was confronted with the scandals of the Catholic church. He said, "Well, I've had my scandals too. It just happens because of our different doctrines. Most of mine are heterosexual." [Laughter] And I said, "Well, I can understand why the Catholic church got into so much trouble, because of all of the religions, they're the one that's most into forgiveness. A person can be redeemed. How about you?" And he said, "Oh Charlie, I forgave every single one [because of what's it's like to live somewhere else?]." Well, that's the wonder of forgiveness. [Laughter]

COMMENTS RELATED TO BERKSHIRE HATHAWAY

Comments on the Reinsurance Business

I think the reinsurance business is a very difficult business. And it's a very tempting business, in which a guy writes you really large checks in advance. That kind of field will lead to a lot of dumb stuff and a lot of calamities. It takes exceptional skill to do well in reinsurance over the long term. Few people can do it.

So you might ask, Why do we think we can do it? Well, we're not everybody else. [Laughter] If you stop and think about it, that's the only logical answer. The only other alternative is that we're nuts, a possibility you'll have to consider. [Laughter]

What is Berkshire's Formula for Pricing Super-Cat Insurance?

The answer is, there is no formula. Ajit [Jain] and Warren are like father and son in how they interact. They're like a couple of bridge players. Anything they want to do is okay with me. You should be so lucky to have Ajit Jain and Warren Buffett doing this for you.

What Investment Hurdle Rate Do You Use in Your Models When Deciding Whether to Make an Investment?

We don't do a lot of involved math with schedules of investments. Certainly we expect a decent return or we don't do it. We use a lot of experience and do it in our heads. We distrust others' systems [and complex models] and think it leads to false confidence. The harder you work, the more confidence you get. But you may be working hard on something you're no good at. We're so afraid of that process that we don't do it.

How Do You Judge Managerial Talent: the Paper Record or Your Own Judgment? And How Did You Judge Eitan Wertheimer?

The paper record is usually a better indicator of talent . The paper record of this man is so extraordinary that it couldn't have been created by an ordinary human being. If you add to that the man’s obvious character and intelligence – who isn’t looking for that? You also want to get a fair price of course.

Eitan said he learned some things from us. He’s one of the smartest men I’ve met in my whole life. I can’t imagine he’d learn anything from me.

When You Bought Iscar, Did You Consider That One of Israel’s Greatest Companies Is No Longer Israeli Owned and Controlled?

You gotta understand that these people picked us. All we did was say yes. [Laughter] We think the kind of people who seek us out have such marvelous judgment that they’re the kind of people we want to be in business with.

Details on Iscar

That was a very intelligent question and I’m going to give you a very intelligent answer: I’m not going to answer. [Laughter] All I’m going to say is that we are very happy with the acquisition and the price we paid. It’s not rudeness. We want Iscar to be run like it has been in the past. They want to be private and quiet and we have a tradition of respecting this.

Do You Have Difficulty Reading Financial Statements of Foreign Companies?

We’ve been looking at financial statements for a long time. We feel, in some cases anyway, that we know what a foreign financial statement is telling us. Generally, would we would we feel more confident in our own currencies, etc.? Yes. But we feel that we can understand them [foreign financial statements].

Difficulty Investing in a Foreign Culture

Of course it’s more complicated to make a decision in a foreign culture. But I think you can discern a great business in a foreign culture. [But you have to be careful.] I was amused when the dictator of Indonesia said, “What look like embezzlement to you people looks like Asian family values to us.” [Laughter]

Why Doesn’t Berkshire Just Buy 100% of Wesco?

It’s complicated. You people, because you like the value system, have bid the price of Wesco above the liquidating value of the business, so we can’t merge it into Berkshire. There are a lot of irritating conflicts. But I like you and I don’t feel guilty because you can always sell your stock for more than [Wesco’s] liquidation [value]. It has its disadvantages [but they’re not insurmountable].

Comments on Berkshire's Float

We love having the float at Berkshire. If we didn't have it, Berkshire would be worth less than it is. It will grow more slowly in the future. There isn't that much float in the world [for Berkshire to continue growing it at such a high rate] – it's not a huge market. Float's very desirable thing. We don't think it's a model that will help you in other investment opportunities.

Why Haven't You Invested More in Foreign Stocks?

We've light on foreign stocks for our entire history, but we were still able to get the company [Berkshire] from $10 million [in stock market value] to over $100 billion, so there were worse tragedies that we missed foreign stocks. I don't know a lot about foreign stocks. I do think that there have been opportunities in some foreign countries that if we'd looked at them closely we would have wanted to invest. But every one that I can think of that looked intriguing was way to small to be of interest for Berkshire – they weren't the great big ones.

Overall, I don't have many regrets here – I think the United States has been a better place to be than, say, England for the past 30 years.

Buffett's Decision to Sell the South Korean Stocks He Bought

Warren's entitled to do whatever he wants with the sell decisions. Anyway, he was more interested in finding an inefficient market than he was in making the money. [Laughter]

Why Didn't You Invest in K-Mart or Tyco?

I didn't think about K-Mart. As for Tyco, I thought about and I passed, but I don't want to tell you the reason.

Impact of Lead Paint Liability?

Berkshire has one subsidiary, Benjamin Moore, that's been making paint for a long, long time. But it's a tiny part of Berkshire and my guess is that this issue is not meaningful.

The Morality of Investing in PetroChina, Which Is Helping the Government of Sudan, Which is Behind the Genocide in Darfur

You've raised a subject about which I know absolutely nothing. But all major oil companies that work in the Third World run into the problem of having to work with governments that are doing bad things. This is a classic problem.

I think it would be very hard to invest in oil at all without encountering some of these issues. Under those circumstances, what do you do if you're the company? Not go in? Or if you're already in, pull out?

I don't think, by and large, that passive shareholders of companies need to have fits if a company they're invested in is doing something somewhere that you and I wouldn't approve of.

USG

USG of course was a great success story. It benefited greatly from the great construction boom, and it worked out deal to deal with its asbestos agony. They now have a plan to exit bankruptcy. I think management has done a hell of a job.

Do You Think One Has Lived a Better Life If One Builds Wealth By Owning Businesses Rather Than Buying Stocks?

The answer is HELL YES! If all you do is make yourself rich through buying passive stakes, [you haven't lived much of a life]. Making your way as a professional poker player in Las Vegas – it pays the bills but is not a great moral beacon.

Obviously we think the pattern and life [of owning businesses] is better. Gin rummy behavior [of rapidly swapping] colleagues and businesses changing. No one admires that with wives and many of us spend more time with our businesses than wives. So constantly changing businesses [is nuts]. I don't consider this as good a life as the one we're living. Maybe [our behavior] is just serving our personal idiosyncrasies, but I say we're entitled. [Laughter]

But You Sold US Airways

Yes, but US Airways was not a subsidiary. We had some representation on the board, but did not control it. [That being said,] had we controlled it, we still would have sold it. It was out of control. But the sales we've made over the years are tiny and few.

Macro- and Micro-economic Considerations When Buying Companies

We simply try buy things for less than they're worth. We're not making microeconomic decisions or forecasts. We predict they [the companies we buy] will swim better, but we're not betting on the tide.

If we found a good business tomorrow, we'd buy it. We've been doing that all along. I'm not good at predicting macro things.

Since Size Hinders High Investment Returns, Why Don't You Focus on Managing Your Own Assets, Rather Than Berkshire Hathaway's?

Since my own assets are in Berkshire, so I don't have much choice, do I? [Laughter]

Is Your Salary of only $100,000 Per Year Fair?

Yeah, it's fair. I like to think that it's more than fair, but what the hell. [Laughter]

Berkshire's Influence as a Role Model

[The questioner addressed him as "Mr. Buffett," to which Munger replied, "My name is Munger. [Laughter]]

Obviously, with the annual meetings and writing what we write, we're trying to have some influence on other people. But in terms on changing other people, I think the influence is tiny. It's very hard to change people when the incentives are in the opposite direction. I know many people who've bought lots of copies of Poor Charlie's Almanack and given it to their children and grandchildren in the hope of influencing them [but I don't think it's had much impact]. If that worked, there'd be a line from here to Denver [to attend the Wesco meeting]. [Laughter]

ADVICE ON INVESTING

Lessons from Losing Money in the Munger Partnership in 1973-74

That is a very good question. When I operated a partnership, I got hit in 1973 and 1974, which was the worst collapse since the 1930s. So I got hit with a once-in-50-years-type event. It didn't bother me with my own money, but it made me suffer the tortures of hell as I thought through the loss of morale of the limited partners who had trusted me. And the agony was compounded because I knew that these assets were sure to rise because they could be liquidated for more than I'd bought them for in due course. But the individual securities were traded in liquid markets so I couldn't mark them up from the trading price because the opportunity cost for my partners was set by the trading price. I would say that was pure agony. The lesson from that for all of you is that you can have your period of pure agony and live through is for many decades. It's a test of character an endurance.

I don't think any fully engaged young man wouldn't have gotten into the pain that I did in 73-74. If you weren't aggressive enough and buying on the way down and having some agony at the bottom, then you weren't living a proper investment life. I wouldn't quarrel with anyone who was more cautious and less aggressive than I was. But what got me into the agony was buying things for far less than what I was sure I could liquidate them for in due course. I don't think it was wrong, but it was agony.

More Comments on Activist Investors

Enormous blocks of stocks are held by employee pension plans with an ax to grind. Other groups of activists [have their own agendas]. It would be nice if the people who would be natural activists would be the type of people we'd want [to act on behalf of all shareholders, but they're not]. I think the world is better when the Predators' Ball days waned. Generally speaking, shareholder activism is naturally going to be done by a group that many of you won't admire.

Lamenting Best Minds Going Into Hedge Funds

Somehow we've created a perverse system of incentives. At Samsung, their meeting of engineers is at 11pm. Our meetings of engineers [meaning our smartest citizens] are also at 11pm, but they're working to price derivatives. I think it's crazy to have incentives that drive your most intelligent people into a very sophisticated gaming system.

A rich system can endure a lot. If 10% of our people over age 60 want to spend X hours per week playing Texas Hold Em, we can afford it. But it's not good. But do we want our auto industry to just crumble away and somebody else's to take over because they do it better? I don't think it's a good outcome. I don't think we can stand a diversion of our best minds to hedge funds.

How to Pick a Good Money Manager

There are a lot of honorable people out there and a lot of charlatans. If you don't have expertise in the field, it's hard to do – I don't have a one-sentence formula for doing that. I always prefer a system in which people are eating their own cooking, so look for a money manager who has almost all of his net worth alongside yours in his fund. This was Warren Buffett's rule when he ran the Buffett Partnership. Another rule is to avoid things with a high commission: avoid *anything* sold by *anyone* on a high commission!

Thoughts on Value Investing

Some people come to our annual meetings to figure out how to many money. We've always believed in value investing – just try to get more value than you're paying for. There are a lot of ways to do this – it could even be investing in another manager. Or you could invest and hold for 30 years.

But nobody could make a living if that's all they practiced. You need some mumbo jumbo if you're going to be a witch doctor. You need some song and dance. [Laughter]

Investor Irrationality

Copper stays low for decades and we finally get a shortage of it, and all of a sudden it's in the stratosphere. I've seen housing prices collapse when the population is leaping. Once prices start galloping, people buy real estate like they buy stocks in Saudi Arabia or Kuwait – because they're doing up. A whole class of day traders became condo flippers. It really happens – thousands of them.

But you always have stock markets where prices stay low for long time. This is good for people like you. This is why you can afford to fly long distances to come to Pasadena [to hear me and learn about value investing].

Learn at the Temple of Rationality

All you have to do is keep trying to learn at the temple of rationality and do things [when it makes sense]. I'm quite prosperous even though I didn't invest in K-Mart's bankruptcy. You can miss a lot. We bought 4% of Freddie Mac [many years ago] yet none of Fannie Mae. How could the same mind have done that?! It wasn't very smart.

But despite the many cognitive mistakes [we've made], we're a lot richer now than we were then. I think you need to constantly remember the mistakes of omission. We're very good at this. Nobody remembers them – nobody thinks less of me for missing K-Mart – but I think about it every day. It's a very [useful discipline to have].

Chris Davis [of Davis Advisors], who's not here, has a temple of shame for mistakes. [It's a wall in his office in which he hangs stock certificates of the worst stocks he's ever invested in.] But this is inadequate. You need the temple of shame squared – great things you almost did and, had you been a little more rational, should have invested in. You'll be a lot better investor if you do this. You ought to remember boners of both kinds. Reality doesn't distinguish – either way, in 10 years, you're poorer. So why not celebrate your mistakes in both categories?

Efficient Market Theory

We didn't get any courses [on value investing] into [the curriculums of] major universities for the first 30 years [in which investing was taught], but it's shifted a bit in the past 10 years. The flat earth people [meaning the believers in the Efficient Market Theory] are only now about 75-80% [of the faculties].

RISKS IN THE FINANCIAL SYSTEM

Derivatives and Accountants Selling Out

This world of derivatives is another place the world has gone absolutely bonkers by the standards of the past. You take Fannie Mae – a big, clumsy, dumb bureaucracy to start with – and they're in this great privileged position where they got enough of a government halo so that their borrowing costs were lower than other people's. And they created this marvelous intermediary system where they were able to take an override on the safe mortgages of the world. They could raise earnings 20% per annum for a decade or so, but that wasn't enough. They wanted to make sure that they earned 15-20% every quarter than they earned in the previous year's quarter. And so they listen to the siren song of the professionals who invented these mad derivatives. And of course there was a lot of leverage in the bargain.

When they tried to clean up Fannie Mae, the new CEO complained that spent hundreds of millions of dollars on experts just trying to understand what's already on the books. You get people investing weird things, complex things for other people to gamble in. And those silver-tongued salesmen going into leading institutions, with wonderful slide shows showing how everything's going to work way better for them – weird things get done. What happens, of course, is that the same derivative trade that's put on, the accountant for Firm A says that the firm made $8 million, and the accounting firm for firm B says its client *also* made $8 million, and it's the same trade. I've never met anyone in the accounting profession that's bothered by this. They go around and *check* to see if the retailer owes some money to a wholesaler – they want to make sure that it's the same on both sides. But on derivatives, the accounting profession has sort of given up – it gets complicated. I don't think given up is the right word: They sold out. You'd think they'd learn by now and put more integrity into the system. But telling people to do something unpleasant when they're making a lot of money out of it…it's too hard. I likened it in some previous discussion to what doctors have to do when someone's on life support. The religions of the world say it's perfectly alright to withdraw the tubes – you can withdraw artificial help. But when you do it and the patient shrivels up like a prune, the guy who pulls the tube out feels like a murderer. He's not – it's the correct thing – but that's what he feels like. I think that's the way the accountants react to the situation when $8 million of profit is being booked by each side of the same trade. He can't pull this plug. He doesn't want to think about the consequences.

Maybe there's some more kindly explanation. [Laughter] I'll give our accountant [who was sitting on the stage next to Munger] the opportunity if he wishes to participate in this discussion and explain why the accountants are doing what they're doing. [Short pause] He says he has nothing to add. [Laughter. (That's Munger's oft-repeated line from the Berkshire Hathaway annual meeting.)]

More on the Risk of Derivatives

I regard the counterparty risk as extreme. But no-one cares about this because the accounting statements assume it away. If you look at the trading sheets on Wall Street, there's no line for counterparty risk. The person who is supposed to think about this would be very unpopular [if he tried to add this]. Pulling away the punch bowl at the party has never been a way to prosperity and popularity.

If you look at derivative markets enough, you think it was scandalous. That doesn't mean it can't go on for along time, however. Look at Japan. Great civilizations can withstand a lot of terrible behavior. It's a good thing. Lord knows, we'll need it.

Look at Berkshire's Gen Re derivative book. It was valued at $400 million on the balance sheet [but when he reached for the money, it wasn't there]. Imagine an balance sheet item labeled: "Asset – good until reached for"! [Laughter] [My comment: In fact, Berkshire has taken hundreds of millions of dollars in losses as it's run off this derivatives book – during a benign time in the markets, when no-one else was trying to run off their book! Can you imagine the utter chaos that would ensue if, say, JP Morgan Chase tried to run off its $40+ *trillion* derivatives book?!]

Final Comments on Derivatives

If we have a hell of a mess due to a big derivatives blowup, the country will survive it. Did we need derivatives to get to their current huge size? [Of course not.] [People argue that because] it lays off risk, it therefore it must be wonderful. That is not the Munger mindset. If you're lucky, we'll see who's right.

Danger of Ballooning Consumer Debt

There's no question that huge ballooning credit practices in other places have caused crashes. For example, South Korea had a huge crash from irrationally ballooning consumer credit. But I can't predict whether the troubles I foresee will come soon or later. All I can predict is that there is considerable danger.

Risk of a Hedge Fund Blowup

There will be some repeat of Long Term Capital Management in some place – you can count on that. There's a lot of real brainpower at a lot of these firms and some are making a lot of money by being very shrewd. The problem is envy and imitation. The result will be like what happened with early stage venture capital in Silicon Valley. Envy will lead to a flood of money and then a disaster.

Should One Be Worried About Having Cash in a Brokerage Account?

I think a cash account at the really strong brokerages is safe enough. You have other better things to worry about. As for margin accounts, with hedge funds using leverage, there will be troubles there. You'll notice there's an uproar at Refco. You do not want to have a margin account at a dubious firm. And personally, I wouldn't want 100% of my assets in a brokerage account at even the strongest financial firm in America. Margin debt I'd be very goosy about right now.

How Fearful Should We Be About a Major Meltdown?

Every period is weird in its own way, but this period is extra weird. I could add the twin deficits to what I said earlier [about the things that worry me]. Yet economy is [rolling along]. I think it's almost always a mistake to think that a great civilize can't take some more [bad behavior]. I have friends who are building bomb shelters and the like [which is going overboard in my opinion]. I'm all for being reasonably cautious, like John Arrillaga [who Munger discussed in his opening remarks]. I haven't had any debt for a long, long time. Neither has Warren – not any significant debt anyway; maybe a blip.

But I think the rationality you're talking about is pretty sure to work. It won't save you from a terrible accident or the death of a child, but character and rationality will save you from a lot.

It's all about not trying to get the extra zero on your portfolio's total value when you die. It's playing the game all the way through with both character and rationality. It doesn't do any good to [have good motives?] if you're a horse's ass [?]. [Laughter]

COMMENTS ON BUSINESS AND ECONOMIC MATTERS

Backdating Stock Options

I think backdating stock options is embezzlement. I would argue that if it happened, it was criminal.

But I would bet that the people who did it think it was god's work. [They probably said to themselves:] "If options are great, then this must be even greater!" I'll bet there's no sense they did anything wrong. It's hard to believe that the human mind can play such ghastly tricks.

How to Change Corporate Directors' Behavior

The only thing that will change corporate directors' behavior is if they look ridiculous in the press. Otherwise the CEO could be an ax murderer. [Laughter]

Is Home Depot's CEO [Bob Nardelli] Being Paid Too Much in Light of the Company's Stock Decline Since He's Been CEO?

Generally I don't think management should be blamed if the stock market goes crazy for a certain period of time. If it went up 35 times earning and then declined to 25 times earnings, how is that the CEO's fault? Lou Simpson bought that stock and I don't think he'll want to comments on the situation at Home Depot. I'm not in a position to judge if the CEO's compensation is reasonable or not, but I wouldn't be surprised if it was.

Corporate Compensation

I don't know how we're going to fix corporate compensation. To have the CEO rewarded in a way that's so extreme [is terrible].

Future Oil Prices

I think eventually the price will be higher than it is now, but what will happen in the meantime I don't know. I'm not an expert on the price of oil, but I think it will get harder to extract hydrocarbons and demand for them will go up.

I think future generations will curse us for using hydrocarbons for our cars when they need them to grow food to eat.

Views on Naked Shorting

One of the nice things about being an old man in a secure place is that I don't have to think about many things and naked shorting is one of them. My jihad calendar is full enough. [Laughter] I'm sorry, that's all I have to say.

Book Recommendation: <u>Fortune's Formula</u>

I like that book that I recommended [a while ago] in which the guy that explained all of these weird guys at the horse races – a value investing thing with a lot of math in it. What was the name of it? Fortune's Formula. It's a very worthy book and you all ought to read it.

In Hong Kong, people are crazy about horse racing and everyone bets on the races, yet somebody was actually able to develop a lot of algorithms such that, in spite of the croupier's take, he was able to make a lot of money. Some of that is going on in a lot of these hedge funds. Some guy can develop a lot of algorithms and can outwit the other guys' algorithms. But it's not for me…

Comments on the Kelly Formula, Which Is Detailed in Fortune's Formula

[Munger had trouble hearing the question and asked the questioner to repeat it more slowly, saying, "Keep in mind you're dealing with a slow-witted old man."]

The first time I read that sizing system, my take is that it seemed plausible to me, but I haven't run that formula through my head – and I won't. You couldn't apply it to the investment operations I've run [I think because of Berkshire's size], but the gist of it in terms of sizing your bet makes sense. Whoever developed that formula has an approach to life similar to mine.

If you could flip a coin and get a 4-to-1 payoff [if you called it correctly], would you invest your house, your net worth, everything? I don't think so. You only get to live once.

[The person who asked the question answered, "Maybe" [Laughter]]

All I can say is that you remind me of a man who once worked for a contractor I knew. He was very bold and aggressive. The contractor said, "Old Charlie is going to become a millionaire – several times." [Laughter] I think we've identified another Old Charlie. But at least you're asking the right question and at least you said maybe.

Generally speaking, I'm closer to you when you said maybe, at least I was when I was your age.

Unrealistic Return Assumptions of Pension Funds

Both Warren and I have said that to predict 9% returns from those pension funds is likely to be wrong and it is irresponsible to allow it. They do it to delay bad news. Look at Berkshire and our paper record, which is obviously much better [than the investment track records of the pension fund managers]: we use 6.5%. For example, the Washington Post has the best record [of virtually any pension fund, yet it assumes a 6.5% annual return]. Do you want to believe the predictions of the people with the best record or do you want to believe the people who are acting in the way Demosthenes predicted when he said the wages of profit are [?]. In other words, what a man hopes is what he believes.

Housing Bubble

The weirdest things I see are in really good coastal properties. It can't keep bubbling up like it has been. But when and how it will collapse I don't know.

Housing Bubble and Likely Future Low Returns from Real Estate

Recently someone paid $800 per square foot for the air rights to build a piece of property in Manhattan. This is driven by the prospect of selling condos for high prices. The condo selling game has already crested in Las Vegas and Miami. In Los Angeles, I don't think it's quite crested, but certainly you're seeing weird prices.

I'm not sure it's crazy. In other words, if you have an apartment building, after costs of maintaining it, assuming no rent control ever, you might earn a 4.5% annual return [if you pay today's prices for it]. I'm not sure that that's crazy. It's not as good as the kind of stocks Berkshire would own, but it's not crazy. We may be in that kind of world [of low returns]. That's already happened in Europe where apartment buildings already have 3% yields. Stranger things have happened...

Interest Rates and Inflation

I have never believed that interest rates have a perfect correlation to inflation. I think there's some relation, but it's complex and not easily quantifiable.

Class Action Litigation

It doesn't affect Berkshire because we don't offer Directors & Officers coverage, though we do cover product liability. There's a lot of abusive litigation in the silicosis field. The asbestos lawyers just rewrote the same complaints. [It reminds me of the class action lawyer who, faced with a judge who wasn't friendly,] said, "By god, I'm getting tired of this harassment and by god I'm going to take my witnesses and go to Chicago!" [Laughter]

The behavior of the class action lawyers [who sue companies] may be quite inappropriate, but the behavior of the people in the corporations may be quite inappropriate as well.

Municipalities' Bad Accounting for Future Pension and Healthcare Liabilities

They've gotten very lucky thanks to the accountants. [My comment: Unlike corporations, which have to account for such liabilities on their balance sheet and in the footnotes to their financial statements – at least in part (there's massive abuse and understatements here) – a loophole in accounting rules has allowed cities and states across the country to make promises of pension and healthcare payments to municipal employees' unions totaling hundreds of billions of dollars in present value, yet this doesn't have to be disclosed or reserved for. The accounting loophole was recently closed and I predict there will be hell to pay as municipalities have to suddenly come up with this money.] If that [continued bad accounting] doesn't work, then they'll have to go to Plan B: increase taxes. I predict that whatever disgusts you in this field will continue for a long time.

Newspapers

I think their future is way worse than their past.

Dividend Payout Ratio of the S&P 500

I don't really have a big opinion on the dividend payout ratio of the S&P. To me, it's within hailing distance with being reasonable…That's all I have to say. [Laughter]

ADVICE ON LIFE AND OTHER

The Importance of Being an Exemplar

I think people have a duty when they rise high in life to be exemplars. A guy who rises high in the Army or becomes a Supreme Court justice is expected to be an exemplar, so why shouldn't a guy who rises high in a big corporation act as an exemplar and *not* take every last penny?

It's not a problem we've had at Berkshire, but look at how far it's spread. We have about two imitators. [Laughter]

The Future of American Civilization

I've said that American society is *near* its apex. It could be just before or just ahead of that point. Other people are more optimistic; Warren is more optimistic than I am. We've had the most incredible generations. Do you think it can go from generation to generation, from apex to apex? The historical record would give you some caution.

Whether the good behavior and values will outweigh the bad, I don't know. On my way over here, I stopped to watch the concrete being poured for a new Wesco building. The design is sound. The system for putting it together is sound. The skill of the crews is sound. The inspection process is sound – every single pour of concrete is watched by an inspector paid by the city of Pasadena, and he's a good, competent man. He watches to make sure every bar of rebar is correct. This building will outlast the pyramids. This system is a credit to our civilization. In contrast, look at the same process in Latin America or Japan, where guys take bribes.

There is a lot that is right in our country. In a recent five-year period, not one passenger died on a major airline. Imagine if other engineering systems were as good. A lot of pilots are recovering alcoholics, yet the system is safe enough to get us around this.

United States Fiscal and Trade Deficits

Regarding currency and oil – this is a very sophisticated crowd [laughter]… Regarding currency, the United States is very peculiar running such a large trade deficit and a fairly big fiscal deficit. [I couldn't hear his remarks for a few sentences here.] The absurdity of this kind of thing…I'd rather not run such a big fiscal and trade deficit. If we have a war, I'd rather add a blank space on tax returns, asking people to pay 10% more for a national emergency. It wouldn't be compulsory, but if you don't pay, we'll publish your name. [Laughter] I'd be in favor of that kind of stuff. Maybe I'd [be great?] for the United Jewish Appeal [an extremely successful fundraising organization, in part because it's very public about who makes big donations – and if you're a wealthy Jew, you're shamed if you're not on the list].

But my ideas aren't winning. They're odd, of course. I'm not predicting ruin, but I think it would be more conservative to behave differently.

China's Growth and Future Pollution

China's vast growth of GNP of 9-10% per annum is a remarkable thing. I think the government will be smart enough to let the tiger grow and then there will be a big pollution problem – and the United States will be way less important relative to other nations than it is now.

Best-Loved Ideas That He's Destroyed Recently

[In last year's annual meeting, Munger talked about the importance of destroying at least one of your best-loved ideas each year, so a shareholder asked which of his best-loved ideas he's destroyed in the past year.]

I had more scorn for fixed income arbitrage in the past than I do now. I was also more hopeful about troubles in the Middle East than I am now. So I've destroyed some of my optimism in favor of more realism. I don't think there's a man or woman in the room that thinks they have a better grasp of what going on in the Middle East [now than they did previously]. Doesn't matter what you think of this administration.

The ability to destroy your ideas rapidly instead of slowly when the occasion is right is one of the most valuable things. You have to work hard on it. Ask yourself what are the arguments on the other side. It's bad to have an opinion you're proud of if you can't state the arguments for the other side better than your opponents. This is a great mental discipline.

Reflections on Looking Back at His Life

I wouldn't have done a lot in my life different. I think I've been a very fortunate man and I don't think I should be complaining about how my life has worked out.

The other day, I was looking back at Berkshire over the past 10 years, since it was recently the 10-year anniversary of the Berkshire B shares. Sure, the rate of growth has come down, but we have added *a lot* of value and that's with a tough strategy the past few years. So generally speaking, I have no regrets.

The only regret I have it that I'll soon be dead. [Nervous laughter] I deal with it through humor. Some people deal with it through religion; I deal with it through humor.

[My comment: Munger has in the past spoken many times about the reality that he won't live forever, usually in a light-hearted way, but this was the first time I felt he was really serious. It was a poignant moment, as a great man shared with his wife (Nancy, who was in the front row), family, friends and most ardent admirers his sorrow that he sees the end of his road approaching. That being said, his mind is as sharp as ever and he clearly relishes his life, so I think he's got quite a few good years left!]

Whitney Tilson's 2007 Wesco Annual Meeting Notes

May 9, 2007

This is an advance copy intended only for those who have registered for the 3rd Annual New York Value Investing Congress. To register, please go to www.ValueInvestingCongress.com

***Note**: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what was said.*

For my columns and notes on previous Berkshire and Wesco meetings, click here.

OPENING REMARKS

I note that this year we're in a tent. It's amazing that a tent can be made to work so well. It's a tribute to our civilization. If our ancestors had been in a tent, it would not be like this one, with air conditioning and so forth.

It's amazing that all you people come. You know, I didn't set out in life to become the assistant leader of a cult. [Laughter] As they say, experience is what happens when you're looking for something else.

It's amazing that many of you come to this meeting after the Berkshire meeting for so many years. It's like the person at the Catholic church who doesn't want the catechism changed.

People are obviously here to some extent to leave a little wiser than when they came. It's very hard to do this by merely hearing someone else talk. That's why most teaching is vivid. For example, when they trained soldiers for World War II, they shot real bullets above them, which really taught them to hug the ground.

That's why so many learn lessons the hard way, through terrible experience. Mark Twain once said that picking up a cat by its tail yielded better learning than was available in any other fashion. But that's a terrible way to learn things. Another comic thought man ought to learn vicariously: you shouldn't have to try it to learn not to pee on an electrified fence. [Laughter]

It's really hard to get ideas from one mind into another. That's why learning institutions are so selective.

I want to do something I haven't done before. I feel obligated because so many of you came from such great distances, so I'll talk about a question I've chosen, one that ought to interest you: Why were Warren Buffett and his creation, Berkshire Hathaway, so unusually successful? If that success in investment isn't the best in the history of the investment world, it's certainly in the top five. It's a lollapalooza.

Why did one man, starting with nothing, no credit rating, end up with this ridiculous collection of assets: $120 billion of cash and marketable securities, all from $10 million when Warren took over, with about the same number of shares outstanding. It's a very extreme result.

You'll get some hints if you read Poor Charlie's Almanack, which was created by my friend Peter Kaufman, almost against my will – I let him crawl around my office when I wasn't there. He said it would make a lot of money, so he put up $750,000 and promised that all profits above this would go to the Huntington Library [one of Munger's favorite charities]**.** Lo and behold, that's happened. He got his money back, and the donee's receiving a large profit. Some people are very peculiar, and we tend to collect them.

A confluence of factors in the same direction caused Warren's success. It's very unlikely that a lollapalooza effect can come from anything else. So let's look at the factors that contributed to this result:

The first factor is the mental aptitude. Warren is seriously smart. On the other hand, he can't beat all comers in chess blindfolded. He's out-achieved his mental aptitude.

Then there's the good effect caused by his doing this since he was 10 years old. It's very hard to succeed until you take the first step in what you're strongly interested in. There's no substitute for strong interest and he got a very early start.

This is really crucial: Warren is one of the best learning machines on this earth. The turtles who outrun the hares are learning machines. If you stop learning in this world, the world rushes right by you. Warren was lucky that he could still learn effectively and build his skills, even after he reached retirement age. Warren's investing skills have markedly increased since he turned 65. Having watched the whole process with Warren, I can report that if he had stopped with what he knew at earlier points, the record would be a pale shadow of what it is.

The work has been heavily concentrated in one mind. Sure, others have had input, but Berkshire enormously reflects the contributions of one great single mind. It's hard to think of great success by committees in the investment world – or in physics. Many people miss this. Look at John Wooden, the greatest basketball coach ever: his record improved later in life when he got a great idea: be less egalitarian. Of 12 players on his team, the bottom five didn't play – they were just sparring partners. Instead, he concentrated experience in his top players. That happened at Berkshire – there was concentrated experience and playing time.

This is not how we normally live: in a democracy, everyone takes turns. But if you really want a lot of wisdom, it's better to concentrate decisions and process in one person.

It's no accident that Singapore has a much better record, given where it started, than the United States. There, power was concentrated in one enormously talented person, Lee Kuan Yew, who was the Warren Buffett of Singapore.

Lots of people are very, very smart in terms of passing tests and making rapid calculations, but they just make one asinine decision after another because they have terrible streaks of nuttiness. Like Nietzsche once said: "The man had a lame leg and he's proud of it." If you have a defect you try to increase, you're on your way to the shallows. Envy, huge self-pity, extreme ideology, intense loyalty to a particular identity – you've just taken your brain and started to pound on it with a hammer. You'll find that Warren is very objective.

All human beings work better when they get what psychologists call reinforcement. If you get constant rewards, even if you're Warren Buffett, you'll respond – and few things give more rewards than being a great investor. The money comes in, people look up to you and maybe some even envy you. And if you buy a whole lot of operating businesses and they win a lot of admiration, there's a lot of reinforcement. Learn from this and find out how to prosper by reinforcing the people who are close to you. If you want to be happy in marriage, try to improve yourself as a spouse, not change your spouse. Warren has known this from an early age and it's helped him a lot.

Alfred North Whitehead pointed out that civilization itself progressed rapidly in terms of GDP per capita when mankind invented the method of invention. This is very insightful. When mankind got good at learning, it progressed in the same way individuals do. The main thing at institutions of learning is to teach students the method of learning, but they don't do a good job. Instead, they spoon feed students and teach them to do well on tests. In contrast, those who are genuine learners can go into a new field and outperform incumbents, at least on some occasions. I don't recommend this, however. The ordinary result is failure. Yet, at least three times in my life, I've gone into some new field and succeeded.

Mozart is a good example of a life ruined by nuttiness. His achievement wasn't diminished – he may well have had the best innate musical talent ever – but from that start, he was pretty miserable. He overspent his income his entire life – *that* will make you miserable. (This room is filled with the opposite [i.e., frugal people].) He was consumed with envy and jealousy of other people who were treated better than he felt they deserved, and he was filled with self-pity. Nothing could be stupider. Even if your child is dying of cancer, it's not OK to feel self pity. In general, it's totally nonproductive to get the idea that the world is unfair. [Roman emperor] Marcus Aurelius had the notion that every tough stretch was an opportunity – to learn, to display manhood, you name it. To him, it was as natural as breathing to have tough stretches. Warren doesn't spend any time on self-pity, envy, etc.

As for revenge, it's totally insane. It's OK to clobber someone to prevent them from hurting you or to set an example, but otherwise – well, look at the Middle East. It reminds me of the joke about Irish Alzheimer's: when you've forgotten everything but the grudges.

So this is a lesson for you to draw on – and I think almost anybody can draw those lessons from Warren's achievement at Berkshire. The interesting thing is you could go to the top business schools and none are studying and teaching what Warren has done. There's nothing nutty in the hard sciences, but if you get into the soft sciences and the liberal arts, there's a lot of nuttiness, even in things like economics. Nutty people pick people like themselves to be fellow professors. It gets back to what Alfred North Whitehead talked about: the fatal unconnectedness of academic disciplines. When people are trying to recruit people to be PhDs in their subjects – the results are often poor.

On the other hand, if you have enough sense to become a mental adult yourself, you can run rings around people smarter than you. Just pick up key ideas from *all* the disciplines, not just a few, and you're immensely wiser than they are. This is not a great social advantage, however, as I can tell you from experience of the early Charlie Munger. To meet a great expert in a field and regard him as a malformed child is not a winning social grace. I got a lot of hard knocks when I was young. You could say I was forced into investing. The world will not ordinarily reward you for correcting other people in their area of expertise.

Accounting is a noble profession. It came out of Northern Italy, Venice, spread, and became part of standard accounting textbooks. The people who carry the torch in accounting are in a noble profession, yet these people also gave us Enron. You could have walked into an insane asylum, which was better than Enron, and yet accountants blessed it. So there are defects. I talked to a leading person in the accounting field and said it didn't make sense to let companies mark weird stuff to their own models – that it would lead to disaster. She looked at me like I was out of my mind and asked, "Aren't you for the most current data in accounting? My system is more current and therefore should be better." This mind would score highly on an IQ test, but is scarcely able to throw out the garbage.

There are two factors in interplay a) you need currency and b) you need to set up a system in which it's not easy for human beings to cheat or delude themselves, despite the presence of incentives to do so. If you can't perfectly weigh the relative importance of these two things in contrast, you're a horse's patoot and not qualified to set accounting standards.

If you go into liberal arts, you'll find that education isn't as good as it should be. I wish I had two or three more lives to live, one of which I could devote to fixing colleges. There is much that is good, but much that is utterly awful and only slightly improved in the 65 years since I left it.

You could say that the dysfunction of others has been an advantage to me. That's the way it is. That's really why you're all here. You all want to get more than you deserve out of life by being rational – who doesn't?

Also, an enormous pleasure in life is to be rightly trusted. One of my kids was a computer nerd and his school gave him access to the entire school computer system. He was exultant by the extreme trust. If your friends are asking you to raise their children if they die, you're doing something right. It's wonderful to be trusted. Some think if we just had more compliance checks and process, virtue would be maximized. At Berkshire, we have subnormal process. We try to operate in a web of seamless trust, deserved trust, and try to be careful whom we let in. They act like this at the Mayo Clinic. Imagine if they didn't. Most patients would die.

Well, I've fulfilled as much as I have a stomach for in making some unscripted comments.

QUESTION AND ANSWER PERIOD

[My notes here are organized by topic, not the order in which the questions were asked.]

COMMENTS RELATED TO BERKSHIRE HATHAWAY AND WESCO

Comments on Berkshire

The Munger family has the better part of $2 billion in Berkshire, so there has been some thought as to whether this is a good idea. The answer is that I'm quite content to hold that position and I hope my family members will hold an overwhelming amount of that for a long time. They won't have the same kind of results that I have had getting the position to its present size from small beginnings, but they don't need the kind of results I got.

Berkshire's a very reputable place, full of the right kind of people with the right kind of values. If your expectations are moderate and you like to sleep well at night, it's not a bad place to have your money compared to other stocks. If what you need is 30% compounded for years into the future, our stock is not for you. Compared to the other stocks available to you, it's OK and will stay OK long after Warren and I are gone.

I just had breakfast with Joe Brandon. Gen Re is a hell of a good place. Joe said to me that with $11 billion of net worth and Berkshire's name and reputation, they have lots of desirable options. They ought to do all right if they keep the faith.

We ought to be alright. Berkshire is full of places that are likely to be alright.

As I said on an earlier occasion, if you get Warren Buffett for 40 years and the bastard finally dies on you, you don't really have a right to complain. [Laughter]

Berkshire vs. Wesco stock

It's been very awkward in my position. The truth of the matter is that Berkshire is a better business operation by far. First of all, the guy there [Buffett] is 76. The momentums are way better. That advantage of Berkshire has increased. We would have long ago avoided this duplication except for people like you. You bid Wesco so high that we'd be giving more than we'd be getting if we merged Wesco into Berkshire. So people like you are responsible.

But I like you guys. It's an acquired taste. [Laughter]

Do you prefer to buy equities in Berkshire or Wesco?

Berkshire has bought somewhat faster. The two companies have never followed the same path. They have different reporting requirements. As soon as we announce, people like you follow us in. Sometimes it [whether Berkshire or Wesco buys] happens by accident. Generally, we haven't been terribly enthusiastic about equities in recent periods. But we like the best equities better than we like bonds. In both companies we're buying more equities.

Constraints of Berkshire's size

We're horribly constrained. It's hard to buy in quantity, even in a large company in a major market. It's a problem of [our] wealth. I hope that problem gets worse and worse. [Laughter] We don't have a way out of this problem. Warren occasionally buys derivatives. Just because I don't like the accounting for some of them doesn't mean we won't own them. Sometimes they're mispriced.

Look at the last 15 things we've bought – they've worked out well, but we have so much size that we haven't spent what we wanted. This won't bring tears. What may bring tears is that we're settling for lesser prospects than we did. Warren said Berkshire's portfolio will outperform the markets by about two percentage points per annum. That doesn't mean we don't find other things to do other than buy a big portfolio of securities. I'm continuously bullish. Berkshire is a great place.

Will Berkshire ever pay out its excess capital?

It's very unlikely that Berkshire will be making large distributions of what you call excess capital, though we would start thinking about such things if we ever got discouraged at turning each retained dollar into more than one dollar of market value for shareholders.

The entity that should be thinking about this is Wesco. It has a lot of capital, capital gains taxes are at all-time low, and we don't have the same prospects as Berkshire, but you cult members make that hard to do because you keep bidding up its shares above intrinsic value. Anyone who wants to leave can sell above intrinsic value. Those of you holding the stock hope we can create more than $1 of value [with each dollar of our retained earnings], and I'm hopeful we can do this, though we won't do as well as Berkshire.

If we thought most shareholders wanted Wesco to distribute capital, we'd do it so fast it would make your head spin. Let us know. I don't think most shareholders want us to do it because they're members of the cult. I don't think we will unless there's some very unusual development.

Can you tell us about the person you want for Berkshire's CIO?

We don't want people who want to learn from us – not that that hasn't already happened. We want someone young enough to have a long run – if it worked with Warren, why not try to get another long run going? We are perfectly positioned to set up some people doing this and watch them for a few years. We never considered doing this until Warren was 75, but now that he's older, we have. We like a very peculiar mindset**.** People chosen won't look like standard people. Obviously, we'd like to try to get somebody that reminds us of Warren.

[In response to a second question on this topic]

We're looking for a few people to manage money for a few years, hoping that one or more of them turn into the next Warren. They can be independent money managers doing their own thing. Lou Simpson manages a few billion for us and he can live wherever he wants and operates as he chooses. It makes sense to have a few more Lou Simpsons.

Who will make the decisions on buying entire companies?

The independent subsidiaries [of Berkshire] can acquire companies that fit. They usually check with Warren on the big ones, but they often don't and he never says no.

We have no CIO now. The question of who would acquire whole businesses might fall more to CEO than to the manager of a portfolio and marketable securities. Wherever Berkshire has useful talent, it will use it. We don't have any military-type rigidity.

Buffett's getting better with age

Warren is actually still improving. I know it's hard to believe, but he's in a field where one can actually improve at Warren's age.

Can you imagine the early Warren risking billions in a currency trade and making a couple of billion? He has also made a couple of derivative trades. Warren keeps learning. There has to be a crest to this someday, but I think it's ahead, not behind.

What role does the board of directors play at Berkshire?

The board is a safety valve in case I go completely crazy and Warren doesn't do anything about it. [Laughter] They are eminent people. We're required to have a board with independent directors and since we're required to have such a board, we figured we might as well have a good one.

[He paused here, apparently debating whether to add the following:] Would we have had a board if we were allowed not to have one? No, we wouldn't have a board. [Laughter]

Did you sell your silver position too early because of the Salomon crisis?

We bought it [our silver position] too soon and sold it too soon, but other than that it was the perfect investment. It was all totally voluntary and had nothing to do with Salomon.

Comments on the Salomon crisis

What was interesting about that day was that it would have had reverberations that would have made the Long Term Capital Management blow-up look like nothing if the Secretary of the Treasury, Nick Brady, hadn't reversed the government's decision to suspend Salomon from participating in government Treasury auctions. Nick Brady's family was one of the original shareholders of Berkshire but sold out before Warren came on.

Nick correctly recognized that the New England textile industry was doomed and sold all of the family's Berkshire stock. His cousin held on until Warren came on and even after. By making this correct decision, one branch of the family benefited from lollapalooza effects.

Because of this, Nick Brady knew all about Warren, and I think he trusted Warren. [During their phone call on that fateful Sunday afternoon,] there was a catch in Warren's voice. Faced with a decision that would have had catastrophic impact had they made the wrong decision, but when Nick heard the catch in Warren's voice, he realized how concerned Warren was and trusted him when he said he needed some reversal of an announced Treasury decision.

Getting a good reputation in life can have remarkably favorable outcomes, and not just for Warren. If Salomon had gone under, it wouldn't have been trouble for Berkshire but would have been terrible for the country and Warren.

Views on the insurance business and ethical limits

I don't think the insurance business will be that great for most people in it. I think we will do way better. We have great people. When I was younger, I probably wouldn't have even tried to get into the game. It's like a juggler with milk bottles who ends up juggling ten. Before we knew it, Berkshire had 10 insurance businesses. [Munger asked Gen Re CEO Joe Brandon to comment and he said, "We have the best collection in the world." Munger continued:] That may be an absolutely correct statement. We gradually learned our way into that position. It didn't happen overnight. If you're not a learning machine, it won't happen.

My father had a friend who used to say everyone's the same over the years, only more so. To some extent we're more so. We learned good lessons when we were young. We've been more selective. I don't think we've ever regretted not making a lot of easy money when we decided it was beneath us.

Warren told the story of the opportunity to buy Conwood, the #2 maker of chewing tobacco. I never saw a better deal, and chewing tobacco doesn't create the same health risks as smoking. All of the managers chewed tobacco – it was admirable of them to eat their own cooking. Warren and I sat down, said we're never going to see a better deal; it's a legal product; and we can buy it at a wonderful price; but we're not going to do it.

Another fellow did and made a couple of billion easy dollars. But I don't have an ounce of regret. I think there are a lot of things you shouldn't do because it's beneath you.

Comments on Gen Re

Joe Brandon has had a job with many unpleasant aspects. There were a lot of problems, he had to do brutal, unpleasant work, and many people resisted. But now Gen Re is enormously improved – in fact, I think it's now worth the stock we gave to get it. There was a time we weren't so sure – there was a time before Joe did his work where we weren't as confident of that as we are now.

Comments on Iscar

It's not a Ben Graham stock – in fact, it would be the ultimate non-Ben Graham stock. It's located a few miles from the Lebanese border in Israel. It has a high ROE, doing business all over the earth, using a certain technology to produce carbide cutting tools. The reason I got so high on it so fast was that the people are so outstandingly talented. The idea of being in business with them just struck me worth straining for. We didn't know when we were young which things to stretch for, but by the time we reached Iscar, which we never would have bought when we were young, we knew to stretch for the right people. It's a hell of a business. Everything is right there. Isn't it good that we keep learning? Better late than never.

Berkshire's investment in railroads

Railroads – now that's an example of changing our minds. Warren and I have hated railroads our entire life. They're capital-intensive, heavily unionized, with some make-work rules, heavily regulated, and long competed with a comparative disadvantage vs. the trucking industry, which has a very efficient method of propulsion (diesel engines) and uses free public roads. Railroads have long been a terrible business and have been lousy for investors.

We did finally change our minds and invested. We threw out our paradigms, but did it too late. We should have done it two years ago, but we were too stupid to do it at the most ideal time. There's a German saying: Man is too soon old and too late smart. We were too late smart. We finally realized that railroads now have a huge competitive advantage, with double stacked railcars, guided by computers, moving more and more production from China, etc. They have a big advantage over truckers in huge classes of business.

Bill Gates figured this out years before us – he invested in a Canadian railroad and made eight hundred percent. Maybe Gates should manage Berkshire's money. [Laughter] This is a good example of how hard it is to change one's mind and change entrenched thinking, but at last we did change.

The world changed and, way too slowly, we recognized this.

Berkshire's investment in POSCO

I would argue that what POSCO does is not a commodity business at all – it's a high-tech business. They learned from Nippon Steel and they're now even more advanced. I'd argue that if you have the most technologically advanced steel company in the world making unusual, [non-commodity] stuff, then business can be quite attractive for a long time.

Should USG [a Berkshire holding] have issued stock to fund a recent acquisition?

I'm hesitating because I'm trying to decide whether to duck that question or give the correct answer. [Laughter]

That was a foolish thing to do, but they can't help it: some of them went to business school. [Laughter and applause]

Why don't you sell Precision Steel?

We have this personality that we don't sell businesses because they're a bit on the difficult side. As for Precision Steel, it might even be a decent business. It's our catechism that we don't play gin rummy with our businesses. And, averaged out, the catechism has benefited shareholders because people are willing to entrust us with their businesses that we won't sell. At Precision Steel, there are a couple of good niche businesses. Holding on is a nonevent.

Why did you buy stock in Tesco and J&J?

Ordinarily we don't go into reasons for buying things. Obviously, we think they're very respectable enterprises. One is the dominant grocery retailer in England and J&J has one of the great long-term records in its field.

These are just portfolio securities. We expect to moderately outperform the market with these securities.

Wesco's surety insurance subsidiary

Wesco's surety insurance subsidiary [Kansas Bankers Surety] insures small banks. That is a wonderful business because it knows what it knows and knows what it doesn't know. By specializing in a particular area, it does well. It's like a specialist in an ecosystem: it occupies a tiny niche and does it well. You just have to look at the numbers – underwriting profits year after year – to know it's a very good business. We're capable of making those decisions.

ADVICE ON INVESTING

Is value investing becoming more widespread?

I think our way of looking at things will become more popular. In fact, it already is a lot more popular than it was decades ago. I used to look out at this group and it was 20 people. The increased popularity of the investment style will not make it easier for all of you to make a lot of money. All these smart people competing will make it harder, but that's not all a bad thing: maybe some of you will have to make money less the way we did and more the way some engineer does.

Efficient markets

If markets were efficient, this tent wouldn't be so full. Some business schools are teaching properly, but the world grew up amidst a different fashion, encouraged by academics of the era. What we believe is simple, and many avoid it because of that simplicity. They want to be experts. And how can you be an expert if it's simple? Also, execution is difficult – and people don't like to fail.

The whole institutional reward system encourages different behavior and thought. If you went to work at a big firm, you'd grind your way up. It's a hierarchy. Nobody cares about how to do it better. And by the time you'd been there 10-15 years, you'd be thinking their way. This didn't happen to Warren.

[Wesco board member] Peter Kaufman came into a business [Glenair] and became the CEO in his early 30s, so he's been the CEO a long time. The whole place is twenty or more times bigger. That's a Berkshire experience, but that's not normal. Normal bureaucracy doesn't reward an attitude like ours.

Where are there market inefficiencies?

Two markets are inefficient: very small ones (which are not much use to Berkshire, with its $120 billion), and ones where crazy people are doing crazy things, especially if they're selling. From time to time, the big markets have some crazily mispriced securities in them. But there's no question that in small markets there's a lot of opportunity to find mispricings.

Is the Chinese stock market a bubble?

The Chinese market is divided into two parts: Shanghai and Hong Kong. The Shanghai market shows some signs of gross excess and I have no interest in what's traded there given prices at present. But there are other parts of the Chinese market that are at least interesting. We don't comment on individual securities for obvious reasons.

Comments on Andy Kilpatrick

I don't think he's the greatest Warren Buffett fan, but he's the most resolute. Andy met Warren through the Washington Post connection and Andy had the same experience that St. Paul had on the road to Damascus. Andy was decisive, he bought all the Berkshire stock he could on margin, it went up, he bought more, it went down and he sold just enough. In due course, became quite rich. He did this by making one decision.

Not only Peter Kaufman [Poor Charlie's Almanack], but Andy self-published his book [Of Permanent Value: The Story of Warren Buffett].

A lot of other people met Warren and said, "Who in the hell is this bumpkin?" Now they've had to pretend they bought Berkshire.

COMMENTS ON BUSINESS AND ECONOMIC MATTERS

Tax rate for hedge funds and the concentration of wealth

If you're running a hedge fund, you're paying the lowest taxes, lower than a college professor or a taxi driver. This is madness of a sort. It would not surprise me if this changed in the near future.

There's an enormous concentration of wealth in people who don't make or invent anything. It *can't* be good for our system to create this new kind of hero if our graduating brilliant young give up engineering to go into trading derivatives. This is rewarded by a peculiarity in the tax code, but it'll probably change.

If you have a Jasper Johns painting, this is the world for you. These hedge fund guys seem to like Jasper Johns paintings and what's $120 million if you made $1.7 billion last year? That's the world that we live in and you gotta admit it's very interesting.

Subprime and the rating agencies

The rating agencies have prospered mightily, and their most likely source of embarrassment is subprime paper. Overall, they do a good job, and you always miss things with the benefit of hindsight. I would not predict they encounter great distress. If you want to pick things to disapprove of, the rating agencies would be far down on the list.

You might pick many originators of the subprime mortgages. They are some of the most disgusting people we've been able to produce, and many of them belong in the lowest circle of hell. There will always be such people, making money by misleading people. You'll always get people like the worst commissioned salespeople in the mortgage brokerage business. This isn't the real tragedy.

The real tragedy is the people higher up at the Wall Street banks who only asked if they could sell it, not if they should do it. They violated engineering principles and ethical principles.

There's nothing wrong with giving a mortgage to the deserving poor. Here's a guy who's working hard, etc., and even if you give him a 90% or 100% mortgage, he'll pay it. Making such loans worked and was good for us and the nation.

But if you look for the undeserving, dishonorable, addicted people with silly views on their own entitlement – if you start giving them phony mortgages so they can drink more, gamble more – it's like pouring gasoline on the floor and throwing a match. I would argue that in very high places in America, it's not enough to call it folly. It's sin-folly. It's sad that that much terrible behavior came in, due to the self-serving bias. Because they made easy money doing it, they rationalized it.

Dean Kendall of the University of Michigan music school once told a story: "When I was a little boy, I was put in charge of a little retail operation that included candy. My father saw me take a piece of candy and eat it. I said, "Don't worry. I intend to replace it." My father said, "That sort of thinking will ruin your mind. It will be much better for you if you take all you want and call yourself a thief every time you do it."

It's a good story and we need more Dean Kendalls in the high reaches of American business. This and envy cause so much trouble. They account for so much of what you see in the abuses of the subprime field.

We knew how to do it once. The subprime for the deserving poor worked, but egalitarianism and biases led to a big mess.

Why hasn't the declining dollar led to increased inflation?

The dollar's been going down like crazy, but the prices at Costco [Munger's on the board] have shown no inflation for many, many, many years. It's a good question. A lot of economics professors would say it couldn't happen, but it did. It's very important. There's been an unusual set of circumstances. It's easy for me to tell you it matters. But how it matters – if I were able to do that, I wouldn't be qualified to sit here. The answer is, I don't know.

Is there a trend in the private equity business?

Of course there's a trend. The LBO funds get larger and larger and buy larger and larger businesses, so it's a huge trend.

It's a different lifestyle than Berkshire's. We almost never sell – we don't want to do that. We don't want to play gin rummy with our friends, dumping five businesses and getting five new ones. We aren't buying to resell.

The leveraged equity crowd is getting bigger and bigger and bigger. What's happened is endowments and pension plans are believing in the tooth fairy. With assets being bid up, they're not getting enough return from ordinary investments from stocks and bonds. Then silver-tongued people came along and said you don't have to suffer low returns. Give us the money, we'll lever up, pay us a lot of compensation and we will give you 15% not 5%. It's worked – not as well as claimed; there's dubious use of statistics – but for good shops, it works.

Then, a lot of envy sweeps the field. Yale can't stand Harvard making more. Envy is a huge motivator, though it's seldom admitted. In my whole life, I've never had someone say, "Charlie, I'm doing this out of envy."

In venture capital, except for a handful of firms at the top, the returns are lousy. This will eventually happen to the LBO firms as well. God has not decided that anyone who wants 15% can get it.

How do you invest the funds of the hospital you're chairman of?

The nonprofit hospital of which I am the chair is really nonprofit. It loses so much money in a good year it's awkward and a bad year is something awful. Given the conditions under which we labor, we leave all money in short-term instruments. We need all our assets in a liquid reserve.

I'd like to have a hospital where my biggest problem is what to do with the surplus, but that has not been my lot in life.

I don't think hospitals have different investment needs than other places. I don't think the investment process would be any different.

Comment on UnitedHealth, its CEO and the options backdating scandal there

It's hard to say anything but that that was very regrettable behavior. The man lost his job and he deserved to.

View of lawyers

The standard way lawyers think is to weigh both sides. There's forced objectivity and a procedural system. That's a huge plus. So if that's what you're talking about regarding law practice, that's good, but there's a lot that's not good, a lot that's drifted away. It's not at all uncommon that billing rates will exhaust the amount in dispute before you get to trial. If you're doing this as a lawyer, that's a moral minefield.

The legal profession attracts a lot of smart people who can express themselves well in words and numbers. There are many good people coming out because many good people are going in. Yet much of what law schools do is a joke.

View of investment bankers

At Salomon we asked, "Where is the list of things you won't do because they're beneath you?" We never saw it. Envy and greed lead people to doing almost anything that looks profitable and does not require use of a machine gun. Investment bankers were better when I was young. They used to care about the quality of deals – they cared a lot. Ethics attenuated a lot. This was not good**.**

The deterioration would be an interesting subject for social science. You'd have to understand psychology – it would be very difficult for somebody to do it.

Why is the high road the best way in investment banking? It's not very crowded. [Laughter]

The possible rise of protectionism

It's hard to predict if there will be a lot of protectionism. At the current time, a flood of imports is changing the world. Some ordinary guys are having a tougher time and feel that China is oppressing them.

MENTAL MODELS

Using mental checklists

I'm a great believer in solving hard problems by using a checklist. You need to get all the likely and unlikely answers before you; otherwise it's easy to miss something important.

Using superior thinking to get ahead

[Referring to his opening remarks in which Munger said "At least three times in my life, I've gone into the other field and succeeded." I asked what those three times were. He replied:]

The first two are easy: real estate development and managing money. I can't claim to have clobbered the locals in the third, so I don't want to talk about it. [Laughter]

Can you give an example of giving up a closely held idea?

Even as fanatical as I am about throwing away a wrong idea and grasping a successful one, I have a hard time coming up with a recent example. Certainly I've become way more disenchanted with certain people and that seems to happen all the time. In that sense, I seem to keep learning a lot. I've discarded so many ideas long ago that I don't have many left.

Anytime you catch something just barely, where if you hadn't caught it you'd be in terrible trouble, you're using a checklist, even if not consciously.

I'm answering the question I'm capable of answering, instead of the one you asked.

I invert: I try to figure out what I don't like and try to avoid it. It's worked wonders for me.

What is your favorite human misjudgment?

My favorite human misjudgment is self-serving bias: how the brain subconsciously will decide that what's good for the holder of the brain is good for everyone else. If the little me wants it, why shouldn't the little me have it? People go through life like this. I've underestimated this phenomenon all my life. People go bonkers taking care of their own self-interest. It's a sea of miscognition. People who write the laws, people who treat patients, who experiment with rats, all suffer horribly from this bias.

Hardly anything could be more important to the study of law than the study of psychology, but there's a taboo against it. You see many people who've gotten straight A's at law school, but they screw up in dealing with self-serving bias.

I would say that the current head of the World Bank [Paul Wolfowitz] had an elementary question: as head of the Bank, a lot of people hate you, so how bright do you have to be to distance yourself from a question of a large raise from your live-in girlfriend? He sent it to the lawyers, they hemmed and hawed, and he lost his moorings. Even a child shouldn't make his obvious mistake. Similarly, I'd guess President Clinton would have had a better record if he'd had better insight on certain subjects. Note that I carefully picked one from each party. [Laughter]

Nuttiness in the world

I once asked a doctor why he was still doing an obsolete cataract operation when a new, better one had been developed. He said, "Because it's so wonderful to teach!" He only changed when patients voted with their feet. And this was at one of the best medical schools!

There's a lot of miscognition. If you can just tune out all of the big folly, you'd be surprised how well you can do. There's a lot of nuttiness. Who gives up an operation he likes doing and is really good at? It's a really human thing to cling to things most practiced. This happens even in physics. A lot of people cling to bad ideas. If the brightest people in the world do this, imagine everyone else.

If you can train yourself not to do this, you'll be way ahead. If you come all the way to Pasadena from New Delhi to hear a guy well into his 84th year say something so obvious, not everyone would agree this is wise. [Laughter]

Opportunity costs

I just wanted to do the best I could reasonably do with the talent, time and resources I had available. That's what I was doing then and now. Everything is based on opportunity costs. Academia has done a terrible disservice: they teach in one sentence in first-year economics about opportunity costs, but that's it. In life, if opportunity A is better than B, and you have only one opportunity, you do A. There's no one-size-fits-all. If you're really wise and fortunate, you get to be like Berkshire. We have high opportunity costs. We always have something we like and can buy more of, so that's what we compare everything to.

All of you are in the game of taking the lot you have right now and improving it based on your opportunity costs. Think of how life is simplified if you approach it this way.

ADVICE ON LIFE AND OTHER COMMENTS

[After his microphone stopped working temporarily:] I've worn out the patience of my listeners, but I've never worn out a microphone before. [Laughter]

Munger's need for "glorious independence"

There's a poem by Burns, the great Scottish poet, where he urges Scots to work hard, even connive, to get a glorious independence. You don't have to listen to me very long to know my views wouldn't be welcome everywhere, so I decided I needed glorious independence, which required that I be a man of independent means. I didn't buy a new car until I was about 60 and I was very rich before then. I wanted independence for the same reason George Bernard Shaw sent his mom out to work: I wanted to make a mental man of myself. Warren kids me about this.

I said I would sell the best hour of the day to myself in order to improve myself. Only then would I sell the rest of my time to my clients. Of course, when I was in a demanding situation, I'd make an exception. To make a man of yourself intellectually, you need to work at it. I don't think even [famed mathematician] Johnny von Neumann did it naturally.

For many people it's good that they're extra busy. They're not good thinkers, so you get more out of them if they just keep doing what they're doing. But if you're a person of good cognition, you can learn a lot more if you put your mind to it. I don't think there's any substitute for just sitting and thinking.

Nature vs. nurture

In nature vs. nurture, nature is way more important than people give it credit for. That's not to say people can't improve, but nothing on earth could make me succeed in music or basketball. You need to recognize where nature has been kind and play a game where nature has given you the greatest talent. Man is the prisoner of his talents. I'm afraid that's the hand we're given to play in life. If you're 5' 2", I don't think you want to play basketball.

People who are a credit to our civilization

I don't know much about Whole Foods or Google. I tend to think there's a fair amount of puffery when it comes to organic claims. Yet I read a very interesting article in Harvard Magazine about how modern cows, with artificial insemination, are kept pregnant 300 days a year and their hormones go into the milk. Is this a problem? That's an interesting question. It's a credit to Harvard to publish it. It's not a problem with skim milk. The kind of person writing that article is a credit to the civilization.

I went to the University of Michigan a few months ago and went to the Biology Department, including the medical school and hospital. They decided they'd go totally self-insured. If they made a mistake, they'd admit it – no hiding stuff. They'd go to the bedside and admit it. They did what they probably should have done from the beginning. Now their malpractice costs are lower. The guy who runs this is a credit to the civilization. This is not present in the hospital of which I'm chair. I can't get there from where we are, but I'd like to.

There are lots of people like this. I live in a state where they gerrymandered districts so that, mostly, only certified nuts can win the primary, and once they're elected, can't be voted out. How bad is this system? I'd like a world with more people like those in the [University of Michigan] hospital.

Global warming

Warren has never had any scientific training and he avoids these questions because he says, "I have no specific aptitude and I won't make a fool of myself." I'm almost as ignorant as Warren, but I am a Cal Tech-trained meteorologist, though it was a long time ago and this subject was then a very empirical activity.

My own view is that it's overwhelmingly likely that increased concentration of CO_2 is leading to some warming. For Al Gore, once he has this insight, he thinks we should do a lot about it right now, even though he has a house with 20 rooms.

For me, what we should do about it right now is a very complicated question. The prognosis for a decline in CO_2 emissions from China and India – which have many, many people who want to live more like we do – is zero. Before we are done, I suspect we'll change the reflectivity of the earth and play a lot of other tricks. But there's no simple answer like just sign treaties with people who are going to hugely multiply their own emissions.

It's a problem I'm not going to have to deal with personally. I'll bequeath it. It's very important, but it's not the end of the world if the world warms a few degrees. If some islands have to be depopulated, and if it happens over 100 years, with population growth of 1-2% per annum, it can be dealt with. As I said at the Berkshire meeting, with enough time, these things can be adjusted to. I don't think this is likely to be an utter calamity for mankind. It is something that we can deal with.

Book recommendations

Peter Bevelin, the author of Seeking Wisdom, is here and he sent me the book The Martians of Science. It's a hell of a book about five Hungarian physicists, driven to the United States by Hitler, who contributed much to science here. I can't recommend it enough.

I read the new biography of Einstein by Isaacson [Einstein: His Life and Universe]. I've read all the Einstein biographies, and this is by far the best – a very interesting book.

What do you think Ben Franklin's greatest regret was?

Well, his wrong medical decision killed his only son. But, mostly, he didn't allow himself much regret. Franklin made a very ill-advised marriage. He married someone who wasn't suited to the life he ended up living. That's hugely important. All honorable people will do the best they can with the bed they've made. Franklin did that and did not allow himself to feel regret. All in all, he had a fabulous life.

Thoughts on his advancing age

I'm getting more experienced at aging. I'm like the man who jumped off the skyscraper and at the 5^{th} floor on the way down says, "So far this is not a bad ride." [Laughter] I'm getting better with aging. I'm not going to complain about age because if I didn't have it, I'd be dead.

Can you tell us about your worst experience and how you dealt with it?

I'm not going to answer that.

Career advice

[The questioner asked Munger for advice on which of two career choices he should pursue – I forget what they were.]

A lot of people who follow either of the courses will find it very difficult. You're a young person. You can't give that kind of answer in a one-size-fits-all way. It depends on your talents. The decision may be forced on you. If you can work with people you really admire, role models, then that's where you should go.

Ideally, you would have figured it out by now. If you're only now asking that question well along in your business school career, then your business school is about as effective as I would have guessed. [Laughter]

The importance of reading

It's a good question, which brings up a very interesting fact. How did Berkshire's track record happen? If you were an observer, you'd see that Warren did most of it sitting on his ass and reading. If you want to be an outlier in achievement, just sit on your ass and read most of your life. But they fire you for that!

Look at this generation, with all of its electronic devices and multi-tasking. I will confidently predict less success than Warren, who just focused on reading. If you want wisdom, you'll get it sitting on your ass. That's the way it comes.

Deserve what you want

The best legal experience I ever got when I was very young. I asked my father why he did so much work for a big blowhard, an overreaching jerk, rather than for his best friend Grant McFaden. He said, "That man you call a blowhard is a walking bonanza of legal troubles, whereas Grant McFaden, who fixes problems promptly and is nice, hardly generates any legal work at all." My dad was teaching me a lesson and it worked.

Considering its size, Berkshire has supported fewer lawyers than any company I can think of. We've gone through the world like Grant McFaden, the pioneering Omaha Ford dealer.

Figure out what you don't want and avoid it and you'll get what you do want. Warren had the same instincts I had. We haven't had our share of disappointed, angry people that ruin so many lives. It's easy to get into that position. Ask the question: How can you best get what you want? The answer: *Deserve* what you want! How can it be any other way?

Views on Social Security

In the U.S., I think we'll meet the Social Security problem. As long we can keep GDP per person growing at, say, two percent per annum, I think we can meet this problem by allocating a little bit bigger slice of a growing pie. I differ with most of my Republican friends on this.

In New Zealand, they had a rebellion and a counter-rebellion. And New Zealand's working. I don't think we'll have a big problem.

The U.S. role in the world

We’re used to being the most important place in the world. Every previous country in this position lost it. We’ll be the same. Why not? Sure, the leadership of the world will eventually change.

What are the world’s greatest dangers?

The biggest problem is obviously some sort of war that goes nuclear or pathogenic. That problem is so hard that most people shove it to the side and hope it works out.

I would argue it’s probably not a good idea for the human population to double from here. I read some paper that expressed a lot of confidence that this won’t be a problem, but put me down as dubious. And having all of the nondeveloped populations grow to our living standard will have all sorts of environmental consequences.

I think you can get civilizations that can deteriorate into god-awful conditions, where you have a government of kleptocracy, an awful, corrupt, brutal, stupid system, full of intramural hatreds. Our third problem is that we get a lot more of that. Look at the craziness in the Middle East. A lot of people are not just ideological, but religious. There are a whole lot of young men with not much hope, future or much to do. This is very explosive and dangerous and there are not many examples where this is getting fixed. Maybe Turkey?

But the world has always had these sorts of defects. It makes us treasure what we have. This room is full of extraordinarily fortunate people. If you think you’re having a hard life, you got on the wrong planet.

More on terrorism

I think we’ve been very lucky that the terrorism is the U.S. has been as low as it’s been, and the future probably will be worse. There’s a lot of terrorism in the Middle East. It’s a very serious problem, and I don’t think it’ll go away. What you can’t fix you have to live with. We’re trying to fix it as best we can, though I question when [at airport security] an old lady with her kids gets frisked and a guy with a bushy beard and a thick accent goes right through, but it’s politically incorrect to give special attention in a logical fashion.

2008 Wesco Shareholder Meeting: Detailed Notes
by: Shai Dardashti posted on: May 09, 2008 | about stocks: BRK.A / BRK.B / WSC

Wesco Annual Meeting, Pasadena CA 2008
May 7, 2008

Notes courtesy of Peter Boodell; thank you!

http://valueinvestingresource.blogspot.com/2008/05/2008-wesco-shareholder-meeting-detailed.html

(As is standard, no recording equipment was used to reproduce these notes. My high school typing teacher gets all the credit. As a result, these notes are recollections only – not quotes, and should not be relied upon as a literal transcript. –PB)

CM: Testing, can you hear in back? Mr Denham has an announcement.

Denham: We ask you not to use your video recorders, thanks.

CM: Welcome to the 49th annual meeting of shareholders of Wesco Corp. Please register to vote at entrance. Anyone wishing to speak, state name, wait for microphone. List of shareholders, 96% of outstanding proxies received. Election of directors? All in favor? [Aye]. Motion is carried.

Six nominees are elected. There will be a long Q&A preceded by Socratic solitaire conducted by the Chairman. Meeting is adjourned.

We now begin Q&A, starting with a long game of Socratic solitaire. During questions, do not ask what we are buying or selling. Any other question is fair game, but we don't agree to answer them.

Because many of you have come from such a long distance, I will talk before I take your questions. I will address two topics, general investment climate [and learnings from Berkshire Hathaway]. We normally avoid [discussing the general investment climate] like the plague. Most assets are priced to a level where it is hard to get excited. It is hard to get 4% yield on a nice apartment, and it doesn't include replacing the carpets. Bonds of strong corporations are 4% yield. Corporate equities are paying 2% pa, growing 4% per year. Such a world isn't the one that made all of you able to come to the meeting. Last generation has been in hog heaven – some bumps, but it had easiest time getting ahead. In the eighteen years that preceded hog heaven, the purchasing power of Yale's endowment went down 60%. They were getting real investment return of 0%, negative. It is not at all impossible that brilliant investors like Yale get bad results in the future.

People are used to laying money aside and investing in standard fashion, and become quite comfortable. It is easy to forget that this isn't guaranteed. Many have recognized this, but for those running pensions it is difficult [to adjust down assumptions] —like the agony of raising taxes or not looking good as CEO of a company. Some of them wonder if they have signed up for something too hard when running a defined pension plan. That crowd doesn't want to go to a 4-5% assumption, because the pain of the money needed to correct the plan is large. Bonds pay 4%, so they go to alternative investments with profit sharing. They solve the problem by giving 'reasonable return' and sell hedge funds and venture capital fund, mid-stage, late stage, private equity, etc etc etc. They do complex trading strategies, private equity in Africa. They buy timber. [audio system malfunctions] Evidently that machine didn't like the remark. People go into alternatives, and this has worked very well so far. A lot of university endowments have done it – and that is game we are in. If natural return is 5%, getting it to 9% is very unlikely to work well long term. It's going to be difficult for people to have high real returns from deferring consumption. The reason my generation did so well was kind of a fluke, and won't necessarily continue. There will be lots of chicanery in future. Many claim alpha – but really they are just taking earthquake risk. At end of year, when there is no earthquake, they take the money. This is a dishonorable way to invest. It is always easier to get felicity by reducing expectations instead of seeking extreme results.

We have plenty of scandals coming. Lots of rot has gotten into system. It has caused unpleasantness. What is next? I suggest the derivative trading books of the world are next. The accounting allowed in derivative books has been god awful. The morals and intelligence has been god awful. 'I'll be gone and you'll be gone' is phrase they use. What is buried in those books is dangerous, with clearance risks with optimistic assumptions that the accountants allowed. I was at Salomon when interest rate swap accounting was changed. They had a matched book. They were making $7mil, 25m over 18m. Both sides wanted to mark trades profitably. They couldn't retain derivative traders if they didn't have bad accounting. There is a lot of Gresham's law here, where the bad practice drives out the good.

If you run a good bank, and testosterone bank around corner pressures you, there are tremendous pressures to conform. Everyone starts replicating. If every university puts 2% into timber, that can go on a long time. But it is self-fulfilling. When it comes to the unwind, when they all want to get out. A lot of things rely on momentum. Valuations make everyone look good for a while.

We have seen consequences in this mortgage meltdown, not pretty. The amount of knavery and folly revealed in last eighteen months has been unbelievable. I will ask a question, then I will attempt to answer it. Why did this happen? Greed, envy, and terrible accounting was part of it. There was a general lack of conservatism. The engineering mindset that everything must withstand great stresses was thrown out for 'if music is playing, you gotta dance'. I don't feel compulsion to dance, to join the crowd.

One of my favorite stories is boy in Texas, when the teacher asked the class the following question. There are nine sheep in pen, and one jumps out, how many are left? Everyone got it right, and said eight are left. The boy said none are left. The teacher said you don't understand arithmetic, and he said ‘no you don’t understand sheep’. Sam Goldwin had a saying – ‘include me out’ – it is one of my favorite expressions.

People were distributing stuff that they wouldn’t buy themselves. It is the structure of the modern world. Favorite philosopher: Frankl. He said the systems have to be responsible. People who are making decisions must bear results of decisions. In Rome, the builder and designer stood under the bridge when the scaffolding was removed. In parachutes, you pack your own chute. Capitalism works that way too. At a restaurant, owner is bearing the consequences. If he slips, he doesn’t do well. Frankl would be pleased with restaurant business, and not pleased with investment banking. They sell, take the money, go home – it doesn’t work. And people wouldn’t get by if accountants didn’t bless it. When I was at Salomon, I was on the audit committee. A group came and said that we want to change our accounting, and where our credit is terrible – we want to report automatic profits – ie, to buy counterparties out cheaply because they want to sell. I told them that ‘You will have that accounting over my dead body’. I won that battle, but I lost the war.

Post Enron, accountants made mandatory that where the worse your credit gets the more profits you make. In the old system, the liabilities are always 100% good – it’s the assets you have to worry about. Accountants have thrown it out. They have made it standard. If you ask accountants about it, they say it is so complicated we won’t get to it in 3 yrs. They want something simple to do. A silly procedure and silly result doesn’t bother them as long as it is in some book. That is not wisest way to run a profession.

Legal profession comes in for own opprobrium. Knavish people were deliberately blind. They didn’t want to wrestle punch bowl away from a couple burly drunks. I had a friend who once proposed a rule at the partnership that they would fire one client per year on moral grounds. They would get rid their most venal and dangerous client once a year. That proposal went down in flames. There is a certain amount of deliberate blindness. If you want to prevent, you must have whole lines of activity that people are not allowed to engage in. [more problems with sound system] We are in shadow of Caltech and we can’t get the sound system right. Envy effects corporate compensation. People want to be paid like movie stars rather than archbishops. I don’t think it is necessary. Most would occupy top position at lower compensation rate. It is terrible to civilization. It brings extreme envy into population at wide. In Britain, they took taxes so high that anyone with property was leveled down to growing their own tomatoes. It was not good, very counterproductive. It was matter of envy. The working population required it and it was reaction to envy effects. It is not good to have the results we have had.

If we turn to Berkshire Hathaway, we have faults, but some of standard faults we deliberately avoid. Someone recorded what we would have had if Warren had paid himself 2&20. We would have had much lower taxes, so some other shareholders would have been better off, but Warren would have had 3x what he has now. Would world have been better if it had been run that way? I don’t think so. There is a lot to be said that people in power make money with shareholders, not off them. I’m not asking for an unreasonable ethos. It was compulsory in Athens. Liturgos, means required behavior. You had to give like hell if you were a leader. They had banishment. When language and traditions impose these… we might need it. We should restrict people in a more old fashioned way.

I remember what I was going to say. Privileges. If you are an investment bank and had to be rescued, there should be limits on leverage and the complications of your business. There should be qualitative limits too. By and large banks behaved well when it worked this way. When I was young, Bank of America – would not have done things they do now. Derivative trading, no good clearance, no rules, excess and craziness feeding on itself. The plain vanilla products got priced down to no profits. They wanted to do complicated stuff. Not sure if it cleared, or other side would be good for it. It didn't bother anyone since they wanted the profits. The hidden trouble in derivative books is awesomely large. Greenspan overdosed on Ayn Rand ethos. He never got it out of his system. As long as axe murders were a natural outcome, then they were okay. I don't think it is necessary – and think you can regulate ax murders away. People talk about marvels of system and risk transfer – but some of our troubles COME from having so much risk transfer.

After South Sea Bubble, Britain outlawed public corporations – only private ones allowed. And they led the world for 100 yrs. A modest amount of liquidity will serve the situation. Too much liquidity will hurt human nature. I would never be tenured if I said that. But I'm right and they are wrong. We don't need worst excesses. We do not need smartest people in science and math in computer driven strategies. This is not a plus for wider civilization. Derivative trading books – is one big clump of excess not having had its denouement.

I am now going to turn to a more interesting subject, the Berkshire Hathaway phenomenon. What are the lessons? On investment side, people are realizing that old fashioned idea of trying to get more value than you are paying for. I think that idea is gaining, and I think a plus for rationality. It doesn't make it any easier. By the nature of things, it will be difficult to make easy money.

How is it organized? I don't think in history of world has anything Berkshire's size organized in so decentralized a fashion. Net amount of bureaucracy is tiny, costs are low, autonomy in subsidiaries is vast, no common culture shuffling people around. How far can this go? This system has gone farther than any other system. Low cost, not a lot of envy effects – where everyone compares everything. People in subsidiaries have a feeling – whereby there is less fealty to headquarters. If you want an imperial headquarters which exacts a big overhead charge on the provinces – they will resent it. Net number of intra-subsidiary transfers is tiny. It has worked well. It can go a lot farther. No one else has been here before.

There are defects to the conglomerate system, where you have a separate quota system driven by headquarters driving provinces to meet central numbers. It causes a lot of expenses at headquarters. GE is good at running a conglomerate system. Berkshire has avoided the minuses. It can go farther. It has a system of running a financial system with low leverage and extreme willingness to let assets run out – that is quite rare. Most financial institutions talk our talk but don't walk our walk. People can't stand watching a place shrink. If you take General Re, they needed a derivative book like I needed a case of syphilis. It made headquarters more interesting. When we reached for money it wasn't there. Out derivative book produced $400m of losses, and we were more conservative than most places.

[break to fix the sound system]

We have moved to a hard mike, so please return to your seats. Microphone system has an educational value. What they should not be allowed to do – is anything that is too complicated. The hard mike system [vs the wired], lo and behold, is working as it always did. Systems need duplicative systems, back up system one, and back up system two. Complicated systems – the high priests usually don't understand it either. The system just goes out of control. Now we have government guaranteeing credit and then letting investment banks do what they want -- it is a very foolish system. They ought to have behavioral standards. They feel entitled, and that is not what they should feel with privilege of Federal Reserve backing. At Berkshire, we are ridiculously conservative. Even our reserves have reserves. We don't have to renew our credit every Monday morning. We behave in way that we never need to renew our credit, and we still don't need the money.

There have been comments on derivative trades we have done. If other people shouldn't be doing it, why are we? Other people pay us money because people know we don't have clearance risk, we are not at whim of other parties. It is a very different kind of a trade. The only reason we can make those trades is because there aren't many out there who others would trust to make those trades. If you ask me, would I give up all of the opportunities of derivative trading to go back to a simpler cleaner world like engineering of yore--I would do it in a heartbeat. But what we have seen in mortgage market is only an aperitif to what we would see, in a system with bad rules and incentives. Especially with the appetites of males – women wouldn't get us into this mess. In a soccer game, if there were no rules, people would destroy the body of the person on the other side. That is what referee is for. So we need referees to tell boyish adults not to hurt others. I don't make this stuff up. Mark Twain said that truth is stranger than fiction because fiction has to make sense.

Some people call you people cultists, but most here are people who want to learn. It is a very good thing to be in this world. I think we are accidently creating something which is a learning institution, which may work that way for a long time. I don't think Berkshire will perish when Warren dies. I had lunch with two Berkshire executives, and my heavenly days, those two guys are likely to make that business one of best in the world. How could there be a business like that buried in a place like Berkshire? There are very good things in this place. With reputation, comes duty. We should try to earn it. And run it in a way that people who succeed us do the same thing. That is what we are trying to do. Warren will never spend any of the money. He has never given a way a dime he needed. He deserves no credit as a philanthropist. I think we are part of something quite interesting and worth following. We get calls from people who trust us, and who don't trust anyone else. We don't get many calls like that, but how many of you get any?

I have rambled on. Academic response to Berkshire has been pathetic. It is soft science with enviable formulas. So you had to program a computer to buy only highly volatile stocks in order to make 7% per annum more? But if true, computers would do it. I don't know why people pay attention to those ideas. Down boy, they say, you just don't understand modern finance. And these are grown up people. One man, to whom they gave the Nobel, he kept saying Berkshire just lucky. A six sigma event – he wasn't going to change his theory on the facts available. Business is simple, the details are hard. You need mementoes in place to help you in daily fight.

The only duty of corporate executive is to widen the moat. We must make it wider. Every day is to widen the moat. We gave you a competitive advantage, and you must leave us the moat. There are times when it is too tough. But duty should be to widen the moat. I can see instance after instance where that isn't what people do in business. One must keep their eye on ball of widening the moat, to be a steward of the competitive advantage that came to you. A General in England said, 'Get you the sons your fathers got, and God will save the Queen.' At Hewlett Packard, your responsibility is to train and deliver a subordinate who can succeed you. It is not all that complicated – all that mumbo jumbo. We make bricks in Texas which use the same process as in Mesopotamia. You need just a few bits of ethos, and particularly engineering ethos. Think through the system, and get a margin of safety. Like this backup microphone.

Q1: Thank you Charlie. Financial risk transfers – 500trillion notional value. Sort of like Lilly Toms – things will get worse before they get worse. How does this all unwind?

When the Chinese A-shares went utterly crazy, you could predict this has to collapse. When mortgage excesses got crazy on slicing and dicing by scummy hucksters, it was similar. Derivatives trading books however are not similar. It has no automatic collapse surely to come. Some day it will be a mess, but I don't know when. The mess that would have been if Bear Stearns went under would have been awesome. In CDS, assume $100mil bond issue, and they allow issuance of $100b notional contracts. You have huge incentive for company to go broke. You are not allowed to buy insurance on other people, unrelated parties. There is no reason in America to have vast bets on $100m bond issue to which no one is party. It creates needless complexity and very perverse incentives. They say "it's a free market". The correct adjective is insane.

Q2: Mark from Auz. Last year I was concerned about solvency in banks. I had stocks sent to me in scrip form. Is it now safe to let large corporations hold our stock or safer to keep at home?

Good question. I think risks are low in a cash account at reputable firms. Even in a margin account I think risks are low. It is inconvenient to keep them at home. They all end up in depositaries anyway. Everyone relying on electronic blips. I think fairly safe.

Q3: NY. The amount of derivatives out there today 30tril, 3x GDP. Do you think volumes will present danger in future, have you ever spoken to someone who writes derivatives?

It is complicated. They show large profits. It is peculiar thing – allowed to morph to huge size. Interest rate swaps – overstated. So imperfectly regulated it has a danger to the rest of us.

Q4: CA. Named our son after Warren. We are in market for a house in CA. Wanted your views on house prices.

Housing prices are going down in most places in CA. If you want house in Pasadena, if offer price 1.8m better to start bid at 1.85m. So not going down everywhere. Generally speaking the time to buy a house is when you need one. If you make money on it, it is just a byproduct of you doing your family duty.

Q4: NY. Have you ever asked quality programs at subsidiaries to improve margins?

We try to buy companies so permeated by good ethos that they don't need checking from headquarters. We are trying to live in a seamless web of deserved trust. It has worked for us, and it is the ideal way to live. If your marriage partner has sixty page contract, you shouldn't enter. You want to get a seamless web of trust. If life is hard, you may need a command control system. But we try to avoid it.

Q5: NJ. Railroad regulation?

CM: They are regulated. Earned so little money for years, that I expect rules will be better in future. They have increased capacity in a great way. It has been costly. I would not anticipate regulatory burdens to be high because the railroads have behaved well.

Q6: NY. Rationality? No one is 100% rational. How do you reconcile rationality with irrationality required for successful human relationships?

CM: There are some relationships you couldn't have if you were rational. If someone asked you to join heroin smoking party, you wouldn't qualify if you were rational. I think rationality is of immense benefit. It is a deep moral duty, you must hold it in trust and must hone it. People who are no good at it, they have to go to a different guru. I was born into a different skin.

Q7: WA. Inflation?

CM: If you have competitive advantage, and make 10% of sales, and sales go up 10% due to inflation, you will tend to make a little more money. Whether we will earn less or more, my answer is probably earn a little more.

Q8: UT. General Re. Brandon resignation.

We want to stay away from that subject. But we will stand behind Joe Brandon. He did a magnificent job. We stand behind that observation. I would trust him personally. [applause]

Q9: TX. Howdy. US force feeding 2bil per day. $2b a day to other countries, is it sustainable?

I would not be running twin deficits if I was running this country. I would have policies that didn't push things as far as they have been pushed.

Q10: Dan Rizowsky. Discuss opinions and which model to reach a resolution?

We come to agreement once in a blue moon. Very seldom does he do something I wouldn't do. Once in a while will we change each others' view. We're like an old married couple, humph humph and a nod and it is decided – no conversation necessary.

Q11: Harold from LA. Comments on Alan Greenspan and Ayn Rand and finance professor who can't believe the success of Berkshire. Has there been a time like today when facts on the ground count so little for people in position of power?

You hang around with fellow ideologues. You should avoid this. Many people are totally confident they know the answer. When you have this confidence you need to get over it.

Q12: James Armstrong from Pittsburgh. You have said that Moody's and HBS have the best pricing power of anyone in the world. What causes Moody's moat to shrink?

All the rating agencies with 20/20 hindsight have performed poorly. When you perform poorly you impair your franchise. They weren't quite fundamental enough. Exact example of the kind of thing I was speaking about. In an attempt to make more, they made their position a little worse. This is obvious isn't it?

Q13: Scott from LA. With portfolio of $2m, vs. that of Berkshire, how would your mandate be different? Small vs mid, us vs intl, etc?

If I was managing smaller money I'd be looking in smaller places, I'd look for mispricing. But I don't want to change places with you. [laughter]

Q14: Matt from San Jose. California is single A rating. Only other one is worse is Louisiana.

Both parties have been gerrymandering the legislature. It's hard to get elected unless you're a left or right wing nut. It's a perfectly natural result in an insane system. We are not voluntarily going to change the system. I was the largest donor to the last attempt to change this system. We went down in flames. Stay tuned.

Q15: Sam from Santa Monica. What are your thoughts on the war on terror and the war in Iraq?

A: You're going pretty far afield. Terror is a hell of a problem. People are vastly overconfident in the solution. They are probably making an error.

Q16: Phil, shareholder. What would you do if you were Fed. Suggestions on short and long term solutions to credit crunch?

Changing the system so the system is more responsible. We had margin requirements for decades and the fed forced this. Now with the combination of options and derivatives margin requirements have vanished. Federal Reserve has no power to deleverage. I think the system is seriously wrong.

Q17: Casey from Pasadena. Strong return on intangible assets is what WB likes. What else do you look for?

We buy Kraft these days because we have so much money. We are accepting way lower returns now than we were ten years ago. It is natural consequence of the world getting more competitive.

Q18: What do you think of the treasury market with negative real yields?

It would be depressing if that was my best opportunity.

Q19: Forest from Ft. Worth Texas. Do you look at railroads from a replacement value standpoint?

Do you know what it would cost to replace Burlington Northern today? We are not going to build another transcontinental. And those assets are valuable, have utility. Now they want to raise diesel prices on trucks. Wish I was smart enough to identify this few years earlier. Avoiding the most extreme follies of man makes you better.

Q20: CA. Why has commercial property not fallen as much as residential?

Cap rates came way down and asset values went way up. Financing transactions are getting away from euphoric conditions. A lot of the real estate fortunes have been made with extraordinary leverage. Commercial real estate is not a good business for us but ok for the entrepreneurial types. We shouldn't be doing it.

Q21: Matt from NYC. How does Berkshire thru its subsidiaries manage an annual budgeting process?

We don't have one. Obsessing over budgets creates bad incentives. Just eliminate unnecessary costs. Budget committees tend to do just the opposite.

Q22: John, shareholder. Any recent books you recommend?

I'm a bug for history and science. Yes by Cialdini is good. Most of the psychology professors can't handle this real life material. It's not a perfect book and not as good as Influence. As Warren says, experience is what happens when you're looking for something else.

Q23: Peter, Yonkers NY. Which is better, insurance based float or money management float?

A: In terms of pure utilitarian perspective, you can make way more money in money mgmt than insurance business. There are few businesses as good as money management. Average returns in insurance property and casualty have been pretty pathetic. Once you have enough money you stop accepting compensation and just manage money -- it is more manly. At least 95% of the insurance businesses in the world are worse than ours.

Q24: Ashok from LA. Checklist?

I don't have a simple checklist. You have to work at it a long long time. I still do dumb things after years of hard work. The more big ideas you have the easier. We exclude a whole lot of things because they are in the too tough pile. If you exclude, you do better. Then you must have field where rationality will be rewarded. Some of political ideas – it is very hard to know how they will work out over next few centuries. We are not trying to involve ourselves. We look for things that can be done. But I have no little short list. People who sell strong abs on TV at night might have one. I have no rule for a strong brain.

Q25: Whitney Tilson. NY. You reported earnings, but not a single shareholder asked about it. I was hoping for a comment on Berkshire earnings, and on mark to market derivative losses.

It was a very remarkable occurrence. Like the Sherlock Holmes story – about the remarkable happening with the dog's behavior. Sherlock Holmes asks about the behavior of the dog in the night. "The dog didn't make a sound." "Yes, that was remarkable." That perhaps is teaching a lesson. Those people trust us. They trust Warren, and rightly so. You saw an interesting example of deserved trust working in real world and in Omaha. By the way, we love that position. The accountants don't know what they are doing but I don't criticize them.

Q26: LA. In 25 yrs, where would you see oil production? What year do you see the peak?

This is very flattering, but I don't think question nor my answer will do much for my reputation. We don't know year, and the reason Warren picked up on my answer last weekend so strongly is that it is a radically different world where oil production is down 25 yrs from now, with radical adaptations necessary. Hubbert pretty accurately predicted peak. If it hasn't peaked, it soon will, and it will go down. At $120 / barrel, there are obvious strains in the production system.

Q27: LA. I went to private school where you donated science building. For many minorities, there are low graduation rates. What can government do to help? What can we do?

Very serious problem, anguish causing. CA had once the best public education system in USA. It is a very sad thing. The private system is very competitive. Warren has suggested that if no one was allowed to use private schools, citizens would make sure public system was good. Not sure Warren is right on this. Personally I am better at lifting top up than the bottom up. Why shouldn't I stick to game where I'm better suited? If you want to know how to raise top higher, I think I could help you a lot. If you want to raise lowest, I don't know how to do it.

Q28: Boston. Swiss Re transaction. Could you add some color? Long tail insurance?

It will be long tail. It won't be a bonanza. It ought to be reasonable, we like Swiss Re.

Q29: I'm curious, you are student of history. Does today remind you of any time in past, and why?

I punched premium channel in hotel in Tokyo, and out came exercise in pornography. I would argue Soddom and Gomorah is still around. I think Athens of Pericles is still around today. Our bullies are similar to past eras.

Q30: LA. How will meltdown affect Brazil and China. Will you invest there?

We have [economic] system which is interdependent. [A slowdown here] would have repercussions elsewhere. Will Brazil have troubles? No. Brazil is favorably located now. If I could get equivalent business prospects I would prefer USA. That iron mine that Brazil owns, you only need small knowledge to know that it is one of best in world. Agriculture – they are in a very strong position. We are not invested there at the moment. We have a small position in Brazilian Real.

Q31: CA. Health insurance?

The health insurance industry gets bad press it doesn't deserve. When medical care fails, they say that characterizes it. But they also prevent a lot of interventions too. But Hollywood assumes everything is bad about health care. I don't know what will happen. I think single payer could happen, and might not be too far in future. In fact it probably would happen, maybe 50% likely if Democrats win both houses.

Q32: LA. Absurd leverage in banking system. Large mess. Only response is that government has taken toxic portion and thrown it onto their books.

Not at all clear what will happen. If government intelligently spent $500bil dollars, it wouldn't be that bad. But now they do it unintelligently. I am not shocked that we all have to pony up $500b. We did it in savings and loan crisis, $150bil.

Q33: CA. Hyperinflation. Real estate and gold?

I don't have a good opinion on that subject. We have not been good at taking advantage of inflation. Net inflation at Costco was zero for ten years. Even Costco is starting to feel it. Not desirable. The previous situation was too good to continue. If it can't go on forever, it will eventually stop.

Q34: Germany. Many managers typically would be carried away by all the success. Is it genes or is it still to come?

Very flattering. Success tends to make most people pretty pompous. Someone once suggested in a public setting, 'Don't you think financial success is making Munger pompous?' An old friend of mine stood up and responded, "No, that is unfair criticism, I knew him when he was young and poor and he was still pompous."

Q35: Beverly Hills. Berkshire has history of acquiring operating companies. Wesco has been less active. Will you get more active?

Berkshire will be better at stuff than we are. We have not bought our last operating business at Wesco, so, stay tuned.

Q36: Auz. Wells Fargo, how did you get comfortable with their derivative positions?

They will not be exempt, but we believe they will have less than their share of troubles. I think they have a better culture.

Q37: CA. Common stock returns going forward? Should we go overseas? So much less transparency… hard to satisfy conservativeness.

P&G and Coca-Cola is in developing world. We have exposure there. For a great many investors, the best way to do it may be to own Coca-cola. We've thought about these things. We do not lack participation in the rest of the world. And we may get more.

Q38: LA. If you were younger, what asset management type would you join?

If doing it again, I'd find someone I really liked being associated with, and I'd serve little time in a pompous place doing a lousy job. But most of jobs are in lousy places. My Harvard law professor used to say – 'tell me what your problem is and I'll try to make it more difficult.'

Q39: Germany. Insurance accounting: Cost or market, or lower of cost or market? Was this good move for accountants of insurance coompanies 30 yrs ago?

Very tough question. Generally speaking, lower of cost or market (standard for inventories) – but various financial types wanted to get away from this. There is a risk of self fulfilling prophecies, like an autocatalytic reaction in chemistry. Conservative insurance companies marking common stocks to market is not a bad thing. If we had lower of cost or market in derivative books, they would have worked better. All intelligent people find it so. You are to be complimented for being bothered by it.

Q40: CA. Average investor should invest in index funds.

All intelligent investing is value investing. Calling something a value fund doesn't absolve it. You can call yourself a ballet dancer if you dance like me, but it is not a good thing. I wouldn't recommend people broadly invest with any value fund. I would avoid funds that have 100% turnover per year. It is a ridiculous way for an ordinary index fund to behave. It is imperfect, but best outcome for most know-nothings, in order to avoid being misled by fools and liars.

Q41: USD Currency. How many months would it take for exporters benefit?

I don't think USD weakness will fix trade deficit.

Q42: MN. Insurance and healthcare: How can we go about having best medical care at lowest cost? Also, could we get your book in schools?

A lot of people think existing system is all bad. People tire of dealing with dumb insurance companies. There may be some reality. Changes have been hard. If you look at hospital I am Chairman, we used to knife the kidney. Now we use lithoscripsy, with a 100% cure rate. I would argue our specialist doctor was one of greatest doctors Los Angeles ever had. I think there are good things in system as well as bad. It isn't clear how it will work out.

I do have one clear opinion. There is way too much intervention when dying. It is a national disgrace. They are way better at handling it in Europe than US. You can take pride in Europe at dealing realistically. We blow more money on stupid cases near death where no one is helped by the intensity of the interventions.

I have trouble getting my family to read my book.

Q43: US. Are we losing our competitive edge? Education failing, infrastructure falling down. Should corporations move abroad?

Some movement offshore for tax reasons is happening, and it hasn't ruined the country. It is the natural response to incentives. Berkshire could save a lot of money, but we just haven't done it. We have some companies in lower tax zones. But we pay enormous income taxes. There is a huge taxation claim between you and your money. We pay taxes that are astronomical. I hope they become more astronomical. There is some development to shift around to save taxes.

Should be concerned if it gets big, but it isn't really big at the moment. Pharma co's make drugs in Puerto rico, etc etc.

Q44: CA. Insurance linked securities. Can you discuss insurance linked securities? Are they a threat to quality of underwriting?

Of course. Like slicing and dicing insurance risk – it wouldn't improve matters.

Q45: What has changed since you first started investing?

I owe a great deal to Mr Buffett. It took a while to convince me. Warren and I together got very good at reinsurance transactions and portfolio transfers. We've learned together at it. Berkshire would have been a mess if it had ever stopped learning. Only reason we've been able to keep a shred of decency in our record is that we have been hell bent to keep learning.

Q46: There is no shortage of well regarded financial experts about debt – equal to great depression?

Pushing credit hard makes me nervous. I know how countries got ahead, and it wasn't by pushing consumer credit to its extreme. I am not wild about the developments. But a great system will handle a fair amount of abuse. Some of the [credit] expansion was good. Do I like multiple credit cards being juggled? Do I look like kind of person who thinks that is good idea? It turns someone into a serf. You get customers just screwed together enough to pay you but who don't realize cost of 36% interest... I don't admire the guys who are good at acquiring the serfs.

Q47: Sweden. Why do you have so few followers?

From my point of view, we have too many damn followers. I don't think we have shortage of followers. Of course great bulk of people do things differently because people running the systems have incentives to do it differently. For a security to be mispriced, someone else must be a damn fool. It may be bad for world, but not bad for Berkshire.

Q48: Germany. What do you think of energy drink business and how to can you avoid a bad marriage?

I abuse caffeine, and I like soft drinks. I've never even tried an energy drink. There seems to be a growing market for it. Marriage: Ben Franklin gave best advice, keep your eyes wide open before marriage and half shut thereafter. [applause]

Q49: TX. You said at the Berkshire meeting that if there is inflation, Iscar would make a lot more money.

Iscar is selling to very professional customers who know a lot. They can just raise prices like some consumer goods. If I gave impression they would make a lot of money, I didn't make myself clear. Iscar is so good at delivering good products, it is hard for me to imagine them not selling more to customers who are making more money. They don't have automatic pricing power. But a price increase is a price increase.

Q50: In 2005 both Berkshire and Bill Gates bought NZD. What do you think now?

I don't have an opinion about NZ. Some things Warren does I just ignore. [laughter, pause] If I had something intelligent to say, I would say it.

Q51: Why the reluctance to own real estate?

Total real estate holdings are close to zero in the total enterprise. The Chairman has quirks. Old real estate purchases, at times we did borrow out equity in old real estate in order to reinvest it in Coca-cola and other things. We have huge surplus of cash now. But believe me we know all the tricks. We may behave differently in future.

Q52: Where would you sell an operating business?

We tend not to sell operating businesses. That is a lifestyle choice. We have bought well. We have a few which would be better if we sold them. But net we do better if we don't do gin rummy management, churning our portfolio. We want reputation as not being churners and flippers. Competitive advantage is being not a churner. Warren says, 'you should take high road since so much less crowded.'

Q: Amex Visa Mastercard. Can you compare these companies?

American Express has better customers, and we like that position, a lot.

Good friends – you are through another of our idiosyncratic meetings.

[standing applause]
Shai Dardashti

WESCO ANNUAL MEETING MAY 6, 2009

(As is standard, no recording equipment was used to reproduce these notes. My high school typing teacher gets all the credit. As a result, these notes are recollections only – not quotes, and should not be relied upon. –PB)

CM: Welcome to the 2009 annual meeting of Wesco Financial. Directors please stand. If anyone present hasn't registered, please do so. This blue book is list of shareholders entitled to vote at the meeting and has been available for ten days at our offices. Our corporate secretary has a record that every shareholder was notified of the meeting. 7,119,807 shares outstanding. 97.5% proxied. Elections of directors. Motion to close. Motion is carried.

CM: We'll have a long question and answer session upon adjournment. Meeting is adjourned.

CM: We'll copy Berkshire this year in part. I'll ask a bunch of questions of myself and then I'll answer them. After you get tired of that we'll go to the audience.

Q1: CM: How serious is the present economic mess?

CM: Deadly serious, it is the worst mess since the Great Depression. The Great Depression caused Adolf Hitler to rise in a formerly civilized nation. You can't predict what happens when people get dissatisfied enough. We have a deadly serious problem, and it could lead to terrible problems.

Q2: CM: What caused the economic mess?

CM: It was a lollapalooza event – a confluence of causes, that is how complex systems work. All of the following helped:

1) Abusive practices in consumer credit. People who couldn't handle credit were deliberately seduced. People who did it justified it by saying competitors would do it if they didn't. That is not proper. Sometimes you should let others proceed and not copy them. It is abusive folly. I talked to a plastic surgeon last night who used to let people write checks against a line of credit on their house. Now his clients are finding those credit lines harder to get. A multiple credit card borrower is dangerous. He can look great right up until he goes bankrupt. Banks have abused their prerogatives and have stuck it in too hard. I have a fundamental theory that in some way the world is just, and if you do something immoral or stupid there will likely be a whirlwind someday where you get clobbered.
2) Mortgage brokers – often these are scum of the earth rejoicing in "rooking" the borrowers with flim-flam tricks, which often can happen with minorities in poor neighborhoods. On first and second mortgages – they built a huge balloon bound to create horrible mess, and the mess finally happened.
3) Wall Street went crazy. Any way of earning money short of armed robbery was ok. The last mortgage broker Merrill Lynch bought were a bunch of sleazy crooks even on the face of it. When people behave like that you get a tremendous mess.
4) Regulatory apparatus that allowed all this was also foolish. The regulators and legislators were in two categories. Legislators wanted poor people to have houses, but this is a bad idea since you want credit practices to be sound just like you want your engineering practices to be sound. People making money just rationalized what they did. Accounting systems spit it out as okay, even though in substance it wasn't right. It was ghastly and there was huge envy in the thing. If Joe made $3m, I'm better than Joe and so I deserve $3.5m.

5) Credit system was the repo system, one of best ways to grant unlimited credit ever invented. Then banks offered access to the repo system to hedge funds. It went to enormous excess. Some of it was due to democratic legislators hoping to help the poor, and some also was due to Republicans who overdosed on Ayn Rand. For Republicans, it was like legalizing armed robbery for anyone under 25. It was like letting the financial class prey on the poor. If it was unreasonable for the buyer, you got 9% for selling it. Ethos was of the "buyer beware". The vendors in America should care about selling good stuff to the customer.
6) Then the other issue was in terms of dizzy leverage on stock indices and CDS – where anyone could bet someone would go broke, even if they had no economic interest in the outcome. Then you could help that person along to ruin. We prohibited this in life insurance. I can't buy insurance if I don't have economic interest in the person (spouse, etc). These wise rules were thrown out in CDS markets. Then the people who did the accounting used mark to model. Both sides would allow profits. Anyone with engineering cast of mind will feel like throwing up into the aisle. Well go ahead, it will be a memorable moment if you do [laughter].
7) Accounting was phony because all the customers wanted it phony. Commissions were awesomely large, and it influenced people. And Greenspan was saying it was all for the best in the best of all possible worlds. To allow predatory class of people to do whatever they want to others is not like free enterprise at restaurants. The whole thing could go… back in September it was as if every bank deposit became unavailable – it looked like whole system would come crashing down last fall, and it accelerated downwards.
8) Luckily the government was awake, and was sensible enough to try to fix the situation. To fix it, we have to save the banks. That doesn't bother me, if you want perfections you don't live in this world. We had to save people who didn't deserve it, but it was important. It was smart government, taking over Fannie and Freddie and reducing mortgage costs. It was a correct decision.
9) Bank situation is much more complicated issue. The traditional way is you don't hear anything about the regulatory process, then you hear about the results after. There was no bake off – and that is a good system. The announced contest [*ed: the stress test*] makes me dubious, but it is better than nothing. Some banks should get more financing. Averaged out I would give Treasury Dept good marks, though I don't look forward to what they likely will do to WFC, since we own a lot. Their credit costs them so much less. Treasury are using a one size fits all. I would give WFC a flaming pass. But if it is a little unjust, maybe their duty is to take their medicine. When we have this much trouble, everyone shouldn't be screaming for the last iota. I think everything is working out fairly well. Much of what has been done has been done beautifully.

Q3: CM: What will be long term consequences of crisis for Wesco?

CM: Almost nothing. We are rich and well financed. By and large our businesses are gaining market share though the economic mess. That is the right way to run a corporation.

Q4: CM: What government response has been inappropriate?

CM: Ethanol is one of stupidest ideas invented by rational people. They don't count the fossil water or topsoil, and you don't get much more energy from it, and losing the safety net of cheap food so that food gets high priced is a monstrously stupid idea. People don't want to admit how stupid it is, but that inanity might pass. The other inanity is cap and trade. China spews out the most carbons, and they won't stop. Cap and trade would be a huge, massive interventionist tax. We don't need it. If everything is in one country, maybe you could cap and trade. But it is not.

What do we care about? Not using up the hydrocarbons of the world too fast. We do not have good substitute for fertilizers. Preserving those for later times is a good idea. So if we have a good idea why do we need a bad idea like cap and trade worldwide with a bunch of people who won't do it?

How do we solve it? We have to use the energy of the sun. I don't think we want everyone to have nuclear plants. So we should harness the energy of the sun, and we should cover the nation with an efficient power grid. Then we shift cars to battery propulsion. We know how to create the grid, we understand that already. Getting solar down 50% in price will probably happen. Freeman Dyson is smart man, and he thinks energy cost is 5% more or less for whole world. Listen more to Dyson, less to Al Gore. One knows how to think, one doesn't. Chinese create the most coal plants, and they are choking to death in their cities. Chinese are logically located to gain enormously and markedly in manufacturing solar. If we want them to get rid of brown coal, then it would be wonderful if they can gallop to leadership in harnessing the energy of the sun. My mind drifts in the direction of photovoltaic, rather than to solar thermal. If they last a long time - good, and prices are likely to come down.

And we need the stimulus of a big energy grid. We have intelligent things to do with the money. Clean power -- that is what we should do. We need the stimulus. The cost saving doesn't matter, but still think it will come. I think we can adapt to a world with more electricity. Israel is interesting place. Half of water used in Israel is from the sea, they take salt from seawater. When mankind does that on huge scale… think of the benefits. But a huge desert with endless power from the sea, maybe everyone there in Middle East can get along better when they collaborate on a large engineering solution. Wang Chuanfu will you stand [*ed: CEO of BYD*]? He is on his way. I am pleased that the world has the capacity I foresee. I think building a big grid is a good idea. I'm not into systems on everyone's garage. I'd rather utilities worked out the scale issues, so that whatever you need just comes. Utilities need time shifting of power, so better battery technology is important. We need it in a car since lithium is a light element. I'm told that lithium is very efficient in amount of charging and discharging, and other elements are all cheap. The sea contains lithium - lithium mines are old sea beds. To me these are ABC, every bright high school student should be nodding his head. Though I'm not sure I'm having same effect. [laughter]

If one enables Arabs and Israelis to live together, cheap power would be very good. It is exactly what should happen, and it will happen. If seas rise a little bit, we can handle it. In Holland, much of the country lives below sea level. We have Nervous Nellies, and they enjoy being the town the crier of misery. Correct cry is "plenty", not misery. That lithium powered car in Omaha, the amount of torque in an electric car is something – the tires would squeal if you pressed to hard.

You need economic action. What is big risk using unemployed people to build big electricity grid? And we need to change our laws so that festering blobs of local policy making can be overridden. You may not like Chinese, but when they need to do something THEY DO IT. India has too much due process, they copied England, and it was not a good idea. Some places have sacred cows, can't fix the traffic due to the cows downtown. We need some amendments to our religious ideas. That said, in big scale of things, there is a lot to be cheerful about.

Q5: CM How fast will improvements come?

CM: We have some sober facts. Japan had boom, and they put full resources of government into fixing it. But they got stasis, not growth. They spent an immense amount of money, and they got only stasis. That would be terrible here, and we have way more trouble. I would predict that it would very awkward to have no GDP growth per capita in USA. No economist in world predicted it for Japan 10 yrs ago. I think Japan is an interesting and threatening example. I don't know if we will do better. Japan stimulus was worthless in some ways, every pothole got filled 3 times. They didn't do highly useful things. If we create a big electric grid I think that is best way to go. I have never taken a course in economics, and here I am speaking about Japan. I'm not apologizing. I'm trying to do it my own way.

Q6: CM: Current stock prices?

CM: Warren said this weekend that the best year he ever had was a recession when economy going down and stocks were going straight up. If you wait, you'll miss it. I'm willing to buy common stocks at current prices with long term money. Coca-Cola and WFC I would buy today. I wouldn't expect miracles – no doublings. Anyone who promises miracles should be shown the door. If it promises high rates of return and has high commissions don't read it. You shouldn't wait for agony to be over before buying common stocks. I for myself am pretty well invested. If there is a big bottom out there, I'm going to miss it. All these things are pretty obvious. I think we are lucky in that we have a stimulus. There is a way of doing this [*ed: electrical grid investment*]. I have been quoted figures of 7-8% of power losses in big systems over long distances. I don't think we ought to care we are leaving it. Iowa – 20% of electricity is from wind. All kinds of things can be done.

Q7: CM: Big issue – what kind of re-regulation should come to financial industry?

CM: I don't know why something that can't fail should be allowed to be anything other than a pretty boring business. That is what it used to be. Partners didn't make a ton of money, and they were quite conservative. They were old fashioned, they had seen the 1930s. We don't need a system where every bright young man needs $8bil to play with financed daily in the repo market. I think we should take away all the activities that aren't boring. They should do moderate things, stock-broking, etc. That doesn't take a huge amount of capital and does not present huge dangers. If someone wants to go crazy, I would close the system for him too. Massive leverage is bad. We don't need options exchanges which have made margin rules uncontrollable. We don't need credit default swaps. If someone wants to be gamey, he can operate as a hedge fund, and take in only sophisticated investors. But I would not reward the ballooning of the operations. A man does not deserve a lot of pay because he balloons a balance sheet at a tiny spread. An idiot can do it, and many do. But you can imagine how many would scream in London and NY. But if I were a despot, that is what I would do. I would run like Singapore. I wouldn't run a world with 10-15% of engineers trying to make money by outsmarting other people. What purpose does this serve? The world worked fine in the 1950s. Obama intends to reduce the power of NYC, and I admire him for saying it. I don't think he'll have guts to reduce it as much as I would. We'll see. Do you really need to announce to friends at country club that daughter marrying a hedge fund professional, and this is the highest rung? It is not pretty to take money away from people because you are a better card player than they are, and can lure them into the game and take a croupier fee. We need to protect the body politic, and it would be constrictive at start. [Wolfenhouer] is an economist I like a lot, he thinks like me.

Q8: CM: Berkshire vs Wesco?

CM: Berkshire is better. Wesco sells too high because you people are cultists. If I were buying today, I'd buy Berkshire. That is the place the entrepreneurs want to join. Berkshire is where people want to be. It is a historical accident that Wesco is independent.

[Munger now invites several attending journalists to ask questions.]

Q9: Mattias Schwartz from Harpers Magazine. You talked about what you would do if you were President. What would you do if you were Sec of Treasury?

CM: I think they have been doing pretty well. I agree with Hank Paulson and his work on the toxic asset scheme. That said, it was not nearly strong enough. I think he deserves credit for changing his opinion/adapting as facts changed. Geithner and Summers are very good. They are terribly constrained by the politics of their locale. You know what should be done, but can't get it done under the constraints of politics. I never had interest in Government. I wouldn't want to be prominent with someone pounding on my head with two hands tied behind my back.

Q10: Buck Hazel, Motley Fool. What would you do…?

CM: I would reduce incentives to go to Wall Street. I would make Wall Street purposely less efficient. I would invest in the electric grid, and I would change laws so little hamlets couldn't reject rational action. I would go hell for leather for electric grid and electric cars.

Q10: Car incentives?

CM: Toyota has a problem in the world I forsee. Detroit will have a hell of a problem when Toyota has a problem. To solve Detroit, I would throw out all the contracts, and let one company take only what they want [from the factories and models and dealers], and abandon the rest. That would have a 40% chance of working. The same thing happened with British Leland, and after billions of pounds, it didn't work. These people haven't covered themselves with glory. There is nothing in this crowd that makes me feel the way I feel about some of other people that are bringing the new world in a rational way. I remember when Rochester had two of the best companies in world, Xerox and Kodak. Is this end of world now, now that someone else is winning? They have great medical centers and nice cheap houses. It is unthinkable that any geographic area shouldn't lose what it formerly enjoyed. It is natural that some places go down while others rise in capitalism. If someone my age can cheerfully die, some geographic area can see its main industry shrink.

Q11: Cathy Kristoff. In the last year individual investors, have become disillusioned, believing now that Wall Street is corrupt. They worry that they shouldn't trust corporate stocks. Hundreds of shareholders have said I've sold out of stocks, citing Ponzi schemes, and exorbitant pay.

CM: First, everyone should maximize their social security benefit. What to do if you have investable sums? I think to expect a lot is irrational. In other words, you are likely to be happier if you are aiming low. The right way to get felicity is by aiming low. Not many can get felicity by aiming high. Having realistic expectations is important. You should defer consumption, and do some investing. Now stockbrokers in this room are smart, but they aren't normal. In general stock brokers are a disaster waiting to happen.

Q12: Are shareholders being robbed, or is it a misperception?

CM: It is in nature of stockmarkets that they go down. So people suffer then. Conservative investing and steady saving without expecting miracles is the way to go. Some people in this room can figure out how to average twice the rate of return. I can't teach everyone else to do it. It is pretty difficult.

Q13: Charlie, [Gurustocks.com]. Lots of investors lost 30% last year. What should we do to avoid those losses in future, or should we live with it?

CM: I don't have a system to avoid downmarkets. If anyone told me he could skip the downmarkets and catch the upmarkets, I'd throw him out. If you aren't suffering a little right now, you haven't lived your life right.

Q14: Paul Larsen, Morningstar. Investment books you would recommend? We didn't get any books on Saturday.

CM: <u>Outliers</u>, by Malcolm Gladwell. It is a terrific book, a bestseller. There is a reason why it is a best seller. The guy has a way of picking out examples that guide reason well. I tend not to read self-help investment books. Like soap operas, I know the plots.

Q15: Kim Voss, Berkshire shareholder. Inflation is coming. How to hedge?

CM: I remember 2c stamps, 5c hamburgers, and the minimum wage of 30c / hr. In 80 yrs since those prices, there has been lots of inflation. Did it ruin investment opportunities? No. It isn't easy, there are always huge risks, and of course there will be inflation. It was a miracle between 1860 and 1910 there was no inflation. For a long time the country got ahead without inflation. That world is not coming back.

Q16: Melbourne, AU. Is Berkshire doing anything to protect against inflation?

CM: Berkshire is aware that inflation is the long term way of the world. We try to do the best we can. We bought utility bonds to yield 9 or 10%. What about inflation, you might ask? Well, government bonds are yielding 3%, so 9% isn't bad. We don't have one size fits all.

Q17: NYC. You have spoken out against Wall Street and executive compensation. How do you justify your investment in Goldman Sachs?

CM: We thought their merits outweighed their defects. We don't expect perfection.

Q18: Vinesh, CA. What about the commercial real estate disruption and GE Capital?

CM: They will lose some money.

Q19: Palo Alto, CA. Coca-Cola company. Neville Isdell and Mukthar Kent appear successful right now. Why?

CM: I think current CEO will likely to be an exceptionally gifted CEO. Coke has a strong position in the world, and when run by a strong CEO the results will be good.

Q20: How will WFC business model look different going forward?

CM: I think they are pretty well located. I think their culture is well-adapted. I think WFC has bright prospects. I wouldn't be surprised if we had more regulation. I think raising people's interest rates on credit cards – well, that infuriates people. Banks will have to behave better, and should not be totally unregulated.

Q21: Berkshire. Executive leadership – can you teach great qualities in leaders, or is it innate?

CM: Some people are more teachable than others, and the same is true of dogs. I wish you lots of luck if trying to win the prize with an unteachable dog, or human. Capitalism filters out people who don't do well, and replaces them. Think of golf, it is a tough meritocracy. I like it that way, think of the talent we get to watch! I first look for trust, regardless of talent. First you need trust and then good judgment. Warren talks about IQ130, that they have all they need. But if people have enough sense to operate in field of competency, you can do very well. It is the overreaching, the crazy overconfidence that does in so many people. And salesmen are very sophisticated. I saw a REIT prospectus recently -- I don't see how anyone could read the prospectus and buy it. But there was a big commission for the salesman. Throw it in wastebasket. You don't have to smart to do this.

Q22. CA. Renewable energy lessons, thank you. India and china – how is the long term investment climate in India vs China?

CM: I think Wang Chuanfu will do amazingly well in China. He has the right discipline and personal attributes. I wouldn't personally choose to spend my life competing with Wang Chuanfu -- there must be easier people to compete with. I think he wants to make a contribution to civilization. I wish I could live longer so I could watch, as he is almost sure to succeed. I may be wrong, we will see. I think he will succeed because he deserves to succeed.

Q23: I always have tough time balancing short term and long term decisions. Right now I will take any customer and investor – because I am starting a new business.

CM: I don't try to back start-up businesses. There were already huge achievements at BYD by time I decided to back them. I don't do startups because I have found a way that is easier for me.

Q24: Why is growth so important. Everyone is obsessed, are there any limits?

CM: There are limits to growth, you can't have infinite growth of finite goods.

Q25: St. Louis, railroad investments. Pricing power in railroads may be at risk, and coal volumes may be at risk. What would you change your view on railroads?

CM: If we stopped using coal it would be bad for railroads. I think there will be a lot of freight still. They now have a competitive advantage over trucks. But it will be more foolproof if we didn't rush into an electric grid.

Q26: San Francisco. National electric grid planner – how long would you spend on engineering?

CM: We understand the technology. I don't have a good feeling for timetables. The Chinese don't fool around, but in other places it takes forever. We would need a streamlining process to do it. We had streamlining processes on natural gas pipelines, and look at how well they work. I have no feeling that it isn't perfectly [*ed: within reach*].

Q27: Tilson. Newspapers portrayed you as negative this weekend, but I heard different meeting.

CM: I think our utility operation is as good as any in the country. I would imagine that if a better grid comes Berkshire will be heavily engaged in it. It would be a waste to not use the managers of our energy subsidiary. They try to deliver what they would want if they were the regulator.

We almost bought Constellation Energy -- that would have been immense. It blew up, but with substantial profit to Berkshire.

Q28: Florida. Do you have any recent fresh ideas on human misjudgment or cognitive errors?

CM: Misjudgment is like sunshine, it will always be part of the world. Many of the misjudgments will be massive. We have misjudgment too at Berkshire, but we have less than others. If you can stay high in the pack, you'll do well. Best chapter in Outliers was about people with an IQ of 200 who failed utterly in life. If you can't learn from that chapter, I don't want to bet on you. I don't know Gladwell but I was flabbergasted – it was a marvelous book. It gives you an insight into what you might call fate. It is good to know how fate will rule your odds.

Q29: CA. Oil production?

CM: Ultimately we will produce oil at lower levels. We are near peak oil production now. The interesting one is natural gas. We have found a lot of good natural gas, and it has surprised everyone.

Q29a: *Any thoughts on upper threshold?*

CM: World will adapt to whatever the price of oil is, because it will have to. I don't think it is the end of the world if prices go up.

Q30: A few years ago I met Phil Fischer, and he said the right answer wasn't right, that is was better to ask the right questions. What questions should we be asking?

CM: I don't think we know how this will all play out. What are the odds of a hostile weapon being used in next 30 years? Pretty high, I'd wager. I think you have to think over all the possibilities. I don't think it is a big deal. I was in Japan a year ago. It is civilized place with static GDP, and it is not a disaster. Mono-ethnic populations can get along better than diverse ones.

Q31: Municipal bonds?

CM: I don't think I want Berkshire to insure an endless amount of municipal bonds. They have good credit rating, but I don't think they always will. I think politicians, if they can throw it to bond insurer, they will.

Q32: Geico- Advertising spend of $800m, on the weekend you suggested this represented approximately 100m for maintenance capex, and 700m for growth capex – is this right?

CM: That is correct.

Q32a: Snowball, what did you think?

CM: Snowball is an interesting book covering a single life in such detail. That said, some facts will be incorrect. And she made a lot of money for herself.

Q33: CA. Reverse mortgages?

CM: They make sense in some ways, but they tend to have big commissions. With old people with problems, so I am leery of it. I don't say they shouldn't exist, but I am leery of anything with a commission and sold to the old.

Q34: Las Vegas. Berkshire has evolved into institution of learning. On Saturday you began to talk about how Berkshire would have effects on civilization after you both are gone. Could you elaborate? Have you or Warren documented your decision-making process?

CM: Berkshire model is so different from standard model that it has had only modest effect/copycats. There was a surgeon once who invented a very difficult surgery. Many saw it and said 'I won't do it – it's too hard'. Many think we are nuts. Ben Franklin's last recommendation to the Constitutional Convention was that government workers not be made a permanent professional class. I love that idea. There is a wise saying, 'There should be no man fit to hold public office who isn't perfectly willing to leave public office at any time." We don't pay directors anything, they all own lots of stock. They are wise. No one at Berkshire needs his director's fee. Normal corporations pay $250k per year, and that is a lot of money to a college professor. But corporations of America would be better run if directors were unpaid. [clapping] You clap, but that idea is not spreading like wildfire. And I think Franklin was right. I think unpaid University Trustees are a good system. I think Walmart may be more important than Harvard. These are very important places. Who has the power is very important. If you stop to think about it, it is interesting to be a director, to interface with good people to solve good problems? Why should they want a lot of pay? We self-select for people who want a lot of pay, and I'm not sure that is best way to do it. If you like it, you carry the torch.

Q35: Is investing in a paper company that supplies central banks a good idea?

CM: Because you have identified the problem, doesn't mean that is right for you. If you bought real estate for inflation, it went down. The nature of game is that it is hard. My son knew a man with a nice house. He had USD1m of securities. He was living in his house free and clear. But he felt he didn't have enough. He sold puts on tech stocks in 2000. He lost his house and assets, and now works in a restaurant. Stretching to reach sacred needs is difficult. Needs should not be sacred. People who can handle credit and have discipline, they are the people I like. Sometimes salespeople love a second pair of shoes, and soon they start cheating someone to have a better life.

Q36: De-inflationary environment?

CM: I don't think every asset class and every region is the same. Now with interest rates at 4.5%, if I had good credit in Omaha I would buy a house in Omaha. But in other places there is more horror still to come. You have to make these judgments all the time. We have submarkets everywhere and they are quite different. Pasadena houses are high priced. But it is run well, there are talented politicians. But I'd probably buy now in Pasadena. Though I might buy at foreclosure…

Q37: Have you read man who loved china, by Ogilvy …. Obviously you have great interest in China. Why did China cease to being a leader in the world?

CM: Because there was a dumb self-satisfied emperor followed by a self-selecting group of Confucian bureaucrats. It got to be like French literature at Yale, it's nutty. But now I think they get it.

Q38: It is also a huge population base with a huge pool of latent talent. Do you find something unique in China?

CM: I like Confucianism, and it pays attention to elderly males, and the love of learning, and their family mindedness. Wang Chuanfu – where will he get $300k to start his company? Well, he had a cousin. The cousin had an ethos – and out comes the $300k. I like Confucianism, I like work ethic, I like that rising leaders are engineers – that is my kind of communist. It is a great nuclear power. We'd be crazy not to get along with China, and they would be crazy not to be friendly to us. I think culture and genetics work together. There is a theory that the Chinese got talented because growing rice takes high IQs. That is not politically correct by the way. Somebody said rice growing regions smarter. I don't know if true.

Q39: David Winters. Is AIG still mispricing risk?

CM: These are sad days at AIG. They have lost some of their position. It does not help to be headlines, when you are selling insurance and people need to trust the insurance. AIG has been very unlucky. They have had difficult hand to play. That could happen to Berkshire. It happened to China – it is easy to fall backwards. It is hard to go forward. It is particularly hard when your children are raised in affluence and the Imperial Guard at headquarters gets to thinking they are the cats meow. We don't want to deny our children anything. We would like it more if children were more disciplined and ambitious. If you take every leading civilization, they have all passed it on to someone else. Where is Egypt or Athens or London? It is nature of things that we do baton passing. It is state of nature that baton gets passed, to someone who tries harder and cares more.

Q40: Student in Amsterdam. Having CAPM arguments with professors.

CM: Future of finance? By and large I don't think too much of finance professors. It is a field with witchcraft. I think a lot of physics and engineering professors. They try to teach it like physics, but it doesn't yield to that. I never went to university with finance professors. Finance professors all believe in diversification, while we try to beat the average. If you buy a dob of everything, that is different than buying something you know something about. That is a different fountain than I want to drink in.

Q41: How do you get a feeling for managers trustworthiness?

CM: There isn't a single formula. You need to know a lot about business and human nature and the numbers. How would you read bone tumor slides? Nobody is any good who hasn't been doing it for years. It is unreasonable to expect that there is a magic system that will do it for you.

Q42: Capetown SA. You point to crazy fees and commissions, what about expensive lawyers?

CM: Cost is too high and education is imperfect. If you go to law school, it is a good place to find a mate. Big firms have gotten too prosperous and there is too much paperwork, and not enough good sense. If I were running a law firm, I would cull one client a year on moral grounds. My partners refused, they were afraid it would be there first client. One of my early business successes was firing most of my customers. We were making transformers, and purchasing agents wouldn't let us make any money. We shrank the business and we returned to a nice profit. There are some customers you don't want. Peter Kauffman is here, he tries to get his suppliers to make money. That is win win. I think a huge mistake to try to rip off suppliers. Whether they are lawyers or others, it is okay for them to make money.

Q43: Newspaper companies, potential? CA taxfree bond market?

CM: The ordinary daily newspaper will perish. Maybe they will find a model a lot like public broadcasting, where they get a few people to pay a good price. But microeconomics of newspapers not a great place to invest money. CA bonds? I believe the rating is the worst in the country, slightly worse than Mississippi's. Gerrymandered legislature with certified nuts on right and left hate each other. It is a very serious problem and big mess. You can't just assume good will win. Sometimes evil wins, and that may happen in legislature for some time. Deliver to others the kind of service you would want yourself. It is such a simple idea.

Q44: US trade deficit. Unsustainability? Decline in USD not enough?

CM: Strange things happen that after 20 yrs of labor governments in UK that Thatcher would come along and change things around. Warren is more pessimistic than I am. China is prospering enormously taking our paper, and they are gaining market position by doing so. If it doesn't show up in equations of economists, they aren't using right equations. Deflation on securities is small price to pay for a civilization growing at 8%. I think China doing things amazingly well.

OK, We'll go to the director's meeting. [4:08pm – early!]

Wesco 2010 Meeting Notes, Part I

The meeting was called to order at 1:57, the nominees for director were elected, and the meeting was adjourned at 2:02.

Charlie then announced that he would follow the same format as last year, in which he'd "prattle" for a while before taking questions from the floor, except that this time he wouldn't ask himself questions. "I'm of course flabbergasted that we have so many people coming to Pasadena after Omaha"; obviously we "have some addicts out there." He will aim to cover matters not covered in Omaha.

Wesco's market cap has grown from $20 million to $2 billion under current management, a "failure" compared to Berkshire but pretty good compared to other things, especially to almost every other California savings and loan; virtually every other S&L "went blooey." Why? Because running a big firm living on a small spread is "very precarious if you're ambitious." If you pursue 10 to 12% growth, you'll take your institution into ruin. Your competition will make bad loans, and you'll either have to fire people and cut back or join the race to the bottom. It's like Greek tragedy. The same problem exists on Wall Street. Why is there no better system for preventing ruin due to deteriorating asset quality? Because wealth leads to power which leads to political influence and bad audit standards. "We were on the edge of something deadly serious."

Why can't we get the "peace process" right after the financial blowup the way we got it right with the Marshall Plan after World War II? Because "our elites failed us." Academia is still teaching failed financial ideas. Charlie has thought about why some high-IQ people make bad decisions while other make good ones. "If your way of making a living depends on X, it's hard to convince yourself of non-X" (which he attributes to Upton Sinclair). To be in the "sane minority," you have to practice right decision making just as you practice making the right swing in golf.

Other folly: Diversification ("diworseification")—it can avoid disaster, but it can't find success; beta—low beta won't cause success either.

Charlie pointed out Li Lu in the audience as someone who liked business school but didn't learn much there, except when Buffett gave a lecture. What we do at Berkshire is very difficult and therefore hard to teach. Business schools fail by teaching what is easy to teach but less useful. Going back to teaching business history as Harvard used to would be good; there's a lot to be learned from the rise and fall of GM, or the rise/fall/rise of railroads.

Charlie told the story of a friend who learned in business school to prosper by abusing his suppliers, driving up their working capital while driving down his own—it was simple algebra. On the exam, he gave the math the prof wanted but said it was asinine; in the real world he'd want his suppliers to prosper and be happy. That's how he behaved in the real world, and to say he prospered himself is a gross understatement.

A second anecdote about a friend: Guilford Glazer. Back from the war, he was admitted to Harvard Business School, but his father's machine shop was struggling, and he asked for a year's deferment to help out, which was granted. A year later, he asked for a second deferment. The Harvard guy asked, "How many employees did you have a year ago?" "Fifty." "And now?" "Nine hundred." "I don't think you need to come to our school. Why not just stay where you are, and come by later and endow the place."

Guilford's father gave him some advice relevant to recent events: only sell things that are good for the customer. He took the advice, and is now a billionaire.

Soccer is also relevant: In soccer, it's hard to win if the other team has a really good player. If you let players do what they want, they'll "work mayhem" on the other team's star, so you have referees running up and down the field to limit the mayhem. It's the same with other highly competitive people like investment bankers; you can't expect them to rein themselves in, so it's government's role to referee. "At its peak, something like the Lehman firm just before it went under was pathological," "like the worst boiler-room operators," far from Guilford's father's advice of selling people only things that are good for them. The people who did this mostly blame others for the bad results.

You need a referee; yet Fannie Mae and Freddie Mac had 200 people at OFHEO to supervise them, and "right under the nose" of OFHEO they went bust and used phoney accounting to juice the executives' bonuses. It's not enough to have a regulator refereeing; there's co-option of the regulator, or simple bureaucratic inertia (as with Madoff and the SEC), and there's no point giving more authority to such regulators. So you must curtail the activities that are permitted. Not everybody can be trusted to do what Goldman Sachs does, so it must be curtailed—and Goldman Sachs must share in the curtailment. It was done in the 1930s, and it worked.

We don't need the capital allocation of civilization to be mixed with a casino. We need to separate commodities and derivatives from investment banking. Underwriting, running margin accounts for hedge funds, advising, commissions, spreads—there's a lot of legitimate activity for investment banks to do; they don't need to do everything else. They could spin off the people and capital associated with other activities; there would be no big hardship involved.

Charlie digresses to comment that it's hard to sit up here in his 87$^{\text{th}}$ year. It reminds him of a story about George Burns, late in life, receiving a singing telegram featuring four beautiful girls. "I'm sorry," he said, "but I'm afraid that one of you will have to come back tomorrow."

The referee needs to say, If you're going to be backstopped by government credit, there's a whole bunch of stuff you can't do; otherwise you get Lehman.

On Goldman Sachs: they have the "best morality and wisdom" among the investment banks, and Charlie doesn't like the government jumping on them, although he doesn't think they're doing it to be "asinine" on purpose but just stumbled into it.

Charlie knows a poker game where the best players like complicated games because they make it easier to beat the less skilled. It's the same in finance. Too many Caltech grads are going into finance. But in finance you clobber your own customer by being cleverer. For example, in Korea and Mexico, investment bankers sold ordinary businesses currency derivatives that made a little money usually, but eventually blew up. "When a guy is offering you free money, don't listen to the rest of the sentence" – Munger's Rule. It's a *mistake* to unethically rook your own customers; we won't miss it if it's curtailed.

A lot of this happened because accounting failed. For example, the derivatives book Berkshire acquired was said by the accountants to be worth something positive, but the reality turned out to be negative $400 million. We don't need mark-to-model accounting. There is too much math in accounting and not enough horse sense. For example, over- and under-reporting assets look equally bad mathematically, but *over*-reporting is much more dangerous. Lower-of-cost-or-market valuation sometime caused under-reporting, but letting people mark assets *up* causes real trouble. Charlie gave the example of the Morgan bank switching to allow trades to be marked up, because, they said, their traders would leave if they didn't. The explanation was honest, but the attitude was crazy.

You can look at major banks' balance sheets and see hundreds of billions of dollars of uncleared derivatives. It's like hydrogen and oxygen sitting by the roadside, waiting for a flame.

Is there any example to give us cheer? Yes, Lee Kwan Yew of Singapore. The average guy in his ethnic group married a pretty but less intelligent woman; Lee, however, noticed one who was slightly smarter than he was, and married her. His son is now prime minister. Lee drained the malarial swamps without worrying the effect on some little fish, fined people with stagnant water in their back yards, and got rid of malaria. To solve the drug problem, he looked around and found the solution in the US, of all places. He copied our military: urine tests at any time and mandatory rehab on failure. His policy was to check hard anything that might grow like cancer. If you tried to start a gang, your fifth or sixth recruit would turn out to be in the secret service. It led to prosperity. It was paternalistic, but we need more attention to his model. Singapore doesn't have 100% free speech; it's a crime to insult the ethnic Malay minority. Charlie thinks Lee's Singapore has had a positive influence on China. They saw the Cultural Revolution wasn't working and were impressed by what they saw in Singapore. Charlie wishes we were more like Singapore; "in many respects we're too damn permissive."

Permissive accounting led to Enron booking twenty years' projected future profits as an asset. We have to say no. Another accounting example is setting reserves for banks by actuarial techniques: When there's a boom on, there are no losses on loans, so you let your bad debt reserve go to zero just when it should be building up most—insane. You have "mathematical consistency," but it makes no sense. Yet another: When all your creditors are scared, with good reason, that you'll go broke, and are willing to sell your debt for forty cents on the dollar, you now get to book a huge profit, even if you have no cash to actually buy the debt in.

Some of our better leaders like Jamie Dimon are complaining about accounting standards—actually, only him. "My hat is off to him," but I'd take away his derivatives book if I could.

By the way, some investment banks actually bought casinos; "why run a casino in drag if you can run a real casino?" But a casino isn't a useful thing, although it's a great business, and running a bank as a casino avoids the fixed assets and restrictions on location that apply to real casinos.

Back to Wesco. What about the future? succession planning? You shouldn't think there is a future for an independent Wesco. You guys bid the stock up to "where it would violate all of Warren Buffett's principles as a capitalist" to buy you out with stock, and we don't like to force people out with cash, but it will happen eventually. Either the price will be right, or at some point it will be just a blip to Berkshire. "I don't know why you like this sort of thing. I was never this popular in my youth."

The Berkshire model is extreme decentralization combined with extreme centralization of excess cash. Both features are extremely peculiar but the benefits exceed the harm from each. Centralization of investment means they think about opportunity cost and look at opportunities broadly. For example, Charlie was once asked to look at company in China, liked it, but said no because he knew of something else he liked even better.

Why high-tech stuff like Iscar and BYD after all these years? When Charlie was young he poured money into a scientific-instrument company with a great oscillograph. Then some venture capitalist hired the top guy away, and the invention of magnetic tape came along and suddenly made the oscillograph obsolete. Damn near went broke and soured on high tech. So why now? Multiple models, and in this case the northern pike model. If you throw a few northern pike into a lake full of trout, soon you have big pike and few trout. Charlie recognized Walmart as a northern pike. Costco is too, plus they have Gil Glazer morality; he wouldn't want to compete with Costco. Bill Gates said more than once that the standard result for a dominant company when disruptive new technology comes along is to fail. So why invest in tech now? Because some models got so powerful that we thought we could make predictions.

If Charlie said he could lift 800 pounds you'd laugh, but if you saw him do it a few times you'd change your mind. The same thing happened with BYD. True, we bought in early at a much better price than currently through the wisdom of Li Lu. How can you know we got it right? You can't, but we're not going to do it often—there aren't that many BYD's. Charlie doesn't consider it venture capital; more like betting on a sure thing. Big lithium batteries for utilities to time-shift, electric cars, better cars for the masses in China—these are all Holy Grails. Why do these folks in China have the lead in pursuing them? A very unusual individual in a very unusual place.

Charlie recently drove a BYD car with a 200-mile battery around the parking lot at Dodger Stadium and was very impressed; it compared favorably to his Mercedes 550. Why is Mercedes forming a joint venture with BYD? It can only be because they've tested the battery.

Still, Charlie's not recommending any of you get into tech. The old ways were safer. But there's an exception to every rule, and "I think I'm right about BYD." And you're entitled to an explanation.

Questions and answers to follow in Part II.

Wesco 2010 Meeting Notes, Part II

Questions and Answers

[I've tried to identify the questioners with as much as I caught of their self-identifications.]

Q *(New York BRK shareholder)* How big a problem are distorted incentives of regulators vs. the regulated (pay differentials and regulators hoping for later jobs in industry)? In Singapore. . .

A Yes, it's a problem, and yes, I like Lee Kwan Yew's solution of raising regulators' pay (he also has draconian anti-corruption policies). But in the US, I think the problem with regulators is more "cognitive insufficiency" than corruption.

Q *(Whitney Tilson)* Cayne and Schwartz are up testifying to Congress that there's nothing they could have done to prevent the meltdown. Are the hearings a circus?

A There's not much point in the hearings. It's human nature to blame others. But Congress is "mad," and rubbing their noses in the mess they made isn't useless.

Q *(David Winters)* When will insurance pricing be better, and Berkshire able to grow float?

A Odds are float will not grow much, and may even decline. It's very hard to increase it. "Is that negative enough for you?"

Q *(Some media guy)* Questioner was in China and really blown away; he doesn't think the US is recovering and getting back to basics. Why aren't we getting back to basics, manufacturing and infrastructure?

A Of course we're seeing more troubles than we're used to, and we've failed to change some things that need changing, such as education. But I'm not as pessimistic as you are; I'm optimistic about California despite it's troubles—it has its climate, it faces Asia, it has an influx of new talent, especially from Asia. And a big mess brings on corrections; "this very failure that's bothering you so much looks like the first rays of sunshine" to me.

Q Any tips on how to develop temperament and character in young people of the BRK type, rather than the MBA type?

A It's good to understand models for failure. For example, East Germany. The best 5 million left and the worst 17 million stayed. Then they lived under Communism 60 years. That'll ruin even Germans. The same thing is going on in central cities. It's not an easy problem to fix. Prevention is preferable, though it's not easy to preemptively stamp things out in a democracy. You can't blame the Greek politicians for trying to make it easier for Greeks, but when it comes unglued. . . . In business, if you see high-quality people leaving A for B and C, and no high-quality people going into A, that's a similar model for failure. I recommend a tough-minded, rational approach, plus good will. An ounce of prevention is often worth a ton of cure.

Q *(James Armstrong, Berkshire shareholder, Pittsburgh)* Last year you talked about a smart electrical grid. Are the BNSF rights of way useful for that? Could that add anything to Berkshire's net worth?
A I've never heard anyone talk about it but can't imagine the rights of way full of towers. "Put me down as skeptical."

Q Is BYD too dependent on a single person?
A There's a risk, but I'm used to it, working around our 80-year-old gallant leader. [At this point, Charlie asks Wang Chuanfu and BYD's vice-chair to stand and wave (applause).]

Q *(Alex Laga, a BRK and Wesco shareholder, Milwaukee)* An engineering mentality is prone to paralysis by analysis and to a fascination with models for their own sake. How does one avoid that?
A Look at BYD: 16,000 engineers but *determined* to be rational. They don't like unnecessary delays, nor analysis for the sake of analysis. By contrast, India has too much paralysis by analysis.

Q *(Austin, TX)* WEB credited you with giving him the concept of "durable competitive advantage." What are the best ideas he's given you?
A Warren knew about durable competitive advantage. He didn't need me. The amazing thing is we did so well while being so stupid. "That's why you're all here: you think that there's hope for you." Go where there's dumb competition. Patrick Wolff once told me I was better at what I did than Wolff was at what he did. I said no, I just played weaker competition.

Q *(Australia)* How do you determine bet size when you invest? Do you use the Kelly formula?
A We don't use any formulas. If you're referring to "Fortune's Formula," it's very intelligent if you get to make lots of bets that pay off quickly, but we get very few opportunities and our problem is to get enough of them to invest a lot of money. I suspect I may have intuitively used the formula when younger. It's correct, but of very little use to how BRK operates.

Q Given the high price, and in stock, for BNSF, can you improve their operating margins to CN levels?
A That's an easy one: we don't have to do "one damn thing—just let Matt Rose do whatever he pleases."

Q To what extent did you share ideas with WEB before you began co-investing?
A I always talked over ideas, but not with many people.

Q *(San Diego)* Excesses in the economy blew up in '08. You compared it to being on drugs. Are things worked out, or is there a hangover still?
A Of course it's not worked out. What you and I see as excesses are regarded by the

people doing them the way a diver regards his air hose. "I need it and I want it and so I should get it" is childish. We need to make changes, or we'll get more trouble.

Q *(Germany)* What do you think about central banks printing money and the ECB accepting Greek "garbage" as collateral?
A Everybody knew Greece was problematic when they joined the EU. It's amazing we didn't get a Greece-type problem sooner. It's very hard to fix: you don't want to set a bad example, nor let them go under. Ireland got a big benefit from joining the EU, but Greece threatens the whole system. [Charlie paraphrases a Woody Allen line: "Today we are at a crossroad. One road leads to hopelessness and despair; the other to total extinction. Let us pray we choose wisely."] I'm glad it's not my problem to solve, though I believe that, with my mindset, I would have acted earlier.

Q You suggest studying people one admires and the eminent dead. You've mentioned Lee Kwan Yew, Ben Franklin, Paul Volcker. Who else?
A There are lots within Berkshire. An example: managers are reporting, and one says he uses the 80/20 rule, focusing on the 20% of the business that makes 80% of the profit. The next says he does the opposite, focusing on the 20%-profit businesses that you can buy cheap and improve. They're both correct. You need multiple models.

Q *(College student)* I want to invest in Berkshire but I'm worried about succession and the future.
A BRK will be very successful long after we've gone. It has wonderful businesses and a durable culture.

Q If you were starting out with a small amount of capital, where would you focus?
A I wouldn't go where the big boys have to be, trying to decide whether Merck's pipeline is better than Pfizer's. I'd go where there are market inefficiencies and your work could lead to knowing important things that other people didn't.

Q *(Fund manager, New Delhi)* I admire your "lattice work" model but in applying it find that adding to one's toolkit takes a long time because you have to fit new things into a complicated framework. Is this inevitable or is there a way to speed up integration?
A I was born with a mind that works that way and am also curious, so learning isn't work but play. If your nature's different, you'll "have to figure out your own damn answer."

Q *(Student, Toronto)* Why is it the government, rather than someone like Berkshire, bailing out the banks this time?
A It's way worse this time. Nobody in his right mind wanted to see how far it would have gone if the government hadn't acted. It's a credit to democracy. England showed us that we could intervene directly in major banks, which was much better than TARP. It's a credit to Paulson that he switched plans when he saw a better one.

Q *(South Pasadena)* What about those condos Wesco built next to the headquarters building?
A I'm glad you brought that up because it's like rubbing my nose in financial failure, and

that's good for me. We had surplus property and decided to build condos several steps up from what you could buy in downtown Pasadena. We came to market in the worst condo market in a long time. We're selling condos at prices that give us a modest loss and resisting doing stupid things. Eventually there'll be one condo left and two or three buyers. I think it'll make a lot of money eventually for the buyers, but never for Wesco.

Q You said you regret so many Caltech grads go into finance. But mightn't they end up running those businesses and do better at it than Fuld?
A That could be true. You could probably take anybody at random out of Caltech and have them do better than Fuld. But there's an opportunity cost; there's a loss to civilization when bright people go into money-grubbing instead of science.

Q Can you comment on the state of the insurance business?
A Casualty insurance is intrinsically a very difficult business. As in financial businesses, people delude themselves to maintain volume. I wouldn't be looking for investments in the field. Berkshire is different, and a few others too, but those others are generally known and priced accordingly. Reinsurance is even worse.

Q *(Ottawa)* WEB says he expects a "reasonable return" on BNSF. What percentage or range of percentages is reasonable? Also, any books you've read in the past year and recommend?
A Berkshire is looking at opportunity costs. We spent 6% of shares outstanding to acquire BNSF. We were getting low returns on cash, and we paid low rates on the money borrowed to do the deal. It's a better deal for Burlington shareholders, but that doesn't mean it's a bad deal for Berkshire shareholders. Bringing in Matt Rose, who's quite young, is a huge plus. Though not an iron rule, we hope to make, say, 10% pretax long term when buying with equity. But this was part equity, part debt. Stocks generally will probably do worse that 10% pretax; this isn't an environment you should be happy about. We might be wrong about getting 10%, too. As for books, the ones about the Great Recession are all very interesting. John Paulson is a very interesting story; his imitators are going to create a lot of trouble. The same applies to me to some extent; I try to atone by doing other things.

Q *(Toronto)* It seems the rate of change in business is speeding up. Does that make things harder?
A I don't know what will happen in the next 20 years and have very little reason personally to care. That said, the most interesting rate of change is in China—so fast, so pragmatic that I am quite optimistic. An amazing percentage of Chinese Communists have engineering training. "That's my kind of Communist." We're too critical for expecting them to do things exactly our way. They're coming up the technical competency curve at a rate with no precedent except perhaps Japan, and they're a big country. It's very difficult to compete with them. They're wise to foster people like BYD who are trying to make things better rather than just cheaper. In my youth, I liked the King Fong Restaurant in Omaha. Recently, I drove by, and downtown Omaha has gone to hell but it's still there. The Chinese find a way to survive.

Q *(San Jose)* You said solar was too expensive for your house, yet Midamerican is investing in solar and wind.
A I don't second-guess Midamerican. As for photovoltaic, I thinks it's about to get a lot cheaper, and therefore isn't a buy now. But I could be wrong.

Q Float at Wesco has gone up quickly compared to float at Berkshire. Can it keep going up? Also, why was it Berkshire and not Wesco that invested in BYD?
A The second one is easy: strategic stuff almost always involves BRK, which is bigger and famous. To repeat, Wesco is not a smaller Berkshire. The insurance is a gift; if Wesco wasn't part of BRK we wouldn't have any way of getting it. As for CORT, it "looks pretty damn mediocre" and was bought at the top of a boom; still, I think it will do all right over time. You shouldn't analyze Wesco as an independent entity; it's a "weird historical accident."

Q *(USC MBA student)* Can you come talk to us?
A I used to once a year; one talk's in *Poor Charlie's Almanack,* and it wears pretty well, so you don't need a live Charlie. Warren does a lot of that and likes it; my taste for it is limited, so I can't help you.

Q Does WEB prefers durable competitive advantage to Graham-style investing because it's a better model, or because it works better for large amounts of capital?
A If I were young and had a small amount to invest, I would be looking in the small-cap world.

Q *(Los Angeles)* Is CORT in a cyclical or secular decline? Is there a goodwill writedown coming? And what about Goldman Sachs?
A CORT will do OK and justify the price paid but not be a worldbeater. But it's getting pretty dominant in its niche, so maybe I'm too negative. On Goldman: The total return derivative is a way to avoid margin limits and deceive accountants; I hate its social implications. I dislike other derivatives too. Warren wrote a letter against allowing S&P derivatives, but after they were made legal anyway, he invested in them; nothing inconsistent in that. In a world where derivatives were allowed, I see no reason to think Goldman was misbehaving, just doing what others were. The disadvantage is that it's hard to explain to the public. I suspect they'll change; Blankfein is pragmatic and flexible. Goldman deserves its share of blame for helping to persuade the government to allow derivatives trading, but no more. The idea that any sort of risk transfer between consenting adults ought to be legal is wrong. But Goldman Sachs shouldn't be singled out.

Q *(Boston)* Why did Coke buy back its bottlers, and what makes a good distribution business?
A I don't follow Coke, but originally they spun off low-margin businesses into non-consolidated entities to make the accounting look better. That's not a Munger-type thing to do, so if they're undoing it, that's a good thing. By the way, I think the new CEO of Coke is the best we've had in a long time.

Q *(Chicago)* Clayton's products are great, but it's almost impossible to put a Clayton home in Chicago due to zoning. Will that change?
A Kevin Clayton is very interested in taking Clayton techniques upscale and getting past regulatory problems. Clayton houses are improving. Charlie thinks we'll see more Clayton-type methods used in the future, though it's a slow process of change; the custom home approach is *so* expensive.

Q *(Los Angeles)* Can you recommend investment books for children and strategies for getting them interested in investing?
A I'm not sure I believe in getting you children interested in investing. For myself, I think that investing helped with wisdom acquisition, and wisdom acquisition is a moral duty; but the money all goes away when you die.

Q *(Shreveport)* Why do you and WEB read 5 newspapers daily? And will Goldman Sachs divest its derivatives business?
A To the second question, not unlessed forced to, any more than a diver will step on his own air hose. To the first, "It's all I can conveniently crowd in." "I am particularly charmed by the *Financial Times*," but I also like the *Wall Street Journal;* I'd read more if I had the time. I skim. I don't know anyone who's really wise in the practical world who reads no newspapers. Maybe you can do as well with keyboards and multitasking, but I don't think so.

Q If you were 35, would you move to Singapore?
A I'm such a lover of the US I'm not going to move to Singapore. With all its defects counterbalanced by its virtues, I love this country. The move might be right for somebody else. If crime goes up by a factor of three, affluent people might move to Singapore, but I won't.

Q *(Santa Monica)* You said reinsurance is a tough business, so why the Swiss Re and Munich Re investments?
A Warren makes those decisions. Those are both respectable businesses that have been around a long time. They're portfolio investments at what seemed like reasonable prices. That doesn't change my general view of reinsurance. *Of course* it's difficult to judge whether to invest in them. I like no-brainers like Costco and BYD better, but you don't find very many.

Q *(Los Angeles)* With banks moving away from mark-to-market and keeping troubled assets on their books, how is Wells Fargo affected?
A Wells Fargo got very cheap at the low tick. Yes, they made mistakes, and yes, they have a lot of work cleaning up Wachovia, but it's a good investment even at the current price. Even the best banks drift with the times and do stupid things, but I suspect Wells faced up to it better. We may be getting changes in credit cards. We've been issuing them to "fiscaholics." I don't like issuing credit at 30% to people who can't really handle it. "But that's a crotchet, not a complaint." However, how many here agree? (Many hands go up.)

Q *(Chinese online journalist)* What fields for investment are you interested in, besides BYD, in China? And what advice do you have for Chinese investors?
A It's hard to imagine finding another one as good as BYD. We'll look, but will be surprised to find another one.

Q Any more add-on activities at GEICO?
A The credit card was "a really stupid decision that got a bad result." I hope we don't find another "opportunity" like that.

Q *(Los Angeles area accounting prof)* Advice to accounting students? And should our investment group buy more Berkshire?
A Huge changes are needed in accounting standards, but that's a problem at the top of the profession. As a professor, you have to hold your nose and teach the standards as they are. We never—well, almost never—tell people when or whether to buy Berkshire. Accounting is a noble profession; double-entry bookkeeping had a big role in the rise of Venice. But accountants fear liability if they make difficult decisions. I would favor exempting them from liability for anything except deliberate fraud, in exchange for requiring them to be conservative.

Conversation with Charlie Munger
July 1st, 2011
Pasadena Convention Center

Opening Remarks:

The question after Wesco was bought by Berkshire Hathaway (BRK) was who was going to pay for the event today. Charlie decided to pay for it to continue the tradition.

Wesco Merger:

Said he feels like a captain who finally got to the port he had always dreamed of. He believes BRK is the right port for Wesco. About one half of the Wesco shareholders became shareholders of BRK. The contract was disadvantageous for BRK because of the losses recognized in Swiss Re. BRK's stock subsequently went to a price that was so low that Wesco shareholders got more shares than Warren and he had ever intended. He thinks there was a favorable wind at the end though.

Warren and Charlie developed a reputation for doing the right thing. It has worked well to be known for doing the right thing, even when BRK has the power and their partners or counterparties do not.

Quote: How nice it is to have a tyrant's strength and how wrong it is to use it like a tyrant.

Academic Discussion

Charlie didn't think the audience would bear listening to this at the end of the conversation so he put it in the beginning. When you have a complex system, what he calls lollapaloozas can be very impactful. These almost always come from a confluence of factors operating in the same direction, but coming from different academic disciplines—economics, finance, and psychology. He has never cared what disciplines they come from though. It is that they come together to have a large impact that is important.

With lollapaloozas in mind, he wanted to let us know how he approaches things. There is a problem that has bedeviled the economic departments of universities. When economists went to the movie theater, they noticed that Coke and popcorn were priced way too high relative to the prices of these goods elsewhere. There have been millions of man hours devoted to understanding this phenomenon. They understand why first class airplane seats sell for more than coach seats but can't understand—using marginal utility—why candy bars sell for so much at theaters.

Similarly, it is well know that car manufacturers sell a car for $40,000 and then sell you an extra gizmo that costs $20 for $400. When you are paying $40,000 for a car, a $400 charge is so small that people barely even notice it and the seller can extract more money out of customers this way. Nothing can be simpler than what he told us but he can't believe how many academics don't understand this. He then suggested that if you can adopt his tricks and his approach, you can do better than most other people.

He then applied the same approach to something that is far more complex. It became orthodoxy from a Keynesian point of view that you can borrow and print money to ameliorate recessions. The Keynesians believed that recessions would be short and depressions less likely as a result of borrowing and printing money. People became so enamored with this idea that they thought these economics laws were like those of physics.

The Japanese got in trouble because of an idiot boom in real estate. They now have tried everything in the Keynesian book to try to fix that. They have had to deal with 20 years of stasis, which they are uniquely able to handle. They are a nice and polite people. However, Americans and people from most other countries would likely not be able to go through 20 years of stasis. If the "new" laws of economics do not work as well as the professors think they will, Americans will be in trouble.

Of course Keynesian and monetary tricks do not work as well when everyone knows you are playing them. For example, things that worked in the 1930s might not work now. Back then the US had better credit and people did not use the polls to make themselves rich. Meaning, people did not get voted into power and then use their power just to become rich. This is a lollapalooza system.

Next, Charlie provided an explanation of Japan's economic malaise that is not commonly cited. Japan is an export dependent economy. In the late 1980s and 1990s, Japan got huge and credible new competition from China and Korea. They got this because the traditional laws of economics were working well in China and Korea when they adopted something like free market capitalism. The main competitors got more competitive and this impacted Japan substantially. This is an explanation that you never hear. This is why you need to try multiple approaches to solving problems—using checklists.

Additionally, Charlie recently re-read Matt Ridley's *The Rational Optimist* again. This is a great book. Ridley is absolutely charmed with the way that free market capitalism changed the world. Specifically, he has fallen in love with the idea that the division of labor was the main contributor to this success. He only looks at this explanation though and it is wholly inadequate. There are multiple factors that have made free market capitalism so successful. Even if Stalin were running a pin factory (made famous by Adam Smith in *Wealth of Nations*) he would get efficiencies out of it. The process of competition between different operations and companies causes the power to be allocated to people who are good and can perform a great service. But, if you just stop there you miss other things. For instance, what happens is that the owner of a business gets "reinforcement" very often. Each time the cash register rings he or she gets an "aha" feeling. There are lots of rewards and punishment in free market capitalism that do not necessarily apply to someone who works for the Department of Agriculture (and can't be fired) or who is a communist in Eastern Europe.

The takeaway is that there are all kinds of problems that are better solved by going through a checklist. This works well in primary medicine too. Only a terrible internist jumps to the first conclusion and sticks to it. (Sadly, this represents about 75% of internists.)

Blue Chip Stamps

He then went on to talk about Blue Chip Stamps, a "doomed" trading stamp company. Almost all of these companies are now dead or almost dead in general. However, when this business was more profitable it produced a large float like a casualty insurance company. What was interesting about the task of investing that float was that BRK only found 3 big things to do in decades with the money: it bought Sees, Buffalo News and control of Wesco. The idea that he and Warren only made 3 moves is interesting given how investment bankers are always pushing people to buy things. It is "boring" to run a business and make sure each restaurant is clean, for example. It is much more fun to look for things to buy. However, almost any data suggests that most shareholders lose with all of these mergers—academic studies prove this. But, BRK shareholders did not lose because he and Warren only did 3 things and were patient. They were able to be patient because they had something else to do with the money. They had the option to buy marketable securities. Most companies don't have this option and the combination of options gave them a respectable repertoire provided that they were patient.

Strangely, the worst thing that could have happened was the purchase of Wesco. The other two businesses they bought were way more profitable. But, even so the Wesco stock went from $5 to $385. Even if starting Microsoft was better financially than buying Wesco, he and Warren don't care. They don't want to fall prey to envy. Envy is stupid because you can't have fun with envy—envy always represents a total net loss. There is always someone doing better than you.

Another advantage to BRK's process was that Warren and Charlie were learning as they went. They didn't understand the power of a great brand until they bought See's Candy. They found that they could raise the price 10-15% each year and nobody cared. This understanding then changed BRK and its investment pattern. We are all ignorant—no one knows enough now to cope with the future. His motto is to pay yourself first—protect your own mind and make it better. You always have to learn. Increasing rationality is a moral duty and it is very important to keep improving as much as you can. That's how he and Warren went at it and it worked well.

They weren't the smartest guys—they were massively ignorant. In fact, many of the major successes of BRK started off with massive failures. For example, they bought one of the 4 major department stores in Baltimore. This was really stupid! But they recognized the mistake, tried to exit, and did. They were able to sell it for what they bought it for, basically. Out of the contacts they made when they bought the department store they were able to buy a niche retailer that made them a lot of money.

Many people graduate from Wharton now and think they know how to do everything—that is a big mistake. What is needed is a lifelong learning process—this is both helpful and a lot of fun. He said that he has had so much fun learning. In fact, it is amusing to see economics professors spending all these man hours on silly problems that he could solve with his left hand even though he never took a class in economics.

The Great Recession

The bubble in America was from a combination of megalomania, insanity and evil on the part of a lot of people in banking—both mortgage and investment banking. Greenspan was a smart man but he overdosed on Ayn Rand at a young age. You can't have total freedom to create gambling games. Much of what crept into investment banking was a gambling game in drag—it was not capital raising. Now, the banks have developed an advantage in derivatives and do not want to give it up. A casino would never give up slots to keep roulette and blackjack. Similarly, the banks don't want to give up their best businesses to save the rest of us from risk. It makes sense that banks don't want to give it up.

Betting on a stock index is like betting on a bucket shop. The banks brought back bucket shops with the derivatives markets. With casinos you have to have parking, bars, restaurants and entertainers. But the banks have a casino with no overhead. The government then allows them to operate with leverage through the repo system. Conservative investment banks went to 30-50x leverage, making small returns on each transaction but making a lot of money in aggregate.

Then, the accounting profession allowed banks to show income and assets that weren't really income and assets. Accountants didn't think they had a responsibility to show the actual mess that could bring down the entire system. The medical system wants to prevent epidemics but the accounting profession does not want to deal with difficult and systemically risky issues—they want to charge more by making everything more complex. This is a contemptible approach. What accounting figures have expressed contrition? What major person in the US has been embarrassed by US accounting? Very few. But one such person is Jamie Dimon of JP Morgan who has written scathing criticisms of the accounting rules in his annual reports.

As an example, bad debt reserves go to zero in a boom. What kind of maniac would think that is good accounting? Only a CPA or a professor of accounting. The rest of us are grown-ups and know that is not good accounting. Paraphrase of a quote from Burke: For all of the folly in the world to prosper and become rampant, all the good and wise men have to do nothing.

Bernie Madoff has shown no contrition. In his mind, he was OK. Most people think the 150 years he got were unfair. Charlie would bet that Dick Fuld does not feel any contrition today either. He totally ruined Lehman Brothers with his megalomania. This is very serious situation because people won't show any shame. You need to have a society with the right rules to stop people from going crazy. There ought to be rules that only allow banks to do simple things with the government's credit. Remember what happened in the S&L business? Bankers are clearly not that wise or disciplined. They go crazy with envy. If the guy down the street is making a lot of money, it is hard not to try to do the same. Major accounting firms starting selling fraudulent tax shelters. But, when they finally got the whistle blown on them, they reluctantly threw out the partners who were involved. However, he never hears anyone saying they feel ashamed. Well Charlie feels ashamed to be in the same race as these people. Wise laws that protect against people doing crazy or evil things are important.

In the cases of Korea and Mexico, investment bankers sold them derivatives and caused those countries and decade old firms to go bankrupt. It is OK if financial companies are a little boring. Some of our best banks gave free checking to get people who couldn't handle credit to sign up, a situation that led to overdrafts and people getting socked with huge fees. The banks also programed the computers to process the biggest check first and that led to even higher fees. The banks are paying for these actions through class auctions suits right now—and they should. Wise laws that constrain the worst activities that people somehow are able to rationalize are very valuable.

You are talking to a Republican who admires Elizabeth Warren. He then said that these comments are not quite as contemptuous as what he wrote in the piece about the people who were at fault for the Great Recession.

Current Investment Scene

The scene is very difficult. Charlie likes the "new normal" concept from Bill Gross of PIMCO and thinks the world is going to be lousy. He said we can't love bonds because yields are so low. Further, with so much trouble, the old tricks no longer working in Japan and Europe, and those countries having an "adult" experience, the world looks lousy. Of course picking some stocks carefully will be profitable. However, these returns will be tempered by the fact that there are consultants, managers, traders, and analysts that cost so much and will take profits from the rest of us. Now people are doing what is basically legalized front running because of their skills in math and with computers. Our university endowment and pension funds are paying for this unfair advantage through lower returns. Even worse, the people with power in public pension plans are working in ways to escalate the size of the pensions. Soon-to-be retirees are manipulating pensions by working a lot of overtime during their last year to make the final year salary abnormally high. From there a police officer who has made $50,000 his entire career can retire with a $100,000 pension. This is evil and wrong.

Charlie said that one of his favorite incidents from history occurred in the days of the Punic Wars. Rome couldn't afford to lose wars because when that happened, people became slaves. But, in this unusual case, Rome paid back 2/3rds of the war debt (in hard money) before the war was over. The emperors kept debasing the currency during the period but the right lesson for us to take away was from the guys who had the discipline to pay back the debt. He doesn't like the message that we can't have tax increases in the US under any circumstance (the current stance of Republicans). But, the other idea that the rich should pay all the tax is equally crazy (the current stance of the Democrats). The rich should pay the majority of the taxes but everyone should pay moderate taxes.

In any case, extreme divisiveness is not good. He remembers real nobility among the American political class in the past. After World War 1 the Allies decided to make the Germans really pay for their transgressions and that decision led to the rise of Hitler. If he had been a little wiser, Hitler's ancestors might still be in charge of the world. Charlie claimed that the Allies won the war because of luck and Hitler's blunders. Fortunately, we learned after World War 1 that we don't want to do things that cause desperation and thus decided not to be vindictive after World War 2. The Germans had put Jews in ovens and the Japanese marched people to death. But, what did we decide to do? We decided to give them money and let bygones be bygones. It was a great decision, especially the Marshall Plan.

Keynes wrote *The Economic Consequences of Peace* (in 1919—in which he argued for a more generous peace) and people later realized he was right. Consequently, Americans behaved really well at the end of World War 2. It is hard to imagine the same will be true now. The politicians hate one another and he hates to watch it. He is mildly hopeful it could change. But, the current system is dysfunctional and we need change.

The combination of patience and opportunism is important. Charlie had a great grandfather who had a great influence on his life. This man was one of Charlie's only ancestors who became rich. He told Charlie that you have to be ready to take advantage of opportunities to succeed. This is what they do at BRK. They are always ready. You do not want to be timid when great opportunities arise. It is kind of like how most marriages don't work and you may have only one chance to marry the right person.

Question and Answer Session:

Q1: At this point in your life, what are the 3 most important components of your legacy?

Munger: Charlie hesitated to answer this question because he believes that he is not a good example. Most people who follow his example would turn out to be quite unloved. He is really into self-improvement but certain peculiarities of his personality should not be imitated. For example, copying his insistence on improving his own mind and his irreverence will get you in trouble. Rationality and objectivity work. But, the qualities that bring so many people to hear him speak may not work for others.

Q2: The first question had to do with the Wall Street Journal's deterioration since Rupert Murdoch took over. The second question had to do with whether or not California should become a single chamber state.

Munger: Regarding, the first part, he loves the Wall Street Journal (WSJ), although he has never liked the editorial page. However, the publication he likes best is The Economist. He believes it is the adult intellectual publication of the world. The WSJ is not as good but is good in its field.

Regarding the second question, California should not have a unicameral legislature. He is agnostic on the subject, trending towards suspicious.

Q3: What are your thoughts on Exchange Traded Funds (ETFs) and mutual funds?

Munger: Said he didn't know because he never looks at them. In general, he likes low cost mutual funds and thinks people do better with them than by hiring fancy managers. He doesn't know which funds are better than others because he is not investing in them. He prefers to try to do considerably better by investing in specific companies.

Q4: Question had to do with why Munger has chosen to fight a commercial real estate battle in Brentwood.

Munger: Partly because he is crazy. To the extent that he is not crazy, he has done some things in his life that he knew would be very hard. He has occasionally taken on stuff that would make his life difficult.

He felt a duty to do the right thing, regardless of whether or not it would work out for the Mungers. There is a limit to this masochistic ethos however. His life has been so favored and he is so un-humbled by disposition that maybe he needs some masochism.

Q5: Question had to do with whether or not BRK's stock is undervalued now.

Munger: It is tough to buy stocks and operating businesses. He and Warren are better investors in stocks because they own the businesses and they are better business operators because they own stocks. When they buy companies they pay quite liberal prices—like they did for Dexter Shoes. But, in the case of Dexter, they utterly failed at an easy problem. When they do buy businesses they do not buy them cheaply—however some like See's Candy worked out really well. When all of the deals are averaged out he likes what has happened because BRK owns a ton of good businesses. The future can't be like the past because the weight of BRK's net worth and assets will limit returns. Having said that, he believes that someone who owns BRK stock and does nothing but hold it will do really well.

He likes to think that the culture of BRK has made a contribution to the world. Although, he has waited for a cascade of high ranking executive followers to take only a $100,000 salary (like he does) but it hasn't come. Only the Rockefellers and Carnegies were willing to do that. Additionally, few corporations are as critical as BRK is of other business. As a result, deep down some people really don't like him. For instance, he doesn't make great friends on Wall Street when he says people there are stupid and evil. This is not the way to get ahead in corporate America.

Q6: What recommendations do you have for successfully raising a family and dealing with adversity?

Munger: When it comes to adversity, you have just to soldier through. Being too frightened leads to contempt. Coping with adversity brings opportunities. Don't panic or go crazy. People will always remember the person who could keep his or her cool. When Bobby Kennedy was dying and the entire Kennedy family was falling apart, Jackie Kennedy was the only person who kept her head. Who do we remember? We remember Jackie Kennedy.

Q7: Given the fall in the share price, does BYD's stock represent is a major opportunity right now? What percentage of his money would he put in BYD shares?

Munger: He doesn't want to tout one security—especially when he has avoided early stage companies for most of his life. BYD is a high technology company trying to make lithium batteries that do not blow up. They have 20,000 engineers to cope with these very difficult issues. He will hold his BYD stock to the bitter end because he loves the people. But, he can't say what other people should do with their money. He has very little experience in early stage venture capital (implying that the purchase of BYD shares was similar to a venture capital investment); he is investing in the company because he wants to improve his mind.

Q8: Regarding inflation, what are his thoughts given all of the money printing? Is more inflation ahead? If the US was a corporation and each dollar represented a share of stock, would he buy, sell or hold? (The questioner mentioned that the dollar has lost 95% of its value since the early 1900s)

Munger: He said it is pretty likely that we will have inflation over a 50-100 year period. But, contrary to people's fears, inflation has not halted the success of our civilization. We have had growth of 2% in GDP per person for decades despite the inflation we have had. The questioner suggested that the inflation in the pipeline would represent failure. However, failure is way worse than that. In fact, the situation the questioner described is hog heaven even though the dollar has lost 95% of its value. Charlie said he went to a hotel in Italy and paid his bill in billions. So, what the questioner described with horror is the top of success in Charlie's mind.

If every person in this room had to live with a real investment return of 0%, after tax, he thinks we all should be reasonably happy. A lot of people would not be happy though—look at Greece for example. In Greece, they don't want jobs: they want to sit on their asses as the money comes in. A job is a burden; it wastes 8 hours a day. If he were running the European Union (EU) he would not have let Greece in. He said that we should have an EU, but not for basket cases. When you get into a mess like Europe is in, you have to draw a line somewhere. In his mind, they can't let the depositors of their major banks get wiped out. They can let the shareholders of the banks fail but not the depositors. He knew that the Euro wouldn't work and at some point the EU will have to face the music.

We drew the line pretty well in this country with Lehman Brothers. But, after Lehman failed, we had to intervene to a major degree. He feels good about the way that Hank Paulson, both parties and George Bush handled the Great Recession. The massive intervention was successful. If you assume things will be really tough but you can bear it, you just smile and go on. And if the world is so tough that the Munger's fortune loses purchasing power, so what? Such great wealth may not be good for the family anyway.

Q9: In the US engineering cultures are important. Are there historical precedents of what happens to companies that the market currently thinks are deteriorating (the questioner mentioned Google, Intel and Apple)?

Munger: This is something that he does not know enough about. He does not know how you displace Google but a lot of the other companies will have competitive troubles.

Q10: Munger has been very critical of the financial activities of others. However, in his financial activities, has he added value to society?

Munger: If all he ever did was figure out what securities would go up in price and sat on his ass, then that is not much of a contribution. The only difference is that he is ashamed of it so he has added all of these other activities—like his masochism with property development in Brentwood. He then said that we may think we were at this event due to some nobility in his nature. However, in fact, hosting an event like this is nothing more than atonement.

Q11: He seems like he was very strict as a father. What is his relationship with his children now that they are older? Has he helped his children financially?

Munger: Of course he has helped them financially. Rich people who don't help their children out at all end up having children who hate them. He was lucky in a sense that he was not always rich. He probably raised his earliest children better than the later ones. Will rich children ever be as motivated as people who had to struggle? No. You won't get people to be willing to suffer and provide "wonderful" hardships for their family. Thus, the answer is that rich people should lose graciously. But, this does not include providing artificial hardships for children—it is just not practical.

Q12: Which economic entities in history were most similar to BRK? What are BYDs competitive advantages?

Munger: If you go back to 1911 and look at the top ten companies of the time, many of them are gone. The 2 main ones that remain are General Electric and Standard Oil. Of all of the big companies of today, Standard Oil stands all by itself. It succeeded because of its engineering culture and from being in the right place. Everything was working for the company. When oil was seeping out of the ground, you didn't have to be that smart. You just had to be early rich and have the ability to buy oil-rich properties. The nature of the game was that as energy supplies got shorter and shorter, oil prices went higher and higher. In fact, Paul Getty became very rich precisely because he had oil reserves that he couldn't pull out of the ground quickly enough and then, while the oil was still underground, the price appreciated enormously.

What is the Standard Oil of today? He doesn't know. There were 13 Standard Oil companies when it got broken up and they were all huge successes. He has no idea what the next Standard Oil is.

Regarding BYD, he likes the fact that they are tackling tough engineering problems. He likes that they put their heads down when they fail and keep trying. He has gotten so old that he would rather make money thinking about people he admires than dealing with other people he doesn't care as much for. Luckily, he admires BRK so he doesn't have to worry about his money.

Q13: Chuck Gillman of Boston Avenue Family Office- Would you like to see more value investors run proxy battles at under-performing companies?

Munger: Charlie said he is conflicted about this subject. He doesn't really like people who run around like vultures raising hell. However, he also doesn't like entrenched managers who are not good and who are over-indulgent. In the end, he does not want more corporate raiding though. He would rather endure the evils we already have.

Q14: How should we prioritize our time based on which stage of life we are in?

Munger: Charlie said that he did not have much advice apart from his general advice to invest in personal learning—he believes in continuous improvement. He doesn't believe that you can change your life midway. You can't be a total jerk and then be nice later in life. If you know where you want ago, you might as well get there sooner. Lifelong learning works and it is a lot fun. He is 88 years old and he is learning more about astrophysics. What could come from it? Very little—but he is really enjoying it. The good news is that he understands astrophysics better than an average 88 year old.

Q15: Will he do this event again next year? How does BRK take care of its cash? Is the company at risk to bank or counterparty failure?

Munger: Said he is glad to host the event this time but he doesn't want to continue because he thinks we need a new cult hero. So, by not hosting the event next year, he is actually trying to help us by allowing us to move on.

BRK is dependent on the modern financial/deposit systems and computer trading systems. Unfortunately, BRK has to deal with people who Warren and Charlie don't like or are whose actions elicit skepticism. For example, he doesn't like credit card companies that are pushing credit on people who will inevitably hurt themselves with credit. At one of the Wesco meetings he said that firms should only make money by selling things that are good for customers—not things that are more like gambling. Yes, he is directing these comments at our leading investment banks.

Q16: If you were a college age students and had 20 years to become an expert in a specific field, what would focus on?

Munger: He said that this is an easy question. When you are looking around for something to do as a young person, you have to select something you like doing. He has never been good at things he wasn't interested in— he is way more effective when he is interested. If god has given you a passion for drawing buildings then you have to be an architect—which is a terrible way to make money by the way. However, he has an architect friend who says he doesn't care if it is a bad way to make money. The man doesn't care because in his mind it isn't work.

A man is a prisoner of his talents. This statement is true in his life as well. He couldn't have been a ballet dancer or a professional football quarterback. Law may not have been perfect for his talents and interests but it was the next best. Unlike others, he was not willing to be ill-paid.

Q17: He once said he sold the best hour of his day to himself. What does that mean? Is Coca Cola (KO) as good today as it was 20 years ago?

Munger: When he was a lawyer, he said he spent an hour to himself in the morning and then gave the rest of the day to his clients. Most people would not admit it if they did that but he thinks it was very valuable.

KO is not as good as it was 20 years ago. Compared to the big companies that sell consumer products however, it is better. But, it is like BRK in that the company is so big that it is hard to move the needle. Think about it this way: if we have to drink 8 glasses of water a day and company can slightly improve the taste of that water, it is a cheap and easy way to get people to drink those 8 glasses of water. It is hard for competitors to knock off a cheap product with a great brand name. That may not be true with a $500 computer though. If he were investing for pension funds, there wouldn't be an account that didn't have KO in it. It doesn't mean KO will do wonders for people, but compared to other companies, he would rather own KO.

Q18: How does he plan his day?

Munger: Said he fills his duties first because he doesn't want to disappoint people. But he says no to many new opportunities—he is brutal in that way. He has an amazingly open calendar—like that of

Buffett. He likes to have the freedom to take calls from friends and family. He doesn't want to be booked like a busy dentist and this flexibility has worked for him. There is an advantage if you have a temperament that allows you to cope with problems that others can't understand. He prefers hard problems and doesn't want to be a dentist (who follows simple processes over and over).

Q19: Regarding Buffett's comments on future performance, is it unrealistic that BRK will outperform indexes slightly over a few years?

Munger: No, it is not unrealistic. If they just held big common stocks it might not work. But, with a mixture of operating business and business owners selling to them because they don't want to sell to someone else, Buffett may get his wish. However, Buffett might not get his wish to be there for 20 years to see it happen.

Q20: What is his advice regarding raising a son?

Munger: Don't preach one thing and then live another life!

Q21: Has being a cult hero limited or improved his ability to do what he wants?

Munger: It has done both. It is only peculiar people like us that he wants to impress. He is lucky because we are the only people he has ever impressed. To the extent he is known by this crowd, he thinks it is a net plus. But, he doesn't want a bigger house or more acclaim. In fact, he has outshot himself already on those fronts.

Q22: Could we get a list of the 99 mental models he uses?

Munger: The women who asked the question appraises him higher than he does himself. He can't do that!

Q23: Question had to do with the prospect of a BRK dividend.

Munger: He said that some of us will live to see a BRK dividend but he doesn't want to see it. It will mean that the company does not have great investment opportunities available any longer. He doesn't want to see what he would consider failure.

Q24: When assessing durable competitive advantages, what does he consider the most?

Munger: He and Warren only look at industries and companies that they have a core competency in. Every person has to do the same thing. You have a limited amount of time and talent and you have to allocate it smartly.

Q25: Do you see parallels between the decline of the US and that of the Roman Empire?

Munger: Of course he sees parallels. The failure rate of great empires in terms of geography is 100%. Just look at Athens and Britain today—everyone has passed the baton in due course. However, there is one sense in which these empires are still with us today. What was great about ancient Greece is with us in the world today—it has just moved. You can be confident that the US will not be the most dominant and admired country in the world forever. We may have a longer run than most– we may even have a long run ahead. But, we will eventually fall from the top.

But, the US has had a huge, constructive influence on Asia. Asia is important for the future of the world and many people there have learned from the US's experiences. Another person who has been a great instructor to the world is Lee Kwan Yew of Singapore. He helped change China. Where did Lee Kwan Yew learn his values? He was educated in England and was English speaking all of his life. As such, a lot of the culture of this room was absorbed by Singapore. If China becomes the greatest nation in the world, some of our best virtues will be a part of that country as well.

Q26: Do you see a depression in the near future due to high unemployment?

Munger: Employment conditions are bad compared to what we desire. Employment is going to be a problem for a considerable period. But, that doesn't ruin life. He was raised in the Great Depression and it did not ruin his life. A good way for us to deal with the employment problem is gumption. (Gumption is one of his favorite words that no one uses anymore.)

Q27: Is there anything he suggests that can be done to help employment?

Munger: Like Japan had in previous decades, the US has had huge new competition from places like China. This dynamic has reduced employment opportunities. These are very real issues that investors have to take into account. Going forward they have to be wiser than BRK was when it bought Dexter Shoes (and the company soon lost out to cheaper Chinese competitors). Part of the trouble is that the Asians are so talented. They were held down so long because they were stuck in a Malthusian trap—they didn't have enough to eat and now that problem has been alleviated to a large extent. These people now have been unleashed and they have great ambition and culture. We have benefited from Chinese goods being better and better and cheaper and cheaper. But, as a side consequence we have a lot of competition in terms of manufacturing.

Charlie said he is very philosophical about stuff like this. He likes that the Chinese are coming up. He likes what was achieved by Japan's success. Look where car and TV production went—it went to Korea and Japan and away from the US. He can hardly believe the modern products that are developed. For example, his dentist has had at least 4 total equipment makeovers during the years he has been going there. The equipment is so good he thinks even he could use it. The dental assistant now has the modern equivalent of miner's lamp that helps her see better. Now she is less likely to stick something into his gums rather than where she wants to.

Q28: What does he advise for concentrated investors who run pension money?

Munger: Modern consultants with their style boxes and all of the fees are not going to work worth a damn, on average. But, he believes that someone with the attitude and philosophy of the questioner will do better than average. But better than average may not be good enough for certain employers. He would never let pension funds make 8% return assumptions. With low yielding bonds and stocks, how do you come up with 8%? You come up with it because that is what you want. That is not the Munger system. In his eyes you go through life looking for pain and taking it advance. It makes you a protector of yourself and your employer.

Q29: Which is the company you love the most outside of BRK? What CEO do you admire the most?

Munger: His only other directorship position is on the board of Costco. He is on the board because it is his wish and also because many companies avoid him and wouldn't want him on their boards. He would argue that Costco is one of the most admirable firms in the world and that CEO Jim Sinegal is one of the top executives in the world. Charlie can't say enough about his admiration of Costco. But the world has figured it out and the stock sells at 25x earnings. The world should work that way—finding great places to invest. If you are comfortable with 25x earnings, slow advances, and working with great people, Costco at 25x earnings is one of the most admirable capitalistic institutions in the world. It is a total meritocracy. They pass on savings to their customers as if it were a moral duty. The company is losing money in the short term to make money in the long term. Everyone in the room should go through Costco's annual report. In fact, every time Donald Trump says something and you get discouraged, just think about Costco.

Q30: The question had to do with what books he reads and what he does if he starts a book he doesn't like.

Munger: As he starts regretting reading a book, he starts turning the page faster. But, he is not too burdened by god awful books because he either avoids them altogether or desists after a short time. He passionately read the world's great fiction when he was young. But, he gradually drifted out of it after he knew most of the tricks. He moved to non-fiction for the most part and rarely reads fiction now even for pleasure's sake.

When he was a kid he loved Sherlock Holmes. Then, later in life he read a paperback that included the total work of Arthur Conan Doyle. He found that some of the non-Sherlock Holmes stuff was just awful. The Sherlock Holmes genre was a gold mine. Conan Doyle wasn't even that good—he just stumbled into the right gold mine. However, Charlie likes the idea that he can now admit that what he once admired was not that good. He also likes to better understand how important it is to stumble on the right gold mine.

Similarly, he loves to admit it when he is a total horse's ass. Recently, his country club wanted to tear out a lot of trees at an exorbitant cost and he fought the plan. Now that the trees are gone, he sees that it was worth spending the money and that he was a horse's ass. You take the pain out of being foolish if you take pleasure in rubbing your nose in your own mistakes. It is a wonderful thing to do. You will never lack for opportunities.

Q31: How would you approach selecting an investment manager if you could not see his or her returns?

Munger: It is very hard to do. Tons of people come to BRK who are very high grade investors but picking a manager is not like shooting fish in a barrel. You don't want to find people who will only be really good if they stick in their niche. Charlie and Warren could scale and that was their advantage. He only knows of one person right now who can scale in that way. He doesn't like the manager's manager concept (funds of funds for example)—too many people and complexities. He is going to leave that selection process to Harvard—an endowment that makes a lot of asinine mistakes.

It is easy to find people to avoid but it becomes tough with admirable people. This is especially hard as the managers get bigger and hire more people. The big investment firms underperform as they get more money. But, it sure is a wonderful problem to be so rich that you need an investment manager.

Q32: Will recent and continuing disasters change the property and casualty insurance industry?

Munger: This business is continuing as it has it in the past—it has always been a mediocre business. Any business where you take in money, keep it for a while and then have to give it back much later will attract a lot of dumb people. The business has no receivables and is very attractive on paper. But, the insurance industry always goes a little crazy. Although, it is not terrible in the way finance is—where people go plum crazy. The casualty business is a very tough business and life insurance is even harder. He then said that the insurance business is currently normal, despite recent awful events.

Q33: What is your perception of how the US will become more adult?

Munger: As Dickens said, it is the best of times; it is the worst of times. For example, people have looked at the energy situation and decided to turn corn in fuel. This is an asinine idea and people are just starting to see how stupid it is. He knew it all along but couldn't do anything to stop it. He mentioned that 20% of BRK's Iowa utility's power comes from wind. Before the world could think seriously about having energy without hydrocarbons, you could be glum about human's future. But now we can be more optimistic—we are likely to have enough energy to face the depletion of certain resources. We are going to have to pay more for things like shale natural gas. But, having access to that gas is a very positive thing. We are going to take a lot of energy through the sun in the future. We are going to have a big national grid at some point. We are learning from China as China is putting in a huge grid.

Many technical problems are solvable if you have power. We will have global warming and man may have some impact on it. But, he doesn't believe that it will be that bad. There are people who like to sit around and think about how bad things will be but mankind has adapted to temperature changes in the past. It has been colder and hotter during periods of time. We now even have the power of geo-engineering. We can change the temperature of the earth if we are not happy about it. We can reflect more light if we want to. He also said that it might be a good idea to have a slightly warmer world. He doesn't see many people moving to North Dakota from Southern California. Also, there is a lot of land in Canada that could be much more productive if the world warmed a bit. He likes the work of a guy named Freeman Dyson on this subject.

Q34: Jeff Ellis of UCLA Anderson and West Coast Asset Management- Questioned about the role of the Chairman when Buffett dies. Would Bill Gates be a better Chairman than Howard Buffett?

Munger: Would not comment on whether or not one of Buffett's sons would make a good a Chairman.

Q35: Victor Liu of Causeway Capital- Does he favor public school or private school education?

Munger: Public schools are now nowhere near as good as private schools like Harvard Westlake. He wonders how much better he would have done if he would have gotten an education for Harvard Westlake instead of Omaha's public schools. But, he thinks his public school education was good enough. He thinks he would have forgotten calculus quickly in any case—it wouldn't matter when he learned it.

In the end you need to get a certain baseline education for a child. But, dragging a kid a few years ahead can be problematic. He was obnoxious enough as a kid as it was. He thinks it is worth it to push the best modern schools. He wants to see how good we can make our system. But, whether the students who graduate from these schools will have a major advantage is unknown. What he does know is that there are a lot of defective college students. Kids who come from great schools just run rings around them.

Q36: What advice does he have for judging good management?

Munger: Judging the management at a company like Iscar is easy—those people are enormously talented and wonderful. But, there aren't many managements like that and few people with the incentive of such intensity. Failure is not an option in Israel—they have no hydrocarbons and enemies everywhere. It is easy to judge great managers.

On the other hand, he knows of a company with a great culture and a great business and he and Warren admire the guy who runs the company. But, the man just made an awful acquisition. Charlie believes that you have to be willing to be disappointed by managers. All managers are going to drift. If he and Warren could be so wrong as to buy Dexter Shoes then we should not be surprised that others make acquisition mistakes. If you are not frustrated by what you see, you don't understand it.

Q37: US Bank (USB) and Wells Fargo (WFC) have done better than other banks but could get pulled down by bad actors in the industry. How can they avoid that?

Munger: No one can 100% stay away from trouble. However, companies like USB and WFC are better at avoiding the common stupidities of banking than most. BRK doesn't get to have perfect managers either. There is always a compromise—like what his wife did when she married him. They have to deal with what is available. He knows people who will not own financials because they think the banks will go crazy. Charlie knows this is not an irrational statement. But, he likes that these banks acknowledge this problem. Bankers from WFC admit that they had their heads up their asses when they made a lot of 2nd mortgage loans.

Look at the troubles that Bank of America got into. Talk about a disgrace in terms of decision making. Of course there are risks with these companies. But, manufacturing companies are not perfect either. His life expectancy is not what it used to be but he is still here relatively cheerfully. Would it be better if he were on the floor sobbing about it?

Q38: The question was about the prospects for Level 3 Communications?

Munger: He said he didn't know much about the company. People build too much fiber optic cable just like they built too many train tracks in the past. They then got the same outcome: a huge contraction. He has never looked at Level 3. He has three folders on his desk—in, out and too tough. Level 3 fits in the too tough bin.

Q39: The question was about Ben Franklin's role in his life.

Munger: Franklin said something to the effect of: "When the citizens of the world find out that they can vote themselves into money, they end of the civilization is nigh." People now act as if they need it, want it and deserve it (money and power that is). These are pathetic adults acting like children. If Franklin were alive today he would highlight this issue. Our ancestors limited this by only allowing property owners to vote but we are having trouble with it because of our voting rules. He used to ask why everyone should vote. He has always opposed mandated voting because he thinks it would actually hurt the civilization if everyone voted.

Munger's response to the applause at the end of the Q&A session: He liked the reaction he got and the great turnout as opposed to the huge turnout the dead man gets when people show up to the funeral just to make sure he is dead.