The View *from* Burgundy

MAY 1994

Berkshire Hathaway's '94 AGM

Most people who are readers of *The View from Burgundy* are quite familiar with Warren Buffett. According to Forbes magazine, he is currently the richest man in America through his holdings of Berkshire Hathaway stock. His investment record with Berkshire Hathaway over the last 27 years is so superior to what any market index has done that it cannot be attributed to good fortune or chance. Clearly, Warren Buffett is the greatest investor of our time, and there is much that can be learned from his writings and his answers at the Berkshire Annual General Meeting (AGM).

In order to glean some further insights into the way that Buffett invests, and his views on current market issues, we journeyed to Omaha for the Berkshire AGM. In preparation for the meeting, we read Berkshire's Annual Report, and in particular, the Chairman's Letter. Once again, we were struck by the common sense logic both of Buffett's writings and his thoughts. That same common sense approach, which bears greater tribute to the intelligence of the author than the mathematical modelling approach to investing that dominates today's environment, was very much in evidence. This quarter's *View* is a reflection of the thoughts and ideas that were expressed at that meeting.

The business part of the meeting lasted seven minutes, followed by a 3.5-hour question and answer session handled by Warren Buffett and his associate, Charlie Munger, Vice-Chairman.

Staying Within Your "Circle of Competence"

- Buffett emphasized several times that an important factor in the success of Berkshire is staying within its "circle of competence." He said, "Charlie and I don't like difficult problems."
- He spoke of the danger of hiring experts. He said, "Don't ask the barber if you need a haircut."
- He emphasized how little really goes on at the headquarters of Berkshire, and how old fashioned it is. He pointed out that at this moment, while the meeting is going on, there was only one secretary at Berkshire's head office. The company's Chief Financial Officer was manning the microphone at the company's AGM. Buffett spent his time at the office reading and on the phone. There are no formal meetings at Berkshire.
- Munger spoke of the "eternal verities" in business.
- Buffett said that he has no views on the economy or the stock market. He is an "agnostic" on these issues. He feels they are of no value in making successful investments.

Risk

- One key aspect to risk is how long you expect to hold an investment (e.g., stock in Coca Cola might be very risky if bought for a day trade or held for only a week). But, over a 5- or 10-year period it probably has almost no risk at all.
- The myth that volatility of a stock somehow equates to risk was discussed. In Buffett's view, volatility in fact often created great opportunity. The following comments on risk in investments were on page 14 of the 1993 Annual Report:

"Charlie and I decided long ago that in an investment lifetime it's just too hard to make hundreds of smart decisions. That judgment became ever more compelling as Berkshire's capital mushroomed and the universe of investments that could significantly affect our results shrank dramatically. Therefore, we adopted a strategy that required our being smart – and not too smart at that – only a very few times. Indeed, we'll now settle for one good idea a year. (Charlie says it's my turn.)

The strategy we've adopted precludes our following standard diversification dogma. Many pundits would therefore say the strategy must be riskier than that employed by more conventional investors. We disagree. We believe that a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying into it. In stating this opinion, we define risk, using dictionary terms, as "the possibility of loss or injury."

Academics, however, like to define investment "risk" differently, averring that it is the relative volatility of a stock or portfolio of stocks – that is, their volatility as compared to that of a large universe of stocks. Employing databases and statistical skills, these academics compute with precision the "beta" of a stock – its relative volatility in the past – and then build arcane investment and capital-allocation theories around this calculation. In their hunger for a single statistic to measure risk, however, they forget a fundamental principle: It is better to be approximately right than precisely wrong.

For owners of a business – and that's the way we think of shareholders – the academics' definition of risk is far off the mark, so much so that it produces absurdities. For example, under beta-based theory, a stock that has dropped very sharply compared to the market – as had Washington Post when we bought it in 1973 – becomes "riskier" at the lower price than it was at the higher price. Would that description have then made any sense to someone who was offered the entire company at a vastly reduced price?

- Charlie Munger stated, "A lot of modern finance theory can only be described as disgusting."

Derivatives

- Buffett believed that derivatives were a potential major risk for financial markets. He referred to the Carole Loomis article in Fortune magazine a month ago as an excellent discussion on the subject.
- He said that the "combination of ignorance and borrowed money" usually leads to serious problems. This is the second year Buffett has warned of possible dangers from derivatives.

Management

- Buffett thought that there were two main factors in assessing management:
  - How have their results been?
  - How do they treat the company's shareholders? Look also at how management treat themselves relative to the shareholder by reading the proxy circular.
- Buffett said that he advocates "finding the 0.400 batters, and letting them swing."
  Buffett later went on to say that one of the two or three most important things a Chief Executive Officer does is to allocate capital (i.e., invest money – either retained earnings or new outside capital). Yet few CEOs are trained for capital allocation because they rose through other streams in the business such as operations, sales or finance. Referring still to capital allocation, Buffett said that most CEOs, when they get the top job, are "like a concert pianist arriving at Carnegie Hall – only to be handed a violin."
  Often, CEOs who are inexperienced in the field of capital allocation will rely on so-called "experts"; Buffett saw this as extremely dangerous.

Various Investments

Private Investments vs. Public Investments

- Berkshire has previously said that it would prefer more private investments, but has had trouble finding suitable ones. At the present time, the public market offers more opportunity. There are very few good private situations around and those that are available tend to be overpriced. Berkshire has a billion dollars in cash at present.

- Buffett said that there is more possibility of significant "mispricing" in the public stock market. This is because emotion plays a larger role both in the public market and in the very superficial knowledge with which most investors operate. On the other hand, owners of significant private businesses tend to have a much better idea of what their businesses are really worth.
- There is very tough competition currently for the few good private businesses of decent size from:
  - MBO funds or LBO funds: Typically these funds are run by people using other people's capital; they benefit from upside but don't suffer as much from downside since it is not their money that is at stake. Therefore, they are less worried about overpaying for a business.
  - Other public companies: They don't mind overpaying; management of these types of companies are often more focused on size than on return on investment, and often they are not big shareholders. These types of buyers don't mind issuing new stock in payment, whereas Berkshire doesn't like to issue new common stock.
- Buffett definitely felt that the "stock market is far less efficient than the private market."

Permanent Investments

- Buffett and Munger viewed the following Berkshire investments as "permanent holdings":
  - The Washington Post
  - Capital Cities/ABC
  - GEICO
  - Coca Cola

Banks

- Banks are much better capitalized today than several years ago. Loan demand is down; therefore, some of this surplus capital is not currently needed. Acquisitions and share repurchasing may continue to be a strong feature of the bank industry in the near future as a result of this excess capital.

Tobacco

- Buffett said that he wouldn't want too much of his net worth invested in this industry and that its future will ultimately depend upon the view of society as a whole.
- He said that last year, Berkshire Hathaway was rumoured in the press to be purchasing shares in at least 10 different companies. He said that in the "majority of cases," the rumours were wrong. U.S. Tobacco, Philip Morris and Wrigley were among those that Berkshire was allegedly buying. We suspect that Wrigley meets Buffett's investment criteria except maybe as to the current share price.

General Electric

- Buffett spoke very highly of the Company and its chairman, Jack Welch.

Freddie Mac/Fannie Mae

- They can create insurance products significantly cheaper than savings and loan companies.

Insurance

"Supercat" Insurance Risks

- There are two big risk possibilities in Berkshire's "supercatastrophe" business:
  - a hurricane – especially if it occurred over Long Island or the Northeastern United States
  - and/or a major earthquake.
- He spoke very highly of Berkshire Hathaway's management, and reiterated that Berkshire's huge net worth gives the company an enormous competitive advantage in this area over all of its competitors.
- GEICO could withstand a few catastrophes in a row.
- New Bermuda insurance companies have brought $2-3 billion in new capital and caused more

competition in reinsurance rates.

- Berkshire tries to "price to exposure," whereas most large insurance companies "price to experience."
- Buffett emphasized not letting the market think for you.

Reinsurance

- Buffett thought that a lot of dumb things are done in the reinsurance business. This is an industry where "you don't know who is swimming naked until the tide goes out."

Various Musings

Appropriate Discount Rates

- Buffett stated that the proper way to value an investment is by discounting the future estimated stream of free cash flow. Buffett said that he would use a discount rate of around 10% if the government long-term bond yield was 7%.

The Federal Reserve Board

- There was a question on the effectiveness of the Federal Reserve. Greenspan has a very tough job and Buffett seemed to feel that he does it reasonably well.
- The Fed's main job is "to take away the punch bowl once in a while," he said.

Regarding Synergy

- Both Coke and Gillette are doing business in China. A negative for Gillette is that the Chinese shave less often than we do in the West. Buffett wondered if "something could be put in the Coke" to get the Chinese to shave more frequently!

Taxes

- Buffett said that he would prefer a steeply progressive consumption tax and would emphasize this rather than income tax. But, he felt that the rich get a good deal in America.

Favourite New Books

- Someone asked about Buffett's favourite new books:
  - Janet Lowe's biography of Ben Graham is being released in September 1994 (Buffett has read the galleys and thinks it is good).
  - Connie Bruck's biography of Steve Ross (the deceased former chairman of Time Warner).
  - Later, Buffett again mentioned *The Intelligent Investor* by Benjamin Graham as the most important investment book, especially Chapters 8 and 20.
  - Buffett, in earlier years, has also referred to the two books by Phil Fischer as key reading for serious investors.
  - He also recommended *The General Theory of Employment, Interest, and Money* by Keynes.

Hedging Currencies

- Berkshire doesn't hedge its currency exposure. Why spend money to hedge a 50/50 proposition (i.e., a random event)?

As we have previously stated, Burgundy's investment philosophy is based on buying securities of good companies when they are selling below "intrinsic value," with a significant margin of safety.

We think of stocks as fractions of companies (which they are!) and analyze them accordingly.

We know of no better spokesman of many of these principles than Warren Buffett and hope that our readers find his thoughts of value.

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