The VIEW *from* BURGUNDY

JUNE 1996

BERKSHIRE HATHAWAY'S '96 AGM

WE ATTENDED THE BERKSHIRE HATHAWAY Shareholders' Annual General Meeting held on May 6, 1996 in Omaha. There were a number of subjects of interest that came up during the marathon five-hour question and answer session handled by Chairman Warren Buffett and Vice-Chairman Charlie Munger. We thought several topics, while not new, were quite relevant to the way we run our investment practice at Burgundy, so devoting significant space to Berkshire in this issue of *The View from Burgundy* seemed worthwhile. Like those who are great at most endeavours, Mr. Buffett brings to investing an ability to articulate simple, common sense, easy-to-apply principles that can be very helpful to us lesser mortals.

New Share Issues

A large part of the Q&A session was taken up with Berkshire's issue of Class B shares. Unlike virtually anyone else who has ever done a share issue, Buffett recommended against anyone buying his stock. But when he began to talk about new issues in general, we found his remarks very useful.

Buffett pointed out that there is a tremendous amount of promotion and hype at the time of a new issue. Often, as part of the sales pitch, management states, or certainly implies, that the issue price is "undervalued." Buffett made the point that if management really thinks a new issue is undervalued, then they are harming the existing shareholders by diluting them at a price below what their shares are worth. The management, he said, is doing a great disservice to current shareholders in these circumstances.

New issues are usually not of much interest to us at Burgundy. The reason is simple – they are usually not "bargains." In fact, many of the type of outstanding companies we prefer seldom need to raise equity capital simply because they are sufficiently profitable that growth can be funded from retained profits. Many of our favourite companies are in fact doing share buybacks when circumstances permit. This is currently being done in a significant way by First Empire, Walt Disney Co., American Express and Philip Morris, among others.

In fact, we joke at Burgundy that the true meaning of "IPO" is not the conventional "Initial Public Offering," but rather, "It's Probably Overpriced."

Occasionally, there is an exceptional IPO selling at a good price. Late in 1995, for instance, we took a significant position in a very attractive Canadian insurance company called Kingsway Financial Corp., a niche casualty insurance company with a big market share in non-standard auto insurance. The market was slow to react as it perceived Kingsway to be rather dull. It was obvious no one had taken the time to understand the company's attractive economics and brilliant track record, or to meet its capable management. But all this is to our clients' advantage – they got a good company at a good price and now the stock is up 60% in only four months. We emphasize that an IPO like this is very rare for us. We don't buy stocks expecting this kind of short-term performance.

Capital Inflows and the Timing of Investments

A considerable amount of discussion at the Berkshire meeting centred around the importance of "opportunism" in making investments. Buffett has often made the point that great opportunities come unpredictably and infrequently. Great opportunities are businesses with outstanding economics, run by good people who treat the shareholders as partners in the business, and whose equity is available at a favourable price.

A problem in the investment business is that sometimes investment managers receive money from their clients at inopportune times and feel compelled to invest it. The supply of money becomes the factor motivating the so-called "professionals," rather than the availability of outstanding investment opportunities. This has contributed much of the strength to the recent bull market as people have plunged into mutual funds in record amounts, and many mutual fund managers have in turn been investing this money with little regard for value.

Buffett feels that one of Berkshire's strengths is that he and Charlie Munger are happy to sit with large amounts of cash without it "burning a hole in their pocket." Similarly, Buffett feels that a key factor in Berkshire's success in the reinsurance business is only accepting risks they really want; there is no pressure whatsoever on Berkshire's underwriting team to write policies just to keep busy.

At Burgundy, we see the application of this principle of opportunism as a constant challenge in the conduct of our investment activities. Sometimes money flows in at times when you really don't want it and sometimes there is pressure to invest just to get money working. Even our own analytical staff occasionally feel that if they don't find new opportunities, perhaps they aren't doing their job. There are many other influencing factors, including brokers and the media who constantly promote and publicize their "new ideas" and "stories."

We are very conscious of the principle of opportunism. We try our best only to invest in good companies at good prices. The pressures are very real, however, and while we try to resist them… we may occasionally be influenced by them. Our awareness level is high and we feel that we probably resist better than most, but we must do even better.

An important point to note is that Berkshire has no business plan or budget for its investment activities. There is no pre-ordained plan or blueprint for investment behaviour. Rather, each investment opportunity is evaluated as it evolves, with reference to whether the acquisition is beneficial to shareholders. Similarly, in Berkshire's reinsurance business, there is no business plan with goals for market share, type of risks sought, growth rate or budget.

The Importance of Management

Buffett has always stressed that he devotes a lot of his personal time to the careful study of annual reports for those companies in which he is interested. Wall Street, he says, has not given him a worthwhile idea in 40 years.

One question from a shareholder at this year's meeting was, "What particular information does Buffett look for in reading an annual report?" He stated that on average he spends 45 minutes to an hour on a report. The first thing he looks at is the people running the company:

- Examine management's record; he says that he wants consistent 0.350 ball hitters and doesn't want to gamble on a CEO with weak historical results who is trying to improve his track record. He said that you should avoid the 0.125 hitters who are on a hot streak.
- Try to discern the attitude of the CEO towards the shareholders. Will he treat you like a partner?
- Look for managers who know and love their business, and respect their shareholders.

Reporting to shareholders should outline the material things that have happened over the last year and what the future risks are. Reporting to shareholders should be the same as reporting to a 50% partner in a private business who has been out of the country for a year. Buffett has also talked about how important it is that management should want shareholders to understand what they are doing. If you have difficulty understanding an annual report, it's probably not an accident.

Management should run their companies as if they were going to be running them forever. In other words, deal with the problems now, plan to grow over the long term and don't worry about looking good over a one-year period. A really great company is not only great for three years but for a lifetime.

Buffett says that businesses with poor economics won't survive at all in the long run unless they have good management. Really great companies with strong economics don't necessarily require such great management, but when you find great management and a great business combined, "Bet heavily and don't sell out,"[1] he said.

This is an area of weakness in the investment management industry in our view. When dealing with vast quantities of money in this complex world, institutional investors often rely heavily on statistics, computer screens and brokerage reports. The assessment of management and the structure of the Board of Directors and their capabilities receive only limited scrutiny, although to us it seems enormously important.

The assessment of management is an area of focus at Burgundy. It's an area where mistakes can be easily made, and assessing people is never easy. But in publicly-traded companies, the diligent investor is greatly assisted because of the availability of plentiful information including historical financial data, speeches by the CEO, annual reports and annual meetings.

If you want your management to think like shareholders, Buffett advocates making them shareholders, not through fixed-price stock options but by way of actual cash purchases. Ten-year fixed-price options are essentially interest-free loans. You wouldn't do it as part of your regular business so you shouldn't do it just to increase share ownership.

Concentration of Investments Versus Diversification

Buffett is a tremendous believer in concentrating his money in relatively few well-chosen businesses or stocks. Buffett says, "All you need in your lifetime are three great businesses and you can get very wealthy."[2] How many great fortunes have come out of portfolios with 40 or more stocks in them? The main advantage to diversification in investments, he said, is "protection against ignorance."[3] The conventional institutional investor's practice of wide-spread diversification is a confession to not really understanding the individual business that well. For example, "There simply are not very many companies with economics as outstanding as Coca Cola,"[4] he said.

A discussion of diversification in investments led to wide-ranging comments on the subject of corporate finance and investments as taught in business schools, and presumably (although not stated) in the Chartered Financial Analyst (CFA) program.

Among the topics emphasized in such courses are "diversification" and "the efficient market theory." The efficient market theory holds that it is impossible to "beat the market" in the long run. At the mention of these subjects, the normally reticent Charlie Munger came to life with a vengeance. "Much of what is taught in modern corporate finance classes is twaddle,"[5] stated Munger emphatically.

The Securities Industry

In reference to Salomon Bros., Buffett talked about the relative "value of the chair versus the value of the trader"[6] and asked this question: "Would you rather own a piece of the Mayo Clinic or its best surgeon?"[7] In the end, the surgeon may feel that he is responsible for all of the success, and will want all of the reward. But the Mayo Clinic's reputation rests with no one individual, but rather with the institution. Wall Street has a problem with dividing up credit and profits between shareholders and insiders. While some securities firms manage this issue better than others, it remains the highest concern for investing in brokerage stocks.

In terms of volatility of earnings, Buffett thought that this was the nature of the securities industry. Volatility is fine as long as the company achieves a high average ROE over time. In his Annual Report for 1995, he said that he "would rather own a company with lumpy earnings and a 15% average return on equity (ROE) than a company that earned 12% every year."[8]

Buffett's Comments on Specific Companies

Freddie Mac/Fannie Mae:

The business is riskier than in the past due to the nature of contracts. Mortgage holders can pay back the mortgage without penalty or keep it for 30 years – a very disadvantageous relationship when you are the holder of the mortgage. Freddie has offset the risk somewhat through the use of callable debt and further structuring of its balance sheet, but it remains a more difficult business than it once was.

First Empire:

"In banking, as in any retail, anything you do can be easily copied, though there is some advantage in being first. If run right, banks can be great businesses, and Bob Wilmers runs First Empire right."

Walt Disney Co.:

"Buffett said that Michael Eisner is an example of a great manager; the business is getting more competitive, especially in animation, but Disney has a better chance of maintaining a special place in the minds of children and adults in the future.

Walt Disney Co. owns a number of wonderful assets, such as Snow White and Mickey Mouse, for which they pay nothing to use again and again. To Buffett, the great thing about Mickey Mouse is that he doesn't have an agent."

Owning the rights to a movie like "Snow White" is like having an oil field where you pump out all the oil, sell it, and then the oil seeps back into the field to be pumped out again."[9]

Endnotes

1 - 4. Buffett, Warren E. Berkshire Hathaway Annual General Meeting. 1996.

5. Munger, Charlie. Berkshire Hathaway Annual General Meeting. 1996.

6 - 9. Buffett, Warren E. Berkshire Hathaway Annual General Meeting. 1996.

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