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On Thursday evening (5/9/02), Columbia Business School's Seminar on Value Investing welcomed Warren Buffett as the guest speaker. I was lucky enough to worm my way into it. Here are my notes. (I don't claim that everything is completely accurate, but I think I captured at least the proper meaning of everything).

5:55 pm – 5 minutes to go. The classroom looks like it was built to hold about 160 students and currently holds about 200 people – mainly students, with a few suit-and-tie types sprinkled in. There is some excitement, but not as much as the Berkshire annual meeting I went to 2 years ago. It was an interesting dynamic: In Omaha, everyone there made an effort to be there, which resulted in almost everyone knowing a good deal about Buffett and having some familiarity. In the classroom, there was a bit more curiosity, a "Do you think he'll have bodyguards?" kind of thing. I take my seat in the back and notice 3 cans of cherry coke lined up on the front table.

6:05 – Buffett walks in, picks up a can of cherry coke and holds it aloft. Everyone laughs. Bruce Greenwald (http://www.amazon.com/exec/obidos/ASIN/0471381985/104-9675556-5361512) acts as moderator. After a couple of class-related announcements, I get my first surprise – Walter Schloss is here, too. "If Warren Buffett can be thought of as the Babe Ruth of value investing, then Walter Schloss is the Ty Cobb and Satchel Paige combined." He notes Schloss' longevity – 47 years of remarkable performance. [Prompted by Buffett later on, Schloss claims a 20.9% (pre-fees) annual return over that time period.]

Greenwald then notes how peculiar it feels to be responsible for introducing someone who clearly needs no introduction. He identifies Warren Buffett as "The Rose Blumkin of the investment world." Buffett takes the microphone – "Testing, one billion, two billion".

Some early remarks:
- Speaking on the longevity brought up with regard to Schloss, Buffett knows what he wants people to be saying at his funeral: "My God, he was old!"
- Notes that he has now been married for 50 years and 3 weeks and says that being married to Susie is "the only thing that's happened better than taking Graham's class." He then points to Susie, who is sitting in the front row (surprise #2). [I think that Carol Loomis and Peter Buffett were also there, but I'm not positive.]

Next, the questions, which he leaves open to anything, whether business or personal related. As anyone who's ever seen Buffett speak can tell you, the questions were pretty standard. What makes the presentation interesting is the path that Buffett's answers take. Throughout this question and answer period, which lasts slightly over 2 hours, WEB is on his feet, leaning back onto a table, cherry coke at his side.

1. Options – We know you don't like them, but what about the companies you own?

WEB only knows of 2 companies that expense options (as is allowed under SFAS 123, but not practiced by many, for obvious reasons): Boeing and Winn-Dixie. He notes that a company (in Manhattan?) is currently voting on switching to an expensing convention. In most cases, options don't do a great job of providing the right incentives. Of all the employees in Berkshire Hathaway, Gen Re employees have made more, by far, from options in the last couple of years than anyone else in BRK. Looking at the dismal results of Gen Re indicates how capricious option rewards can be.

For BRK specifically, it doesn't make sense to give options to anyone. Anything that a division/subsidiary manager does to influence results is swamped by wiggles in the overall portfolio of businesses. Compensation arrangements at BRK are created and agreed upon in minutes – no consultants needed.

Across the spectrum, compensation plans are crazy.

WEB has an envelope with the name of his successor. (The first thing this note says is “Check my pulse again.”) It makes sense for him to have options – he would be responsible for the overall business. However, 2 critical features of these options would be:
- They would be granted with an exercise price equal to the greater of intrinsic value or market value.
- They would include a cost of capital effect so that the exercise price would be increasing each year.

As generally done, options are terrible. There's nothing inherently wrong with options. In the Buffett Limited Partnership, he had options: 25% of any returns in excess of 6%. However, he drew no salary and those options included a cost of capital.

2. Will the Wall Street Journal erode their moat with their recent cosmetic changes [moving a little towards USA Today]?

WSJ is an interesting case. 30 years ago, Dow Jones & Co. owned the world with regard to financial information. They had no competition to speak of. Most newspapers at that time defined their population by geography. The WSJ editor (name?) built the circulation from 50,000 to 1.5 million by defining population by interest. Their population had amazing demographics.

Over the past 30 years, financial information has been a growth industry. Dow Jones missed the boat. Their business was taken away by CNBC and Bloomberg. They got very self-satisfied. In 15 years, they went from #2 on Fortune's “Most Admired Companies” list to about #200.

He compared it to Classic Coke vs. New Coke. In the 1980's, Pepsi was conducting their “Pepsi Challenge” across America – and winning. People at Coke wouldn't admit it, but in 1985, Pepsi was driving them buggy. Americans will always go for a sweeter product in a taste test. Pepsi simply had [has] more calories than Coke and was [is] sweeter. So

Coke decided to add some sweetness/calories to compete. They tested New Coke across 300,000 people in every conceivable demographic slice before they brought it out. Pepsi capitalized on New Coke by calling the introduction of New Coke a product recall of Old Coke. Pepsi actually declared a holiday in their company on that day and took out ads the day before the formal New Coke release: “The other guy just blinked.”

As it turns out, the mystique of the Coke formula is great. Only 2 people know it, it's locked in a Sun Trust vault, blah blah blah. In reality, Coke can make Pepsi and Pepsi can make Coke. You can break down the formula. At one point, Pepsi was moving towards introducing a product called Savannah Cola, which was equal in formula to the Old Coke. The only problem they faced was that one of the ingredients from the formula was hard to obtain because almost the entire production was purchased by the Coca Cola company. Little by little, they were able to obtain this ingredient and were within 2 weeks of bringing it out when Coke relented and made Classic Coke.

[Talk about how important the “feelings” are with Coke. The associations one has when thinking about Coke. The fact that he could say RC Cola and no one would have much of a response, but he could say Coke and every single one of us would have some type of reaction. Pepsi consistently beat Coke in a blind challenge. New Coke consistently beat Old Coke in a blind challenge. Yet for some reason, people went ballistic when Coke changed the formula. That's how embedded the Coke idea is.]

It's like See's Candy. It's not that well known in the East, but 33 million people in California will all have a reaction to the See's name. When people in California put a piece of See's Candy in their mouth, they like it a lot. When you tell them that it's See's, they like it even more. It's the combination of all the thoughts that go into the experience.

The Coke CEO a couple of years ago got into trouble when he spoke of a vending machine that could vary prices depending on the weather, increasing prices in hot weather. [WEB: At least say it in a way like you're lowering prices in cold weather.] That brought a lot of bad feelings with it. When you're making $0.01 per 8 oz. Serving and serving over 1 billion of those servings every single day, that's $4 billion in earnings per year – all because of $0.01 per serving. It's critical, huge to keep a favorable opinion in people's minds.

3. Concerning the comment about a nuclear attack made at the annual meeting – how is BRK insurance adapting?

BRK writing probably more terrorism insurance than anyone else. Amazingly it is almost all being sold with NCB (nuclear, chemical, and biological warfare) exclusion. A few policies have been sold without that exclusion, but not many. BRK can't sell very much insurance without NCB exclusion.

WTC is the largest workers' comp event in history – about $1.8 billion in workers' compensation claims. The other day, BRK wrote time-sensitive earthquake insurance – it only pays if the earthquake occurs between 6 am and 6 pm. The Northridge earthquake in 1994 would have been a huge workers comp event, but it occurred at 4:30 in the morning.

With regard to his prediction about a nuclear attack on a major American city: The chance of anything (NCB) occurring in the next year is very low. Over the next 10 years, that likelihood increases – there are more people in the world, more people hate us, and technology is improving. Over 50, that chance increases to a virtual certainty. In the early 1960's, only 2 countries had nuclear capabilities, and we damn near screwed it up. [Noted there was a good movie on the Cuban missile crisis a couple of years ago. I assume he means 13 Days, which I thought was good.] Now the chances are higher – there are way more people.

4. BRK has a history of striking quick deals and deals done over a handshake. Has there been a change based on the Enron-type financial deceptions?

No. Talked about how he closed the deal with Larson-Juhl, the custom frames maker. Got called up, talked on the phone for 20 minutes, heard the financials and heard the price, flew the guy to Omaha. “I've never seen the Company. I hope it's there.” [This was actually pretty funny as WEB did an impression of some scam artist: “Hey, what numbers should we report to Warren this month? Hahaha”] It's a great business – price is not a factor in custom frame purchasing. There are a ton of small framing businesses, dozens in Omaha alone. LJ supplies them all, usually delivering the product within a day. [Is this right? For a custom frame?]

“I could give you $100 million (I'm not going to do that) to build a competing organization. You couldn't do it. It won't double in size, but it's a great business. I can see the durable advantage of that business. You can't mess it up.”

We just don't spend a lot of time researching deals. It's like teaching a class on the Efficient Markets Theory. You walk into class on the first day and say, “Everything's priced right.” Then what? What else do you need to say? You just don't need that much time. If it's not obvious right away, it won't be obvious with a year's worth of due diligence. (Used Chrysler and Ford as examples.)

Somehow moved into a Snickers and Wrigley's example. Snickers has been the top selling candy bar for 40 years and probably will be in 10 years. If you were chewing spearmint gum 10 years ago, you're still chewing it today. Those are great businesses. If you walked into a store for a Snickers bar and the guy behind the counter offered you a chocolate bar with the same taste and same gooeyness for 5 cents less, but it was “Joe's Chocolate Bar”, you wouldn't buy it. Due diligence – whether or not they have a bad lease or their bad debt reserve is too low – doesn't matter. It's about the durable advantage.

5. Do you see value in tech stocks today? Is there ever value? Where would BRK invest in tech?

If we could look out 5-10 years and see durable advantage and likelihood of high incremental ROE, that would be the place. We're not religious about not investing in tech stocks. (“In fact, I don't even know if there are religions against investing in tech stocks.”) “There's no reason to look for a needle in a haystack if the haystack is made out of gold.”

You could have bough the pharmaceutical industry in 1993 with a high degree of conviction. Maybe you couldn't identify the one or two winners, but the industry had marvelous economics and you know there wasn't going to be some new kid on the block to just completely up-end Merck or Schering Plough.

6. Can you speak about investments you made that didn't work out?

Errors tend to be of omission, not commission. Not necessarily Intel or Microsoft, but those situations where he knew the business and did nothing. “Thumb sucking”. Often happens when he is buying a stock at $x and it goes to $x 1/8. He goes into paralysis. Fannie Mae is one example. Errors of omission have cost BRK billions and billions (20 – 30 billion).

BRK almost lost a lot on US Airways. “As the ink was drying on the check, they started losing and losing money.” Salomon investment. 9/11 insurance – not the fact it was a catastrophe, but that the terrorism insurance wasn't built into the premiums.

The biggest mistake in management is not recognizing that very smart people will do dumb things – without trying to. [References Lowenstein book on LTCM.] Once an organization starts to gain momentum, it's impossible to stop them. Often happens with acquisitions. If the hurdle rate is 84.3%, the deal will be projected to return 84.4%. If the CEO wants it, it'll happen.

7. As you look at the entrepreneurs of the firms you've bought, what do you look for? What advise do you have for potential entrepreneurs?

We look for passion. WEB talked about Al Ueltschi for a while.

Sit down with them and find out if they love the business or love the money. We've never bought a business from a financial operative. We've never participated in an auction. If a guy auctions his business, we don't want him/it. There's nothing wrong with loving money, it's just not for us.

8. As the best professional in the industry, are you still getting better?

[At this point, Greenwald paraphrases the question as, “Do you still have the mental capacity to do the job?” I'm having flashbacks to Mycroft.]

Investing is great because you're always building a database. Every year you're adding a little bit more (new industries) and there's not that much leakage on the other end. GEICO purchase was a result of his existing database.

“I understand underwear”, so Fruit of the Loom wasn't a tough decision.

Everything is cumulative in investing. When he hears something today, it fits in some way into a model built by years of experience.

[Side note: This is an integral part of the whole “no due diligence” phenomenon. They don't necessarily perform due diligence prior to doing a deal precisely because they are performing an abstract version of due diligence on companies and industries every day by adding to their database.]

9. Asbestos payouts seem like they're being accelerated. Comments?

The claims acceleration has tended to be those companies that are in bankruptcy. For companies not in bankruptcy, claims rate hasn't really changed.

BRK has some asbestos claims out there (a lot from Gen Re) that arose under the normal course of business, and a lot of claims resulting from retro insurance. The deals rely upon timing of payments. BRK is conservative both in the premium demanded and the accounting for the deferred charges. Most asbestos claims are from policies where there is a finite limit.

Overall, payment rate is somewhat slower than anticipated. The results have been perfectly satisfactory so far. [The retro deals, I assume.]

10. What do you see in the underwear business that other people didn't and still don't in Sara Lee (owner of Hanes)? What EBITDA do you see for FoL? What stocks are cheap today?

[I'm cringing at the expected answer to the EBITDA and I expect a stonewall to the stock tips.]

Basically, EBITDA is worthless.

As far as underwear goes, Hanes and FoL own the market. There are higher-end makes (Calvin Klein, Jockey), but those two control the mass market. Sara Lee (Hanes) pursued an asset-light strategy. [Note: Enron pursued an asset-light strategy – a desire to take assets off balance sheet by removing ownership. Not that I'm really comparing the two.] We control the assets in place at FoL. You can't really buy another version of FoL because if you buy Hanes, you're buying the rest of Sara Lee's portfolio.

Wouldn't be surprised to see FoL earn $130-140 million pre-tax.

Again, we hate EBITDA. Depreciation is the worst kind of expense. (May have even called it despicable.) It's reverse float.

As far as what stocks are cheap, that sounds like a very theoretical question. [Laughs] That's one question I won't answer. Talks about how they keep their activities private.

As far as what companies are in the picture, WEB will never buy a glamorous stock. Money doesn't know where it came from. There's no sense paying more money for a glamorous company if you're getting the same amount of money, but paying more for it. It's the same money that you could have gotten from a bland company for a lower cost.

11. General question about the attractiveness of distressed debt.

There's nothing intrinsically good or bad about distressed debt.

FoL was bought at about $0.50 on the dollar. It was a very unusual kind of debt because it kept paying interest during the bankruptcy proceeding, so BRK got a lot of cash from it.

On the Finova transaction: They bought it before it was going to go bankrupt, but knew it was going to. The key there was to evaluate their receivables portfolio (about $14 billion?). WEB estimated a worst-case scenario for the receivables and used that to determine the purchase price.

Comparing the two, Finova hinged on an evaluation of the receivables portfolio. Fruit of the Loom hinged on an evaluation of the brand.

Distressed debt requires more expertise than common stock. There is money to be made on some issues. [At this point, WEB and Schloss start rehashing an old railroad bankruptcy where apparently everyone got rich. Phenomenal level of detail remembered by both of these guys.]

We have never bought a junk bond when it was initially offered because Wall St. has a special sales push. We buy them later when they get in trouble.

12. What's your take on companies re-incorporating offshore for tax reasons?

I don't like it. I don't like individuals who made the money here living offshore [without paying taxes]. One guy tried to get himself declared an ambassador so he could live in the US full-time and still be a foreign citizen. [I think I got that right.] I'd like to think that we (BRK) wouldn't take that opportunity if presented, in the same way I'd like to think I wouldn't walk into a bank and take $1 million if it was just sitting there. But you never know until it happens.

All of the big accounting firms have offered tax strategies, but we're not interested. We have a simple tax return.

On tax rates: Imagine that 24 hours before you're born, you and an effective twin (same DNA, etc.) will be born, one in the U.S. and one in Bangladesh. What percentage of your future income would you pledge to be born in the US? Most likely a pretty high amount. The US offers an extraordinary level of benefits.

13. Pro forma earnings are no good. But how can you look at a company like BRK with a 9/11 event without considering pro forma earnings?

You need to look at the long-term results, but you can't ignore the fact that management missed it (9/11 event). Look at the company's normalized earning power.

Look at this most recent quarter. One of the most benign quarters in insurance – nothing happened. No “cats” anywhere. You don't see insurance companies reporting good results and saying “Excluding the abnormally low level of claims, we actually would have reported a loss in this quarter”.

There are 2 keys to valuing BRK:
- How much cash will the current operating companies be kicking off over the next 10 years?
- What interesting things will be done with that cash in the next 10 years?
[I love it – WEB speaks of real options.]

14. On BRK investing abroad

We'd love to find businesses overseas similar to those we own. We have not had luck to date. 2 problems:
- Of the good businesses, most are in the US, so there's just not that many abroad.
- BRK is not as well-known overseas, so it's harder for them to get unsolicited calls.

Mentioned that 80% of Coke's earnings are from outside the US.

We own 15-20 stocks right now. 3 of those are entirely outside of the US. We'd be delighted to own any of those 3 in their entirety at the prices we paid for the piece we do own.

One issue is that reporting requirements are tough. In the US, you must disclose upon obtaining 5% of a firm. If you're an insurance company, you must disclose upon obtaining 10% of a firm – if you obtain between 5-10%, you can wait to disclose until year-end. In other countries, that threshold is lower. In the UK, 3% ownership requires disclosure, so our moves are limited.

15. In an investment partnership, how does lack of managerial control (over the firms you invest in) influence decisions)?

We have very little influence anyway, even as a director, so it is not a big deal. Very rarely can you change the course as a director and you can't attempt to very often. Someone invited to parties will find he is no longer invited if he is constantly belching at these parties. [<- Terrible paraphrase. More or less the same quote as he used at the annual meeting 2 years ago.]

Even with 100% owned companies, we accept decisions that we would not have made ourselves. In the long run, they probably balance out to be at least as good as what we would have done. More importantly, it allows the managers to treat the companies as “their” businesses. Do you think Al Ueltschi, who owns $1 billion in BRK stock, is going to want to keep running his business if I'm over his shoulder making decisions?

16. Why don't you sell things when they hit extremely high prices?

We're not selling a See's Candy for any amount of money, even if someone offered us 3-4 times its value. Why? It's a quirk of ours. We don't get many opportunities to form associations with good people. When we forge an association, we don't like to ruin it by turning it over to someone else. Small equity pieces are a different matter.

With Buffett Limited Partnership, it was a different matter. It was WEB's job to make the most money possible. Now it's his job to run a business in an agreeable way that hopes to perform well. It's no longer the goal to wring every last dollar out of every situation.

Also talked of the benefits of having a reputation for not selling. [Same masterpiece discussion as recorded elsewhere.] When someone builds a business, they're building their own masterpiece. If we purchase that painting, we're offering to hang it, not buy it and quickly sell it to someone else. I tell the prospective seller they can choose to hand it over to BRK, where I will never tell them to add more blue paint or less red paint, but simply hang it. Consider BRK the Metropolitan Museum. Your alternative is to hang it in a porn shop. [I must be delirious. Did he really say this or am I just imagining this whole conversation?]

17. Interest rates are extremely low. What's the lowest benchmark you set?

Good question. I want 13% pre-tax. Over the last couple of years, we made about 8-10 acquisitions, and I think they'll work out to 13% pre-tax. There have been times where the interest rate was 20%, and 13% would be unacceptable. But the opposite doesn't hold. I can't go arbitrarily low with a required return. I'd rather have short-term returns of 1 ¾% than buy stocks or companies returning 8-9% because I'm going to be holding on to those forever. Those returns are fine now, but enough acquisitions like that and you end up with a very average business.

So, in this low-interest environment, we have a lot of money in bonds right now. Either we expect to get more good opportunities or the environment will change.

By the way, the environment will change.

The financial markets have a long history of doing crazy things. You are all young, you'll see those things repeated. [Tells a story about how he has a very old newspaper clipping of a brewer/investor who drowned himself in a vat of hot beer because of troubles arising from excessive margin use.] Those things will happen again. You'll have a lot of opportunities to get rich, even if the environment doesn't look like it right now.

18. Describe the H&R Block competitive advantage.

They had a disappointing quarter several years ago, but their franchise was not impaired. The market drove the price down.

Everyone knows H&R. You think of tax preparation, you think of H&R. How many people here can name the #2. Not many. [Apparently Cendant owns it.] How much would it take to topple them? The only thing to kill it would be a radical change in the tax laws (e.g., a move to a consumption tax).

We were willing to buy the entire firm at 75% more than what we paid for the piece we bought. [I think he said large insider ownership prevented it, but I'm not sure.]

19. Greenwald: Last question – We moved away from using the first edition of Security Analysis. What are we missing by not using that?

The historical perspective. People will continue to do dumb things.

“History may not repeat itself, but it rhymes.” (Twain?)

The first edition is good for a sense of history.

[At this point, he kind of wrapped up.] There are 3 things that are key:
1. Margin of safety (Finova deal) is absolutely essential.
2. Look at a stock as a business. “I spent 8 years buying stock without thinking of it that way.” [“I started at age 11 – I don't know why I started so late.”]
3. Develop the proper attitude towards the market. It is there to serve you, not instruct you. Too many people are instructed by the market.