

University of Kansas Business School Students – Q&A with Warren Buffett  
Kiewit Plaza, December 2, 2005

Laptops were not allowed, so these notes are a product of the speed of my writing and my memory (egads!). They have been cross checked with other students, so while the quotes will not be exact, I believe we've captured the essence of how Buffett responded to each question.

Buffett began the session by stating that he was here to talk about what was on the students' minds. The only thing off limits was the recent Kansas/Nebraska football game (the Jayhawks beat the Cornhuskers 40-15 snapping a 36 game losing streak!).

**Q: As you get older, how do you continue to find motivation to earn outsized returns?**

**WEB:** I don't measure success by money earned or some compound rate of return. Adding more zeros to your net worth won't make you happy. In what I do, there is no endpoint; it's a journey without a destination. I've been lucky that I've had fun throughout my journey.

There's no four minute mile in finance. If my goal was to run a four minute mile, and I accomplished that goal, I'd have nothing else to work towards. With business, there will be new problems to keep things interesting, but those problems will be similar enough to the past that I can apply knowledge gained in the past.

I plan to keep going until I go ga-ga. The problem is you don't know when you've gone ga-ga; someone else has to tell you. I've told my children that all three of them have to tell me at the same time when I've lost my mind. If one of them were to do it, I'd probably end up taking that child out of the will!

**Q: A lunch with Warren Buffett recently sold for \$350,000 on eBay. How can an investor determine the value of Warren Buffett?**

**WEB:** I think the money goes towards a really good cause. Glide Memorial Church, based in San Francisco, was assigned an inexperienced minister, Cecil Williams, who was in his 20's back in the early '60s. It was a dying church, but Cecil revived it by taking in those that had hit rock-bottom. The Glide Foundation continues to provide a lot of help to those that have been marginalized by society. The organization gets a lot of support from celebrities. Cecil believed auctioning lunch with me would be a good fundraiser. The first year it went for \$25,000. Two years ago, the first year on eBay, it went for \$250,000. This year it went for \$350,000. I agree to have lunch with the winner and then they have me for the afternoon. All of the people I've met have been really interesting. The guy from the last lunch has a company that designs databases for security applications. He identified 5 of the 19 9/11 hijackers. He was so interesting that I agreed to meet him again. This time I bought him breakfast. It cut the price of lunch in half – to \$175,000!

**Q: You have a lot of influential friends. What have you learned from them?**

**WEB:** I've learned the importance of having good friends. They are smart people, so they've given me good ideas over the years, but that's not as important as having good friends. I've been on four major trips with the Gates. Each time, Bill always ensures that I have a good time. While planning a trip to China, he asked me what types of food I'd like to eat during the trip. I told him I haven't found anything I like better than what I was eating when I was five years old. He took me serious and planned ahead by sending chefs to China to teach people at the places we were going to stay how to prepare burgers and other American food. He had me playing ping pong against a 12 year old (of course she was a champion). We've also played Texas Hold'em, taken art lessons together and of course we play a lot of bridge.

Soldiers talk about war-time bonds. Those are formed from looking after each other for a number of years. I feel the same way about my friends.

As for Charlie [Munger], he of course influenced me to look at good businesses instead of cheap businesses. If I could only have the business/intelligence half of Charlie, or the personal half, I'd take the personal half hands down. Charlie and I have had a lot of fun together.

**Q: You studied under Ben Graham and give him a lot of credit for your success. However, measured in wealth created, he was much less successful than you. How do you explain that?**

**WEB:** Ben didn't care about making money. Investing was a sideline for him. He wrote plays, transcribed Greek books into English, etc. Graham wasn't playing the wealth maximization game. He was a liberal arts graduate, but was convinced to work on Wall Street to provide that liberal arts students could succeed on in the finance industry.

Graham didn't get excited about making money. I would come to him with a great investment idea, I'd say "we're going to get rich!". He didn't care (although Jerry Newman did).

He wrote books because he had an academic nature. He wanted to explain investing in a way anyone could understand. Graham wanted to develop a method that a dentist in Iowa could follow, a system that someone with no special knowledge could use and make money. He wanted to provide a quantitative approach that anyone could follow.

The three big ideas that came from Graham are all in *The Intelligent Investor*. 1) View stocks as pieces of businesses; 2) The market is a voting machine in the short term, but a weighing machine in the long term; 3) Margin of safety.

**Q: You have over \$40 billion in cash. How do you plan to invest it?**

**WEB:** We've been able to invest a lot more cash this year. \$3.4 billion was spent on the Pacific Corp. acquisition, for example. There is still a lot of competition for potential acquisitions. It's hard to find 50 cent dollars, so the question becomes whether or not it makes sense to buy 80 cent dollars. Charlie and I get antsy with \$40 billion, but there are worse problems to have. Eventually the market will change and we'll see opportunities. We have to be prepared to act.

1998 was an example. Most of the opportunity was in fixed income at the time because of what happened at Long Term Capital Management. You had to be able to disassociate with fear at the time, but I was tough. I was on vacation with the Gates at the time. We could have made \$2 billion if I was in New York instead of Yellow Stone.

**Q: You don't believe the semi-strong efficient market theory. What are your arguments against it?**

**WEB:** How can you argue for it? The market is fairly efficient. Most stock prices are appropriate. There is a huge difference between stocks being priced appropriately most of the time and all of the time. It's the difference between getting rich and staying poor. For example, Washington Post was valued by the stock market at \$100 million. You could have had an auction in the middle of the night on some island and bidders would have been swimming to it to bid \$400 million. How can you call the market efficient?

It's important to do a lot of digging to find those situations. Back in the 1950s the Moody's and S&P manuals were a good source of information. [Buffett then showed the students the actual copy of the 1951 edition of

Moody's Banks and Finance manual. He then proceeded to flip through the pages and then turned to page 1431, which listed Western Insurance Securities.] This is panning for gold. Western Insurance Securities had EPS of \$21.66 in 1949, EPS of \$29.09 in 1950. The price range in 1950 was \$3-13. I personally went to check out the company and found nothing wrong. I ran an ad in the Fort Scott Newspaper to find shares. [Buffett then flipped to page 1443]. Now I'll flip a few more pages to 1443. I was in gold territory! Here is National American Insurance. It had EPS of \$29.02 and traded in a range of \$27-28. This company was located a block and a half from where I was working at the time in Omaha. Again, I went to check it out and there was absolutely nothing wrong. Of course, a professor would say the markets are efficient so these stocks must have been priced right!

So the question is can you still do this today? [Buffett then pulled out the 2004 Korean Stock Guide compiled by Citigroup]. My broker at Citigroup told me to look through this Korean version of the Moody's guide. He said it would look just like 1951. He was right. I began flipping through the pages and found a lot of good companies trading at very low multiples. In 5-6 hours I put together a small portfolio of 20-25 stocks – about \$100 million total. One example was DaeHan Flour Mills. It has a 25% market share in wheat flour in South Korea. Book value was 206,000 Won and the company had 201,000 Won in marketable securities and was trading at 2x earnings. The market is clearly not efficient all the time. There are certain opportunities that can make you fabulously rich.

Professors have to pledge allegiance to the efficient market hypothesis or they risk getting ostracized.

### **Q: What sources of investment ideas are available today?**

**WEB:** First, you need two piles. You have to segregate businesses you can understand and reasonably predict from those you don't understand and can't reasonable predict. An example is chewing gum versus software. You also have to recognize what you can and can not know. Put everything you can't understand or that is difficult to predict in one pile. That is the too hard pile. Once you know the other pile, then its important to read a lot, learn about the industries, get background information, etc. on the companies in those piles. Read a lot of 10Ks and Qs, etc. Read about the competitors. I don't want to know the price of the stock prior to my analysis. I want to do the work and estimate a value for the stock and then compare that to the current offering price. If I know the price in advance it may influence my analysis. We're getting ready to make a \$5 billion investment and this was the process I used.

I used to handicap horse racing. The odds had to add to 100%. Sometimes there would be what in horse racing is referred to as an "overlay". We're looking for overlays in the stock market. It's like a treasure hunt.

You can increase your sources of investment ideas by widening your circle of competence. I've widened my circle over the years. I only needed to understand insurance in 1951. There were enough opportunities in that sector alone.

### **Q: How should current college graduates go about finding a job?**

**WEB:** [Buffett gave his standard reply to this question: do what you love, don't worry about the money, etc.]. Don't do something you don't believe in or work with people you don't like or trust. Most pick their job based on top pay and happenstance.

### **Q: Thoughts on giving money?**

**WEB:** It all starts with a simple question, “how do I save the most lives/\$ spent?” Gates has given \$30 billion. He’s given a lot to cure Malaria. His decision was based on that question, not whether he would have a building named after him. I think that is a terrific approach.

The estate tax is a good thing. Out of the two million that die every year, only 30,000 are affected by the estate taxes. The money has to come from somewhere.

The question is how to give. At the end? Yearly? What I could give 25 years ago would not make much of a difference. The Gates model would not have worked for me then. Now it makes more sense because I could do more.

**Q: Gold prices are at an all-time high, what are your thoughts on gold?**

**WEB:** \$50 billion worth of gold mined each year. The utility of gold does not command that much gold. In 1900, gold was trading at \$20/ounce. It was revalued in ’33 at \$35/ounce. In ’70 it traded freely at \$20. Now its at \$500 today. It offers no income, plus you have storage and insurance expenses. The S&P or Dow has done a lot better, plus it pays you dividends. Gold is a lousy long-term investment. It has to be. There simply is not that much intrinsic value. Oil and certain other commodities have much more utility. I like assets that are producing money all the time; gold just sits there.

**Q: Anheuser Busch is growing its presence in China. Is investing in American companies like AB the best way to invest internationally?**

**WEB:** Few U.S. companies have enough value coming from foreign operations. It’s a diluted way to get into a growing international market.

As for Anheuser Busch, China is a tiny plus for the company, but I’d rather they be there than not. It did not account for much of my valuation.

China is a tough place to invest. Our only direct investment was in PetroChina. I knew nothing about PetroChina five years ago, despite it having 500,000 employees. I read a report three years ago that made good sense and the company sold for one-third of other big oil companies. I would rather have those assets in the U.S., but wouldn’t want to pay 3x the price. I read their annual reports. It says right in there that they are going to pay out 40% of dividends to shareholders each year. The dividend this year was \$100 million. We only paid \$400 million investment.

I’m not comfortable investing in banks and insurance companies in China because I don’t know what is going on or what could happen there.

**Q: What is the best question you’ve ever been asked?**

**WEB:** I guess the best question I’ve ever asked is my wife to marry me. Her answer might have been her worst! [Buffett paused for a moment] Why don’t you tell me the best question you’ve ever been asked and I’ll answer it? The best questions ask what I’ve learned about life over the years. You can’t know those answers when you’re young. For both men and women, the most important decision you’ll ever make is your choice of spouse. The most important job is raising children. The first five years are very important in a child’s life. The Gates do a good job raising their children and have thought about it a lot.

**Q: How would you like to define your personal and professional legacy?**

**WEB:** For Berkshire, I'd like it to be looked at as a success that accomplished its success in an unorthodox way, i.e. the way we delegate to management; the unconventional rules. It would be tough to look back if Berkshire wasn't a success.

Personally, if Berkshire does well after I die and what is done with the money is important. I don't want Berkshire to be dependent on me. I also want the "stock checks" to benefit society. The test is also based on your children and grandchildren and how they contribute to society.

**Q: You've had a lot of financial success. How do you weed out those that want something from you because you're rich?**

**WEB:** I've had a lot of friends that I've acquired over the years, so they aren't friends necessarily because I'm wealthy. It's a tougher problem for children of wealthy families. I've never really been in that situation. I get a lot of letters, especially from prisons! He's received letters from prisoners who play a lot of bridge.

Life really is not that much different with more money. I can't change the score of the Nebraska/KU game! I still sleep the same (seven hours a night and on the same mattress you can buy at Nebraska Furniture Mart). I listen to an iPod while I'm on the treadmill just like you can. All of you live better than J.D Rockefeller did.

Right now [as college students] you are investing upfront for a future payout. You are an asset – do things to improve that asset. Adding \$100 million to that asset won't change you that much.

**Q: Should the government step in to stop the recent shenanigans in corporate America?**

**WEB:** What Spitzer did was wonderful for society. Millennium Partners just settled for \$180 million. Their reputation is now destroyed. Because of what Spitzer's done, you won't see those problems in the mutual funds and insurance in the future because of the embarrassment. Charlie always says that a few public hangings per year would help society to no end...metaphysically speaking! Bad press will go a lot further than statutes such as Sarbanes-Oxley. Spitzer may cross the line at times, but net has done a lot of good for society.

# Warren Buffett's Question and Answer Session with Harvard Business School Students

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## *Buffett's Introduction*

- Ground rules for the Q&A session
  - I'm willing to talk about anything that you're interested in – politics, business, philanthropic issues, etc. The tougher the questions, the more interesting.
  - I'll discuss anything except for what we're buying and selling. That's off limits.
- Nebraska Furniture Mart (NFM) – The Story of Rose Blumkin, the Founder of the Mart
  - When she walked out of Russia, she couldn't speak a word of English. She spent 16 years selling used clothing to pay for bringing her other family members over to the U.S. and in the process saved \$500 doing this.
  - Rose learned English from her granddaughter who came home and taught her the words she learned in elementary school.
  - When she started the Mart, she had a real estate disadvantage, a buying disadvantage, a credit disadvantage, an educational disadvantage as well as a reputation disadvantage. Despite these obstacles, she outmaneuvered and outcompeted everyone else, and built the largest furniture business in the country
  - She was smart, but she was smarter about defining her circle of competence. She knew furniture and carpet, but not many other things. She knew where she was playing with an advantage and where she wasn't, and she stuck to what she knew.
  - In 1937, she started with \$500 of paid-in capital, and now the business has \$700MM in revenues between the different stores.
  - Rose lived three blocks from the store and kept price tags on her belongings in her house because it made her feel like she was in her store, which made her more comfortable.
  - In 1983, Mrs. B was 89, and she and her four children each owned 20% of the business. Louie worked in the store and ran it. However, as long as Mrs. B was alive, she was the boss. She was worried that in the future some of the children would want to cash in and others might not.
  - Warren heard she wanted to sell her business and the sale process that ensued was remarkably simple by today's Wall Street norms:
    - Warren sent a short letter to Mrs. B and family – Berkshire has long admired your business...and proposes to purchase it.
    - Diligence Requests: Give us your tax return. Tell us you don't owe anything else against the property.
    - Final sale contract was a page and a quarter vs. the huge volume of papers used today on Wall Street for closing deals.
    - Total legal and accounting fees were \$1,400. He never tells that part of the story at law schools.
  - "Take care of thy shop and it will take care of thee." Ben Franklin – but that was Mrs. B.

- Louie, her son, went to WWII, and he and Mrs. B corresponded regularly dreaming about what they would create.
- Mrs. B didn't know debits from credits, but she knew what they were intuitively.
- If she was told dimensions of a room, she could tell you the square inches of carpet required and what it would cost.
- Warren said she was a combination of a peasant and a genius.
- Mrs. B never went to school a day in her life. Warren told her she was the only person who didn't go to kindergarten who has an honorary PhD (from NYU).
- Keys to success:
  - Keep costs down.
  - Sell what people want to buy.
  - Work hard.
- We've bought business after business like the Mart.
- Flight Safety is another example
  - Al Ueltschi started Flight Safety with only \$10K and now has \$1B of Berkshire stock.
  - Al believes in producing safer pilots. It's a passion for Al, and he built a fabulously successful business.
  - Warren met him for a hamburger and cherry coke at Skadden's offices. They had a deal in about an hour.
- Value of an HBS education: It won't hurt you to have an HBS education, but the keys to success can be learned elsewhere.
- Advice on how to do business: Find people you like and are capable, and things will work out.
- Charlie's hearing loss...or not
  - Charlie Munger, Warren's long-time partner, is going to be 82 on Jan 1<sup>st</sup> (2006). Warren was worried Charlie was losing his hearing. He asked his doctor how to test his suspicion, and his doctor recommended that he ask Charlie a question from across his office. If Charlie didn't respond, the doctor recommended that Warren ask the question again when he was halfway across the room. If this still didn't work, the doctor recommended that he stand right next to Charlie and ask the question again.
  - Warren, taking his doctor's advice, tried this. He asked Charlie, "What do you think about buying Microsoft at \$26?" Charlie did not respond. Warren then tried again from halfway across the room, but still no response. So Warren stood right next to him and asked the question again.
  - Finally, Charlie responded, "For the third time, yes."

***What do you think is your single most important attribute that has contributed to your success as an investor? Can this be learned?***

- Warren read Ben Graham's book, The Intelligent Investor, at age 19.
  - He feels lucky to have found the book.
  - Warren had been fooling around with stocks, but he didn't know how to invest. He bought his first stock at 11, and he kicks himself for not starting earlier.
  - At first, he was into technical analysis. He read anything he could about stock investing, but he didn't have a philosophy.
  - Graham's book gave him the framework for approaching stocks.
- Warren's advice was that you don't need to be a genius to do well in investing, but you do need the right temperament.

- If you have an IQ of 170, you can sell 45 points to someone else and still do well in securities.
- He said it's not clear how much of temperament is innate and how much can be learned.
- What's critical to success in investing is the ability to think independently, which is different from just being a contrarian.
- Quoting Graham, "You're neither right nor wrong because people agree with you. You are right because of your judgment."
- Be disciplined.
  - If everyone limited their investments to a punch card with 20 punches, they would all do better than they do today.
  - People get convinced that they have to be doing something in investing at all times.
  - Liquidity with stocks is an enormous plus but most people turn it into a negative.
  - Warren and Charlie have made most of (or all) of their money by being right about a business and sitting on it.
- The three most important lessons from The Intelligent Investor
  - Think of a stock as a part of a business.
    - A stock is not simply an item with a ticker symbol and past movements.
    - If you're right about the business, then you'll be right about the stock.
    - Chicken tracks in the past don't predict where chicken tracks will go next.
  - How to think about the market.
    - The market is there to serve you and not to instruct you.
    - Take advantage of the market when you disagree with what it's telling you.
    - The market is a game where thousands of companies are offered every day at various prices.
    - Graham describes the market as a manic depressive partner named Mr. Market who will buy your holdings out or will sell you additional interests every day.
    - If you look at thousands of opportunities with a crazy partner, you will have opportunities to get rich.
    - It's common for prices to change by 50% or more in a year for some securities. Huge changes in prices like this do not occur in other fields such as farming, real estate, energy, etc.
    - Graham provided him with a framework for dealing with the market.
  - Margin of safety
    - Don't buy things you think are worth \$1 for 99 cents.
    - Wait for big discrepancies between price and value.
    - You need to have the attitude that you will not play until the opportunity is really extraordinary.
    - What's important is buying a good business at a good price. You can skip the rest.

***You talk about your circle of competence and how you are careful not to step out of it. With your success over the years, have you felt the temptation to try to "expand the circle"?***

- His circle of competence does expand.
- If you are interested in the subject of business, you will be interested in learning other things related to business.
- Tom Watson senior (IBM) once said, "I'm no genius. I'm smart in spots." One can expand the number of spots over time.

- Buying See's Candy allowed him to learn more about consumer goods.
- Charlie's and Warren's circles are much wider now than in the past.
- Their largest problem is that "needle-moving" ideas have become harder to find.
- When he started, any investment in the world was an opportunity.
- Now his circle is larger, but there are fewer things within the circle that can make a difference.
- He thinks about business constantly.
- We all know that Wrigley's chewing gum will always be a great business but that doesn't mean it's a great stock.
  - Snicker's candy bar has been the #1 candy bar for 40 years. People aren't going to change. You don't experiment with stuff you put in your mouth for a 5-cent difference in price.
  - He looks for products with moats around their brands.
- Gillette has 70% of the market for razors and blades.
  - It's been 100 years since the founder came up with the product. Lots of people make razors, but haven't been able to displace Gillette as the market leader.
  - Men don't like to change how they shave. It's the only creative thing they do all day. Men don't experiment. They buy the same fashions over and over.
  - Gillette became the friend of the American male as he grew up.
  - Gillette had a low share of the business in 1939. NBC offered advertising for the whole World Series, and Gillette decided to spend their whole advertising budget on the series.
  - The Series was only 4 out of a possible 7 games so they thought they got short end of the stick. But this cemented Gillette's relationship with the male consumer, and was the beginning of their enduring competitive advantage.
  - Warren says he now counts men's faces who need a shave to fall asleep. He used to count women's legs, but that didn't help him sleep.
- See's Candy
  - Before he bought it, the only question he asked of the sellers was, "What hold does this have on consumers? Can we charge another dime without scaring off consumers?"
  - A man doesn't go home on Valentine's Day having bought a cheaper brand of candy.
  - If your sweetheart kisses you after giving her See's candy, then you don't switch brands.
  - A competitor cannot damage See's in California. They have tried, but have not been successful.
    - A billionaire tried, and named his brand after his mother. Unfortunately the guy wasn't likely to shut the business down very easily since his mother wouldn't have been happy, but this competitor still didn't displace See's.
  - Candy bars don't travel, and they are not a global product or even a national product.
    - See's has tried to sell its candy on the East Coast, but there are different regional preferences.
  - Why does Dr. Pepper have 60x the share in Dallas that it does in Boston? This doesn't make sense, but it's the reality of the soft drink market.
  - Everyone in California has something in their mind about See's.
  - Can't get RC Cola into people's minds, but they do have Coca Cola in their minds.
    - They lose a lot of money by being at Disney and the Olympics, but these are associated with happiness and reinforces the Coke brand.
    - Extra penny on a can of coke is worth \$13MM a day or \$4B a year

***In early October, the investment world lost Bill Ruane of the Sequoia Fund. Looking ahead, who do you think will be the "intelligent investors" that people will write about 50 years from now? Likewise, who are some investors that you have the highest respect for?***

- Bill and Warren took Ben's class together (Julian Robertson was also in their class).
- Bill and Warren became fast friends during Ben's seminar.
- If Warren can look at a person's 10-year record and what investments they made, he can get a pretty good understanding of their potential as an investor.
- He's often asked who the next great investor is going to be. There will be some, and they will do it like Bill did.
- Bill loved making money for other people, and he liked giving it away.
- He set up the Sequoia Fund to take care of Buffet's partners as Warren was going out of business. Bill was a terrific friend.
- If Warren dies tonight, the directors of Berkshire know who they will put in place as CEO. Lou Simpson will run the money, but the directors will need to identify someone to take over. It will be difficult.
- Gates has run money very well.
- Great money managers need to have the right temperament, be reasonably bright and be very honest.
- He doesn't have names.
- One manager he can think of gave him an idea that was like shooting fish in a barrel.
  - That guy manages money very well but he's not taking money now.

***How have unforeseen risks changed the way he thinks about investing?***

- If there were two nuclear explosions now, it would change the world in a major way and it is possible that this could occur.
- The three factors necessary to do harm are (a) intent, (b) knowledge and (c) materials.
  - Lots of people want to do harm to us (intent) and a small number have the knowledge.
  - The limiting factor in doing damage is materials and deliverability.
  - Graham Allison wrote a very good book on this.
- The number of people who want to harm us is huge.
- Who has used the atomic bomb in the past? The most prosperous country in the world. Prosperity doesn't impact intent. Intent will be there.
- A millennium ago, intent resulted in throwing rocks. Now it's much more deadly.
- We are not a better class of human beings. Psychotics are probably same percentage and now there are many more of them as the population has grown.
- The knowledge is way more widespread than it was.
- Berkshire is always prepared for something cataclysmic.
- Long Term Capital Management and many others have learned that 10 minutes of the wrong factors can undo everything you've prepared for.
- Berkshire is prepared for the stock exchange closing.
  - This happened after 1914 and for a few days after 9/11.

- There is a very high probability that a major nuclear, biological or chemical incident will happen somewhere. In fact, Warren believes it will happen somewhere. This doesn't change his investment strategy, but it might make him a little more cautious.
- Long Term Capital Management
  - The partners at LTCM believed they failed because of a six-sigma event.
  - But Warren believes it was human panic and error. The same problem that brought down LTCM caused the problems with the Northern Pacific railroad in 1903.
  - LTCM was betting on spread convergence. For instance, they would take two obligations of the U.S. government such as two 30-year bonds, one of which matured in 30 years and one which matured in 29.5 years. At the time the spread between the bonds was 30 basis points. That is not an efficient market. Their problems arose because many people were playing in the same game, and betting the spread would converge. When the music stopped, the spread went the other way.
- Efficient markets break down periodically.
  - The market is not purely mathematical.
  - People who do not protect themselves against the exchange closing or other extreme events are more exposed to risks than they realize or care to admit
- Incidentally, if Hitler hadn't been so anti-Semitic, he probably would have won.
  - His best scientists came to the US and were the reason we got the bomb.

***Has the proliferation of hedge funds, venture capital outfits and the amount of money in private equity made the job of the "intelligent investor" more complicated? Are opportunities made more scarce or plentiful because of these factors?***

- Markets everywhere follow three stages -- innovators, imitators and swarming incompetents.
- We now have \$1 trillion in hedge funds. Opportunities are discovered, people swarm in and the opportunity is competed away.
- A trillion dollars in the hands of smart people leads to a lot less opportunity.
- Huge pools of money doing the same thing Warren is doing makes it more difficult for him.
- Berkshire has an advantage in buying from people who don't want to auction off their business. Family businesses are not a piece of meat. Often a family has personal reasons to sell, but they do not want the business to leave the family. Therefore selling to Berkshire can provide a solution for them.
- Selling families have a choice. Berkshire is like the Metropolitan Museum of Art, or they can sell their businesses to a pawn shop operator. The pawn shop operator (private equity firm) will dress it up and resell it. Do you want the guy in the raincoat or do you want Warren?
- Mrs. B felt this way. Her business wasn't a piece of meat.
  - As a side story, Mrs. B quit at age 97 when she got mad at her family over how they were handling the carpet business. She then opened another store and competed with NFM/Berkshire.
  - Two years later, she called Warren and said she had made a mistake.
  - This time Warren asked for and got a 10-year non-compete. She worked until 103 and died at 104. Warren is still glad he had the non-compete even after she died.
- He made five deals this year and not one has been at an auction.
  - Two of them had higher bids from private equity shops.
  - One was Forest River (makes recreational vehicles).

- Warren received a fax about the company, and indicated his interest the next day. He asked for the audits and other figures.
  - Warren called next day after getting the documents, and offered a price.
  - The founder came to Omaha shortly thereafter, and they struck a deal in 15 minutes.
  - The business earns \$100MM pretax. Warren asked the founder what salary he wanted. He told the founder, “You name a salary that makes you feel good.” The founder thought for a minute. He said, “I looked at the proxy and I saw you make a \$100K a year. I wouldn’t want to make more than you.”
  - They’ve spoken once since then. Forest River is his baby. The founder has opened new plants, and he oversees the building of them himself.
  - It’s still his business. He mails Warren money, but it’s his business.
  - He doesn’t need Warren’s advice. What he wants to do is the same thing Warren wants to do: They both want to keep painting their own paintings.
- Berkshire will continue to be able to buy businesses like these.
  - Private equity and hedge funds will create opportunities for Berkshire. There will be another LTCM-like event.
  - LTCM
    - Warren got call on Sunday night from Eric Rosenfeld asking if he wanted to take on \$6B of arbitrage positions.
    - Larry Hillenbrand came out to see him two weeks later.
    - Warren put in a bid. He was on a trip, and said that’s why his bid didn’t go through.
  - The more venturesome other people get, the more opportunities are created.

***Do you think there will be a shake-up in the hedge fund industry, and if so, which firms will be first to go and which firms will likely survive?***

- It always seems like there is one more dance left.
- Seeing dumb people making money drives people crazy.
- It’s like Cinderella at the Ball. Everyone knows everything turns to pumpkins and mice at midnight, but they are in a room with no clocks.
- People think, “I’ll do this just a bit longer and I’ll get out just in time.”
- In the investment world, there’s no clock on the wall.
- Smart people outsmart themselves.
- At times, people knew the accounting was phony, but they thought it would hold just a bit longer. A crook will keep on cheating/lying.
- The feeling that you’ll know when the party will end is very strong.
- The day the Nasdaq peaked, Berkshire hit a low. This was the day before Berkshire’s annual report was filed. Warren wrote something like the attempt to time the market is the apple in the Garden of Eden. So much money makes it so tempting.
- Barton Biggs – very smart guy – has a new book Warren recommends.

***What are the characteristics of the firms that will survive when a big blowup occurs?***

- Berkshire will survive.
- Cannot play at the edge.
- Warren has a phobia regarding borrowed money.

- Warren might borrow through an insurance form with no due dates and no covenants, but otherwise debt is like a loaded gun.

***If we were taking your investing class, what would be the key takeaways you would want us to learn from the lesson on calculating intrinsic value? We've taken finance classes, but share your lack of confidence in the usefulness of CAPM.***

- How Warren finds investment opportunities.
  - Warren looks for opportunities that fit within his circle of competence, and he looks for good businesses.
  - Quoted Peter Lynch: “Look for a business that an idiot can run, because sooner or later one will.”
  - Warren loves good businesses at fair prices.
- Warren would like to drive a stake in the efficient market theory.
- He came out to Omaha to make money. He didn't expect anyone to tell him how to get rich. He decided the logical first step would be to read through the Moody's manuals to find ideas.
- Moody's had these four big books covering different industries and he read through every manual twice. When reading the manuals, he was looking for 7-footers.
- He also would read annual reports to look for opportunities.
- Western Insurance Securities.
  - He had never heard of the company when he came across it.
  - Earnings in 1949 were \$21.46 per share and \$29 the next year. The price range for the stock was \$3-\$13 over the last year.
  - Efficient market theorists would say there's nothing wrong with that.
  - The company was required to file insurance reports with the state so he looked at the reports and he talked to some of the company's agents.
  - He found that investors just didn't realize the potential of the company.
  - An opportunity of this size couldn't do much for his net worth now, but buying stocks at half price still works.
- Another insurance example
  - The company's stock was selling for \$28 and it had earned \$29 a share the previous year.
  - The company turned out to be one of the most profitable fire insurance companies in the U.S., and was located only a block away from Warren.
  - The manager of the operation fed his good insurance business into this one small company, which he controlled.
  - There is nothing efficient about a market in which this opportunity existed.
- Kansas City Life
  - Warren went to visit the local insurance agent and asked a series of questions.
    - Warren: Is there any better company? Agent: No
    - Warren: Do you have some of their insurance? Agent: Yes, my whole family is insured by them.
  - Warren pointed out to the agent that his company's stock was selling at 3x earnings. The agent didn't have any interest in buying stock in his company from Warren. Warren knew he shouldn't be a salesman at that point.
- Union Street Railroad
  - The company had \$70 in cash on its balance sheet, which was not fully reflected in its stock price. Warren executed a profitable trade based on this pricing discrepancy.

- Warren said he has never learned anything by reading Wall Street reports. He found out about this opportunity by reading the public documents.
- He believes all the info an investor needs is in the public documents.
- Korean stocks
  - Citicorp sent him a manual on Korean stocks.
  - Within 5 or 6 hours, and found 20 stocks selling at 2 or 3x earnings with strong balance sheets.
  - Korea rebuilt itself in a big way post-1998. Companies overbuilt their balance sheets.
  - Daehan Flour Mills – 15,000 won/year earning power. Stock was selling at 2 and change times earnings.
  - Warren’s strategy was to buy the securities of 20 companies thereby spreading his risk. Some of the companies will be run by crooks.
  - He doesn’t know any of the companies and he’s never been to Korea before. Information on these companies is available over the Internet in English.
  - Also, the won has strengthened, which was an added bonus.
  - The investment presented an opportunity to make 150% at which point the stocks would still only be selling at 7 or 8x.
  - It’s ridiculous to say there’s an efficient market.
  - They put \$100MM into this by doing very little work.
- Bob Rubin’s book is a great book

***What is your view on the strategy of shorting individual stocks?***

- Warren has done a fair amount of shorting over his lifetime, and he’s also invested in a lot of arbitrage positions.
- If an investor is smart enough to make money in shorts (100% upside and unlimited downside), he/she can probably make a lot more money on the long side.
- In shorting, management is working against you, and is usually willing to lie quarter after quarter. Investors are dealing with stock promoters who work against them.
- Shorting is just not a smart game. All of the math is for you on the long side, and all of the math is against you on the short side.
- He has had 100 short ideas, and he’s been right on most of them. But it’s still hard to make money.
- Investors should do a little of it in life to have the experience but it’s not pleasant. Investors think about their shorts much more than their longs.
- In high school, Warren described himself as a “pain in the ass”. All of his teachers owned AT&T and had most of their retirement savings in the stock. He shorted the stock and then showed them the transaction certificates to cause them a little heartburn.

***How do you separate good companies with weak capital structures or those in deep industry cycles from companies that are simply bad?***

- Great companies can get into great trouble through debt, scandal, or who knows how.
- Warren told his partners that he wanted to go beyond his limit for a single investment to invest in American Express. None of his partners left, and Warren had all his money in his fund.
- American express suffered a scandal, but consumer habits hadn’t changed. The franchise value of the company had not been damaged.

- GEICO had a similar problem. The company had a removable tumor, and he knew it would still be a great athlete after the restructuring.
- Investors will see great companies occasionally get hit by some negative event. As long as these problems are not fatal (and management teams are honest), there will be great opportunities.

### ***Getting started and establishing a reputation***

- Ohio Town
  - Some time after Warren returned to Omaha, he found a town for sale in Ohio. The government had built it, and wanted to sell it.
  - Warren went all of over Omaha to try to raise the money to purchase the town. He needed a \$150K down payment, and only had \$10K himself.
  - He wasn't able to raise the funds, and he couldn't sell the idea.
- GEICO
  - The first stock he started selling was GEICO.
  - Warren tried to sell it to insurance salesmen, which didn't work.
- He went to work for Graham in 1954. Afterwards he felt like he had all the money he needed. He had no idea he would start a partnership.
- Starting his own business
  - Warren would not tell his partners (and family) what he was doing because he didn't want the pressure that would have caused.
  - It was difficult to get started. Graham referred some investors to him, and over time he built up a track record.
  - He was having a great time with everything he did.
  - Also, he lived the same way he did then as now. We [the HBS students] live the same way he does. We drive the same sort of cars. The only difference is when he travels long distances.
- General Advice
  - We live better than Rockefeller lived. We all live better because the world is better.
  - Health is 95% of success.
  - There once was a Wall Streeter who missed two years of bonuses. To save money, he suggested to his wife that if she learned to make dinner, they could get rid of the cook. She responded, "And if you learn to make love, we can get rid of the gardener."

***In your letters you mention that stock returns approximate ROE over long periods of time, even if the entry price is apparently very high. If this is the case, why do you also say that there are many good businesses, but few at a good price?"***

- Interest rates are the yardstick everything is measured against.
- Aesop – a bird in hand is worth two in the bush. An investor needs to be sure birds are there and needs to know when he'll get them.
- If you are in your circle of competence, you can be more sure that you'll get the birds.
- If you can't be sure about getting the birds, then just sit in treasuries.
- The tough thing for Berkshire is that interest rates are so low now.
- Warren and Charlie will not drop their discount rate below a certain level (based on terribly easy money from the Fed), but will adjust it upward.

- They don't measure buying businesses against a 4.75% long bond, but they are still impacted by the 4.75% long bond.
- They are plenty conscious of interest rates.

***The charitable foundation that is set to be the main beneficiary of your personal holdings of BRK stock will instantly become the most well-funded institution in the world. What are your hopes for its impact on our society?***

- Every share Warren owns will go to charity.
- For a long time he felt society was better served by him compounding his money instead of giving it away.
- He's now thinking more about giving something away now than he used to.
- His guess is he's no longer doing society a favor by compounding.
- He has six trustees for his foundation, and he has written them a seven-page letter with his philanthropic philosophy, which is like his investing philosophy.
- He has told his trustees to do whatever they think will be best for society.
  - This includes things that governments or most foundations will not do.
  - He has told his trustees to pursue whatever paths the social benefits outweigh the costs of solving.
  - He has also told them not to worry about what others think.
  - He expects them to fail.
  - He said the focus should be on something where there's a significant chance of failure.
  - The main thing is to have high-grade, smart people who are independent thinkers. Most of trustees are women.
  - Women's issues are enormously important and underserved. Warren believes that he is the product of prejudice. Women only had four choices. Half the talent pool in the country worked in these four choices. He got the quality education he did because women were repressed. It's shocking to him that the gender inequality still goes on today.
  - He wants to tackle the outrages of society.
  - He thought it might happen at his death but it might happen sooner.
  - This could involve anything on the nuclear, chemical and biological threat that society faces.
- He likes what Bill and Melinda Gates are doing
  - They will spend a \$1B a year, and are focusing on how to save the most lives.
  - It's the most rational and best-executed foundation policy he's ever seen.
  - They have thought this through and have put their hearts and heads into this. They have great analytical minds.
  - He admires them the most.

*This talk is worth studying to learn how Buffett assess businesses. — John Chew*

**Buffett Lecture at the University of Florida School of Business October 15, 1998**

This speech was the first in a series sponsored by the Graham-Buffett Teaching Endowment, established in 1997 by a \$1 million gift from (1970 UF graduate) Mason Hawkins.

<http://Tinyurl.com/c85or>

Introduction:

The *Graham-Buffett* Course sequence is important to this college because it enables us to attract students who want this perspective on investing and managing corporations—a perspective that has been successfully employed by Mr. *Buffett*, Mr. Hawkins and before them, *Benjamin Graham*.

This perspective is quite simple but is sometimes lost in the complexity of our University analysis. The perspective is that you have to understand the underlying economics of the businesses that you invest in, work in. You have to be clear-eyed and not be swayed by the crowd or passing fancies of the moment. And you have to learn and stick to disciplined principles of business valuation.

In the long run this disciplined approach will more often than not bring success or more importantly avoid spectacular failures.

Hopefully at the *University of Florida* we can successfully convey those principles and create a program for the very best students and in time the very best employers as well.

We thank *Mr. Hawkins* for his gift (\$1 million) and share his thoughts today.

**Mason Hawkins:** He is someone I have admired tremendously for the last 30 years. In addition, he is someone each of us could pattern our lives after as a role model. It is my honor to introduce our lifetime's best long-term investor.....

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**Buffett:** (holds mike) Testing: One million \$, two million \$...three million \$.

I would like to say a few words primarily and then the highlight for me will be getting your questions. I want to talk about what is on your mind.

Your Future

I would like to talk for just one minute to the students about your future when you leave here. Because you will learn a tremendous amount about investments, you all have the ability to do well; you all have the IQ to do well. You all have the energy and initiative to do well or you wouldn't be here. Most of you will succeed in meeting your aspirations.

But in determining whether you succeed there is more to it than intellect and energy. I would like to talk just a second about that. In fact, there was a guy, *Pete Kiewit* in Omaha, who used to say, he looked for three things in hiring people: integrity, intelligence and energy. And he said if the person did not have the first two, the later two would kill him, because if they don't have integrity, you want them dumb and lazy.

We want to talk about the first two because we know you have the last two. You are all second-year MBA students, so you have gotten to know your classmates. Think for a moment that I granted you the right--you can buy 10% of one of your classmate's earnings for the rest of their lifetime. You can't pick someone with a rich father; you have to pick someone who is going to do it on his or her own merit. And I gave you an hour to think about it.

Will you give them an IQ test and pick the one with the highest IQ? I doubt it. Will you pick the one with the best grades? The most energetic? You will start looking for qualitative factors, in addition to (the quantitative) because everyone has enough brains and energy. You would probably pick the one you responded the best to, the one who has the leadership qualities, the one who is able to get other people to carry out their interests. That would be the person who is generous, honest and who gave credit to other people for their own ideas. All types of qualities. Whomever you admire the most in the class. Then I would throw in a hooker. In addition to this person you had to go short one of your classmates.

That is more fun. Who do I want to go short? You wouldn't pick the person with the lowest IQ, you would think about the person who turned you off, the person who is egotistical, who is greedy, who cuts corners, who is slightly dishonest.

As you look at those qualities on the left and right hand side, there is one interesting thing about them, it is not the ability to throw a football 60 yards, it is not the ability to run the 100 yard dash in 9.3 seconds, it is not being the best looking person in the class, they are all qualities that if you really want to have the ones on the left hand side, you can have them.

They are qualities of behavior, temperament, character that are achievable, they are not forbidden to anybody in this group. And if you look at the qualities on the right hand side the ones that turn you off in other people, there is not a quality there that you have to have. You can get rid of it. You can get rid of it a lot easier at your age than at my age, because most behaviors are habitual. The chains of habit are too light to be felt until they are too heavy to be broken. There is no question about it. I see people with these self-destructive behavior patterns at my age or even twenty years younger and they really are entrapped by them.

They go around and do things that turn off other people right and left. They don't need to be that way but by a certain point they get so they can hardly change it. But at your age you can have any habits, any patterns of behavior that you wish. It is simply a question of which you decide.

If you did this... *Ben Graham* looked around at the people he admired and *Ben Franklin* did this before him. *Ben Graham* did this in his low teens and he looked around at the people he admired and he said, "I want to be admired, so why don't I behave like them?" And he found out that there was nothing impossible about behaving like them. Similarly he did the same thing on the reverse side in terms of getting rid of those qualities. I would suggest is that if you write those qualities down and think about them a while and make them habitual, you will be the one you want to buy 10% of when you are all through. And the beauty of it is that you already own 100% of yourself and you are stuck with it. So you might as well be that person, that somebody else.

Well that is a short little sermon. So let's get on with what you are interested in. Let's start with questions.....

**Question:** What about Japan? Your thoughts about Japan?

**Buffett:** My thoughts about Japan? I am not a macro guy. Now I say to myself *Berkshire Hathaway* can borrow money in Japan for 10 years at one percent. One percent! I say gee, I took *Graham's* class 45 years ago and I have been working hard at this all my life maybe I can earn more than 1% annually, it doesn't seem impossible. I wouldn't want to get involved in currency risk, so it would have to be Yen-denominated. I would have to be in Japanese Real Estate or Japanese companies or something of the sort and all I have to do is beat one percent. That is all the money is going to cost me and I can get it for 10 years. So far I haven't found anything. It is kind of interesting. The Japanese businesses earn very low returns on equity - 4% to 5% - 6% on equity and it is very hard to earn a lot as an investor when the business you are in doesn't earn very much money.

Now some people do it. In fact, I have a friend, Walter Schloss, who worked at *Graham* at the same time I did. And it was the first way I went at stocks to buy stocks selling way below working capital. A very cheap, quantitative approach to stocks. I call it the cigar butt approach to investing. You walk down the street and you look around for a cigar butt someplace. Finally you see one and it is soggy and kind of repulsive, but there is one puff left in it. So you pick it up and the puff is free--it is a cigar butt stock. You get one free puff on it and then you throw it away and try another one. It is not elegant. But it works. Those are low return businesses.

**But time is the friend of the wonderful business; it is the enemy of the lousy business.** If you are in a lousy business for a long time, you will get a lousy result even if you buy it cheap. If you are in a wonderful business for a long time, even if you pay a little bit too much going in you will get a wonderful result if you stay in a long time.

I find very few wonderful businesses in Japan at present. They may change the culture in some way so that management gets more share holder responsive over there and stock returns are higher. At the present time you will find a lot of low return businesses and that was true even when the Japanese economy was booming. It is amazing; they had an

incredible market without incredible companies. They were incredible in terms of doing a lot of business, but they were not incredible in terms of the return on equity that they achieved and that has finally caught up with them. So we have so far done nothing there. But as long as money is 1% there, we will keep looking.

**Question: You were rumored to be one of the rescue buyers of *Long Term Capital*, what was the play there, what did you see?**

**Buffett:** The *Fortune* Magazine that has *Rupert Murdoch* on the cover. It tells the whole story of our involvement; it is kind of an interesting story. I got the really serious call about *LTCM* on a Friday afternoon that things were getting serious. I know those people most of them pretty well--most of them at *Salomon* when I was there. And the place was imploding and the FED was sending people up that weekend. Between that Friday and the following Wed. when the NY Fed, in effect, orchestrated a rescue effort but without any Federal money involved. I was quite active but I was having a terrible time reaching anybody.

We put in a bid on Wednesday morning. I talked to *Bill McDonough* at the NY Fed. We made a bid for 250 million for the net assets but we would have put in 3 and 3/4 billion on top of that. \$3 billion from *Berkshire*, \$700 mil. from *AIG* and \$300 million. from *Goldman Sachs*. And we submitted that but we put a very short time limit on that because when you are bidding on 100 billion worth of securities that are moving around, you don't want to leave a fixed price bid out there for very long.

In the end the bankers made the deal, but it was an interesting period. The whole *LTCM* is really fascinating because if you take *Larry Hillenbrand*, *Eric Rosenfeld*, *John Meriwether* and the two Nobel prize winners. If you take the 16 of them, they have about as high an IQ as any 16 people working together in one business in the country, including *Microsoft*. An incredible amount of intellect in one room. Now you combine that with the fact that those people had extensive experience in the field they were operating in. These were not a bunch of guys who had made their money selling men's clothing and all of a sudden went into the securities business. They had in aggregate, the 16, had 300 or 400 years of experience doing exactly what they were doing and then you throw in the third factor that most of them had most of their very substantial net worth's in the businesses. Hundreds and hundreds of millions of their own money up (at risk), super high intellect and working in a field that they knew. Essentially they went broke. That to me is absolutely fascinating.

If I ever write a book it will be called, Why Smart People Do Dumb Things. My partner says it should be autobiographical. But this might be an interesting illustration. They are perfectly decent guys. I respect them and they helped me out when I had problems at *Salomon*. They are not bad people at all.

But to make money they didn't have and didn't need, they risked what they did have and what they did need. That is just plain foolish; it doesn't matter what your IQ is. If you risk something that is important to you for something that is unimportant to you it just

doesn't make sense. I don't care if the odds you succeed are 99 to 1 or 1000 to 1 that you succeed. If you hand me a gun with a million chambers with one bullet in a chamber and put it up to your temple and I am paid to pull the trigger, it doesn't matter how much I would be paid. I would not pull the trigger. You can name any sum you want, but it doesn't do anything for me on the upside and I think the downside is fairly clear. Yet people do it financially very much without thinking.

There was a lousy book with a great title written by Walter Gutman—You Only Have to Get Rich Once. Now that seems pretty fundamental. If you have \$100 million at the beginning of the year and you will make 10% if you are unleveraged and 20% if you are leveraged 99 times out of a 100, what difference if at the end of the year, you have \$110 million or \$120 million? It makes no difference. If you die at the end of the year, the guy who makes up the story may make a typo, he may have said 110 even though you had a 120. You have gained nothing at all. It makes absolutely no difference. It makes no difference to your family or anybody else.

The downside, especially if you are managing other people's money, is not only losing all your money, but it is disgrace, humiliation and facing friends whose money you have lost. Yet 16 guys with very high IQs entered into that game. I think it is madness. It is produced by an over reliance to some extent on things. Those guys would tell me back at Salomon; a six *Sigma* event wouldn't touch us. But they were wrong. History does not tell you of future things happening. They had a great reliance on mathematics. They thought that the Beta of the stock told you something about the risk of the stock. It doesn't tell you a damn thing about the risk of the stock in my view.

*Sigma*'s do not tell you about the risk of going broke in my view and maybe now in their view too. But I don't like to use them as an example. The same thing in a different way could happen to any of us, where we really have a blind spot about something that is crucial, because we know a whole lot of something else. It is like *Henry Kauffman* said, "The ones who are going broke in this situation are of two types, the ones who know nothing and the ones who know everything." It is sad in a way.

I urge you. We basically never borrow money. I never borrowed money even when I had \$10,000 basically, what difference did it make. I was having fun as I went along it didn't matter whether I had \$10,000 or \$100,000 or \$1,000,000 unless I had a medical emergency come along.

I was going to do the same things when I had a little bit of money as when I had a lot of money. If you think of the difference between me and you, we wear the same clothes basically (SunTrust gives me mine), we eat similar food—we all go to *McDonald's* or better yet, *Dairy Queen*, and we live in a house that is warm in winter and cool in summer. We watch the Nebraska (football) game on big screen TV. You see it the same way I see it. We do everything the same—our lives are not that different. The only thing we do is we travel differently. What can I do that you can't do?

I get to work in a job that I love, but I have always worked at a job that I loved. I loved it just as much when I thought it was a big deal to make \$1,000. I urge you to work in jobs that you love. I think you are out of your mind if you keep taking jobs that you don't like because you think it will look good on your resume. I was with a fellow at Harvard the other day who was taking me over to talk. He was 28 and he was telling me all that he had done in life, which was terrific. And then I said, "What will you do next?" "Well," he said, "Maybe after I get my MBA I will go to work for a consulting firm because it will look good on my resume." I said, "Look, you are 28 and you have been doing all these things, you have a resume 10 times than anybody I have ever seen. Isn't that a little like saving up sex for your old age?"

There comes a time when you ought to start doing what you want. Take a job that you love. You will jump out of bed in the morning. When I first got out of *Columbia Business School*, I wanted to go to work for *Graham* immediately for nothing. He thought I was over-priced. But I kept pestering him. I sold securities for three years and I kept writing him and finally I went to work for him for a couple of years. It was a great experience. But I always worked in a job that I loved doing. You really should take a job that if you were independently wealthy that would be the job you would take. You will learn something, you will be excited about, and you will jump out of bed. You can't miss. You may try something else later on, but you will get way more out of it and I don't care what the starting salary is.

When you get out of here take a job you love, not a job you think will look good on your resume. You ought to find something you like.

If you think you will be happier getting 2x instead of 1x, you are probably making a mistake. You will get in trouble if you think making 10x or 20x will make you happier because then you will borrow money when you shouldn't or cut corners on things. It just doesn't make sense and you won't like it when you look back.

**Question: What makes a company something that you like?**

**Buffett:** I like businesses that I can understand. Let's start with that. That narrows it down by 90%. There are all types of things I don't understand, but fortunately, there is enough I do understand. You have this big wide world out there and almost every company is publicly owned. So you have all American business practically available to you. So it makes sense to go with things you can understand.

I can understand this, anyone can understand this (*Buffett* holds up a bottle of *Coca-Cola*). Since 1886, it is a simple business, but it is not an easy business—I don't want an easy business for competitors. I want a business with a moat around it. I want a very valuable castle in the middle and then I want the Duke who is in charge of that castle to be very honest and hard working and able. Then I want a moat around that castle. The moat can be various things: The moat around our auto insurance business, Geico, is low cost.

People have to buy auto insurance so everyone is going to have one auto insurance policy per car basically. I can't sell them 20, but they have to buy one. I can sell them 1. What are they going to buy it on? (based on what criteria?) They (customers) will buy based on service and cost. Most people will assume the service is identical among companies or close enough. So they will do it on cost. So I have to be a low cost producer--that is my moat. To the extent that my costs are further below the other guy, I have thrown a couple of sharks into the moat. All the time you have this wonderful castle, there are people out there who are going to attack it and try to take it away from you. I want a castle I can understand, but I want a castle with a moat around it.

### Kodak

30 years ago, *Eastman Kodak's* moat was just as wide as *Coca-Cola's* moat. I mean if you were going to take a picture of your six-month old baby and you want to look at that picture 20 years from now or 50 years from now. And you are never going to get a chance—you are not a professional photographer—so you can evaluate what is going to look good 20 or 50 years ago. What is in your mind about that photography company (*Share of Mind*) is what counts. Because they are promising you that the picture you take today is going to be terrific 20 to 50 years from now about something that is very important to you. Well, *Kodak* had that in spades 30 years ago, they owned that. They had what I call share of mind. Forget about share of market, share of mind. They had something—that little yellow box—that said *Kodak* is the best. That is priceless. They have lost some of that. They haven't lost it all.

It is not due to *George Fisher*. *George* is doing a great job, but they let that moat narrow. They let *Fuji* come and start narrowing the moat in various ways. They let them get into the Olympics and take away that special aspect that only *Kodak* was fit to photograph the Olympics. So *Fuji* gets there and immediately in people's minds, *Fuji* becomes more into parity with *Kodak*.

You haven't seen that with *Coke*; *Coke's* moat is wider now than it was 30 years ago. You can't see the moat day by day but every time the infrastructure that gets built in some country that isn't yet profitable for *Coke* that will be 20 years from now. The moat is widening a little bit. Things are, all the time, changing a little in one direction or the other. Ten years from now, you will see the difference. Our managers of the businesses we run, I have one message to them, and we want to widen the moat. We want to throw crocs, sharks and gators—I guess—into the moat to keep away competitors. That comes about through service, through quality of product, it comes about through cost, some times through patents, and/or real estate location. So that is the business I am looking for.

Now what kind of businesses am I going to find like that? Well, I am going to find them in simple products because I am not going to be able to figure what the moat is going to look like for *Oracle*, *Lotus* or *Microsoft*, ten years from now. Gates is the best businessman I have ever run into and they have a hell of a position, but I really don't know what that business is going to look like ten years from now. I certainly don't know

what his competitors will look like ten years from now. I know what the chewing business will look like ten years from now. The Internet is not going to change how we chew gum and nothing much else is going to change how we chew gum. There will be lots of new products. Is *Spearmint* or *Juicy Fruit* going to evaporate? It isn't going to happen. You give me a billion dollars and tell me to go into the chewing gum business and try to make a real dent in *Wrigley's*. I can't do it. That is how I think about businesses. I say to myself, give me a billion dollars and how much can I hurt the guy? Give me \$10 billion dollars and how much can I hurt *Coca-Cola* around the world? I can't do it. Those are good businesses.

Now give me some money and tell me to hurt somebody in some other fields, and I can figure out how to do it.

So I want a simple business, easy to understand, great economics now, honest and able management, and then I can see about in a general way where they will be ten (10) years from now. If I can't see where they will be ten years from now, I don't want to buy it. Basically, I don't want to buy any stock where if they close the NYSE tomorrow for five years, I won't be happy owning it. I buy a farm and I don't get a quote on it for five years and I am happy if the farm does OK. I buy an apartment house and don't get a quote on it for five years, I am happy if the apartment house produces the returns that I expect. People buy a stock and they look at the price next morning and they decide to see if they are doing well or not doing well. It is crazy. They are buying a piece of the business. That is what *Graham*—the most fundamental part of what he taught me.

You are not buying a stock, you are buying part ownership in a business. You will do well if the business does well, if you didn't pay a totally silly price. That is what it is all about. You ought to buy businesses you understand. Just like if you buy farms, you ought to buy farms you understand. It is not complicated.

Incidentally, by the way, in calling this *Graham-Buffett*, this is pure *Graham*. I was very fortunate. I picked up his book (The Intelligent Investor) when I was nineteen; I got interested in stocks when I was 6 or 7. I bought my first stock when I was eleven. But I was playing around with all this stuff—I had charts and volume and I was making all types of technical calculations and everything. Then I picked up a little book that said you are not just buying some little ticker symbol, that bounces around every day, you are buying part of a business. Soon as I started thinking about it that way, everything else followed. It is very simple. So we buy businesses we think we can understand. There is no one here who can't understand *Coke*..... (end of first side.)

If I was teaching a class at business school, on the final exam I would pass out the information on an Internet company and ask each student to value it. Anybody that gave me an answer, I'd flunk (Laughter).

I don't know how to do it. But people do it all the time; it is more exciting. If you look at it like you are going to the races--that is a different thing--but if you are investing.... Investing is putting out money to be sure of getting more back later at an appropriate rate.

And to do that you have to understand what you are doing at any time. You have to understand the business. You can understand some businesses but not all businesses.

**Question: You covered half of it which is trying to understand a business and buying a business. You also alluded to getting a return on the amount of capital invested in the business. How do you determine what is the proper price to pay for the business?**

**Buffett:** It is a tough thing to decide but I don't want to buy into any business I am not terribly sure of. So if I am terribly sure of it, it probably won't offer incredible returns. Why should something that is essentially a cinch to do well, offer you 40% a year? We don't have huge returns in mind, but we do have in mind not losing anything. We bought *See's Candy* in 1972, *See's Candy* was then selling 16 m. pounds of candy at a \$1.95 a pound and it was making 2 bits a pound or \$4 million pre-tax. We paid \$25 million for it—6.25 x pretax or about 10x after tax. It took no capital to speak of. When we looked at that business—basically, my partner, Charlie, and I—we needed to decide if there was some untapped pricing power there. Where that \$1.95 box of candy could sell for \$2 to \$2.25. If it could sell for \$2.25 or another \$0.30 per pound that was \$4.8 on 16 million pounds. Which on a \$25 million purchase price was fine. We never hired a consultant in our lives; our idea of consulting was to go out and buy a box of candy and eat it.

What we did know was that they had share of mind in California. There was something special. Every person in Ca. has something in mind about *See's Candy* and overwhelmingly it was favorable. They had taken a box on Valentine's Day to some girl and she had kissed him. If she slapped him, we would have no business. As long as she kisses him, that is what we want in their minds. *See's Candy* means getting kissed. If we can get that in the minds of people, we can raise prices. I bought it in 1972, and every year I have raised prices on Dec. 26<sup>th</sup>, the day after Christmas, because we sell a lot on Christmas. In fact, we will make \$60 million this year. We will make \$2 per pound on 30 million pounds. Same business, same formulas, same everything--\$60 million bucks and it still doesn't take any capital.

And we make more money 10 years from now. But of that \$60 million, we make \$55 million in the three weeks before Christmas. And our company song is: "What a friend we have in Jesus." (Laughter). It is a good business. Think about it a little. Most people do not buy boxed chocolate to consume themselves, they buy them as gifts—somebody's birthday or more likely it is a holiday. Valentine's Day is the single biggest day of the year. Christmas is the biggest season by far. Women buy for Christmas and they plan ahead and buy over a two or three week period. Men buy on Valentine's Day. They are driving home; we run ads on the Radio. Guilt, guilt, guilt—guys are veering off the highway right and left. They won't dare go home without a box of Chocolates by the time we get through with them on our radio ads. So that Valentine's Day is the biggest day.

Can you imagine going home on Valentine's Day—our *See's Candy* is now \$11 a pound thanks to my brilliance. And let's say there is candy available at \$6 a pound. Do you

really want to walk in on Valentine's Day and hand—she has all these positive images of *See's Candy* over the years—and say, “Honey, this year I took the low bid.” And hand her a box of candy. It just isn't going to work. So in a sense, there is untapped pricing power—it is not price dependent.

Think of *Disney*. *Disney* is selling Home Videos for \$16.95 or \$18.95 or whatever. All over the world—people, and we will speak particularly about Mothers in this case, have something in their mind about *Disney*. Everyone in this room, when you say *Disney*, has something in their mind about *Disney*. When I say *Universal Pictures*, if I say *20<sup>th</sup> Century Fox*, you don't have anything special in your mind. Now if I say *Disney*, you have something special in your mind. That is true around the world.

Now picture yourself with a couple of young kids, whom you want to put away for a couple of hours every day and get some peace of mind. You know if you get one video, they will watch it twenty times. So you go to the video store or wherever to buy the video. Are you going to sit there and premier 10 different videos and watch them each for an hour and a half to decide which one your kid should watch? No. Let's say there is one there for \$16.95 and the *Disney* one for \$17.95—you know if you take the *Disney* video that you are going to be OK. So you buy it. You don't have to make a quality decision on something you don't want to spend the time to do. So you can get a little bit more money if you are *Disney* and you will sell a lot more videos. It makes it a wonderful business. It makes it very tough for the other guy.

How would you try to create a brand—*Dreamworks* is trying—that competes with *Disney* around the world and replaces the concept that people have in their minds about *Disney* with something that says, *Universal Pictures*? So a mother is going to walk in and pick out a *Universal Pictures* video in preference to a *Disney*. It is not going to happen.

*Coca-Cola* is associated with people being happy around the world. Everyplace – *Disneyland*, the *World Cup*, the *Olympics*—where people are happy. Happiness and *Coke* go together. Now you give me—I don't care how much money—and tell me that I am going to do that with *RC Cola* around the world and have five billion people have a favorable image in their mind about *RC Cola*. You can't get it done. You can fool around, you can do what you want to do. You can have price discounts on weekends. But you are not going to touch it. That is what you want to have in a business. That is the moat. You want that moat to widen.

If you are *See's Candy*, you want to do everything in the world to make sure that the experience basically of giving that gift leads to a favorable reaction. It means what is in the box, it means the person who sells it to you, because all of our business is done when we are terribly busy. People come in during these weeks before Christmas, Valentine's Day and there are long lines. So at five o'clock in the afternoon some woman is selling someone the last box candy and that person has been waiting in line for maybe 20 or 30 customers. And if the salesperson smiles at that last customer, our moat has widened and if she snarls at 'em, our moat has narrowed. We can't see it, but it is going on everyday. But it is the key to it. It is the total part of the product delivery. It is having everything

associated with it say, *See's Candy* and something pleasant happening. That is what business is all about.

**Question: If I have every bought a company where the numbers told me not to. How much is quantitative and how much is qualitative?**

**Buffett:** The best buys have been when the numbers almost tell you not to. Because then you feel so strongly about the product. And not just the fact you are getting a used cigar butt cheap. Then it is compelling. I owned a windmill company at one time. Windmills are cigar butts, believe me. I bought it very cheap, I bought it at a third of working capital. And we made money out of it, but there is no repetitive money to be made on it. There is a one-time profit in something like that. And it is just not the thing to be doing. I went through that phase. I bought streetcar companies and all kinds of things. In terms of the qualitative, I probably understand the qualitative the moment I get the phone call. Almost every business we have bought has taken five or ten minutes in terms of analysis. We bought two businesses this year.

*General Re* is a \$18 billion deal. I have never been to their home office. I hope it is there. (Laughter) "There could be a few guys there saying what numbers should we send *Buffett* this month?" I could see them going once a month and saying we have \$20 billion in the bank instead of \$18 billion. I have never been there.

Before I bought *Executive Jet*, which is fractional ownership of jets, before I bought it, I had never been there. I bought my family a quarter interest in the program three years earlier. And I have seen the service and it seems to develop well. And I got the numbers. But if you don't know enough to know about the business instantly, you won't know enough in a month or in two months. You have to have sort of the background of understanding and knowing what you do or don't understand. That is the key. It is defining your circle of competence.

Everybody has got a different circle of competence. The important thing is not how big the circle is, the important thing is the size of the circle; the important thing is staying inside the circle. And if that circle only has 30 companies in it out of 1000s on the big board, as long as you know which 30 they are, you will be OK. And you should know those businesses well enough so you don't need to read lots of work. Now I did a lot of work in the earlier years just getting familiar with businesses and the way I would do that is use what *Phil Fisher* would call, the "Scuttlebutt Approach." I would go out and talk to customers, suppliers, and maybe ex-employees in some cases. Everybody. Everytime I was interested in an industry, say it was coal, I would go around and see every coal company. I would ask every CEO, "If you could only buy stock in one coal company that was not your own, which one would it be and why? You piece those things together, you learn about the business after awhile.

Funny, you get very similar answers as long as you ask about competitors. If you had a silver bullet and you could put it through the head of one competitor, which competitor and why? You will find who the best guy is in the industry. So there are a lot of things

you can learn about a business. I have done that in the past on the business I felt I could understand so I don't have to do that anymore. The nice thing about investing is that you don't have to learn anything new. You can do it if you want to, but if you learn *Wrigley's* chewing gum forty years ago, you still understand *Wrigley's* chewing gum. There are not a lot of great insights to get of the sort as you go along. So you do get a database in your head.

I had a guy, *Frank Rooney*, who ran *Melville* for many years; his father-in-law died and had owned *H.H. Brown*, a shoe company. And he put it up with *Goldman Sachs*. But he was playing golf with a friend of mine here in Florida and he mentioned it to this friend, so my friend said "Why don't you call Warren?" He called me after the match and in five minutes I basically had a deal.

But I knew Frank, and I knew the business. I sort of knew the basic economics of the shoe business, so I could buy it. Quantitatively, I have to decide what the price is. But, you know, that is either yes or no. I don't fool a lot around with negotiations. If they name a price that makes sense to me, I buy it. If they don't, I was happy the day before, so I will be happy the day after without owning it.

**Question: The Asian Crisis and how it affects a company like *Coke* that recently announced their earnings would be lower in the fourth quarter.**

**Buffett:** Well, basically I love it, but because the market for *Coca-Cola* products will grow far faster over the next twenty years internationally than it will in the United States. It will grow in the U.S. on a per capita basis. The fact that it will be a tough period for who knows—three months or three years—but it won't be tough for twenty years. People will still be going to be working productively around the world and they are going to find this is a bargain product in terms of a portion of their working day that they have to give up in order to have one of these, better yet, five of them a day like I do.

This is a product that in 1936 when I first bought 6 of those for a quarter and sold them for a nickel each. It was in a 6.5 oz bottle and you paid a two cents deposit on the bottle. That was a 6.5 oz. bottle for a nickel at that time; it is now a 12 oz. can which if you buy it on Weekends or if you buy it in bigger quantities, so much money doesn't go to packaging—you essentially can buy the 12 ozs. for not much more than 20 cents. So you are paying not much more than twice the per oz. price of 1936. This is a product that has gotten cheaper and cheaper relative to people's earning power over the years. And which people love. And in 200 countries, you have the per capita consumption use going up every year for a product that is over 100 years old that dominates the market. That is unbelievable.

One thing that people don't understand is one thing that makes this product worth 10s and 10s of billions of dollars is one simple fact about really all colas, but we will call it *Coca-Cola* for the moment. It happens to be a name that I like. **Cola has no taste memory.** You can drink one of these at 9 O'clock, 10 O'clock, 1 O'clock and 5 O'clock. The one at 5 o'clock will taste as good to you as the one you drank early in the morning,

you can't do that with Cream Soda, Root Beer, Orange, Grape. All of those things accumulate on you. Most foods and beverages accumulate; you get sick of them after a while. And if you eat See's Candy—we get these people who go to work for us at See's Candy and the first day they go crazy, but after a week they are eating the same amount as if they were buying it, because chocolate accumulates on you. There is no taste memory to Cola and that means you get people around the world who will be heavy users—who will drink five a day, or for *Diet Coke*, 7 or even 8 a day. They will never do that with other products. So you get this incredible per capita consumption. The average person in this part of the world or maybe a little north of here drinks 64 ozs. of liquid a day. You can have 64 ozs. of that be *Coke* and you will not get fed up with *Coke* if you like it to start with in the least. But if you do that with anything else; if you eat just one product all day, you will get a little sick of it after a while.

It is a huge factor. So today over 1 billion of *Coca-Cola* product servings will be sold in the world and that will grow year by year. It will grow in every country virtually, and it will grow on a per capita basis. And twenty years from now it will grow a lot faster internationally than in the U.S., so I really like that market better, because there is more growth there over time. But it will hurt them in the short term right now, but that doesn't mean anything. *Coca-Cola* went public in 1919; the stock sold for \$40 per share. The Chandler family bought the whole business for \$2,000 back in the late 1880s. So now he goes public in 1919, \$40 per share. One year later it is selling for \$19 per share. It has gone down 50% in one year. You might think it is some kind of disaster and you might think sugar prices increased and the bottlers were rebellious. And a whole bunch of things. You can always find reasons that weren't the ideal moment to buy it. Years later you would have seen the Great Depression, WW II and sugar rationing and thermonuclear weapons and the whole thing—there is always a reason.

But in the end if you had bought one share at \$40 per share and reinvested the dividends, it would be worth \$5 million now (\$40 compounding at 14.63% for 86 years!). That factor so overrides anything else. If you are right about the business you will make a lot of money. The timing part of it is very tricky thing so I don't worry about any given event if I got a wonderful business what it does next year or something of the sort. Price controls have been in this country at various times and that has fouled up even the best of businesses. I wouldn't be able to raise prices Dec 31<sup>st</sup> on See's Candy. But that doesn't make it a lousy business if that happens to happen, because you are not going to have price controls forever. We had price controls in the early 70s.

The wonderful business—you can figure what will happen, you can't figure out when it will happen. You don't want to focus too much on when but you want to focus on what. If you are right about what, you don't have to worry about when very much.

**Question: What about your business mistakes?**

**Buffett:** How much time do you have? The interesting thing about investments for me and my partner, *Charlie Munger*, the biggest mistakes have not been mistakes of commission, but of omission. They are where we knew enough about the business to do

something and where, for one reason or another, sat they're sucking out thumbs instead of doing something. And so we have passed up things where we could have made billions and billions of dollars from things we understood, forget about things we don't understand. The fact I could have made billions of dollars from *Microsoft* doesn't mean anything because I never could understand *Microsoft*. But if I can make billions out of healthcare stocks, then I should make it. And I didn't when the Clinton health care program was proposed and they all went in the tank. We should have made a ton of money out of that because I could understand it. And didn't make it.

I should have made a ton of money out of *Fannie Mae* back the mid-1980s, but I didn't do it. Those are billion dollar mistakes or multi-billion dollar mistakes that generally accepted accounting principles don't pick up. The mistakes you see. I made a mistake when I bought *US Air Preferred* some years ago. I had a lot of money around. I make mistakes when I get cash. *Charlie* tells me to go to a bar instead. Don't hang around the office. But I hang around the office and I have money in my pocket, I do something dumb. It happens every time. So I bought this thing. Nobody made me buy it. I now have an 800 number I call every time I think about buying a stock in an airline. I say, "I am *Warren* and I am an air-aholic." They try to talk me down, "Keep talking don't do anything rash." Finally I got over it. But I bought it. And it looked like we would lose all our money in it. And we came very close to losing all our money in it. You can say we deserved to lose our money it.

We bought it because it was an attractive security. But it was not in an attractive industry. I did the same thing in *Salomon*. I bought an attractive security in a business I wouldn't have bought the equity in. So you could say that is one form of mistake. Buying something because you like the terms, but you don't like the business that well. I have done that in the past and will probably do that again. The bigger mistakes are the ones of omission. Back when I had \$10,000 I put \$2,000 of it into a *Sinclair Service Station* which I lost, so the opportunity cost on that money is about \$6 billion right now--fairly big mistakes. It makes me feel good when my *Berkshire* goes down, because the cost of my *Sinclair Station* goes down too. My 20% opportunity cost. I will say this, it is better to learn from other people's mistakes as much as possible. But we don't spend any time looking back at *Berkshire*. I have a partner, *Charlie Munger*; we have been pals for forty years—never had an argument. We disagree on things a lot but we don't have arguments about it.

We never look back. We just figure there is so much to look forward to that there is no sense thinking of what we might have done. It just doesn't make any difference. You can only live life forward. You can learn something perhaps from the mistakes, but the big thing to do is to stick with the businesses you understand. So if there is a generic mistake outside your circle of competence like buying something that somebody tips you on or something of the sort. In an area you know nothing about, you should learn something from that which is to stay with what you can figure out yourself. You really want your decision making to be by looking in the mirror. Saying to yourself, "I am buying 100 shares of General Motors at \$55 because....." It is your responsibility if you are buying it. There's gotta be a reason and if you can't state the reason, you

shouldn't buy it. If it is because someone told you about it at a cocktail party, not good enough. It can't be because of the volume or a reason like the chart looks good. It has to be a reason to buy the business. That we stick to pretty carefully. That is one of the things *Ben Graham* taught me.

**Question: The current tenuous economic situation and interest rates? Where are we going?**

**Buffett:** I don't think about the macro stuff. What you really want to in investments is figure out what is important and knowable. If it is unimportant and unknowable, you forget about it. What you talk about is important but, in my view, it is not knowable. Understanding *Coca-Cola* is knowable or *Wrigley's* or *Eastman Kodak*. You can understand those businesses that are knowable. Whether it turns out to be important depends where your valuation leads you and the firm's price and all that. But we have never not bought or bought a business because of any Macro feeling of any kind because it doesn't make any difference. Let's say in 1972 when we bought *See's Candy*, I think *Nixon* put on the price controls a little bit later, but so what! We would have missed a chance to buy something for \$25 million that is producing \$60 million pre-tax now. We don't want to pass up the chance to do something intelligent because of some prediction about something we are no good on anyway. So we don't read or listen to in relation to macro factors at all. The typical investment counselor organization goes out and they bring out their economist and they trot him out and he gives you this big macro picture. And they start working from there on down. In our view that is nonsense.

If *Alan Greenspan* was on the one side of me and *Robert Rubin* on the other side and they both were whispering in my ear exactly what they were going to do the next twelve months, it wouldn't make any difference to me what I would pay for *Executive Jet* or *General Re* or anything else I do.

**Question: What is the benefit of being an out-of-towner as opposed to being on Wall Street?**

**Buffett:** I worked on Wall Street for a couple of years and I have my best friends on both coasts. I like seeing them. I get ideas when I go there. **But the best way to think about investments is to be in a room with no one else and just think.** And if that doesn't work, nothing else is going to work. The disadvantage of being in any type of market environment like Wall Street in the extreme is that you get over-stimulated. You think you have to do something every day. The *Chandler* family paid \$2,000 for this company (*Coke*). You don't have to do much else if you pick one of those. And the trick then is not to do anything else. Even not to sell at 1919, which the family did later on. So what you are looking for is some way to get one good idea a year. And then ride it to its full potential and that is very hard to do in an environment where people are shouting prices back and forth every five minutes and shoving reports in front of your nose and all that. Wall Street makes its money on activity. You make your money on inactivity.

If everyone in this room trades their portfolio around every day with every other person, you will all end up broke. And the intermediary will end up with all the money. If you all own stock in a group of average businesses and just sit here for the next 50 years, you will end up with a fair amount of money and your broker will be broke. He is like the Doctor who gets paid on how often to get you to change pills. If he gave you one pill that cures you the rest of your life, he would make one sale, one transaction and that is it. But if he can convince you that changing pills every day is the way to great health, it will be great for him and the prescriptionists. You won't be any healthier and you will be a lot worse off financially. You want to stay away from any environment that stimulates activity. And Wall Street would have the effective of doing that.

When I went back to Omaha, I would go back with a whole list of companies I wanted to check out and I would get my money's worth out of those trips, but then I would go back to Omaha and think about it.

**Question: How to evaluate *Berkshire* or *MSFT* if it does not pay dividends?**

**Buffett:** It won't pay any dividends either. That is a promise I can keep. All you get with *Berkshire*, you stick it in your safe deposit box and then every year you go down and fondle it. You take it out and then you put it back. There is enormous psychic reward in that. Don't underestimate it.

The real question is if we can retain dollar bills and turn them into more than a dollar at a decent rate. That is what we try to do. And *Charlie Munger* and I have all our money in it to do that. That is all we will get paid for doing. We won't take any options or we won't take any salaries to speak of. But that is what we are trying to do. It gets harder all the time. The more money we manage the harder it is to do that. We would do way better percentage wise with *Berkshire* if it was 1/100<sup>th</sup> the present size. It is run for its owners, but it isn't run to give them dividends because so far every dollar that we earned or could have paid out, we have turned into more than a dollar. It is worth more than a dollar to keep it. Therefore, it would be silly to pay it out. Even if everyone was tax-free that owned it. It would have been a mistake to pay dividends at *Berkshire*. Because so far the dollar bills retained have turned into more than a dollar. But there is no guarantee that happens in the future. At some point the game runs out on that. That is what the business is about. Nothing else about the business do we judge ourselves by. We don't judge it by the size of its home office building or anything the like the number of people working there. We have 12 people working at headquarters and 45,000 employees at *Berkshire*, 12 people at HQ and 3,500 sq ft. and we won't change it.

But we will judge ourselves by the performance of the company and that is the only way we will get paid. But believe me, it is a lot harder than it used to be.

**Question: What tells you when an investment has reached its full potential?**

**Buffett:** I don't buy *Coke* with the idea it will be out of gas in 10 years or 50 years. There could be something that happens by I think the chances are almost nil. So what we

really want to do is buy businesses that we would be happy to own forever. It is the same way I fell about people who buy *Berkshire*. I want people who buy *Berkshire* to plan to hold it forever. They may not for one reason or the other but I want them at the time they buy it to think they are buying a business they are going to want to own forever.

And I don't say that is the only way to buy things. It is just the group to join me because I don't want to have a changing group all the time. I measure *Berkshire* by how little activity there is in it. If I had a church and I was the preacher and half the congregation left every Sunday. I wouldn't say, "It is marvelous to have all this liquidity among my members."

Terrific turnover... I would rather go to church where all the seats are filled every Sunday by the same people. Well that is the way we look at the businesses we buy. We want to buy something virtually forever. And we can't find a lot of those. And back when I started, I had way more ideas than money so I was just constantly having to sell what was the least attractive stock in order to buy something I just discovered that looked even cheaper. But that is not our problem really now. So we hope we are buying businesses that we are just as happy holding five years from now as now. And if we ever found a huge acquisition, then maybe we would have to sell something. Maybe to make that acquisition but that would be a very pleasant problem to have.

We never buy something with a price target in mind. We never buy something at 30 saying if it goes to 40 we'll sell it or 50 or 60 or 100. We just don't do it that way. Anymore than when we buy a private business like *See's Candy* for \$25 million. We don't ever say if we ever get an offer of \$50 million for this business we will sell it. That is not the way to look at a business.

The way to look at a business is this going to keep producing more and more money over time? And if the answer to that is yes, you don't need to ask any more questions.

**Questions: How did you decide to invest in *Salomon*?**

**Buffett:** *Salomon* like I said, I went into that because it was a 9% security in 1987 in September 1987 and the Dow was up 35% and we sold a lot of stuff. And I had a lot of money around and it looked to me like we would never get to do anything, so I took an attractive security form in a business I would never buy the common stock of. I went in because of that and I think generally it is a mistake. It worked out OK finally on that. But it is not what I should have been doing. I either should have waited in which case I could have bought more *Coca-Cola* a year later or thereabouts or I should have even bought *Coke* at the prices it was selling at even though it was selling at a pretty good price at the time. So that was a mistake.

On *Long-Term Capital* that is—we have owned other businesses associated with securities over the years—One of them is arbitrage. I've done arbitrage for 45 years and Graham did it for 30 years before that. That is a business unfortunately I have to be near a phone for. I have to really run it (arbitrage operations) out of the office myself, because

it requires being more market-attuned because I don't want to do that anymore. So unless a really big arbitrage situation came along that I understood, I won't be doing much of that. But I've probably participated in about 300 arbitrage situations at least in my life maybe more. It was a good business, a perfectly good business.

*LTCM* has a bunch of positions, they have tons of positions, but the top ten are probably 90% of the money that is at risk, and I know something about those ten positions. I don't know everything about them by a long shot, but I know enough that I would feel OK at a big discount going in and we had the staying power to hold it out. We might lose money on something on that, but the odds are with us. That is a game that I understand. There are few other positions we have that are not that big because they can't get that big. But they could involve yield curve relationships or on the run/off the run governments that are just things you learn over time being around securities markets. They are not the base of our business. Probably on average, they have accounted for  $\frac{1}{2}$  -  $\frac{3}{4}$  a percentage point of our return a year. They are little pluses you get for actually having been around a long time.

### Arbitrage

One of the first arbitrages I did involved a company that offered cocoa beans in exchange for their stock. That was in 1955. I bought the stock, turned in the stock, got warehouse certificates for cocoa beans and they happen to be a different type but there was a basis differential and I sold them. That was something I was around at the time, so I learned about it. There hasn't been a cocoa deal since. 40 odd years, I have been waiting for a cocoa deal. I haven't seen it. It is there in my memory if it ever comes along. *LTCM* is that on a big scale.

### **Question: Diversification?**

**Buffett:** The question is about diversification. I have a dual answer to that. If you are not a professional investor. If your goal is not to manage money to earn a significantly better return than the world, then I believe in extreme diversification. I believe 98% - 99% who invest should extensively diversify and not trade, so that leads them to an index fund type of decision with very low costs. All they are going to do is own part of America. And they have made a decision that owning a part of America is worthwhile. I don't quarrel with that at all. That is the way they should approach it unless they want to bring an intensity to the game to make a decision and start evaluating businesses. Once you are in the businesses of evaluating businesses and you decide that you are going to bring the effort and intensity and time involved to get that job done, then I think diversification is a terrible mistake to any degree. I got asked that question the other day at *SunTrust*. *If you really know businesses, you probably shouldn't own more than six of them.*

If you can identify six wonderful businesses, that is all the diversification you need. And you will make a lot of money. And I can guarantee that going into a seventh one instead of putting more money into your first one is gotta be a terrible mistake. Very few people have gotten rich on their seventh best idea. But a lot of people have gotten rich with their

best idea. So I would say for anyone working with normal capital who really knows the businesses they have gone into, six is plenty, and I probably have half of what I like best. I don't diversify personally. All the people I've known that have done well with the exception of *Walter Schloss*, *Walter* diversifies a lot. I call him Noah, he has two of everything.

**Question: How do you distinguish the *Cokes* of the world from the *Proctor & Gambles* of this world?**

**Buffett:** Well, *P&G* is a very, very good business with strong distribution capability and lots of brand names, but if you ask me and I am going to go away for twenty years and put all my family's net worth into one business, would I rather have *P&G* or *Coke*? Actually *P&G* is more diversified among product line, but I would feel more sure of *Coke* than *P&G*. I wouldn't be unhappy if someone told me I had to own *P&G* during the twenty-year period. I mean that would be in my top 5 percent. Because they are not going to get killed, but I would feel better about the unit growth and pricing power of a *Coke* over twenty or thirty years.

Right now the pricing power might be tough, but you think a billion servings a day for a penny each or \$10 million per day. We own 8% of that, so that is \$800,000 per day for *Berkshire Hathaway*. You could get another penny out of the stuff. It doesn't seem impossible. I think it is worth a penny more. Right now it would be a mistake to try and get it in most markets. But over time, *Coke* will make more per serving than it does now. Twenty years from now I guarantee they will make more per serving, and they will be selling a whole lot more servings. I don't know how many or how much more, but I know that.

*P&G's* main products--I don't think they have the kind of dominance, and they don't have the kind of unit growth, but they are good businesses. I would not be unhappy if you told me that I had to put my family's net worth into *P&G* and that was the only stock I would own. I might prefer some other name, but there are not 100 other names I would prefer.

**Question: Would you buy *McDonald's* and go away for twenty years?**

**Buffett:** *McDonald's* has a lot of things going for it, particularly abroad again. The position abroad in many countries is stronger than it is here. It is a tougher business over time. People don't want to be eating--exception to the kids when they are giving away beanie babies or something--at *McDonald's* every day. If people drink five *Cokes* a day, they probably will drink five of them tomorrow. The fast food business is tougher than that but if you had to pick one hand to have in the fast food business, which is going to be a huge business worldwide, you would pick *McDonald's*. I mean it has the strongest position.

It doesn't win taste test with adults. It does very well with children and it does fine with adults, but it is not like it is a clear winner. And it is gotten into the game in recent years of being more price promotional--you remember the experiment a year ago or so. It has

gotten more dependent on that rather than selling the product by itself. I like the product by itself. I feel better about *Gillette* if people buy the *Mach 3* because they like the *Mach 3* than if they get a *Beanie Baby* with it. So I think fundamentally it is a stronger product if that is the case. And that is probably the case.

We own a lot of *Gillette* and you can sleep pretty well at night if you think of a couple billion men with their hair growing on their faces. It is growing all night while you sleep. Women have two legs, it is even better. So it beats counting sheep. And those are the kinds of business...(you look for). But what type of promotion am I going to put out there against *Burger King* next month or what if they sign up *Disney* and I don't get *Disney*? I like the products that stand alone absent price promotion or appeals although you can build a very good business based on that. And *McDonald's* is a terrific business. It is not as good a business as *Coke*. There really hardly are any. It is a very good business and if you bet on one company in that field bet on (*garbled*) *McDonald's*. We bought *Dairy Queen* a while back that is why I am plugging it shamelessly here.

**Question: What do I think about the utility industry?**

**Buffett:** I have thought about that a lot because you can put big money in it. I have even thought of buying the entire businesses. There is a fellow in Omaha actually that has done a little of that through *Cal Energy*. But I don't quite understand the game in terms of how it is going to develop with deregulation. I can see how it destroys a lot of value through the high cost producer once they are not protected by a monopoly territory.

I don't for sure see who benefits and how much. Obviously the guy with very low cost power or some guy has hydro-power at two cents a Kwh has a huge advantage. But how much of that he gets to keep or how extensively he can send that outside his natural territory, I haven't been able to figure that out so I really know what the Industry will look like in ten years. But it is something I think about and if I ever develop any insights that call for action, I will act on them. Because I think I can understand the attractiveness of the product. All the aspects of certainty of users need and the fact it is a bargain and all of that. I understand. I don't understand who is going to make the money in ten years. And that keeps me away.

**Question: Why do large caps outperform small caps (1998)?**

**Buffett:** We don't care if a company is large cap, small cap, middle cap, micro cap. It doesn't make any difference. The only questions that matter to us:

- Do we understand the business?
- Do we like the people running it?
- And does it sell for a price that is attractive?

From my personal standpoint running *Berkshire* now because we got, pro forma for *Gen. Re*, \$75 to \$80 billion to invest in and I only want to invest in five things, so I am really limited to very big companies. But if I were investing \$100,000, I wouldn't care whether

something was large cap or small cap or anything. I would just look for businesses I understood.

Now, I think, on balance, large cap companies as businesses have done extraordinarily well the last ten years--way better than people anticipated they would do. You really have American businesses earning close to something 20% on equity. And that is something nobody dreamed of and that is being produced by very large companies in aggregate. So you have had this huge revaluation upwards because of lower interest rates and much higher returns on capital. If America business is really a disguised bond that earns 20%, a 20% coupon it is much better than a bond with a 13% coupon. And that has happened with big companies in recent years, whether it is permanent or not is another question. I am skeptical of that. I wouldn't even think about it--except for questions of how much money we run--I wouldn't even think about the size of the business. *See's Candy* was a \$25 million business when we bought it. If I can find one now, as big as we are, I would love to buy it. It is the certainty of it that counts.

**Question: The securitization of real estate?**

**Buffett:** There has been enormous securitization of the debt too of real estate and that is one of the items right now that is really clogging up the capital markets. The mortgage back securities are just not moving, commercial, not residential mortgage backs. But I think you are directing your question at equities probably. The equities, if you leave out the corporate form, have been a lousy way to own equities. You have interjected a corporate income tax into something that people individually have been able to own with a single tax, and to have the normal corporate form you have a double taxation in there. You really don't need it and it takes too much of the return.

REITS have, in effect, created a conduit so you don't get the double taxation, but they also generally have fairly high operating expenses. If you get real estate, let's just say you can buy fairly simple types of real estate at an 8% yield, or thereabouts, and you take away close to 1% to 1.5% by the time you count stock options and everything, it is not a terribly attractive way to own real estate. Maybe the only way a guy with a \$1,000 or \$5,000 can own it but if you have \$1 million or \$10 million, you are better off owning the real estate properties yourself instead of sticking some intermediary in between who will get a sizable piece of the return for himself. So we have found very little in that field.

You will see an announcement in the next couple of weeks that may belie what I am telling you today. I don't want you to think I am double crossing you up here. But generally speaking we have seen very little in that field that gets us excited. People sometimes get very confused about--they will look at some huge land company, like *Texas Pacific Land Trust*, which has been around over 100 years and has got a couple of million acres in Texas. And they will sell 1% of their land every year and they will take that (as income? Garbled) and come up with some huge value compared to the market value. But that is nonsense if you really own the property. You can't move. You can't move 50% of the properties or 20% of the properties, it is way worse than an illiquid stock. So you get these, I think, you get some very silly valuations placed on a lot of real

estate companies by people who really don't understand what it is like to own one and try to move large quantity of properties.

REITS have behaved horribly in this market as you know and it is not at all inconceivable that they become a class that would get so unpopular that they would sell at significant discounts from what you could sell the properties for. And they could get interesting as a class and then the question is whether management would fight you in that process because they would be giving up their income stream for managing things and their interests might run counter to the shareholders on that. I have always wondered about REITS that have managements they say their assets are so wonderful, and they are so cheap and then they (management) go out and sell stock. There is a contradiction in that. They say our stock is very cheap at \$28 and then they sell a lot of stock at \$28 less an underwriting commission. There is a disconnect there. But it is a field we look at.

Charlie and I can understand real estate, and we would be open for very big transactions periodically. If there was a *LTCM* situation translated to real estate, we would be open to that, the trouble is so many other people would be too that it would unlikely go at a price that would get us really get us excited.

**Question: A down market is good for you?**

**Buffett:** I have no idea were the market is going to go. I prefer it going down. But my preferences have nothing to do with it. The market knows nothing about my feelings. That is one of the first things you have to learn about a stock. You buy 100 shares of *General Motors (GM)*. Now all of a sudden you have this feeling about *GM*. It goes down, you may be mad at it. You may say, "Well, if it just goes up for what I paid for it, my life will be wonderful again." Or if it goes up, you may say how smart you were and how you and *GM* have this love affair. You have got all these feelings. The stock doesn't know you own it.

The stock just sits there; it doesn't care what you paid or the fact that you own it. Any feeling I have about the market is not reciprocated. I mean it is the ultimate cold shoulder we are talking about here. Practically anybody in this room is probably more likely to be a net buyer of stocks over the next ten years than they are a net seller, so everyone of you should prefer lower prices. If you are a net eater of hamburger over the next ten years, you want hamburger to go down unless you are a cattle producer. If you are going to be a buyer of *Coca-Cola* and you don't own *Coke* stock, you hope the price of *Coke* goes down. You are looking for it to be on sale this weekend at your Supermarket. You want it to be down on the weekends not up on the weekends when you tend the Supermarket.

The NYSE is one big supermarket of companies. And you are going to be buying stocks, what you want to have happen? You want to have those stocks go down, way down; you will make better buys then. Later on twenty or thirty years from now when you are in a period when you are dis-saving, or when your heirs dis-save for you, then you may care about higher prices. There is Chapter 8 in *Graham's Intelligent Investor* about the attitude toward stock market fluctuations, that and Chapter 20 on the Margin of Safety

are the two most important essays ever written on investing as far as I am concerned. Because when I read Chapter 8 when I was 19, I figured out what I just said but it is obvious, but I didn't figure it out myself. It was explained to me. I probably would have gone another 100 years and still thought it was good when my stocks were going up. We want things to go down, but I have no idea what the stock market is going to do. I never do and I never will. It is not something I think about at all.

When it goes down, I look harder at what I might buy that day because I know there is more likely to be some merchandise there to use my money effectively in.

**Moderator: Ok, Warren, we will let you take one more question from the audience....**

**Buffett:** I will let you pick who get it. You can be the guy...(laughter).

**Question: What would you do to live a happier life if you could live over again?**

**Buffett:** This will sound disgusting. The question is how would I live my life over again to live a happier life? The only thing would be to select a gene pool where people lived to 120 or something where I came from.

I have been extraordinarily lucky. I mean, I use this example and I will take a minute or two because I think it is worth thinking about a little bit. Let's just assume it was 24 hours before you were born and a genie came to you and he said, "Herb, you look very promising and I have a big problem. I got to design the world in which you are going to live in. I have decided it is too tough; you design it. So you have twenty-four hours, you figure out what the social rules should be, the economic rules and the governmental rules and you and your kids and their kids will live under those rules.

You say, "I can design anything? There must be a catch?" The genie says there is a catch. You don't know if you are going to be born black or white, rich or poor, male or female, infirm or able-bodied, bright or retarded. All you know is you are going to take one ball out of a barrel with 5.8 billion (balls). You are going to participate in the ovarian lottery. And that is going to be the most important thing in your life, because that is going to control whether you are born here or in Afghanistan or whether you are born with an IQ of 130 or an IQ of 70. It is going to determine a whole lot. What type of world are you going to design?

I think it is a good way to look at social questions, because not knowing which ball you are going to get, you are going to want to design a system that is going to provide lots of goods and services because you want people on balance to live well. And you want it to produce more and more so your kids live better than you do and your grandchildren live better than their parents. But you also want a system that does produce lots of goods and services that does not leave behind a person who accidentally got the wrong ball and is not well wired for this particular system. I am ideally wired for the system I fell into here. I came out and got into something that enables me to allocate capital. Nothing so

wonderful about that. If all of us were stranded on a desert island somewhere and we were never going to get off of it, the most valuable person there would be the one who could raise the most rice over time. I can say, "I can allocate capital!" You wouldn't be very excited about that. So I have been born in the right place.

*Gates* says that if I had been born three million years ago, I would have been some animal's lunch. He says, "You can't run very fast, you can't climb trees, you can't do anything." You would just be chewed up the first day. You are lucky; you were born today. And I am. The question getting back, here is this barrel with 6.5 billion balls, everybody in the world, if you could put your ball back, and they took out at random a 100 balls and you had to pick one of those, would you put your ball back in?

Now those 100 balls you are going to get out, roughly 5 of them will be American, 95/5. So if you want to be in this country, you will only have 5 balls, half of them will be women and half men--I will let you decide how you will vote on that one. Half of them will be below average in intelligence and half above average in intelligence. Do you want to put your ball in there? Most of you will not want to put your ball back to get 100. So what you are saying is: I am in the luckiest one percent of the world right now sitting in this room--the top one percent of the world. Well, that is the way I feel. I am lucky to be born where I was because it was 50 to 1 in the United States when I was born. I have been lucky with parents, lucky with all kinds of things and lucky to be wired in a way that in a market economy, pays off like crazy for me. It doesn't pay off as well for someone who is absolutely as good a citizen as I am (by) leading Boy Scout troops, teaching Sunday School or whatever, raising fine families, but just doesn't happen to be wired in the same way that I am. So I have been extremely lucky so I would like to be lucky again.

Then the way to do it is to play out the game and do something you enjoy all your life and be associated with people you like. I only work with people I like. If I could make \$100 million dollars with a guy who causes my stomach to churn, I would say no because in way that is very much like marrying for money which is probably not a very good idea in any circumstances, but if you are already rich, it is crazy. I am not going to marry for money. I would really do almost exactly what I have done except I wouldn't have bought the *US Air*.

Thank you.

END.

# Three Lectures by Warren Buffett to Notre Dame Faculty, MBA Students and Undergraduate Students

Spring, 1991

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## Highlights

[The transcript of Buffett's lectures is 39 pages. For those of you who don't have the time to read the entire transcript, we've pulled out some of the highlights – the most interesting things Buffett said and/or the things that we've never heard him say anywhere else.]

## Keys to Investment Success

I found some strange things when I was 20 years old. I went through Moody's Bank and Finance Manual, about 1,000 pages. I went through it twice. The first time I went through, I saw a company called Western Insurance Security Company in Fort Scott, Kansas. They owned 92%, at that time, of the Western Casualty and Surety Company. Perfectly sound company. I knew people that represented them in Omaha. Earnings per share \$20, stock price \$16. (garbled) ... much more than that. I ran ads in the Fort Scott, Kansas paper to try and buy that stock – it had only 300 or 400 shareholders. It was selling at one times earnings, it had a first class [management team]...

[Tape ends here]

... Incidentally, I would say that almost everybody I know in Wall Street has had as many good ideas as I have, they just had a lot of [bad] ideas too. And I'm serious about that. I mean when I bought Western Insurance Security selling at \$16 and earning \$20 per share, I put half my net worth into it. I checked it out first – I went down to the insurance commission and got out the convention statements, I read Best's, and I did a lot of things first. But, I mean, my dad wasn't in it, I'd only had one insurance class at Columbia – but it was not beyond my capabilities to do that, and it isn't beyond your capabilities.

Now if I had some rare insight about software, or something like that – I would say that, maybe, other people couldn't do that – or biotechnology, or something. And I'm not saying that every insight that I have is an insight that somebody else could have, but there were all kinds of people that could have understood American Express Company as well as I understood it in '62. They may have been...they may have had a different temperament than I did, so that they were paralyzed by fear, or that they wanted the crowd to be with them, or something like that, but I didn't know anything about credit cards that they didn't know, or about travelers checks. Those are not hard products to understand. But what I did have was an intense interest and I was willing, when I saw something I wanted to do, to do it. And if I couldn't see something to do, to not do anything. By far, the most important quality is not how much IQ you've got. IQ is not the scarce factor. You need a reasonable amount of intelligence, but the *temperament* is 90% of it.

That's why Graham is so important. Graham's book [[The Intelligent Investor](#)] talks about the qualities of temperament you have to bring to the game, and that is the game.

### **Require a Statement Before Being Allowed to Buy a Stock**

You shouldn't buy a stock, in my view, for any other reason than the fact that you think it's selling for less than it's worth, considering all the factors about the business.

I used to tell the stock exchange people that before a person bought 100 shares of General Motors they should have to write out on a [piece of paper:] "I'm buying 100 shares of General Motors at X" and multiply that by the number of shares "and therefore General Motors is worth more than \$32 billion" or whatever it multiplies out to, "because ... [fill in the reasons]" And if they couldn't answer that question, their order wouldn't be accepted.

That test *should be applied*. I should never buy anything unless I can fill out that piece of paper. I may be wrong, but I would know the answer to that. "I'm buying Coca Cola right now, 660 million shares of stock, a little under \$50. The whole company costs me about \$32 billion dollars." Before you buy 100 shares of stock at \$48 you ought to be able to answer "I'm paying \$32 billion today for the Coca Cola Company because..." [Banging the podium for emphasis.] If you can't answer that question, you shouldn't buy it. If you *can* answer that question, and you do it a few times, you'll make a lot of money.

### **Tests of a Good Business**

A couple of fast tests about how good a business is. First question is "how long does the management have to think before they decide to raise prices?" You're looking at marvelous business when you look in the mirror and say "mirror, mirror on the wall, how much should I charge for Coke this fall?" [And the mirror replies, "More."] That's a great business. When you say, like we used to in the textile business, when you get down on your knees, call in all the priests, rabbis, and everyone else, [and say] "just another half cent a yard." Then you get up and they say "We won't pay it." It's just night and day. I mean, if you walk into a drugstore, and you say "I'd like a Hershey bar" and the man says "I don't have any Hershey bars, but I've got this unmarked chocolate bar, and it's a nickel cheaper than a Hershey bar" you just go across the street and buy a Hershey bar. *That* is a good business.

The ability to raise prices – the ability to differentiate yourself in a real way, and a real way means you can charge a different price – *that* makes a great business.

I'll try this on the students later: What's the highest price of a daily newspaper in the United States? [Pause] [This is what he said to the students later: Most of you are familiar with it. The highest priced daily newspaper in the United States, with any circulation at all, is the *Daily Racing Form*. It sells about 150,000 copies a day, and it has for about 50 years, and it's either \$2.00 or \$2.25 (they keep raising prices) and it's essential. If you're heading to the racetrack and you've got a choice between betting on your wife's birthday, and Joe's Little Green Sheet, and the *Daily Racing Form*, if you're a serious racing handicapper, you want *The Form*. You can charge \$2.00 for *The Form*, you can charge \$1.50, you can charge \$2.50 and people are going to buy it. It's like selling needles to addicts, basically. It's an essential business. It will be an essential business five or 10 years from now. You have to decide whether horse racing will be around five or 10 years from now, and you have to decide whether there's any way people will get their information about past performances of different horses from different sources. But

you've only got about two questions to answer, and if you answer them, you know the business will make a lot of money. *The Form* has huge profit margins, incidentally. Wider than any other newspaper. They charge what they want to basically. It's an easy to understand business – so easy to understand.]

There are products like that, and there are products like sheet steel. And they're night and day.

### **Agony vs. Ecstasy Businesses: Example 1**

It does make a difference what kind of a business you get associated with. For that reason I've set forth in this little handout Company A and Company E. I'm not going to tell you for the moment what these companies are. I'm going to tell you one thing about the two companies. One of the companies, to the point of where this cuts off, lost its investors more money than virtually any business in the world. The other company made its owner more money than virtually any company in the world. So one of these two companies, Company A and Company E, has made one of its owners one of the five wealthiest people in the world, while the other company made its owners appreciably poorer, probably more so than any other company to that point in time.

Now I'll tell you a little bit about these companies (we're leading up to the question of whether the business makes a difference). Company A had thousands of MBAs working for it. Company E had none. I wanted to get your attention. Company A had all kinds of employee benefit programs, stock options, pensions, the works. Company E never had stock options. Company A had thousands of patents – they probably held more patents than just about any company in the United States. Company E never invented anything. Company A's product improved dramatically in this period, Company E's product just sat.

So far, based on what I've told you, does anybody have any idea of which company was the great success, and why?

If you get to buy one of these two companies, and this is all you know, and you get to ask me one question to decide on which one to buy. If you ask me the right question, you will probably make the right decision about the company's stock, and one will make you enormously wealthy.

[Audience asks questions]

Both companies make products used every day. They started as necessities, highly useful, nothing esoteric about either one, although company A does have all these patents. There's more technology involved in company A.

[How many companies compete with either one?]

Good question, very good question. In effect, neither company had any competition. And that might differentiate in some cases.

Well, I'll tell you a little more about it. Company A is known as company A because it was in agony, and Company E, as Company E, because it was in ecstasy. Company A is American Telephone and Telegraph. I've omitted eight zeros on the left hand side, and the American

Telephone and Telegraph Company, at the end of 1979, was selling for \$10 billion less than the shareholders had either put in or left in the business. In other words, if shareholder's equity was "X" the market value was X minus \$10 billion. So the money that shareholders had put in, or left in, the business had shrunk by \$10 billion in terms of market value.

Company E, the excellent company, I left off only six zeros. And that happens to be a company called Thompson Newspapers. Thomson Newspapers, which most of you have probably never heard of, actually owns about 5% of the newspapers in the United States. But they're all small ones. And, as I said, it has no MBAs, no stock options – still doesn't – and it made its owner, Lord Thompson. He wasn't Lord Thompson when he started – he started with 1,500 bucks in North Bay, Ontario buying a little radio station but, when he got to be one of the five richest men, he became Lord Thompson.

...The telephone company, with the patents, the MBAs, the stock options, and everything else, had one problem, and that problem is illustrated by those figures on that lower left hand column. And those figures show the plant investment in the telephone business. That's \$47 billion, starting off with, growing to \$99 billion over an eight or nine year period. More and more and more money had to be tossed in, in order to make these increased earnings, going from \$2.2 billion to \$5.6 billion.

So, they got more money, but you can get more money from a savings account if you keep adding money to it every year. The progress in earnings that the telephone company made was only achievable because they kept on shoving more money into the savings account and the truth was, under the conditions of the '70s, they were not getting paid commensurate with the amount of money that they had to shove into the pot, whereas Lord Thompson, once he bought the paper in Council Bluffs, never put another dime in. They just mailed money every year. And as they got more money, he bought more newspapers. And, in fact, he said it was going to say on his tombstone that he bought newspapers in order to make more money in order to buy more newspapers [and so on].

The idea was that, essentially, he raised prices and raised earnings there every year without having to put more capital into the business.

One is a marvelous, absolutely sensational business, the other one is a terrible business. If you have a choice between going to work for a wonderful business that is not capital intensive, and one that is capital intensive, I suggest that you look at the one that is not capital intensive. I took 25 years to figure that out, incidentally.

### **Agony vs. Ecstasy Businesses: Example 2 (two Berkshire Hathaway companies)**

On the next page, I've got a couple of other businesses here. Company E is the ecstasy on the left. You can see earnings went up nicely: they went from \$4 million to \$27 million. They only employed assets of \$17 million, so that is really a wonderful business. On \$17 million they earned \$27 million, 150% on invested capital. That is a good business. The one on the right, Company A, the agony, had \$11 or \$12 million tied up, and some years made a few bucks, and in some years lost a few bucks.

Now, here again we might ask ourselves, “What differentiates these companies?” Does anybody have any idea why company E might have done so much better than Company A? Usually somebody says at this point “maybe company E was better managed than company A.” There’s only one problem with that conclusion and that is, Company E and Company A had the same manager – me!

The company E is our candy business, See’s Candies out in California. I don’t know how many of you come from the west, but it dominates the boxed chocolate business out there and the earnings went from \$4 million to \$27 million, and in the year that just ended they were about \$38 million. In other words, they mail us all the money they make every year and they keep growing, and making more money, and everybody’s very happy.

Company A was our textile business. That’s a business that took me 22 years to figure out it wasn’t very good. Well, in the textile business, we made over half of the men’s suit linings in the United States. If you wore a men’s suit, chances were that it had a Hathaway lining. And we made them during World War II, when customers couldn’t get their linings from other people. Sears Roebuck voted us “Supplier of the Year.” They were wild about us. The thing was, they wouldn’t give us another half a cent a yard because nobody had ever gone into a men’s clothing store and asked for a pin striped suit with a Hathaway lining. You just don’t see that.

As a practical matter, if some guy’s going to offer them a lining for 79 cents, [it makes no difference] who’s going to take them fishing, and supplied them during World War II, and was personal friends with the Chairman of Sears. Because we charged 79½ cents a yard, it was “no dice.”

See’s Candies, on the other hand, made something that people had an emotional attraction to, and a physical attraction you might say. We’re almost to Valentine’s Day, so can you imagine going to your wife or sweetheart, handing her a box of candy and saying “Honey, I took the low bid.”

Essentially, every year for 19 years I’ve raised the price of candy on December 26. And 19 years goes by and everyone keeps buying candy. Every *ten* years I tried to raise the price of linings a fraction of a cent, and they’d throw the linings back at me. Our linings were just as good as our candies. It was much harder to run the linings factory than it was to run the candy company. The problem is, just because a business is lousy doesn’t mean it isn’t difficult.

In the end, I like to think anyway that if Alfred P. Sloan [the legendary CEO of General Motors during its heyday] came back and tried to run the lining business, it wouldn’t make as much money as a good business. The product was undifferentiated. The candy product is differentiated. (Garbled story of Hershey Bar and Coke versus unbranded but modestly cheaper products).

You really want something where, if they don’t have it in stock, you want to go across the street to get it. Nobody cares what kind of steel goes into a car. Have you ever gone into a car dealership to buy a Cadillac and said “I’d like a Cadillac with steel that came from the South Works of US Steel.” It just doesn’t work that way, so that when General Motors buys they call in

all the steel companies and say “here’s the best price we’ve got so far, and you’ve got to decide if you want to beat their price, or have your plant sit idle.”

### **The Importance of Management: Cap Cities vs. CBS**

I put one business in here, CBS versus Cap Cities in 1957, when my friend Tom Murphy took over Cap Cities. They had a little bankrupt UHF station in Albany. They ran it out of a home for retired nuns. And it was very appropriate because they had to pray every day. At that time CBS was the largest advertising medium in the world: \$385 million in revenues whereas Cap Cities had \$900,000 in revenues. Cap Cities made \$37,000 a year and they paid my friend Murph \$12,000 a year. CBS made \$48 million pretax. Cap Cities was selling for \$5 million in the market and priced on the come, while CBS was selling for \$500 million.

Now, if you look at the two companies, Cap Cities has a market value of about \$7 billion and CBS has a market value of about \$2 billion. They were both in the same business, broadcasting. Neither one had, certainly Cap Cities didn’t have, any patents. Cap Cities didn’t have anything that CBS didn’t have. And somehow CBS took a wonderful business that was worth \$500 million, and over about 30 years they managed a little increase – peanuts – while my friend Murphy, with exactly the same business, with one little tiny UHF station in Albany, (bear in mind that CBS had the largest stations in New York City and Chicago) and my friend Murph just killed them. And you say “how can that happen?” And that’s what you ought to study in business school. You ought to study Tom Murphy at Cap Cities. And you also ought to study Bill Paley [who was the CEO] at CBS.

We have a saying around Berkshire that “all we ever want to know is where we’re going to die, so we’ll never go there.” And CBS is what you don’t want. It’s as important not to do what CBS did, and it is important to do what Cap Cities did. Cap Cities did a lot of things right, but if CBS had done the same things right, Cap Cities would have never come close.

They had all the IQ at CBS that they had at Cap Cities. They had 50 times as many people, and they were all coming to work early and going home late. They had all kinds of strategic planners, they had management consultants. They had more than I can say. Yet they *lost*. They lost to a guy that started out with a leaky rowboat, at the same time the other guy left in the QE II. By the time they got into New York, the guy in the rowboat brought in more cargo than the QE II did. There’s a real story in that. And you can understand broadcasting, so it’s really worth studying what two people in the same field did, and why one succeeded so much and one failed.

I couldn’t resist kicking in the last page: the only public offering Cap Cities ever made, back in 1957 which raised, as you can see, \$300,000. And this was when they were going to buy the station in Raleigh/Durham. The only public offering of stock the company’s every made (aside: they sold us a block of stock when they bought ABC). And if you look very carefully you’ll see that the underwriting commission – they took two firms to get this sold – the total underwriting commission was \$6,500 bucks.

### **The Perils of the “Mindless Imitation of One’s Peers”**

The last thing I want to show you, before we get onto your questions, is an ad that was run June 16, 1969, for 1,000,000 shares of American Motors. This is a reproduction from the *Wall Street*

*Journal* of that day. Now does anybody notice anything unusual about that ad?

[Guesses from audience.]

Everybody in that ad has disappeared. There are 37 investment bankers that sold that issue, plus American Motors, and they are *all* gone. Maybe that's why they call them tombstone ads. Now the average business of the New York Stock exchange in 1969 was 11 million shares. Average volume now is *fifteen* times as large. Now here's an industry whose volume has grown 15 to 1 in 20 years. Marvelous growth in the financial world. And here are 37 out of 37, and those are some of the biggest names on Wall Street, and some of them had been around the longest, and 37 out of 37 have disappeared. And that's why I say you ought to think about [the long-term durability of a business?] because these people obviously didn't.

These were run by people with high IQs, by people that worked ungodly hard. They were people that had an intense interest in success. They worked long hours. They *all* thought they were going to be leaders on Wall Street at some point, and they all went around, incidentally, giving advice to other companies about how to run their business. That's sort of interesting.

You go to Wall Street today, and there's some company the guy hadn't heard of two weeks before and he's trying to sell you. He will lay out this computer run of the next 10 years, yet he doesn't have the faintest idea of what his own business is going to earn next week!

Here are a group of 37. And the question is, how can you get a result like that? That is not a result that you get by chance. How can people who are bright, who work hard, who have their own money in the business – these are not a bunch of absentee owners – how can they get such a bad result? And I suggest that's a good thing to think about before you get a job and go out into the world.

I would say that if you had to pick one thing that did it more than anything else, it's the mindless imitation of one's peers that produced this result. Whatever the other guy did, the other 36 were like a bunch of lemmings in terms of following. That's what's gotten all the big banks in trouble for the past 15 years. Every time somebody big does something dumb, other people can hardly wait to copy it. If you do nothing else when you get out of here, do things *only* when they make sense to you. You ought to be able to write "I am going to work for General Motors because ... "I am buying 100 shares of Coca Coals stock because..." And if you can't write an intelligent answer to those questions, don't do it.

I proposed this to the stock exchange some years ago: that everybody be able to write out "I am buying 100 shares of Coca Cola Company, market value \$32 billion, because ...." and they wouldn't take your order until you filled that thing out.

I find this very useful when I write my annual report. I learn while I think when I write it out. Some of the things I think I think, I find don't make any sense when I start trying to write them down and explain them to people. You ought to be able to explain why you're taking the job you're taking, why you're making the investment you're making, or whatever it may be. And if it can't stand applying pencil to paper, you'd better think it through some more.

People in that ad did a lot of things that could not have stood that test. Some *major* bankers in the United States did a lot of things that could not meet that test. One of the bankers in the United States, who's in plenty of trouble now, bragged a few years ago he never made a loan. And, from the way things are starting to look, he's never going to collect on one either.

You should not be running one the major banks in the United States without having made loans. I mean, you learn about human nature, if nothing else, when you make loans.

### **The Perils of Leverage**

The question is whether LBOs and junk bonds and so on have hurt the country in some fundamental way in terms of its competitiveness vis-à-vis the world. I wouldn't go that far, but I think on balance it's been a huge minus on the financial scene. Extreme leverage has been, generally speaking, a net minus. The analogy has been made (and there's just enough truth to it to get you in trouble) that in buying some company with enormous amounts of debt, that it's somewhat like driving a car down the road and placing a dagger on the steering wheel pointed at your heart. If you do that, you will be a better driver – that I can assure you. You will drive with unusual care. You also, someday, will hit a small pothole, or a piece of ice, and you will end up gasping. You will have fewer accidents, but when they come along, they'll be fatal. Essentially, that's what some of corporate America did in the last 10 years. And it was motivated by huge fees. And it was motivated by greed.

The most extreme case I saw was a television station. About three years ago, a television station in Tampa sold for an amount where, when they had to borrow the money, the interest amounted to more than the total sales of the station. If everybody donated their labor, if they donated their programming, if they donated their utilities, they still wouldn't have enough to pay the interest. They went crazy. And you can buy those bonds at 15 cents on the dollar. Charlie Keating's enterprise [Lincoln Savings and Loan Association in California, which became the nation's largest thrift failure] had a bunch of them too. There's a lot of crazy stuff that went on in the last five or six years. The fees on that deal, they paid \$365 million for the station, they borrowed \$385 million and you can guess where the extra money went. It went into the pockets of the people who put the deal together.

### **Donald Trump and the Perils of Leverage**

Where did Donald Trump go wrong? The big problem with Donald Trump was he never went right. He basically overpaid for properties, but he got people to lend him the money. He was terrific at borrowing money. If you look at his assets, and what he paid for them, and what he borrowed to get them, there was never any real equity there. He owes, perhaps, \$3.5 billion now, and, if you had to pick a figure as to the value of the assets, it might be more like \$2.5 billion. He's a billion in the hole, which is a lot better than being \$100 in the hole because if you're \$100 in the hole, they come and take the TV set. If you're a billion in the hole, they say "hang in there Donald."

It's interesting why smart people go astray. That's one of the most interesting things in business. I've seen all sorts of people with terrific IQs that end up flopping in Wall Street or business because they beat themselves. They have 500 horsepower engines, and get 50 horsepower out of

them. Or, worse than that, they have their foot on the brake and the accelerator at the same time. They really manage to screw themselves up.

... I would suggest that the big successes I've met had a fair amount of Ben Franklin in them. And Donald Trump did not.

### **Life Tends to Snap You at Your Weakest Link**

One of the things you will find, which is interesting and people don't think of it enough, with most businesses and with most individuals, life tends to snap you at your weakest link. So it isn't the strongest link you're looking for among the individuals in the room. It isn't even the average strength of the chain. It's the weakest link that causes the problem.

It may be alcohol, it may be gambling, it may be a lot of things, it may be nothing, which is terrific. But it is a real weakest link problem.

When I look at our managers, I'm not trying to look at the guy who wakes up at night and says "E = MC<sup>2</sup>" or something. I am looking for people that function very, very well. And that means not having any weak links. The two biggest weak links in my experience: I've seen more people fail because of liquor and leverage – leverage being borrowed money. Donald Trump failed because of leverage. He simply got infatuated with how much money he could borrow, and he did not give enough thought to how much money he could pay back.

### **Keys to Avoiding Trouble and Leading a Happy Life**

You really don't need leverage in this world much. If you're smart, you're going to make a lot of money without borrowing. I've never borrowed a significant amount of money in my life. Never. Never will. I've got no interest in it. The other reason is I never thought I would be way happier when I had 2X instead of X. You ought to have a good time all the time as you go along. If you say "I'm taking this job – I don't really like this job but in three years it will lead to this," forget it. Find one you like right now.

# Full Transcripts

## Lecture to Faculty

Thank you. When you asked me what I did, in this year's annual report I tried to describe what I do...

[Told Beemer the Clown story; excerpt from 1990 Berkshire Hathaway [annual letter](#):

Much of the extra value that exists in our businesses has been created by the managers now running them. Charlie and I feel free to brag about this group because we had nothing to do with developing the skills they possess: These superstars just came that way. Our job is merely to identify talented managers and provide an environment in which they can do their stuff. Having done it, they send their cash to headquarters and we face our only other task: the intelligent deployment of these funds.

My own role in operations may best be illustrated by a small tale concerning my granddaughter, Emily, and her fourth birthday party last fall. Attending were other children, adoring relatives, and Beemer the Clown, a local entertainer who includes magic tricks in his act.

Beginning these, Beemer asked Emily to help him by waving a "magic wand" over "the box of wonders." Green handkerchiefs went into the box, Emily waved the wand, and Beemer removed blue ones. Loose handkerchiefs went in and, upon a magisterial wave by Emily, emerged knotted. After four such transformations, each more amazing than its predecessor, Emily was unable to contain herself. Her face aglow, she exulted: "Gee, I'm really good at this."

And that sums up my contribution to the performance of Berkshire's business magicians - the Blumkins, the Friedman family, Mike Goldberg, the Heldmans, Chuck Huggins, Stan Lipsey and Ralph Schey. They deserve your applause.]

We've never had a meeting of our managers. The fellow that runs the candy company we bought 19 years ago [See's Candies], last year came to Omaha because he and his wife wanted to see what the annual meeting was like, but he'd never come to Omaha [before that]. We've never had a meeting with his board. We moved the company's headquarters from Los Angeles to San Francisco because his wife liked living in San Francisco better than Los Angeles. We adapt our operations to the people that run our businesses.

We've got a uniform company in Cincinnati, Fechheimers. Does about \$100 million. Bought it about five years ago. A fellow read the annual report where I list what I'm looking for. I run an ad in the annual report (I believe in advertising) and this fellow walked in and said "I fit those parameters, and the business does" and we made a deal with him. I've never visited Cincinnati. I've not seen that plant. It may be a [hoax] - for all I know, he makes up these little reports every five (garbled). But he sends me cash, and I like that.

So it's a very peculiar operation. I bought a business eight years ago from an 89-year-old woman who started with \$500, never put in another dime, and it was making about \$12 million before taxes (about \$18 million now). She doesn't know what accruals are, she doesn't know any of that sort of thing. She got mad at her grandsons, who work at the company, a few years ago, so she quit and went into competition with us. This taught me that the next time I buy a business from an 89-year-old woman, I'm getting a non-compete agreement. This woman now runs another successful business.

She's a marvelous woman. She walked out of Russia. She landed in Seattle with a tag around her neck. She couldn't speak a word of English. Fort Dodge, Iowa was where her relatives were. She got to Fort Dodge about 1920 or 1919, and they didn't have a penny. She brought over seven siblings, as well as her mother and father, and that took her eight or 10 years, sending \$50 bucks at a time. She made it selling used clothing. She started this company in 1937 with \$500. She was boycotted by most of the suppliers, the main carpet companies in town. They took her into court on violation of fair trade laws. When she got before the judge, Judge Chase, she said "Judge, I paid \$3 a yard for this. Brandeis (a carpet store) paid \$3 too. They sell it for \$6.99. I sell it for \$3.99. Tell me how much you want me to rob people. If you tell me to rob them \$1 a yard, I'll charge them \$4.99." The newspaper picks up all this and the judge comes in and buys \$1,400 worth of carpet. She beat them in court four times and every time she killed them.

This company is now the largest home furnishings store, by a factor of 2 to 1, over any home furnishings store in the United States. It does \$160 million from one location. That one store makes about \$18 million pretax. It has a 500,000 square foot warehouse (garbled).

That woman, who got an honorary degree from NYU business school about five or six years ago (garbled). You cannot beat her record. If you tell her this room is 38 by 16, she will tell you how many square yards it is, just like that. And she's 97. She'll tell you how many yards it is at \$5.99, the extension, and she'll have the sales tax, and she'll knock off something if you're a nice fresh face. And that's it. She can do it all as fast as I've said that. She sold me the business in 30 seconds. She talked to me and told me how much she'd wanted. She'd never had an audit. I didn't need an audit. Her word was better than the Bank of England.

We make all our deals that way. Our total legal and accounting fees on that deal, which was a \$60 million deal, we had to file a 10Q with the SEC, we had to file a Hart-Scott-Rodino filing, our total legal and accounting fee came to \$1,400 bucks. All on one page. There's a mark where her name is. It says "Mrs. B on behalf of herself and her children." She only owned 20% of the business. She made her mark, and the deal was cut.

All our deals are done like that. We've made all our deals, essentially, on the first contact. We never get warranties, we never get anything.

These people are rich, and we have to figure out if they're the kind of people to keep working after they've sold out. We have to decide if they're working because they love the business, or because they love money. And, if they love money, they're not of any use to us because I can't give them enough money after they've got all the money [from selling us] their business.

They've got to love the business. I would say that if we do anything very well at Berkshire, it's spotting the kind of people that, after they are very rich, will work even harder. We get no budgets from them. We have one board of directors meeting a year, which follows the shareholders meeting. No one has to come in. All they have to do is run the businesses. And we've got a bunch of those now.

They mail me the money – that's the second part of their job. And it's my job to allocate capital. They can do whatever makes sense in the candy business, or the newspaper business, but they don't have to go out and do a bunch of foolish things. We like businesses that generate cash. Sometimes we have something to do with it, sometimes we don't. We prefer to buy businesses with it but if we can't buy businesses with it, we buy pieces of businesses called stocks.

Our biggest holdings: we own 7% of the Coca Cola Company, worth about \$2 billion. Your Chairman here [referring to the President of Coca Cola, Don Keough, who was also Chairman of Notre Dame's board] used to live across the street from me in Omaha 30 years ago when he was a salesman for Butternut Coffee. He had six kids, making \$200 bucks a week, and starving to death. He was telling at lunch how he went into his boss one day, and told him about the six kids, about the parochial school, paying him \$200 bucks a week and "it just ain't easy pal", and while he was doing this his boss, Paul Gallagher [the owner of Butternut Coffee], reached into his desk and pulled out a scissors and starting cutting strands off his fraying shirt. He walked away. Fortunately, things have improved some.

We have 7% of Coke. There are 660 million eight ounce servings of Coca Cola products being served around the world today, so in effect, we've got a 45 million soft drink business with our 7%. We think of businesses that way. I say to myself "just increase the price a penny and that's another \$450,000 a day for Berkshire." I mean, it's a nice sort of thing. When I go to bed at night I figure that by the time I wake up 200 million Cokes will have been consumed. We've got some Gillette too, and every night I think about two billion plus men's hair growing and four billion women's legs with hair. It goes all night when I sleep.

So we buy businesses I can understand, whether all of them or small parts of them. We never buy anything that I don't think I can understand. I may be wrong about whether I understand it or not, but we've never owned a share of a technology company. There's all kinds of businesses I don't understand. I don't worry about that. Why should I (garbled). You mentioned Cities Service Preferred, I didn't understand that very well when I bought it. Ever since I met Ben Graham, I was 19, I read his book when I was 18, it made nothing but sense to me. Buy pieces of businesses you can understand when they're offered to you for quite a bit less than they're worth. That's all there is to it. That's what we try to do with 100% of the business, 7% of the business, or whatever. My partner Charlie Munger and I have been together for about 15 years, and that's all we do. And we'll never do anything else.

Mrs. B is that way. I couldn't have given her \$200 million worth of Berkshire Hathaway stock when I bought the business because she doesn't understand stock. She understands cash. She understands furniture. She understands real estate. She doesn't understand stocks, so she doesn't have anything to do with them. If you deal with Mrs. B in what I would call her circle of

competence... She is going to buy 5,000 end tables this afternoon (if the price is right). She is going to buy 20 different carpets in odd lots, and everything else like that [snaps fingers] because she understands carpet. She wouldn't buy 100 shares of General Motors if it was at 50 cents a share.

I would say that the most important thing in business, and investments, which I regard as the same thing, from our standpoint, is being able to accurately define your circle of competence. It isn't a question of having the biggest circle of competence. I've got friends who are competent in a whole lot bigger area than I am, but they stray outside of it.

In that book [Father, Son & Co.](#) [subtitle: My Life at IBM and Beyond] you may have read, that Tom Watson Junior recently wrote, he quoted his father as saying "I'm no genius. I'm smart in spots but I stay around those spots." And that's all there is to it in investments – and business. I always tell the students in business school they'd be better off when they got out of business school to have a punch card with 20 punches on it. And every time they made an investment decision they used up one of those punches, because they aren't going to get 20 great ideas in their lifetime. They're going to get five, or three, or seven, and you can get rich off five, or three, or seven. But what you can't get rich doing is trying to get one every day. The very fact that you have, in effect, an unlimited punch card, because that's the way the system works, you can change your mind every hour or every minute in this business, and it's kind of cheap and easy to do because we have markets with a lot of liquidity – you can't do that if you own farms or [real estate] – and that very availability, that huge liquidity which people prize so much is, for most people, a curse, because it tends to make them want to do more things than they can intelligently do.

If we can do one intelligent thing a year we are ecstatic. You can negotiate us down to one every two or three years without working very hard. That's all you need. You need very few good ideas in your lifetime. You have to be willing to have the discipline to say, "I'm not going to do something I don't understand." Why should I do something I don't understand? That's why I find it an advantage to be in Omaha instead of New York. I worked in New York for a few years, and people were coming up to me on the corner and whispering in my ear all the time. I was getting excited all the time. I was a wonderful customer for the brokers.

Let's talk about what you're interested in.

[Comment from audience]

That's a problem. It helps to have the efficient market out there. It's very nice to have people out there saying, "none of this does any good." It's a real advantage to have. I don't think it's as strong now, but you really had the revealed truths, for a decade or so, saying it didn't do any good to think. Investments presumably means businesses too. And once you say investments are all priced efficiently, you presumably have to go on and say businesses are priced efficiently, and you're just throwing darts all the time. If this group were a bunch of chess players, or a bunch of bridge players, and they were all convinced that it did not pay to think about what to do, you'd have an enormous advantage. We've had tens of thousands of students in business schools taught that it's [a waste of time to think].

You mentioned the five-sigma event; actually it was Bill Sharpe out at Stanford many years ago. My friend Charlie says that “as the record gets longer it’s easier to add a sigma than it is to reevaluate the theory.” Which is sort of true. I think it was Ken Galbraith that said “Economists are most economical about ideas. They make the ones they learn in school last a lifetime.”

[Tape flipped here]

The market generally is pretty efficient. You take the 30 stocks in the Dow and a bunch of very smart minds all looking at them and having the same information and most of the time, not all of the time, they’ll be priced efficiently. So what? You only have to be right a few times. Sometimes it’s very strange things. Sometimes it’s panic (garbled).

In ‘74 you could have bought the Washington Post when the whole company was valued at \$80 million. Now at that time the company was debt free, it owned the *Washington Post* newspaper, it owned *Newsweek*, it owned the CBS stations in Washington D.C. and Jacksonville, Florida, the ABC station in Miami, the CBS station in Hartford/New Haven, a half interest in 800,000 acres of timberland in Canada, plus a 200,000-ton-a-year mill up there, a third of the *International Herald Tribune*, and probably some other things I forgot. If you asked any one of thousands of investment analysts or media specialists about how much those properties were worth, they would have said, if they added them up, they would have come up with \$400, \$500, \$600 million.

Bob Woodward one time said to me “tell me how to make some money” back in the ‘70s, before he’d made some money himself on a movie and a book. I said “Bob, it’s very simple. Assign yourself the right story. The problem is you’re letting Bradley assign you all the stories. You go out and interview Jeb Magruder.” I said “Assign yourself a story. The story is: what is the Washington Post Company worth? If Bradley gave you that story to go out and report on, you’d go out and come back in two weeks, and you’d write a story that would make perfectly good sense. You’d find out what a television station sells for, you’d find out what a newspaper sells for, you’d evaluate temperament.” I said “You are perfectly capable of writing that story. It’s much easier than finding out what Bill Casey is thinking about on his deathbed. All you’ve got to do is assign yourself that story.”

“Now, if you come back, and the value you assign the company is \$400 million, and the company is selling for \$400 million in the market, you still have a story but it doesn’t do you any good financially. But if you come back and say it’s \$400 million and it’s selling for \$80 million, that screams at you. Either you are saying that the people that are running it are so incompetent that they’re going to blow the \$400 million, or you’re saying that they’re crooked and that they’re operating Bob Vesco style. Or, you’ve got a screaming buy when you can buy dollar bills for 20 cents. And, of course, that \$400 million, within eight or 10 years, with essentially the same assets, [is now worth] \$3 or \$4 billion.”

That is not a complicated story. We bought in 1974, from not more than 10 sellers, what was then 9% of the Washington Post Company, based on that valuation. And they were people like Scudder Stevens, and bank trust departments. And if you asked any of the people selling us the

stock what the business was worth, they would have come up with an answer of \$400 million. And, incidentally, if it had gone down to \$60 or \$40 million, the beta would have been higher of course, and it would have therefore been [viewed as] a riskier asset. There is no risk in buying the stock at \$80 million. If it sells for \$400 [million] steadily, there's much more risk than if it goes from \$400 million to \$80 million.

But that's all there is to business. But now you say "I don't know how to evaluate the Washington Post." It isn't that hard to evaluate the Washington Post. You can look and see what newspapers and television stations sell for. If your fix is \$400 and it's selling for \$390, so what? You can't [invest safely with such a small margin of safety]. If your range is \$300 to \$500 and it's selling for \$80 you don't need to be more accurate than that. It's a business where that happens.

At the time we bought Coca Cola just two years ago, [we ended up buying] 7% of the company. We paid a billion dollars, so we were paying \$14 billion, essentially, for the whole thing. You can sit down in five minutes – I mean, everybody here understands Coca Cola. If Philip Morris were to buy Coca Cola that day, they would have paid \$30 billion. And they wouldn't have sold it for that. And you wouldn't have sold it for that. The company's actually repurchasing stock at the time. So, in effect, they're buying for you. They're buying out your partners, at 50 cents on the dollar or less, which is a magnificent sort of business, and there are no morals to it. It's an easy business. There's no doubt about it.

I don't know a thing now that I didn't know at 19 when I read that book. For eight year prior to that I was a chartist. I loved all that stuff. I had charts coming out my ears. Then, all of a sudden a fellow explains to me that you don't need all that, just buy something for less than it's worth.

[Question from audience]

The world, generally, is treated much more favorably in relation to buying businesses than we are because we're restricted now to buying big businesses, or pieces of big businesses. And that is a big disadvantage. As Charlie says "there could be worse things."

You'll find this interesting. At market, we've probably got \$7 or \$8 billion in equities. In 1970, Berkshire had about \$15 million in equities. We owned more securities then than we own now. We do not have it solved by buying more things. Every now and then we find something. In our annual report this year [we disclosed that] we made two large purchases. Each one was \$300 or \$400 million. Every now and then you'll get an opportunity. And when they come, they come for 15 minutes [I think that's what he said]. Some days it's raining gold. Not very often, but when it is, you've got to be out there. And that will happen periodically. It'll happen, but you can't make it happen. In the meantime, you let the cash pile up if that's what happens.

[Question from audience about how many of his investment ideas are pitched to him by others.]

Practically none. The *Wall Street Journal* is my deal source. There are 1,700 or 1,800 of America's companies that I'm generally familiar with – a good many of them. And every day

they move around the prices of them. So here's a business broker's office if you want to call it that. And sometimes they change them pretty dramatically, like October 19<sup>th</sup> of '87. But they change them dramatically. And that is a great start. Any business that I buy will be measured against the yardstick of that business brokers office in Section C of the *Wall Street Journal*.

In terms of deals, our standards are such that very few are going to meet it. We are much more likely to find one from an owner, who owns the business himself, who wants to sell it to someone like us, and if they want to sell to someone like us, we're the only one like us. I can promise them, a) since I control Berkshire, the only one who can double cross them or lie to them is me. If they start with the XYZ company, XYZ can be taken over tomorrow, the directors can get a new strategic [plan] tomorrow, they can have McKinsey come in and tell them to do something different tomorrow. And no one can really make them a promise there like I can make them a promise. I can tell them exactly what will and won't happen when I make a deal, and to some people that is very important.

It's important to me with Berkshire. I've got a lot of things in my will about (garbled) is better, and all kinds of things. I care where that goes, the same way I care about anything else I've spent my lifetime working on. When I run into somebody like that, we've got an advantage. To some extent, they know about us, and I'll hear about them, but not very many. They're very few. And they're usually older when it happens. Sometimes they've got other members of the family in the business that are inactive and want to take the money out. We've arraigned, in three of our businesses, with younger generations to take 18%, or 15%, or 20% of the equity. We can do a lot of things, in terms of meeting objectives, that some owners may [appreciate] although most owners [don't have complex requirements]. But it is not a question of answering the phone and taking an investment banker's call.

In terms of marketable securities or new offerings, we've never bought anything [that's been pitched to us by an investment banker or broker]. We don't pay any attention to investment bankers or brokers. It's not an efficient use of our time [to read their] reports. We read hundreds and hundreds of annual reports every year. I own 100 shares of everything. I find this much more reliable than asking to be put on a mailing list.

I was reading the Gillette report. I noticed that they'd bought in a bunch of stock. I'd known that before. Their net worth was below zero, which doesn't make a lot of difference, but I thought it might bother them, with the kind of history the company had. So I saw the name of a director that was a friend of mine, Joe Sisco. I called Joe and said "I don't know the people up there, but if they're interested in doing something in the way of financing I would be interested and, if they're not, I'll never bother them." Joe called me back in a couple of days, Coleman Mockler and I got together and we put \$600 million in.

We bought Scott Fetzer (World Book, Kirby Vacuum, and all sorts of things). It had been mixed up for about a year and a half, being sort of in play. I'd never met Ralph Schey, never talked to him on the phone, never had any contact with him at all. And I wrote him a letter that said "here's our annual report. If you're interested in talking to me we'll pay cash, our check will clear, it will be a one-page deal. If you're not interested, I'll never bother you again, and you'll never hear again, and throw the letter out." He called me back, we met in Chicago on a Sunday

and we made a deal that night, [signed the documents the] next week, and that was it.

[Question from audience: Wwhat was it about Gillette that appealed to you?]

I can understand (garbled) and shaving, the price flexibility, what I call the moat around the business. The most important thing with me in evaluating businesses is figuring out how big the moat is around the business. I want to know how big the capital is on the inside and then I want to know how big the moat is around it. What you love is big capital and a big moat. Obviously. World Book has a real moat. Kirby has a real moat. You can figure that out if you [studied] the distribution process and everything.

I've been in the textile business. We made half of the men's linings in the United States for 25 years.

[re: Gillette] It was the kind of business we'd put capital into on the right basis.

One of the biggest early things was American Express back in 1962 at the time of the salad oil scam. There was a guy named De Angelis in Bayonne, New Jersey.

American Express had a field warehousing company which was a tiny, tiny, little subsidiary, with \$12 [million] in capital. The field warehousing company's job was to certify that inventories really existed. That was their job. They stuck their name on it, and you could take those certificates that said there was a given amount of whatever there was, and you could borrow against these certificates. Tino De Angelis had this tank farm about 15 miles from lower Manhattan. And the American Express field warehousing company authenticated the existence of salad oil in these tanks. And, at one time, they were authenticating the existence of more salad oil than the Department of Agriculture, in its monthly reports, was saying existed in the United States. But they never told us of that discrepancy. Late in 1962, right at the time Kennedy was assassinated, within a day or two, the thing blew. A couple of New York Stock Exchange firms went broke – Ira Haupt, (garbled), maybe one other – because they lent on these phony certificates.

And American Express, which never even thought of this little field warehousing operation, it was nothing, compared to their money order business, credit card, and travel, all of a sudden, they've got this little subsidiary, not the parent company, but the subsidiary, that was on the hook for tens and tens of millions of dollars, and nobody knows how much. And that is the nice thing about fraud (garbled)...

There was one other little wrinkle which was terribly interesting. American Express was not a corporation. It then was the only major publicly traded security that was a joint stock association. As such, the ownership of the company was assessable. If it turned out that the liabilities were greater than the assets, [then] the ownership was assessable. So every trust department in the United States panicked. I remember the Continental Bank held over 5% of the company and all of a sudden not only do they see that the trust accounts were going to have stock worth zero, but it could get assessed. The stock just poured out, of course, and the market got slightly inefficient for a short period of time.

The American Express Company was a unique company to understand. You could look at that credit card and you knew it was a winner. Diner's Club had been the first, Carte Blanche had come along, but the American Express Card was killing them. They had raised prices every time. Their retention rate was higher. And finally, they raised prices, and Diner's Club didn't go along, and their growth far outstripped Diner's Club even though they were selling at a higher price. So this was a dynamite asset.

The traveler's check business had 60% of the traveler's check business in the world while selling their checks at a higher price than the banks, B of A and what was then First National Citibank, which were the two main competitions. So here were two guys, B of A and First National City, undercutting them on price for 60 years and they still had 2/3 of the market. That is a moat around the business. I went out and did a little check to make sure this thing wasn't affecting them and we bought 5% of the American Express Company for \$20 million, which means the whole company was selling for about \$150 million at that time. The whole American Express Company, synonymous with financial integrity and money substitutes around the world. When they closed the banks, when Roosevelt closed the banks, he exempted American Express Traveler's Checks, so they substituted as US currency. It was not a business that should have been selling for \$150 million, but everyone was terrified. It was very hard to tell how it would all come out in the end. But, probably, it was going to be between \$60 and \$100 million, and that was a lot more money back then in '62 than it is now. I just took the attitude that they'd declared a dividend of \$75 million, sent it out and it got lost. Would that have caused a panic – somebody else gets your dividend but you don't.

No one would have argued about the value of American Express. They just didn't want to own it for a while. That's what you're buying periodically. They didn't want to own the Washington Post in '74. All you've got to do is find one, two or three businesses like that in a lifetime, load up when you do, and not do anything in between. There will be bigger whales in the ocean and they'll (garbled). There will be more of those as we go along. It's harder when you're working with more money, but there'll always be something.

[Question from audience]

Well, I would say this. If we were working with \$25 million – so we could sort of look at the whole universe of stocks – I would guess that you could find 15 or 20 out of three or four thousand that you would find that were A) selling for substantially less than they're worth, and B) that the intrinsic value of the business was going to grow at a compound rate which was very satisfactory.

You don't want to buy a dollar bill that's sitting for 50 cents, and it demands positive capital, and it's going to be a dollar bill ten years from now. You want a dollar bill that's going to compound at 12% for [a long time]. And, you want to be around some competent people. Just the same thing as if you went in and bought a Ford dealership in South Bend. The same exact thought processes goes through you mind if some friend called you tonight and said "I'd like you to go into the Ford dealership" or whatever, is exactly the kind of thought as goes through mind about all the other businesses that are in Standard and Poor's.

When I was 20, I went through Moody's and Standard and Poor's page by page – twice – because that is it, that's the universe. The universe is much smaller now, unfortunately.

I found some strange things when I was 20 years old. I went through Moody's Bank and Finance Manual, about 1,000 pages. I went through it twice. The first time I went through, I saw a company called Western Insurance Security Company in Fort Scott, Kansas. They owned 92%, at that time, of the Western Casualty and Surety Company. Perfectly sound company. I knew people that represented them in Omaha. Earnings per share \$20, stock price \$16. (garbled) ... much more than that. I ran ads in the Fort Scott, Kansas paper to try and buy that stock – it had only 300 or 400 shareholders. It was selling at one times earnings, it had a first class [management team]...

[Tape ends here]

... Incidentally, I would say that almost everybody I know in Wall Street has had as many good ideas as I have, they just had a lot of [bad] ideas too. And I'm serious about that. I mean when I bought Western Insurance Security selling at \$16 and earning \$20 per share, I put half my net worth into it. I checked it out first – I went down to the insurance commission and got out the convention statements, I read Best's, and I did a lot of things first. But, I mean, my dad wasn't in it, I'd only had one insurance class at Columbia – but it was not beyond my capabilities to do that, and it isn't beyond your capabilities.

Now if I had some rare insight about software, or something like that – I would say that, maybe, other people couldn't do that – or biotechnology, or something. And I'm not saying that every insight that I have is an insight that somebody else could have, but there were all kinds of people that could have understood American Express Company as well as I understood it in '62. They may have been...they may have had a different temperament than I did, so that they were paralyzed by fear, or that they wanted the crowd to be with them, or something like that, but I didn't know anything about credit cards that they didn't know, or about travelers checks. Those are not hard products to understand. But what I did have was an intense interest and I was willing, when I saw something I wanted to do, to do it. And if I couldn't see something to do, to not do anything. By far, the most important quality is not how much IQ you've got. IQ is not the scarce factor. You need a reasonable amount of intelligence, but the *temperament* is 90% of it.

That's why Graham is so important. Graham's book [[The Intelligent Investor](#)] talks about the qualities of temperament you have to bring to the game, and that is the game. Now I can (garbled).

He may not know anything about a Coca Cola, or something of that sort, but that isn't what makes you the money. What makes you the money is your attitude going in, your attitude toward stock market fluctuations. There's two chapters in [The Intelligent Investor](#), chapter 8 and chapter 20, they're more important than everything that's been written on investments, in my view, before or since. And there's no specific technical knowledge in those things. It just tells you what frame of mind to be in when you come to the game. And people just don't get it. But that is not because I'm particularly skillful. And bear in mind that I didn't have that

(garbled). It's not like I was Mozart and sat down at five or something. I mean I was churning things, I was computing odd lot statistics, I mean I loved all that stuff because I always liked numbers and playing around with them. It was like baseball averages or something. But what I needed was a philosophical bedrock position from which I could then go out and look at businesses, and probe through that filter, and decide whether that's [a bargain or not]. And that's Ben Graham's contribution. And that's the game. You don't have to be that smart. You don't have to know advanced accounting. It may *help* if you know something, particularly accounting. But the fact that you don't know it may restrict your universe some.

[Garbled comment from audience]

It goes back to a debate I was having with Mike Jensen [a proponent of the efficient market theory who famously wrote in 1978 that "there is no other proposition in economics which has more solid empirical evidence supporting it than the Efficient Market Hypothesis"]. [I rebutted the efficient market hypothesis in] [The \[Super\]Investors of Graham and Doddsville](#). It was an address I gave on the 50th anniversary of [Security Analysis](#). Dave Dodd was there – 90 years old, marvelous guy. And in that room were a half a dozen or more of us who had gone on to study or work, or have some association with Ben Graham. We weren't all five-sigma types, but we've always gotten five-sigma, or three-sigma, or something results. So it isn't because he had carefully culled us out from all over the country, like the Notre Dame football team. We were there just because we kind of stumbled in. And we listened to the guy and then went out and applied it in different ways – totally different ways. I mean, Walter Schloss [has always] owned hundreds of different stocks. Walter is not a 150 IQ guy. Charlie Munger is. There were all different types of [people] with a common philosophical bond. They did not learn any little secrets of technique – they did not learn any systems.

Everybody wants a system. I mean they come to our annual meeting (garbled) the book guy, or the price/earnings, "do I buy them on Monday?" They all want some [system] that you can run through a computer and simulate it out. I mean I tell 'em if past performance were the key to it, the Forbes 400 would consist of librarians. Everybody would be looking it up. It doesn't work that way. They *want* it to work that way. It would be so nice if it did, but it is not that way. It's like picking out a basketball team. You look for guys who are seven feet tall, you look for a guy who can stay in school, there are a whole bunch of things. And there are certain things that point you toward getting the best five guys out there on the court. But I can't give them a formula. I can't say "here's a little formula and if you go to Emporia, Kansas and apply this formula without actually seeing the guys play basketball and working with them, you'll pick up the best basketball team." You won't.

[Garbled question from audience]

To me, it's absolutely fascinating that the teaching of investments has really retrogressed from 40 years ago, and I think it's probably because the teachers are more skillful. They learn all these huge mathematical techniques and (garbled) and they have so much fun manipulating numbers they're missing something very simple. And I think they have, on balance (aside: I say this at Stanford or Harvard), sent people off with the wrong message. And I get letters from students about it. I don't see what the reason for having an investment course is unless you teach people

how to analyze the value of investments. If people thought there was nothing of utility that you could impart on the subject, except for the fact that there is nothing you can do useful, then I don't understand... And I know it isn't true because I've seen people teach other people how to make unusual returns over a 30- or 40-year T-Note.

Phil Caret wrote a book on investing in 1924. He's still alive, he's a shareholder of Berkshire, he's 92 or 93 years old. He writes me letters that say "I approve of your no dividend policy because when I get older, then I want to start getting dividends." But Phil Caret has got a record of 70 years. That is a *lot* of investments and it is a superior investment record. Not done exactly the same as Graham, but it's the same general approach. Even Keynes came to that view. He started out as a market timer. But in the '30s he [changed approaches]. [Keynes later said: "As time goes on, I get more and more convinced that the right method in investment is to put fairly large sums into enterprises which one thinks one knows something about."]

You can't teach people a formula. You can't come in at the start of the term, and when they get all through, understand  $E=MC$  squared. It's not like teaching geometry or something.

You shouldn't buy a stock, in my view, for any other reason than the fact that you think it's selling for less than it's worth, considering all the factors about the business.

I used to tell the stock exchange people that before a person bought 100 shares of General Motors they should have to write out on a [piece of paper:] "I'm buying 100 shares of General Motors at X" and multiply that by the number of shares "and therefore General Motors is worth more than \$32 billion" or whatever it multiplies out to, "because ... [fill in the reasons]" And if they couldn't answer that question, their order wouldn't be accepted.

That test *should be applied*. I should never buy anything unless I can fill out that piece of paper. I may be wrong, but I would know the answer to that. "I'm buying Coca Cola right now, 660 million shares of stock, a little under \$50. The whole company costs me about \$32 billion dollars." Before you buy 100 shares of stock at \$48 you ought to be able to answer "I'm paying \$32 billion today for the Coca Cola Company because..." [Banging the podium for emphasis.] If you can't answer that question, you shouldn't buy it. If you *can* answer that question, and you do it a few times, you'll make a lot of money.

[From the audience: "Well, you bought it, how did you answer it?"]

Well, it was only \$14 billion. I would say this: "If you added a penny to price of every Coca Cola sold in the world this year, that would add \$2 billion to pretax earnings." Now you tell me whether you think there's a penny, worldwide, of price flexibility per serving of Coke. Well, the answer is "you *know* there is."

When they bought the Coca Cola Company, the Candler family bought it from Pembertons back in 1904 or 1906, they paid \$2,000 for the company. If the Pemberton family had reserved a penny a serving royalty a serving, the Coca Cola company would be sending \$2 *billion* to the Pemberton family every year and you wouldn't even see the difference in the figures. It's there.

Now that's not true when I was selling [men's suit] linings [Berkshire Hathaway's original business]. I sold men's suit linings for 20 years. We tried to raise our price a half a cent a yard, and on an 80-cent-a-yard product, people who'd done business with us for 80 years slammed the door in our face. (garbled) ... "but half a cent a yard"... Nobody ever went into a store and said "I'd like to buy a pinstripe suit with a Hathaway lining." Never. They say "I want a coat" all over the world.

Now in this country, Pepsi is, unfortunately, more or less coexistent with Coke. This is their weakest market. They make more in Japan, with less than half the people and way less per capita usage than they make in the United States. Around the world a guy says "I'll sell you an unmarked cola a penny cheaper" ... it isn't going to happen. That is the fastest test.

A couple of fast tests about how good a business is. First question is "how long does the management have to think before they decide to raise prices?" You're looking at marvelous business when you look in the mirror and say "mirror, mirror on the wall, how much should I charge for Coke this fall?" [And the mirror replies, "More."] That's a great business. When you say, like we used to in the textile business, when you get down on your knees, call in all the priests, rabbis, and everyone else, [and say] "just another half cent a yard." Then you get up and they say "We won't pay it." It's just night and day. I mean, if you walk into a drugstore, and you say "I'd like a Hershey bar" and the man says "I don't have any Hershey bars, but I've got this unmarked chocolate bar, and it's a nickel cheaper than a Hershey bar" you just go across the street and buy a Hershey bar. *That* is a good business.

The ability to raise prices – the ability to differentiate yourself in a real way, and a real way means you can charge a different price – *that* makes a great business.

I'll try this on the students later: What's the highest price of a daily newspaper in the United States? [Pause] The highest priced daily newspaper in the United States is the *Daily Racing Form*. 150,000 copies a day, \$2.25 a copy, they go up in 25 cent intervals, and it doesn't affect circulation at all. Why? There is no substitute. If you go to the track, assuming you're a forms player, you don't want "Joe's Little Green Sheet", you want *The Form*. And it doesn't make any difference what it costs! There is no substitute. And that's why they've got a 65% pretax margin. It doesn't take a genius to figure it out.

There are products like that, and there are products like sheet steel. And they're night and day.

[From Audience: You said you only had to have a couple of good ideas, we at Notre Dame had a good one in having you here.] [Applause]

## Lecture to MBA Students

I'll talk for a few minutes on some of the things that relate to this handout I've got, so if everybody has one, or looks with their neighbor, we'll get the (garbled) about how to make a lot of money in stocks as we go along.

Eddie Cantor had a problem with Goldman Sachs in the late '20s. [Cantor was a popular entertainer who lost his fortune in the crash.] He did not do very well in something he bought from them, so he worked them into his routine when he performed, and he told (garbled).

You know Wall Street is a place that people drive to in Rolls Royces to get advice from people who ride to work on the subway.

I'd like to talk to you for just a few minutes about what I regard as the most important thing in investments and also in terms of your career. Because in your career what train you get on makes a lot of difference. Because frequently, perhaps generally, when people get out of business school, they don't give enough thought to exactly what sort of train they're going to get on. And it makes a tremendous difference whether you get involved in a prosperous company, one that's going to really do well. On balance, you want to go with a company whose stock is going to be a good investment over the years because there's going to be much more opportunity, there's going to be more money made, you're going to (garbled). And if you get involved with some of the businesses I've been involved with like trading stamps (garbled).

[Buffett is warning students to stay away from declining businesses such as Blue Chip Stamps, though this was in fact a highly successful investment. In the book [Damn Right!](#), Janet Lowe wrote: "During the late 1960s and early 1970s, Munger, Guerin and Buffett gradually acquired a controlling interest in Blue Chip Stamps. This small company issued trading stamps, which merchants distributed. Customers collected and redeemed the stamps for merchandise. The investors saw untapped potential in the company's float account – the difference between stamps issued and stamps redeemed. Using this pool of capital, Blue Chip's controlling investors acquired several other companies: Wesco Financial, See's Candies and The Buffalo Evening News."]

It does make a difference what kind of a business you get associated with. For that reason I've set forth in this little handout Company A and Company E. I'm not going to tell you for the moment what these companies are. I'm going to tell you one thing about the two companies. One of the companies, to the point of where this cuts off, lost its investors more money than virtually any business in the world. The other company made its owner more money than virtually any company in the world. So one of these two companies, Company A and Company E, has made one of its owners one of the five wealthiest people in the world, while the other company made its owners appreciably poorer, probably more so than any other company to that point in time.

Now I'll tell you a little bit about these companies (we're leading up to the question of whether the business makes a difference). Company A had thousands of MBAs working for it. Company E had none. I wanted to get your attention. Company A had all kinds of employee benefit programs, stock options, pensions, the works. Company E never had stock options. Company A

had thousands of patents – they probably held more patents than just about any company in the United States. Company E never invented anything. Company A’s product improved dramatically in this period, Company E’s product just sat.

So far, based on what I’ve told you, does anybody have any idea of which company was the great success, and why?

If you get to buy one of these two companies, and this is all you know, and you get to ask me one question to decide on which one to buy. If you ask me the right question, you will probably make the right decision about the company’s stock, and one will make you enormously wealthy.

[Audience asks questions]

Both companies make products used every day. They started as necessities, highly useful, nothing esoteric about either one, although company A does have all these patents. There’s more technology involved in company A.

[How many companies compete with either one?]

Good question, very good question. In effect, neither company had any competition. And that might differentiate in some cases.

Well, I’ll tell you a little more about it. Company A is known as company A because it was in agony, and Company E, as Company E, because it was in ecstasy. Company A is American Telephone and Telegraph. I’ve omitted eight zeros on the left hand side, and the American Telephone and Telegraph Company, at the end of 1979, was selling for \$10 billion less than the shareholders had either put in or left in the business. In other words, if shareholder’s equity was “X” the market value was X minus \$10 billion. So the money that shareholders had put in, or left in, the business had shrunk by \$10 billion in terms of market value.

Company E, the excellent company, I left off only six zeros. And that happens to be a company called Thomson Newspapers. Thomson Newspapers, which most of you have probably never heard of, actually owns about 5% of the newspapers in the United States. But they’re all small ones. And, as I said, it has no MBAs, no stock options – still doesn’t – and it made its owner, Lord Thompson. He wasn’t Lord Thompson when he started – he started with 1,500 bucks in North Bay, Ontario buying a little radio station but, when he got to be one of the five richest men, he became Lord Thompson. I met him one time in England as a matter of fact, in 1972, and went up to see him. He’d never heard of me, but he was a very important guy. (I’d heard of him!)

I said, “Lord Thompson, you own the newspaper in Council Bluffs, Iowa. Council Bluffs is right across the river from Omaha, where I live, four or five miles from my house. I said, “Lord Thompson, You own the Council Bluffs [Daily Nonpareil?]. I don’t suppose you’d ever think of selling it?” He said “I wouldn’t think of it.”

I said “Lord Thompson, you’ve bought this paper in Council Bluffs, and you’ve never seen the paper, never seen the town, but I do notice that every year you raise prices.” (garbled)

He's got the only way to talk to people – his was the only “megaphone” for merchants to announce commercial news in Council Bluffs. He said “I figured that out before you did.”

I said, “If you ever raise prices to the point where it's counterproductive (garbled).”

Then [I said] “I've got only one other question: How do you figure out how much to charge people? You look like a man of awesome commercial instincts – you started with a \$1,500 radio station, now you're worth \$4 or \$5 billion dollars.”

He said “Well, that's another good question. I just tell my US managers to try and make 45% pretax and figure that's not gouging.” And as I got to the elevator, he said “If you ever hear of a newspaper you don't want to buy, call me. Collect.”

I rode down and that was two years of business school. I mean, try to make 45% and call me collect if you ever find a paper you don't want to buy.

The telephone company, with the patents, the MBAs, the stock options, and everything else, had one problem, and that problem is illustrated by those figures on that lower left hand column. And those figures show the plant investment in the telephone business. That's \$47 billion, starting off with, growing to \$99 billion over an eight or nine year period. More and more and more money had to be tossed in, in order to make these increased earnings, going from \$2.2 billion to \$5.6 billion.

So, they got more money, but you can get more money from a savings account if you keep adding money to it every year. The progress in earnings that the telephone company made was only achievable because they kept on shoving more money into the savings account and the truth was, under the conditions of the '70s, they were not getting paid commensurate with the amount of money that they had to shove into the pot, whereas Lord Thompson, once he bought the paper in Council Bluffs, never put another dime in. They just mailed money every year. And as they got more money, he bought more newspapers. And, in fact, he said it was going to say on his tombstone that he bought newspapers in order to make more money in order to buy more newspapers [and so on].

The idea was that, essentially, he raised prices and raised earnings there every year without having to put more capital into the business.

One is a marvelous, absolutely sensational business, the other one is a terrible business. If you have a choice between going to work for a wonderful business that is not capital intensive, and one that is capital intensive, I suggest that you look at the one that is not capital intensive. I took 25 years to figure that out, incidentally.

On the next page, I've got a couple of other businesses here. Company E is the ecstasy on the left. You can see earnings went up nicely: they went from \$4 million to \$27 million. They only employed assets of \$17 million, so that is really a wonderful business. On \$17 million they earned \$27 million, 150% on invested capital. That is a good business. The one on the right, Company A, the agony, had \$11 or \$12 million tied up, and some years made a few

bucks, and in some years lost a few bucks.

Now, here again we might ask ourselves, “What differentiates these companies?” Does anybody have any idea why company E might have done so much better than Company A? Usually somebody says at this point “maybe company E was better managed than company A.” There’s only one problem with that conclusion and that is, Company E and Company A had the same manager – me!

The company E is our candy business, See’s Candies out in California. I don’t know how many of you come from the west, but it dominates the boxed chocolate business out there and the earnings went from \$4 million to \$27 million, and in the year that just ended they were about \$38 million. In other words, they mail us all the money they make every year and they keep growing, and making more money, and everybody’s very happy.

Company A was our textile business. That’s a business that took me 22 years to figure out it wasn’t very good. Well, in the textile business, we made over half of the men’s suit linings in the United States. If you wore a men’s suit, chances were that it had a Hathaway lining. And we made them during World War II, when customers couldn’t get their linings from other people. Sears Roebuck voted us “Supplier of the Year.” They were wild about us. The thing was, they wouldn’t give us another half a cent a yard because nobody had ever gone into a men’s clothing store and asked for a pin striped suit with a Hathaway lining. You just don’t see that.

As a practical matter, if some guy’s going to offer them a lining for 79 cents, [it makes no difference] who’s going to take them fishing, and supplied them during World War II, and was personal friends with the Chairman of Sears. Because we charged 79½ cents a yard, it was “no dice.”

See’s Candies, on the other hand, made something that people had an emotional attraction to, and a physical attraction you might say. We’re almost to Valentine’s Day, so can you imagine going to your wife or sweetheart, handing her a box of candy and saying “Honey, I took the low bid.”

Essentially, every year for 19 years I’ve raised the price of candy on December 26. And 19 years goes by and everyone keeps buying candy. Every *ten* years I tried to raise the price of linings a fraction of a cent, and they’d throw the linings back at me. Our linings were just as good as our candies. It was much harder to run the linings factory than it was to run the candy company. The problem is, just because a business is lousy doesn’t mean it isn’t difficult.

In the end, I like to think anyway that if Alfred P. Sloan [the legendary CEO of General Motors during its heyday] came back and tried to run the lining business, it wouldn’t make as much money as a good business. The product was undifferentiated. The candy product is differentiated. (Garbled story of Hershey Bar and Coke versus unbranded but modestly cheaper products).

You really want something where, if they don’t have it in stock, you want to go across the street to get it. Nobody cares what kind of steel goes into a car. Have you ever gone into a car

dealership to buy a Cadillac and said “I’d like a Cadillac with steel that came from the South Works of US Steel.” It just doesn’t work that way, so that when General Motors buys they call in all the steel companies and say “here’s the best price we’ve got so far, and you’ve got to decide if you want to beat their price, or have your plant sit idle.”

I put one business in here, CBS versus Cap Cities in 1957, when my friend Tom Murphy took over Cap Cities. They had a little bankrupt UHF station in Albany. They ran it out of a home for retired nuns. And it was very appropriate because they had to pray every day. At that time CBS was the largest advertising medium in the world: \$385 million in revenues whereas Cap Cities had \$900,000 in revenues. Cap Cities made \$37,000 a year and they paid my friend Murph \$12,000 a year. CBS made \$48 million pretax. Cap Cities was selling for \$5 million in the market and priced on the come, while CBS was selling for \$500 million.

Now, if you look at the two companies, Cap Cities has a market value of about \$7 billion and CBS has a market value of about \$2 billion. They were both in the same business, broadcasting. Neither one had, certainly Cap Cities didn’t have, any patents. Cap Cities didn’t have anything that CBS didn’t have. And somehow CBS took a wonderful business that was worth \$500 million, and over about 30 years they managed a little increase – peanuts – while my friend Murphy, with exactly the same business, with one little tiny UHF station in Albany, (bear in mind that CBS had the largest stations in New York City and Chicago) and my friend Murph just killed them. And you say “how can that happen?” And that’s what you ought to study in business school. You ought to study Tom Murphy at Cap Cities. And you also ought to study Bill Paley [who was the CEO] at CBS.

We have a saying around Berkshire that “all we ever want to know is where we’re going to die, so we’ll never go there.” And CBS is what you don’t want. It’s as important not to do what CBS did, and it is important to do what Cap Cities did. Cap Cities did a lot of things right, but if CBS had done the same things right, Cap Cities would have never come close.

They had all the IQ at CBS that they had at Cap Cities. They had 50 times as many people, and they were all coming to work early and going home late. They had all kinds of strategic planners, they had management consultants. They had more than I can say. Yet they *lost*. They lost to a guy that started out with a leaky rowboat, at the same time the other guy left in the QE II. By the time they got into New York, the guy in the rowboat brought in more cargo than the QE II did. There’s a real story in that. And you can understand broadcasting, so it’s really worth studying what two people in the same field did, and why one succeeded so much and one failed.

I couldn’t resist kicking in the last page: the only public offering Cap Cities ever made, back in 1957 which raised, as you can see, \$300,000. And this was when they were going to buy the station in Raleigh/Durham. The only public offering of stock the company’s every made (aside: they sold us a block of stock when they bought ABC). And if you look very carefully you’ll see that the underwriting commission – they took two firms to get this sold – the total underwriting commission was \$6,500 bucks.

The last thing I want to show you, before we get onto your questions, is an ad that was run June 16, 1969, for 1,000,000 shares of American Motors. This is a reproduction from the *Wall Street*

*Journal* of that day. Now does anybody notice anything unusual about that ad?

[Guesses from audience.]

Everybody in that ad has disappeared. There are 37 investment bankers that sold that issue, plus American Motors, and they are *all* gone. Maybe that's why they call them tombstone ads. Now the average business of the New York Stock exchange in 1969 was 11 million shares. Average volume now is *fifteen* times as large. Now here's an industry whose volume has grown 15 to 1 in 20 years. Marvelous growth in the financial world. And here are 37 out of 37, and those are some of the biggest names on Wall Street, and some of them had been around the longest, and 37 out of 37 have disappeared. And that's why I say you ought to think about [the long-term durability of a business?] because these people obviously didn't.

These were run by people with high IQs, by people that worked ungodly hard. They were people that had an intense interest in success. They worked long hours. They *all* thought they were going to be leaders on Wall Street at some point, and they all went around, incidentally, giving advice to other companies about how to run their business. That's sort of interesting.

You go to Wall Street today, and there's some company the guy hadn't heard of two weeks before and he's trying to sell you. He will lay out this computer run of the next 10 years, yet he doesn't have the faintest idea of what his own business is going to earn next week!

Here are a group of 37. And the question is, how can you get a result like that? That is not a result that you get by chance. How can people who are bright, who work hard, who have their own money in the business – these are not a bunch of absentee owners – how can they get such a bad result? And I suggest that's a good thing to think about before you get a job and go out into the world.

I would say that if you had to pick one thing that did it more than anything else, it's the mindless imitation of one's peers that produced this result. Whatever the other guy did, the other 36 were like a bunch of lemmings in terms of following. That's what's gotten all the big banks in trouble for the past 15 years. Every time somebody big does something dumb, other people can hardly wait to copy it. If you do nothing else when you get out of here, do things *only* when they make sense to you. You ought to be able to write "I am going to work for General Motors because ... "I am buying 100 shares of Coca Coals stock because..." And if you can't write an intelligent answer to those questions, don't do it.

I proposed this to the stock exchange some years ago: that everybody be able to write out "I am buying 100 shares of Coca Cola Company, market value \$32 billion, because ...." and they wouldn't take your order until you filled that thing out.

I find this very useful when I write my annual report. I learn while I think when I write it out. Some of the things I think I think, I find don't make any sense when I start trying to write them down and explain them to people. You ought to be able to explain why you're taking the job you're taking, why you're making the investment you're making, or whatever it may be. And if it can't stand applying pencil to paper, you'd better think it through some more.

People in that ad did a lot of things that could not have stood that test. Some *major* bankers in the United States did a lot of things that could not meet that test. One of the bankers in the United States, who's in plenty of trouble now, bragged a few years ago he never made a loan. And, from the way things are starting to look, he's never going to collect on one either.

You should not be running one the major banks in the United States without having made loans. I mean, you learn about human nature, if nothing else, when you make loans.

[Question and Answer With Students]

That jewelry store, it's an interesting story, I'll take an extra minute. We bought a furniture store about five or six years ago. We bought it from a woman who was 89 [Rose Blumkin, the legendary Mrs. B]. That woman came to this country with a tag around her neck from Russia. She walked out of Russia, and the Red Cross truck got her in Seattle and (garbled) then Fort Dodge, Iowa and sent her there. And she saved money. She sold used clothes and that sort of thing, and she brought over seven siblings, plus her mother and father. She sent over \$50 bucks at a time to get the rest of the family over here.

In 1937, she would have been 44 at the time, she started a store with \$500, a home furnishings store. That's all the money she ever put into it. Last year it made \$18 million, pretax. It's become the largest home furnishings store in the country. And she put everybody out of business. She doesn't know accounting, she's never had an audit, she doesn't know what accruals mean, she doesn't know what depreciation means, but she knows how to run a business. And, unfortunately, two years ago she got mad at her grandchildren and she went out and quit and started competing with us, which shows you how stupid I was not to get a non-compete agreement from an 89-year-old woman! She is now in business right across the street, and works seven days a week at 97 years of age. And if you tell her that this room is 27 by 31, she will tell you how many square yards it is just like that, at \$6.99 a yard, and how much that comes to plus tax. She can do it just like that. She cannot read or write. She has never been to school a day in her life. But she knows how to run a business.

One of the sisters she brought over, also to Omaha, was a woman named Rebecca. She went through Latvia, and the border guard took the money when she got to Latvia, and she had to sit in Latvia for a year until her sister got another \$50 bucks to bring her over here. They got over here, and it took them 20 odd years to get enough money to buy into a tiny little jewelry store. And I bought that business a couple of years ago from the Friedman family, which is Mrs. B's sister. Incidentally, Mrs. B is 97, and her three other (garbled).

In any event, in that jewelry store last year, the sales were up 18%. I believe it's the second largest jewelry store in the United States, next to Tiffany's main location, and it uses *exactly* the same formula the furniture store used in building up the largest home furnishings store. The people that run them never went to business school, and they stress the things that Ben Franklin would stress. Essentially, their business is pure Ben Franklin. Tell truth and give people service. Ben Franklin said "take care of thy shop and it will take care of thee." Now that's old fashioned in terms of the phraseology, but it's that simple. And, the truth is that family... If you were at our

jewelry store last Saturday like I was, Ike Friedman who is 65, 66, was there. His mother, Mrs. Friedman, came in – she’s 89 years old – *Wall Street Journal* under her arm. You’ve got his son there, his only son, two sons-in-law, two daughters in there, they’re all busy. The family’s worth tens and tens and tens of millions of dollars. They don’t do it ‘cause they have to, they do it ‘cause they like to.

The one thing we’ve done well in buying businesses is the people who sold them were in love with their business and not in love with money. If they’re in love with money we can’t do it, but if they’re in love with their business we get along very well because we leave them alone.

Actually Fran Blumkin, the wife of Louis Blumkin, who’s now Chairman of the Furniture Mart, comes in on Saturday, and works Tuesday, to help out Louis’ cousins. And she sells jewelry all the time there. It’s a great business. Berkshire bought a great business. It gets better, and better, and better. And *no-one* can knock ‘em off.

That’s one of the things I always ask myself: If you give someone hundreds of millions of dollars, or billions of dollars, [can you hurt a particular business?] You can’t hurt the Furniture Mart or Borsheim’s.

[Question: When you look at a company, how do you value it, how do you decide how much to pay for it, and after that, would you say how much you’d sell it for.]

Well, we won’t sell it. We just don’t sell businesses. If we had a business that would permanently lose money, or we had a manager lie to us, or cheat us, or (garbled). But we will never sell a business just because we get a wonderful offer for it. My house isn’t for sale. The children aren’t for sale. The businesses aren’t for sale. I tell shareholders that. That may make me crazy, but that’s who they’re getting in with, and they might as well know it. It is not a game we’re playing, like gin rummy, where we pick up one card and discard another.

And I think good human relationships... I work with nothing but people I like. There’s not one person I work with that causes my stomach to churn in the least. In fact, I feel like tap dancing. I work with nothing but people I like. Well, just think how fortunate you are if you’re 60 years of age and that’s the way you’re going to be able to spend your life. These people are wonderful to work with. I mean, Ike Friedman...we never disagree. Charlie Munger, my partner, and I have never had a disagreement in 30 years. And, why in the world [would I sell businesses run by people I like] so that I can be worth 110% of X, instead of X, when I die? It will all be in the foundation anyway. Why should I go around discarding people like that who are in the business, for some people who might not turn out so well? So I’m not interested in selling at all.

Now, in terms of buying, a) I’ve got to like the people. I’m just not interested in marrying for money. That might have been great when I was 12, but it would be crazy now for me to marry someone for money. Why should I marry in business for money? It just doesn’t make sense. I get associated with these people, so I want to buy the people I like, and I want to buy businesses I understand, and then I don’t want to think too much. And, paying too much simply comes out.

If you can tell me what all of the cash in and cash out of a business will be, between now and

judgment day, I can tell you, assuming I know the proper interest rate, what it's worth. It doesn't make any difference whether you sell yo-yo's, hula hoops, or computers. Because there would be a stream of cash between now and judgment day, and the cash spends the same, no matter where it comes from. Now my job as an investment analyst, or a business analyst, is to figure out where I may have some knowledge, what that stream of cash will be over a period of time, and also where I don't know what the stream of cash will be. I don't have the faintest idea of where Digital Equipment will be in next week, let alone the next 10 years. I just don't know. I don't even know what they do. And I never would know what they did. Even if I thought I knew what they did, I wouldn't know what they did. Hershey bars I understand.

So, my job is to look at the universe of things I can understand – I can understand Ike Friedman's jewelry store – and then I try to figure what that stream of cash, in and out, is going to be over a period of time, just like we did with See's Candies, and discounting that back at an appropriate rate, which would be the long term Government rate. [Then,] I try to buy it at a price that is significantly below that. And that's about it. Theoretically, I'm doing that with all the businesses in the world – those that I can understand.

Every day, when I turn to the *Wall Street Journal*, back in the C Section, that's like a big business brokerage ad. It's just like a business broker saying "you can buy part of AT&T for this, part of General Motors for that, General Electric..." And unlike most business broker's ads, it's nice because they change the price every day. And you don't have to do business with any of them. So you just sit there, day by day, and you yawn, and you insult the broker if you want to, and talk to your newspaper, anything you want to, because someday, there's going to be some business I understand selling for way less than the value I arrived at. It doesn't have anything to do with book value, although it does have to do with earnings power over a period of time. It usually relates, fairly closely, to cash [flow]. And, when you find something you understand, if you find five ideas in your lifetime and you're right on those five, you're going to be very rich.

You know I always tell business students that if you got a punch card when you got out of here, and it only had 20 businesses on it, and every time you made an investment decision they took a punch, and when the 20 were gone you were all done, it would be wonderful. You're not going to get more than 20 investment ideas in a lifetime. I'm not going to get more than 20 great ideas. And the important thing is that you recognize them when you see them, and that you do something about them.

So, when we find something we understand, if we're buying all of the business, I want to like the people. If we're buying part of the business, it's less important. We want to buy things we understand, and we want to buy them very cheap. If we don't understand them, we don't buy them. If they're not cheap, we don't buy them. If we can buy them with Tom Murphy, my friend, at an attractive price, we do that in a second.

We bought 5% of the Walt Disney Company in 1966. It cost us \$4 million dollars. \$80 million bucks was the valuation of the whole thing. 300 and some acres in Anaheim. The Pirate's ride had just been put in. It cost \$17 million bucks. The whole company was selling for \$80 million. Mary Poppins had just come out. Mary Poppins *made* about \$30 million that year, and seven years later you're going to show it to kids the same age. It's like having an oil well where all the

oil seeps back in. Now the [numbers today are] probably different, but in 1966 they had 220 pictures of one sort or another. They wrote them all down to zero – there were no residual values placed on the value of any Disney picture up through the '60s. So [you got all of this] for \$80 million bucks, and you got Walt Disney to work for you. It was incredible. You didn't have to be a genius to know that the Walt Disney company was worth more than \$80 million. \$17 million for the Pirate's Ride. It's unbelievable. But there it was. And the reason was, in 1966 people said, "Well, Mary Poppins is terrific this year, but they're not going to have another Mary Poppins next year, so the earnings will be down." I don't care if the earnings are down like that. You know you've still got Mary Poppins to throw out in seven more years, assuming kids squawk a little. I mean there's no better system than to have something where, essentially, you get a new crop every seven years and you get to charge more each time.

\$80 million dollars [sigh]. I went out to see Walt Disney (he'd never heard of me; I was 35 years old). We sat down and he told me the whole plan for the company – he couldn't have been a nicer guy. It was a joke. If he'd privately gone to some huge venture capitalist, or some major American corporation, if he'd been a private company, and said "I want you to buy into this. This is a deal," they would have bought in based on a valuation of \$300 or \$400 million dollars. The very fact that it was just sitting there in the market every day convinced [people that \$80 million was an appropriate valuation]. Essentially, they ignored it because it was so familiar. But that happens periodically on Wall Street.

I wanted to go see Mary Poppins, to see if she'd be recycled, and she was showing at the Loews Theater on 45th and Broadway in New York, and here I am with a briefcase at 2:00 in the afternoon heading in to see Mary Poppins. I almost felt like I had to rent a kid.

[Question from audience.]

There's very little relationship between Walt Disney and Salomon. In Salomon we have lent them, in effect, \$700 million on a preferred which matures in five equal installments, starting five years from now, which is also convertible. And this is primarily a fixed income investment with an interesting conversion privilege attached to it. But it is not primarily an equity investment. We get a 9% dividend which, because of the corporate dividend tax credit, converts to something over 7% on an after-tax basis. It's a form of lending money. It's an alternative to municipal bonds or something of that sort. It is *not* an investment like Coca Cola, or the Washington Post, or Cap Cities, which are pure equity investments.

We would rather, and this is nothing negative on Salomon, buy more things like Coca Cola. You know, those are the things that really cause excitement, because those are super businesses as far as the eye can see. Salomon is a perfectly decent business, but it's just not the same kind of business. Neither is Champion Paper or US Air, which we've done the same thing for. If we had way less money, we wouldn't be doing those things, as opposed to the Coca Cola thing. It's because we can't find more of those. And we should own some fixed income investments because of our [insurance business].

[Question from audience.]

Well, I started out when I was 20. I had just finished Ben Graham's course. And I took Moody's Manuals – they had investment manuals – and I took Standard and Poor's, where they put them all together, and do them all alphabetically, and I went through them all page by page. And things jumped out at me. I saw Western Insurance Services, in Fort Scott, Kansas, looking in Moody's Bank and Finance Manuals. I'd never heard of Western Insurance Services until I turned that page that said Western Insurance Services. It showed earnings per share of \$20 and the high was \$16. Now that may not turn out to be something you can make a lot of money on, but the odds are good. It's like a basketball coach seeing a guy 7'3" walk through the door. He may not be able to stay in school, and may be very uncoordinated, but he's very large. So I went down to the Nebraska Insurance Department, and I got the convention reports on their insurance companies, and I read Best's. I didn't have any background in insurance. But I knew I could understand it if I worked at it for a while. And all I was really trying to do was disprove this thing. I was really trying to figure out something that was wrong with this. Only there wasn't anything wrong. It was a perfectly good insurance company, a better than average underwriter, and you could buy it at one times earnings. I ran ads in the Fort Scott, Kansas paper to buy this stock when it was \$20. But it came through turning the pages. No one tells you about it. You get 'em by looking.

I read hundreds of annual reports every year. I don't talk to any brokers – I don't want to talk to brokers. People are not going to give you great ideas. On the other hand, getting them is not that difficult. If you'd read the Disney report in 1966, believe me, you'd have known as much about Disney then as now. You wouldn't have Michael Eisner, you'd have Walt Disney running it. And you could have multiplied, at two million shares outstanding (garbled).

Cap Cities at that time was an act of faith. You had to believe in Tom Murphy. You could not see (garbled).

(Garbled) and some of you will be stars, and some of you will be less than stars. But it won't correlate with your IQ at all. But you have it already. And everybody in the room has it. I'll give you a little question. Let's think about this. Let's say that everyone here got a bonus when they left Notre Dame. Let's say for \$25,000 you could buy a 10% interest in the income of any one of your classmates that you wanted to. Now, what are you thinking about? You can take anybody in this room, and for \$25,000 buy a 10% interest in their income for life. If they make \$25,000 the first year, you make \$2,500. If they're unemployed, you don't get anything. If they get stock options, you get 10% of the stock options. What are you thinking about as you look around? Are you thinking about which ones are the smartest? It's interesting what ingredients you think now are what's going to produce that in the classroom. I would suggest that you start thinking about, assuming you have a 10% interest, what qualities you want to have. I know I would take Tom Murphy. Why? Well, he's got an IQ, there's no question about that. But, that's something one or two others might have as well.

Think about why you picked him or her, and how much of that is transferable to you. And it usually won't be anything you can't attain yourself. But if it's qualities of character, or qualities of enthusiasm, or whatever it may be, most of those things you can pick up.

[Question from audience.]

Well, we will do that anytime we feel that a dollar we retain in the company is not going to be worth more than a dollar in market price. And that can happen. I mean, as we get bigger, it's more likely to happen. But so far, every dollar we've kept in the company has translated into more than a dollar in market price, so that anybody who wanted to take \$10 a share out, or \$50 a share out, is better off having us keep the \$50, having it appraised in the market at \$60, \$70, or \$80 and selling a little piece. They actually come out dollars ahead by doing that. But, when we can't use the money for any extended period, not for a month or three months, but a period of years, when we find out that we don't have ways to use money in a way that creates more than a dollar of market value for each dollar reinvested, then we won't.

I couldn't attend the 50th birthday of one of my friends so I sent him a telegram "may you live until Berkshire splits." That doesn't apply to cash dividends. It will be a market failure but, nevertheless, that may be what happens.

[Question from audience.]

Well, I won't comment too much on that. The question is whether Security Pacific and Wells Fargo, two of the four largest banks in California, were in talks late last year, and a story appeared in the *Wall Street Journal* talking about this a week or two ago. They were in talks last year about merging. And that excited some people because Wells had done a particularly good job when they took over Crocker four years ago, or so. And then the deal, the Security Pacific/Wells Fargo thing, did not happen. And then the story leaked out so it's in the paper. Security Pacific is probably an \$80 billion bank. Wells Fargo, I know, is a \$50 billion bank. It would have created what would have been the second largest bank in the country, next to Citicorp.

My guess is there will be some bank mergers in the next few years, but they may be more suicide pacts than mergers. There's going to be a lot of action, not all good by a long shot, in banks, simply because there's so much trouble there. The big problem in merging two banks these days is that you don't know what's in the other guy's loan portfolio – because too often *he* doesn't know. And people didn't used to worry about that five or 10 years ago, and they worry about it a whole lot now because, if they merge with the wrong bank, they can go broke.

C&S, the Citizens and Southern Bank of Atlanta, merged with Sovereign earlier this year. Sovereign has got a lot of real estate problems in the Washington D.C. area, and that merger took place less than 12 months ago.

Al Lerner merged his Equitable Trust Company in Baltimore into the old Maryland National. Al Lerner is a very, very, smart fellow. And he merged his own company, which he had a lot of his own money in, he merged it in with MNC and in six months MNC was in huge trouble. The stock was 10% of what the value was when he merged it six months ago. And Al just got in with something where he didn't know how bad it was. But that was easy to do. So, everybody is super careful about that, and this is why there's a problem, because to look at a Wells Fargo with assets of \$50 billion, and Security Pacific with \$80 billion, and if there's \$2 or \$3 billion in there that's no good, that wipes out equity. That's a tough decision to make.

[Question from audience.]

Right now, in property/casualty insurance, generally speaking, prices are lousy, which means business is terrible. We have found a few things to do that will be in our annual report. We've found a few things that are OK, they're not like they were four or five years ago, but they're keeping us out of bars. And that's what we look for in times like this. But that is a *very* interesting business. When that guy was predicting an earthquake near New Madrid we wrote a two month policy against a \$3 billion earthquake for some crazy rate as a percentage of everything. We ought to keep that guy out there.

We've had a chance to do some very interesting things in insurance. It's a very tricky business. We are getting in claims on policies we wrote in 1970. We're not getting in any premium, we're just getting in claims. They tell the story in insurance ...

[Told burying dad in a rented suit story. From the 2001 Berkshire Hathaway [annual letter](#):

Even when companies have the best of intentions, it's not easy to reserve properly. I've told the story in the past about the fellow traveling abroad whose sister called to tell him that their dad had died. The brother replied that it was impossible for him to get home for the funeral; he volunteered, however, to shoulder its cost. Upon returning, the brother received a bill from the mortuary for \$4,500, which he promptly paid. A month later, and a month after that also, he paid \$10 pursuant to an add-on invoice. When a third \$10 invoice came, he called his sister for an explanation. "Oh," she replied, "I forgot to tell you. We buried dad in a rented suit."

There are a lot of "rented suits" buried in the past operations of insurance companies. Sometimes the problems they signify lie dormant for decades, as was the case with asbestos liability, before virulently manifesting themselves. Difficult as the job may be, it's management's responsibility to adequately account for *all* possibilities. Conservatism is essential. When a claims manager walks into the CEO's office and says "Guess what just happened," his boss, if a veteran, does not expect to hear it's good news. Surprises in the insurance world have been far from symmetrical in their effect on earnings.]

We literally will pay hundreds of thousand of dollars for things that happened years back. On the other hand, overall, it can be a good business if you're disciplined. We have a rule, we're very Japanese in that, we never lay off anybody. We tell them, in times like this where we're writing way less than we were writing a few years ago, we tell them that under no conditions will they be laid off for lack of business because otherwise they'll go out and write some business. I mean, it's the easiest thing in the world to do. And we tell them we'll buy them golf memberships, country club memberships, if they'll promise to play golf during business hours, because we don't want them in the office during business under terms that are generally available these days. So we occasionally run into a good big deal, and we keep busy that way, but we are operating at 1/4 speed. We have a lot of people that are doing crossword puzzles, which is fine. It beats whatever

else they'd be doing. You do not want energetic people in a lousy business.

[Question from audience.]

I read all kinds of business publications. I read a lot of industry publications. Coming in today on the plane (garbled). I'll grab whatever comes in the morning. American Banker comes every day, so I'll read that. I'll read the *Wall Street Journal*. Obviously. I'll read Editor and Publisher, I'll read Broadcasting, I'll read Property Casualty Review, I'll read Jeffrey Meyer's Beverage Digest. I'll read everything. And I own 100 shares of almost every stock I can think of just so I know I'll get all the reports. And I carry around prospectuses and proxy material. Don't read broker's reports. You should be very careful with those.

[Question from audience.]

I think the *Wall Street Journal* is essential. I spend 45 minutes a day with the *Wall Street Journal*. Actually, I got up the night before, about 11:00... I frequently read it at night. But I'll read anything. Actually, I probably spend five or six hours a day on reading. We have no meetings at Berkshire. We have a directors meeting once a year, after the shareholders meeting, at lunch. And at the end, I say "I'll see you next year." It's a very economical operation. We don't have a slide projector. We don't have a calculator. We do not have meetings on anything. If I take Ike Friedman, and bring him to a meeting, I've probably lost \$20,000 or something. He should be out there selling. There just isn't anything to meet about. He's having meetings in his head all the time about the jewelry store. I'm having meetings in my head about what to do with the money.

[Question from audience.]

We don't attend any seminars, or trade things. I get all this stuff about how to incorporate in the Cayman Islands or how to never write a check to the IRS. We don't do any of that stuff. There's not much goes on at the place, and that's probably just as well. Every now and then we get a chance to do something and we do it as best as we can.

When Coca Cola got to where it was attractive, for seven or eight months we bought every share of Coca Cola we could. We bought what, on the old stock, 23 million shares, we probably bought that on 150 trading days, that's 160,000 shares a day. You gotta do it when the time is right to do it.

[Question from audience about the possibility of buying British companies.]

I look at them. I read the Financial Times every day. We've looked at, and we've come close, very close, to one deal. There's another proposition I've got right now from somebody. But so far, we haven't done anything. But I don't rule it out.

If Coca Cola were located in London, and was an English company, and did business exactly like they do, it would be worth slightly less than [if it were a US company]. But overall, I'd do it. Obviously.

We've looked at a lot [at foreign companies]. [But] we've got a \$3 trillion pond in terms of market value in this country. And if I can't make money in a \$3 trillion pond, I can't make money in an \$8 trillion pond. We tend to look in the \$3 trillion pond mostly.

[Question from audience.]

Usually they won't. And I tell them, almost always, they shouldn't. I'm going to have a letter in the annual report this year which I've sent many times to possible sellers of businesses. And the one thing I tell them is you're not richer when you sell a business. You've got a wonderful asset that will be worth more money later on. I wouldn't be talking to you if I didn't think this was the case. If it takes care of a specific problem you have, and you want somebody that meets these certain parameters, we'll talk. If it doesn't, that great. You've got something better than I've got, because I've got cash, and I've got a problem, and you've got a good business, and you don't have a problem.

Mrs. B wasn't richer when she sold me the business. She did have one son and, at that time, three grandsons in the business, and she had three daughters and their husbands, and a bunch of their children who weren't in the business, and everybody owned 20% of it. So she thought there would be some sort of problem when she died. She was a strong enough matriarchal figure that there weren't and problems when she lived – she told them what to do, and that was it. But, when she was gone, she could see trouble. You saw it down at the Louisville Courier/Journal a couple of years ago with the Bingham family. You get a lot of money, but somebody gets unhappy. Sometimes the in-laws get unhappy. Some people prefer to solve that problem themselves, when they're alive, rather than have some trust department try and solve it when they dead. But, I don't want people selling to me because they think they're getting richer, I want them selling to me because it solves some particular problem, and I can help them solve it.

I can do things that other companies can't do. I can arrange the transfer of some of the ownership of the business to another generation. I can promise them it won't get resold. Virtually no other American company can do that. If the XYZ company goes out and buys See's or Borsheim's, the President of XYZ company can say "we're not going to sell it" but he may be taken over himself, his board of directors may tell him to do something, McKinsey may come in next week and say "get out of this business and get into some other business." You can get double crossed in a lot of ways that there's no moral stigma attached to, but that's just the way the cards fall. With me that can't happen. The only thing that can happen bad to them is if I double cross them. So they have to make a judgment whether I'm lying to them. I can't come back to them later and say the board's told me we've got to get out of the jewelry business, there's this great offer that's come in, I've got this fiduciary responsibility, blah, blah, blah, blah. That won't happen.

[Question from audience.]

They're rich because they've already gotten rich by having the company. All they're going to do, if they take money from me, is they're going pay some taxes, and they're going to invest in some other business. They might buy Berkshire, they might buy General Motors, they might buy

government bonds, but they already had a good business. And they don't have to pay the taxes. So they are not getting richer.

I can help them with some problems. When Ike at Borsheim's came to me I said "look, I will pay you X, and I will show you how to get more money than that, and here is how you can do it." He said "I'm not interested."

[Question from audience.]

We don't want what I call the used cigar butts, where you get one free puff and that's it (garbled comment from audience). Well, partly I don't have the people to stick in anyway. And I don't want to go through the human travail that's involved in that.

I don't want to go through it, basically. And, if you have your choice, we'll just think in terms of looks now, but marrying some gal that's the girl of your dreams and having another one and saying "If I send her to the psychotherapist for five years and have some plastic surgery" well maybe it will work [tape ends].

## Lecture to Undergraduate Students

[Tape picks up in middle of lecture.]

...we let the operating managers run their businesses, and we have them send the money to Omaha. And then we try to buy more businesses. And sometimes we can buy all of a business, and sometimes we can only buy part of it. But we're the largest shareholder of the Coca Cola Company, we're the largest shareholder of Capital Cities/ABC Broadcasting, we're the largest shareholder of Gillette Company, and then probably Champion Paper, Geico, the insurance company, the Wells Fargo bank. There's quite a few.

We buy entire businesses, or we buy tiny pieces of businesses called "stocks" and we have the same approach to it. And if the capital comes in, we're willing to do either one. In this year's annual report, in answer to the question of what I do, I tell the story of my granddaughter's birthday party...

[Told Beemer the Clown story again]

I sit there in Omaha and wave my magic wand. But, I've got all these Beemers out there, running businesses. They run them exceptionally well. Our businesses are generally characterized by unusual market strength and terrific continuity of management. Almost everybody that works for us is independently rich because we've usually bought their business. And they've received a lot of money from us. And one of the main parts of my job is to figure out, when I'm sitting across the table from John Smith and I'm going to hand him a check for \$50 or \$100 million, I have to decide whether he's going to get out of bed the next morning. And it's very important to me that he is just as interested in running his business, and he thinks of it as his business, the next day, and the next year, and the next decade, as he was when he owned it all himself. With a lot of people, there's no way to buy that. You can't set up an incentive compensation scheme that accomplishes that because they've already got all the money they need. You really have to make a judgment as to whether they run their business because they love business or because they love money. If they love money, we don't have a chance. We can pay them a lot of money, but they've already got a lot of money. They never need to come to work another day in their life after they sell out to us, and yet virtually all of them works harder now than they've ever worked before. The main reason for this is that they're that type – that is the way they're put together.

Secondarily, we try to provide an environment for them which is exactly like what we'd want if we were running a business. The main thing we would want is we would not want a lot of second guessing, we would not want a lot of home office meetings, we would not want a lot of supervision from some group Vice President at headquarters. We just would not want a lot of nonsense. We would like to run our own business in our own way. If you were a great golfer, and let's just say, going back to my generation, you were Arnold Palmer, you'd basically play golf because you like to play golf. But if he was playing golf, and we were doing it for money, and in some way I owned him, and I kept saying "why don't you use a four iron instead of a five iron, and why don't you aim a littler further to the right" after a while he'd wrap the club around my neck. And rightly so. If you get really talented people, you've got to give them a chance to do their own thing.

We bought a uniform company in Cincinnati five years ago, a \$100 million company. I've never been to Cincinnati. I've never seen a factory of theirs, I don't know what their offices look like. I know the people quite well.

We've got a candy company, See's Candies in California. We sold 13.5 million tons of boxed chocolates last year and made \$39 million before taxes. The fellow that runs it has been running it from the day we bought it 19 years ago. We made a deal with him, and in 30 seconds worked out an incentive compensation agreement. In 30 seconds. Never wrote it down, never had a lawyer. That deal is still the same deal 19 years later. He's been to Omaha exactly once. Last year he came to the annual meeting to see whether there really was a Berkshire Hathaway in Omaha. We've never had a group meeting of any kind. We don't force anything on them. We actually moved the headquarters of the company from Los Angeles to San Francisco because his wife liked living in San Francisco better than she like Los Angeles. Instead of having a guy with a wife that was considerably less happy living in LA, it was a lot easier to move the business to San Francisco, so that's where it comes from now.

We have no retirement age. We had a woman running a business for us, we'd bought her business when she was 89, and she was Chairman of the Board, and she ran it for us until she got mad two years ago and left at 95, because, foolishly, I'd forgotten to get a non-compete agreement from this 89-year-old woman when we made the deal. She now competes with us across the street. She works seven days a week. We've never let anybody go because of age. We had one fellow, ran a savings and loan for us in Pasadena [Wesco Financial], he kept trying to get me to get somebody else, he was 75 years old. [He'd say] "you've got to get another guy in here" and I'd say "Louis, how's your mother?" She lived to be 93 and that ended the conversation.

So we have a business with very few rules. The only rules the managers have is to basically think like owners. We want those people thinking exactly like they own those businesses themselves. Psychologically, we don't even want them to think there is a Berkshire Hathaway. They know they will never get sold. They don't have to sit around and wonder if there's going to be a takeover raid on Berkshire.

Let's talk a little bit about what you're interested in. This is a little bit different group than I usually talk to, it's almost always been MBAs in the past, and it's quite refreshing to get a mixture of liberal arts people in, so you can throw anything at me that you care to – nothing's off limits.

[Question from audience.]

They hardly get richer because they sell to me. I tell them "If you come to me, and you've got a wonderful business, I can't make you richer than you are. If you sell to me for \$100 million, it's only because your business is worth \$100 million. And you'll pay a lot of taxes and you won't have \$100 million. If you take the remainder after-tax and buy General Motors and AT&T you'll have a lot of businesses you don't understand, instead of one you do understand. There's no reason to sell to me to get richer. I always tell people the only reason I'm buying is because I think it's going to be worth more. If they are selling to me simply to stick a lot of money into

their own pocket, it's the wrong reason. But frequently....

One woman was 89 when she sold to me. She had four children. One worked in the business, three didn't work in the business. She had multitudes of grandchildren. three of them worked in the business, two of them didn't. The stock was divided equally, 20% with each branch, plus 20% she kept. As long as she was around, she was an enormously strong personality, there weren't going to be any problems because she was going to tell people what he answers were. The day she died, she felt that there would be a developing situation where people didn't work and wanted to get the money out of the business and that the people who did work would resent the fact that the people who didn't work were cashing in. You get a lot of that as families move along. So she preferred to solve it herself by getting cash for the members of the family that weren't involved in the business, and then I moved the ownership of the remaining people down to the lowest generation of the ones that were in the business. That happens a variety of times.

The uniform company we own in Cincinnati had an LBO some years earlier and there were four or five venture capital firms there and they just wanted to take a quick profit. The guy who ran it realized he'd made a mistake when he sold out to a group like that in the first place, so he steered it to us. He wrote me out of the blue.

I've got a little ad in my annual report every year. We're in advertising businesses (garbled) and this year it's under the section "Help, Help." I tell them the kinds of businesses we want to buy. This fellow had seen that in Cincinnati, wrote me a letter and said "I'm your guy." And I looked at him and said "You are my guy." We bought out all the venture capitalists, but we kept the family in. And they run the business. It's that kind of thing that comes along.

The Scott Fetzer company, which is 20 other businesses, World Book, Kirby, 20 others, Campbell Hausfeld, almost a billion of sales. They had been a New York Stock Exchange company and there was a takeover attempt, even Ivan Boesky was involved, they had a whole raft of things. I'd never met the fellow then. I wrote him a letter, I said "Dear Mr. Schey: Here's what we are..." I sent him an annual report and said "If you want to do businesses with someone whose checks will clear, who won't bother you, here's all the shoes that will drop (I told him all the bad things about us), a one-page letter. Sent it. (Kind of difficult to get all the bad things about us on one page.) I said "If you want to talk about it, I'll meet you, and if you don't, throw the letter away." He called me up, we met on a Sunday in Chicago, made a deal that night and, in a week, the deal was done. That was five or six years ago – I've been to Cleveland twice, not because I needed to be. He runs that business exactly like he [owned it himself]. \$97 million pretax earnings.

[Question from audience.]

I don't know if everybody could hear that. In that past, at least in some departments, you've heard that there is no such thing as buying an undervalued stock, or making money in stocks, that the market is efficient, and that everything is priced right at all times relative to the known information about it. Therefore, there's no use thinking. And, of course, from my standpoint I'd like to have everyone believe that, because it's a terrific advantage to be in a game where your opponent has been taught not to think. I wish the people I played

bridge would. An appreciable percentage of the money in Wall Street is managed by people who believe that. It's the old story that if there's a \$20 bill on the floor there's no sense picking it up because it can't be there. That thinking, I would say, prevailed extensively 10 years ago. I would say there's a little less of it now. All I can tell you is it simply isn't true.

The last class I told of how, in 1966 or so, we bought 5% of the Disney company for \$4 million. The whole company was selling for \$80 million! They'd written off all their films, Snow White, Three Little Pigs, Fantasia, all 220 some of them, written down to zero. You got 300 acres down in Anaheim and all of Disneyland for zero. The Pirate Ride had just been put in that year – \$17 million it cost, yet the whole company was selling for \$80 million. It was a joke. Mary Poppins made \$30 million that year. They were going to recycle Mary Poppins seven years later, they were going to recycle Snow White seven years later. It's like an oil field where the oil seeps back in, and every seven years a new crop of kids comes along and they all want to see Snow White. And they drive their parents crazy until they get to see it. Well, that whole company was selling for \$80 million. You don't have to be a financial analyst, you don't have to be finance major, to know that's a ridiculous valuation. Eleven million people a year go to Disneyland. That's seven bucks a person and you get the (garbled) thrown in free. It was a joke. And Walt Disney would tell you, if you went out to see him, would tell you all about the values, and what he had planned. It just happens occasionally in securities.

Now, an efficient market theorist would tell you that \$80 million is the correct value on the Walt Disney company. And he's wrong. You do not have to have very many like that in a lifetime. It's not very esoteric, it does not require some insight into what's going to cure AIDS, or what's going to be the best computer five years from now, or the best software manufacturer – it doesn't require anything like that. It just requires figuring out whether people will be eating Hershey bars or drinking Coca Cola.

This company [Coke] you could have bought one share of stock for \$40 in 1919, when they went public. If you reinvested the dividends, you'd be worth a million now. There are 150 countries in the world where they sell this and in every single one of them per capital consumption goes up every year. It's not that complicated. The Chairman of your [Notre Dame's] Board, Don Keough – I don't know if you're familiar with that; he is also the President of Coca Cola – used to live across the street from me in Omaha in 1960. He was a coffee salesman for Butternut Coffee, making \$200 a week. And if you knew Don Keough there was no way that, if you put Don Keough together with Coke, you were going to miss. There really isn't any way they won't be selling a lot more Coca Cola products five years from now than they are now. And, they'll be making more money on each one. If you raise the price of each one of these a penny, it's \$2 billion a year.

[Question from audience.]

The question is whether LBOs and junk bonds and so on have hurt the country in some fundamental way in terms of its competitiveness vis-à-vis the world. I wouldn't go that far, but I think on balance it's been a huge minus on the financial scene. Extreme leverage has been, generally speaking, a net minus. The analogy has been made (and there's just enough truth to it

to get you in trouble) that in buying some company with enormous amounts of debt, that it's somewhat like driving a car down the road and placing a dagger on the steering wheel pointed at your heart. If you do that, you will be a better driver – that I can assure you. You will drive with unusual care. You also, someday, will hit a small pothole, or a piece of ice, and you will end up gasping. You will have fewer accidents, but when they come along, they'll be fatal. Essentially, that's what some of corporate America did in the last 10 years. And it was motivated by huge fees. And it was motivated by greed.

The most extreme case I saw was a television station. About three years ago, a television station in Tampa sold for an amount where, when they had to borrow the money, the interest amounted to more than the total sales of the station. If everybody donated their labor, if they donated their programming, if they donated their utilities, they still wouldn't have enough to pay the interest. They went crazy. And you can buy those bonds at 15 cents on the dollar. Charlie Keating's enterprise [Lincoln Savings and Loan Association in California, which became the nation's largest thrift failure] had a bunch of them too. There's a lot of crazy stuff that went on in the last five or six years. The fees on that deal, they paid \$365 million for the station, they borrowed \$385 million and you can guess where the extra money went. It went into the pockets of the people who put the deal together.

[Question: Is it comparable to say the same thing about companies and our government debt?]

No, it really isn't comparable. The important thing on government debt is how much is owed externally. If this group landed on an island someplace, we were stranded, and the only person we could do business with was another islander, and we all went to work producing rice, and we worked hard eight hours, and we had just enough rice to stay alive. If we worked out some internal system where some people worked 10 hours a day, and some other people worked six hours a day, and the people who worked six hours a day "borrowed" two hours worth of rice daily from the people who worked 10 hours a day, as an island we wouldn't be getting poorer. We might have some class that owed future rice, plus interest, to the people that had saved, but we would not be any worse off. We would consume all the rice we produced each day, it's just that some of us would have claim chits on each other.

If, on the other hand, we all decided to quit working, because people on the other island would work 16 hours a day, and they would ship over eight hours a day of rice to us, so we would just eat and mail them IOU's (we'd send over a guy in a canoe each night with the IOUs, they'd send over rice every day), we'd all just sit around, but the little IOUs we sent them drew interest, and then after 10 years they said "we would just as soon quit producing rice the next 10 years and you guys work 16 hours a day." That won't work so well, particularly if it's a different generation that's being asked to work the 16 hours a day later on to pay back the rice from the first generation.

External debt, something our country owes the rest of the world, is a whole different question than internal debt. The national debt is largely held internally, but the game is changing as we run a trade deficit. So the trade deficit is a threat, essentially, to living as well as we live now. We are, essentially, selling off a little piece of the farm every day, as we run a trade deficit in

order to finance our own consumption. We've got a very big rich farm, so we can sell a little piece of that farm for a long time without hardly noticing it. It's a lot like eating a little too much over time. You never see it in any one day. You don't all of a sudden get up, all of your buttons pop, and people say "God, you look fat!" It just doesn't happen. What happens is you just keep doing it so pleasantly until, after a while, you've got a helluva waistline. And that is, essentially, the situation in our trade deficit. We are giving the rest of the world claim checks on us. That has consequences over time.

In fact, we sold our building to the Japanese, but it doesn't make any difference whether it's the Japanese or anybody else. We sold our buildings at ABC two years ago for about \$175 million. That was equal to one day's trade deficit with Japan. They sent up a bunch of VCRs and things, and we sent them the title to 54th Street and 6th Avenue. And we use up the one thing and they've got the other.

It's got sort of a poetic justice to it. As a matter of fact, in 1626 I think, Peter Minuet handed a bunch of trinkets to the Indians and they paid him the island. And now, people are handing us the trinkets, and we're giving them the island. It happens every day. The trade deficit will be \$100 billion plus, and that means we are giving out IOUs to the rest of the world that will draw interest, which are claims of future production of everybody in this room.

Now the internal debt, that's an entirely different story. That person helps, but the help is commensurate with the hurt. When it goes abroad, the equation is not the same.

[Question from audience.]

The question is whether we just invest domestically or also abroad. The answer to that is, in terms of buying securities, everything we've bought, almost, has been domestic. It's not that I rule out other investments. We almost bought a pretty good sized investment in England a year or two ago, and we look at things elsewhere.

The United States is a \$3 trillion equity pool, a \$3 trillion pool of equity investments. If you can't make money in a \$3 trillion pool, you're probably not going to make money in a \$6 trillion pool.

Now, Coca Cola earns 80% of its money abroad and we hold 7% of that. Our 7% share is roughly \$100 million. Of that, roughly \$80 million comes from abroad. Coca Cola is spending an enormous amount of money in East Germany in the next year. They were in there big in March of 1990. Interestingly enough, the first Coca Cola they sold in East Germany, you may be too young for this, but it was shipped from Dunkirk where the Germans, essentially, drove the English into the sea 50 years ago. For a while all the Coca Cola was going from our big bottling plant in Dunkirk to East Germany. Now, the infrastructure has been built up within East Germany tremendously, and it will be a good market for Coke.

Coke is also in McDonald's in Moscow. The Moscow McDonald's is doing \$235,000 in business a day, 50 times the average McDonald's in this country. You think of 50 McDonald's opening and that's how much business that Moscow McDonald's has done. That's a lot of people buying Coke.

[Question from audience.]

The question was, “Have I changed my ideas over the years as my bank account has increased?” The truth is, I used to have more ideas than money and now I’ve got more money than ideas. You’ve put your finger on that particular problem, but there are worse problems.

The only ideas we’re interested in now are big ideas. We are not interested in anything that we do not think we can put at least \$100 million into, usually quite a bit more. We own fewer stocks now, with \$7 or \$8 billion, that we owned back when we had \$15 million in 1970.

We do not try and buy more and more of everything. I call that the Noah’s Ark approach to investing – have two of everything. We’ve got a very selective ark, and we only want a couple of specimens on there. It makes it more difficult, but you don’t need very many good ideas. If we get one good idea a year, that would be terrific. And if you negotiate with me, you’d get me down to one every two or three years. That’s all you need. You do not have to keep hitting home runs all the time. That’s one of the nice things about this business. If you make one decision on something like that, it takes care of a lot.

I always tell classes that, in the investment world, if you had a punch card when you got when you got out of school, and there were only 20 punches on it, and when that was done, you were all done investing, you’d make more money than having one with unlimited punches. You’d make sure you used them for the right things.

The big things are not what you do, they’re what you don’t do. Basically, we’ve had very few things we’ve lost money on. We’ve had no more good ideas than other people. But we’ve not made big mistakes – that I learned from Ben Graham. He used to say there are two rules in investing. The first: don’t lose. The second: don’t forget the first.

[Question from audience.]

The first question was, “Does the current recession change our attitude toward investing?” It doesn’t change it a nickel’s worth. If something comes along tomorrow that’s interesting, I will do it tomorrow. And it will be by exactly the same yardsticks I used whenever the business cycle was at its peak. We don’t care what businesses are doing. If the Chairman of the Federal Reserve called me tonight and said “I am really panicking and things are terrible,” I don’t care. We will do exactly what we were going to do tomorrow morning. The truth is, on balance, we will do more business when people are pessimistic. Not because we like pessimism, but because it makes for prices that are much more attractive. If you all have filling stations to sell in South Bend, I want to do business with whomever is most negative about filling stations. And that’s where I’m going to make the best buy. Times are really good and times are really bad, over a period of time. We don’t quit selling candy in July just because it isn’t Christmas. We pay *no* attention to economic forecasts. I don’t read anything [along those lines]. I read annual reports, but I don’t read anybody’s opinion about what’s going to happen next week, or next month or next year.

The second question is whether there are any special industries we favor. The only thing we favor is industries we can understand. And then, we like businesses with what I call “moats” around them. We like businesses that are protected in some way from competition. If you go in the drugstore and say “I want to buy a Hershey bar” and the guy says “I’ve got an unmarked chocolate bar that’s a nickel cheaper,” you’ll buy the Hershey bar or you’ll go across the street.

One of the interesting things to do is walk through a supermarket sometime and think about who’s got pricing power, and who’s got a franchise, and who doesn’t. If you go buy Oreo cookies, and I’m going to take home Oreo cookies or something that looks like Oreo cookies for the kids, or your spouse, or whomever, you’ll buy the Oreo cookies. If the other is three cents a package cheaper, you’ll still buy the Oreo cookies. You’ll buy Jello instead of some other. You’ll buy Kool Aid instead of Wyler’s powdered soft drink. But, if you go to buy milk, it doesn’t make any difference whether it’s Borden’s, or Sealtest, or whatever. And you will not pay a premium to buy one milk over another. You will not pay a premium to buy one [brand of] frozen peas over another, probably. It’s the difference between having a wonderful business and not a wonderful business. The milk business is not a good business.

In our candy business, Valentine’s is coming up, and See’s candy on the West Coast is a very desirable item, and very few men will want to hand their girlfriend, or wife, or whatever, and say “Here honey, I took the low bid.” It just doesn’t sell. We want things where they’re not terribly price sensitive. And if you’re going to go out and buy a car this afternoon, you’re not going to say “I’d like that red job there, but I want to be sure it has steel that came from Bethlehem steel.” You don’t care where the steel came from. And, therefore, Bethlehem’s got nothing to say to General Motors, or Ford, except what wonderful guys they are. And General Motors says “We know you’re wonderful guys, and so, if Y sells it for X dollars a ton and you’d better be \$5 under them.” Anything that differentiates your product – those are the businesses we like to be in.

We like to be in businesses I can understand. There are all kinds of businesses I don’t understand, but we’re not going to own them. Thomas Watson Sr., of IBM, in that book “Father, Son, and Company, that his son wrote, quoted his father as saying “I’m no genius, but I’m smart in spots, and I stay around those spots.” The real trick is knowing what you know, and what you don’t know. It isn’t how much you know, it’s whether you can define it well, so you know when you can take a swing at the ball, and you know when you’ve got no business swinging.

[Question from audience.]

The durability and strength of the franchise is the most important thing in figuring out [whether it’s a good business]. If you think a business is going to be around 10 or 20 years from now, and that they’re going to be able to price advantageously, that’s going to be a good business. And if somebody has to have a prayer session every time they want to raise the price a dollar a pound on whatever they’re selling, that’s not going to be a good business.

What’s the highest priced daily newspaper in the United States? Most of you are familiar with it. The highest priced daily newspaper in the United States, with any circulation at all, is the *Daily*

*Racing Form*. It sells about 150,000 copies a day, and it has for about 50 years, and it's either \$2.00 or \$2.25 (they keep raising prices) and it's essential. If you're heading to the racetrack and you've got a choice between betting on your wife's birthday, and Joe's Little Green Sheet, and the *Daily Racing Form*, if you're a serious racing handicapper, you want *The Form*. You can charge \$2.00 for *The Form*, you can charge \$1.50, you can charge \$2.50 and people are going to buy it. It's like selling needles to addicts, basically. It's an essential business. It will be an essential business five or 10 years from now. You have to decide whether horse racing will be around five or 10 years from now, and you have to decide whether there's any way people will get their information about past performances of different horses from different sources. But you've only got about two questions to answer, and if you answer them, you know the business will make a lot of money. *The Form* has huge profit margins, incidentally. Wider than any other newspaper. They charge what they want to basically. It's an easy to understand business – so easy to understand.

Snow White is going to show up every so often, and when she shows up, millions of kids are going, and they'll make their money, and they don't have to make the picture again. Made back in 1937 or so. It's a perpetual royalty on youth. And that's not a bad business.

[Question from audience.]

Where did Donald Trump go wrong? The big problem with Donald Trump was he never went right. He basically overpaid for properties, but he got people to lend him the money. He was terrific at borrowing money. If you look at his assets, and what he paid for them, and what he borrowed to get them, there was never any real equity there. He owes, perhaps, \$3.5 billion now, and, if you had to pick a figure as to the value of the assets, it might be more like \$2.5 billion. He's a billion in the hole, which is a lot better than being \$100 in the hole because if you're \$100 in the hole, they come and take the TV set. If you're a billion in the hole, they say "hang in there Donald."

It's interesting why smart people go astray. That's one of the most interesting things in business. I've seen all sorts of people with terrific IQs that end up flopping in Wall Street or business because they beat themselves. They have 500 horsepower engines, and get 50 horsepower out of them. Or, worse than that, they have their foot on the brake and the accelerator at the same time. They really manage to screw themselves up.

I tried this with the last class. Let's say each one of you could buy 10% of the earnings, forever, of anybody else in this room, except me. Let's charge \$50,000. And that means that if somebody gets out of here and earns \$30,000 you get a \$3,000 royalty off them. But, if they do extremely well, and become President of Coca Cola like Don Keough did, you'll make a fortune.

How are you going to think, in terms of the rest of the people here, of which one you want to buy the 10% of? Let's say we had Donald Trump here, and my friend Tom Murphy, who runs ABC, or Don Keough, and you're really betting on the lifetime of each of them, and let's say they're all in equally good health. Would you give them an IQ test? Well, you'd want to be certain they have a certain amount of IQ. Would you want to measure how strongly motivated

they were, how much they wanted to get rich? Donald Trump wanted to get rich. That might not be a great qualifier. What would you do to select that one person out of this whole crowd here, because there will be a huge difference in results here. There's not a huge difference in IQ. But there will be a huge difference in results. I would venture to say, I don't know how well this group knows each other, you come from two different schools, so I'd break it down into two groups, I would venture to say that your guesses would not be bad. They'd be better if you'd had more experience with the group, and if you've had more experience generally, but they will be way better than flipping coins. You would probably relate it to a lot of qualities, some of which would be straight from Ben Franklin – I would suggest that the big successes I've met had a fair amount of Ben Franklin in them. And Donald Trump did not.

One of the things you will find, which is interesting and people don't think of it enough, with most businesses and with most individuals, life tends to snap you at your weakest link. So it isn't the strongest link you're looking for among the individuals in the room. It isn't even the average strength of the chain. It's the weakest link that causes the problem.

It may be alcohol, it may be gambling, it may be a lot of things, it may be nothing, which is terrific. But it is a real weakest link problem.

When I look at our managers, I'm not trying to look at the guy who wakes up at night and says "E = MC<sup>2</sup>" or something. I am looking for people that function very, very well. And that means not having any weak links. The two biggest weak links in my experience: I've seen more people fail because of liquor and leverage – leverage being borrowed money. Donald Trump failed because of leverage. He simply got infatuated with how much money he could borrow, and he did not give enough thought to how much money he could pay back.

You really don't need leverage in this world much. If you're smart, you're going to make a lot of money without borrowing. I've never borrowed a significant amount of money in my life. Never. Never will. I've got no interest in it. The other reason is I never thought I would be way happier when I had 2X instead of X. You ought to have a good time all the time as you go along. If you say "I'm taking this job – I don't really like this job but in three years it will lead to this," forget it. Find one you like right now.

[Tape runs out]

**“Academic Economics:  
Strengths and Faults  
After Considering Interdisciplinary Needs”**

**Herb Kay Undergraduate Lecture  
University of California, Santa Barbara  
Economics Department**

**By Charles T. Munger**

**October 3, 2003**

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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/](http://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 it 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 than 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](http://post.economics.harvard.edu/faculty/mankiw/mankiw.html)] new textbook [[Principles of Economics](http://www.amazon.com/exec/obidos/ASIN/0324168624/tilsoncapitalpar), [www.amazon.com/exec/obidos/ASIN/0324168624/tilsoncapitalpar](http://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](http://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](http://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](http://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/](http://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 80<sup>th</sup> 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 "Kiplingism." And when I call it Kiplingism, I'm reminding you of Kipling'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](http://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/](http://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](http://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](http://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 multidisciplinary: 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](http://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.

### *Niederhoffer the curriculum*

There was a wonderful example of gaming a human system in the career of Victor Niederhoffer [[www.squashtalk.com/profiles/niederhoffer.htm](http://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 "Niederhoffer 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](http://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, [<http://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](http://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.” (Laughter).

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 *Alice in Wonderland*]. 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).