WARREN BUFFETT RESPONDS TO QUESTIONS FROM 85 WHARTON STUDENTS ON NOVEMBER 12, 2004

1) Is it more difficult to find predictable businesses today than it has been historically because the rate of change has increased within most industries? Has the accelerating rate of change within most industries caused you to reassess your buy and hold investment thesis, particularly given the inability for many consumer brands like Coke and Gillette to grow?

There are basically two ways to look at change. We see change as the enemy of investments, if it wasn't the richest people would be librarians. Some businesses will change very quickly. We are looking for ones that don't. If you can predict the change then you can become very rich, but the net investment (e.g. from what went on at Kitty Hawk – air flight) to equity investors is a huge negative. For example, I have a list of over 2000 companies that made automobiles, now the last two, GM and Ford, are in trouble. Hundreds are out of business – many people didn't know that Maytag and Du Pont made automobiles. The net investment for investors has not been a great deal. We look for certainty of what won't change. You mentioned Gillette. After 100 years, Gillette still has 70% market share, and yet the distribution, product and raw materials are not mysterious. It has survived within our capitalist system and you know its products will be used regularly.

Coke sells 50% of the carbonated beverages worldwide: about 1.3 billion 8 ounce servings, higher than last year and the year before. I guarantee Coke, Wrigleys and Gillette will dominate. The internet won't change what brands people like.

We are looking for the absence of change. Fruit of the Loom and Haynes together have 80% of boys underwear in the US. I guess we will keep wearing underwear. Bill Gates welcomes the absence of change, he just doesn't get it in his business. Microsoft and E-Bay have some moat. If you can identify change, that is great, but it is a lot riskier and so is the chance of our strategy not working. So we look for absence of change. We don't like to lose money. Capitalism is pretty brutal. We look for mundane products that everyone needs. Patents are the worst way to ensure demand. There is still plenty of opportunity to find predictable demand. The problem isn't the lack of opportunities, it's the prices.

2) You wound up the Buffett Partnership in 1969 due in part to the virtual disappearance of investment opportunities for the analyst who stresses quantitative factors. In your view, is today a better investing environment than 1969? How is it better and worse?

1969 was tough. It wasn't pleasant to do. I had grown from $105,000 to $100,000,000. I had a lot of propositions to take over the partnership. If I had a similar partnership I would have closed it around 2000 in the height of the internet boom.

We were all in REITS in March 2000 when NASDAQ was hitting its high. If I had had a large partnership I would have folded it, but not if it was small. It has to do both with how I feel and how the partners feel. I feel like a jerk (losing on a relative basis) and the jerks are making money. I won't persist in trying to make money when I don't understand what is going on. It is harder to invest and risk other people's money than to invest your own money.

We still get opportunities: for example, we got $8 billion into the Junk Bond thing in 2002 and would have gone up to $22 billion if we had more time. We were buying as fast as we could.

Investing is the world's best game. I was in the department store business – you have to match you competitors – it's a business that throws defensive decisions at you all the time. We want a business with not defensive decisions. Investing is a perfect example. Just watch ball after ball come through and wait for your fat pitch. You can sit and wait for just the right pitch. Harder when you invest in public and the fans are screaming "swing you bum."

But at your age, you can fool around with small money and I see things to do there.

3) You made an argument for 7% returns over the next decade in Fortune. Given that (1) profit margins are at least 30% above historical averages, (2) the ratio of prices/GDP is at least 25% above historical averages, and (3) interest rates are ~25% below historical averages, assuming mean reversion, wouldn't one conclude that while economic earnings growth plus dividends may be 7%, that we are at an unsustainable valuation plateau?

We are near the high-end of the valuation band, but not really at an extreme. I have commented on the market 4 or 5 times in *Forbes* interviews previously (1969, 1974, 1981, and 1977 in *Fortune*). Most of you can say if something is overvalued or undervalued, you can spot the occasional extreme cases.

There is a big band of valuation and the idea is to calibrate extremes. When I look at a business, I look for people with passion. I can recognize a 98 or a 6, not a 63. This rule is good enough in life and investment. You refer to my 2001 article, but returns have not exceeded 7%, so I guess that this is not that precise of a band.

I suspect that stocks are too high now. Nothing is cheap and I am not finding a lot of now but there will be a day when you will be shooting fish in a barrel. The important thing is to be prepared to play heavily when the time comes and that means that you cannot play with everybody.

4) You have said in the past that you would rather buy a great business at a fair price than a fair business at a great price. If the price is fair to both the buyer and the seller and the buyer does not substantially improve the business, then it would be hard to see how the buyer would obtain superior returns from such an investment if the price already discounts the quality of the business. Since you clearly look for superior returns can you explain how you buy at a price that is both fair to the seller and still leaves you room for abnormal returns?

Periodically the stock market does not price rationally. Great businesses have been sold for ridiculously low prices in the past. Unlike negotiated sale of businesses, the market is like an auction and stocks traded on it are not perceived as ownership shares in business. While the price of farmland or apartments in Nebraska does not to vary a great deal around the mean, and have little chance of having wild aberrations, stock prices on the other hand may sometimes vary by as much as 50% to 100%. Accordingly, there are opportunities to buy stocks in businesses at low value.

So we really try to buy wonderful businesses at ridiculous prices. In the case of Washington Post, in 1973 the whole of the company was only selling for $80M (5M shares at $16 each). This is a business that owns a number of newspapers, four TV stations and several magazines (like Newsweek). Most analysts would have agreed that the intrinsic value of the assets was around $400 to $500 million. But you could buy little pieces of the business for much less. Seizing this opportunity, Mr. Buffett purchased around 9% of the shares for $10 million in 20-30 tickets from institutional investors who couldn't sell fast enough because they thought the share prices would keep falling. They wouldn't have argued that the business was not worth $400 million, just that the stock was going down. Subsequently, Mr. Buffett has steadily increased Berkshire's holding in the company (to around 22%) and today the company is worth about $10 billion dollars.

Making purchases through a negotiated markets for entire businesses is different. You may get a decent result. These transactions are to a mild degree effected by the auction market. As Peter Lynch often says, companies will cut the flowers and water the weeds – when a company is in trouble it often sells the crown jewels.

5) What value would you personally attach to $1 received 1 year from today with 100% certainty?

It depends on how much purchasing power $1 dollar has in one year. You need to find the present value of that $1 dollar, using the discount rate (i.e., Treasuries of equivalent maturity). It is very similar to analyzing the stream of a company's earning flow. How much long term earnings flow you would like to have using the discount rate? Also, you need to be aware of whether the interest rates over the medium-to-long term will change quite big or not. Your expectation of the "normal" interest rate will drive what discount rate you apply to the streams of a Japanese company in the mid-1990s, for example. If you think the interest rate will rise sharply, and do not want to buy long-term bonds, you need to think about whether you like to buy the company's long-term earnings yield. If you do like long term bonds, STRIPS are a good investment.

6) This week Eric Rosenfeld recounted the last days of LTCM and your participation in a potential bailout. He believes that if they could have gotten you back on your cell phone in Alaska the bailout would have been consummated: "to this day I think it would've gotten done if he [Mr. Buffett] was in town….however, nobody was willing to put in $4 billion without consulting [Mr. Buffett]". Could you share your version of the story?

Eric called me on Sunday while I was playing bridge. I could tell from the sound of his voice that something grave was transpiring. On Monday he was on vacation with Bill Gates in Alaska, so he was negotiating on a satellite phone, while Bill was looking on. Meanwhile the captain kept moving the boat closer to shore so they could see the bears or something. Gates thought the whole situation was very amusing.

On Tuesday, he was at Yellowstone, and negotiating using an intermediary at Goldman Sachs, and finally gave Goldman his terms on Wed morning. He told Peter (GS Banker) to put in the bid - $3bn from Mr. Buffett, $750mm from AIG, and $250mm from GS. He told Peter to sign his name on the (in)famous letter. Peter asked if he was crazy, but Mr. Buffett told him to just do it. So Peter signs my name, John Corzine's and Hank Greenberg's. He figured if he was on the hook, so he might as well sign Hank Greenberg's name. I don't think anybody's signed Hank's name before. I then went on the bus through Yellowstone (out of range for the satellite phone).

John (Merriwether) got $150mm ($250?). But it left a lot to work out between Wednesday and Monday. "If I'd been in NY, we'd have made the deal….that's [description of Eric Rosenfeld's version] a very accurate rendition of what happened."

They [LTCM] and [NY Fed Governor] McDonnough played the hand the way they should have….but I got to see Old Faithful. I've told Bill Gates lots of times he's cost us a lot of money.

I knew the stuff they were doing…these are the kind of positions I would've put on…I think we would have made multiple billions…I've made a lot of money on weekends.

I don't blame him [Merriwether] – he got an extra $150 million

7) You and Charlie Munger believe that the easiest person in the world to fool is yourself. Have you been fooling yourself by remaining committed to certain buy and hold doctrines, especially considering they are alluring because you have to work less since good investments work for you.

People believe what they want to believe. Everyone rationalizes their actions. A partner like Charlie can point it out to me. If we have a strength, it is that we think things through and we have the advantage of having each other. We are not influenced by other people. Charlie would say we are successful because we are rational and do our own work.

Paraphrasing Keynes', "The difficulty lies not in the new ideas but in escaping from the old ones," Mr. Buffett remarked: The problem is not holding onto the new [ideas]. The problem is escaping from the old. Darwin claimed he had to write down new ideas constantly. His mind would race to find new ideas. But if he did not write down his new findings within 30 minutes his subconscious would wipe them out and revert to old beliefs.

8) What do you believe is the top thing that will affect our great country's competitiveness in the future and what would you advise be done to address it? (can follow up with health care and social security/pension gap)

One of the biggest problems facing the country is weapons of mass destruction. But there isn't much that can be done about the problem (there will always be terrorists).

The trade deficit, of which current account deficit accounts for 90%, is the biggest economic problem facing the U.S. It is very complicated and not covered sufficiently in the debate. Social security and Healthcare are two issues tied in with the issue of the trade deficit. When there is no trade deficit, there is no net holding by foreigners. Currently government redistributes 22% of the US output to social security and healthcare. And these issues are eternal intra-family political squabbles over the redistribution between those who are producing and those who are not producing? Trade Deficit is a transfer of ownership or IOU on converted ownership, representing $1.8BN of outflow to foreign countries. It can't be easily addressed. If the trade deficit continues at the current rate for the next 6-10 years, foreigners will have a permanent call on 3% of the output.

Can we afford this? Potentially yes. Foreign aid administered after the Marshall Plan post-WWII can be appropriate. However this is an accumulated burden to be paid by future generations because their "parents" didn't want to pay for it. This could play a significant factor in future financial market disruption. "When someone fires in the theater on the stage" with significant amount of assets held by foreigners, along with other things happening at the same time, the trade deficit could be the #1 problem in the next financial event.

On healthcare, you have to rationalize healthcare demand when healthcare costs become higher and higher. The demand structure under the current system is not sustainable. We need to reframe some of the expectations of people and reframe what is the appropriate level of healthcare provisions. For example: Should we keep everyone alive for their last 3-6 months? Should people get the maximum amount of care to keep healthy? Government needs to ration it through government policy and people's willingness to wait.

9) Is there a significant portion of the value you generate from the portfolio derived through active investment (e.g., influence on management decision, etc.) If so, what do you think of the role and probability of long-term success of an investment manager with little influence over management decisions, i.e, a passive investor? Has passive investing lost some of its appeal for you because you have been personally disappointed with the management of major American corporations? If so, what implications does that have for America?

In short, Charlie and I do not and should not have a significant impact on the management of our companies. You would be surprised how little impact we have on management. They [CEOs] all have different batting stances and know what style works for them. There would be no point for us to tell them to alter their stance as you can still be a good hitter even if you stand different to the next man - we hire them as they are good hitters.

In terms of our influence on the CEO's of our public holdings - we are "toothless tigers". We do not control the company and do never threaten to sell our stakes if our advice is not taken, therefore we are very much toothless tigers. We are holders of the stock for the long-term and therefore do not gain from short-term increases in the price. Moreover, we actually prefer for the price to go down in the near term so we can buy more stock and increase our stake in the company. However, the disclosure rules make it increasingly difficult for us to build up stakes in companies. For instance, we rarely invest in the UK as there is a 3% disclosure rule so we can not build a meaningful stake before it becomes public. So historically, we performed much better when the disclosure requirements were less stringent and they have been increased steadily over time. Our investment in PetroChina was another example of disclosure rules costing us hundreds of millions of dollars. We had to announce our ownership at a 1% level, after which the price shot up.

Stockholders should be able to think and behave like owners. The three things that a shareholder in a public company should focus on are: do you have the right CEO? does she/he overreach? are they too focused on acquisitions or empire building and stop thinking on a per share basis? Institutional owners need to focus on these three aspects.

Both Charlie and I say we would make a lot more money if we were anonymous. You'd be surprised how little impact we have on management. They're all different individuals with their own egos, money, and even control. You'd be surprised how much we don't steer them. We have very little influence on their investments, but it doesn't matter because we don't buy and sell. We don't gain anything from the stock price going up. Piggybacking doesn't do much.

It's a big minus to operate in a public arena where people are not likely to follow. I still have 99% of my net worth in Berkshire, but I try to buy some on my own anonymously -- I do much better that way.

We ask for confidential treatment in some areas, but the SEC doesn't allow that often.

Passive investor role: big institutional owners should act and behave like owners. The big thing to worry about is whether the company has the right CEO and if it does, does the CEO overreach even if he's a good manager? The only people who can stop that are the directors and owners...and the directors will only stop it if the owners make a case. CEOs will sometimes do things uneconomic to satisfy primal urges. My instinct is that the institutional investors behave better than they did 10 years ago.

10) I am also from Omaha. When I tell people at school about your frugal financial approach, they are stunned. What is your specific philosophy about wealth? And how do you think this discipline has contributed to your success running Berkshire?

Mr. Buffett feels he was lucky to be born in the US (he won the ovarian lottery). He believes that he's wired in a way that works well in a capitalistic society: he has the innate ability to allocate money. He believes that society has enabled him to earn this money and so he believes that the money should go back to society eventually. He believes in a graduated income tax. Society has contributed to his wealth so they should benefit.

He discussed the effect wealth has on an individual and the effect it has had on his life: It means that he can do whatever he wants to do. He has the luxury to make choices. But, he has no desire to be a greenskeeper- to own a 20 acre property which requires him to devote time to organizing and maintaining it. Further, spending the next 4yrs building a house doesn't appeal to him. He won't find a house where he'd be happier than the one he's live in since '58-59. He has no interest in owning a large yacht- he views this as more of a hassle than anything else. He prefers to use his wealth to do what he wants to do with the people he wants to do it with.
He likes his life. He likes the people he works with- nobody has left Berkshire voluntarily in 15 yrs. He won't buy a business owned by someone he doesn't like.

If one were to ask Charlie why they were successful, he would respond that it was due to “rational decision making” and being able to not depend and focus on what someone else thinks is important. Also stressed that he was very lucky to be born in the country that he was. Likened it to a lottery with a 1 in 50 chance. This is because he is “wired in a way to be very effective” in a large economy where capital allocation skills are needed and highly rewarded. He illustrated the counter example with a quote from Gates saying that if he were born a few thousand years earlier he “would be an animal’s lunch”.

As for the trappings of wealth, he believes he already lives the life he wants to live. He cautioned against backing into certain behaviors simply because that was what other rich people do. For example, he does not want to own a large boat as he simply does not derive enough utility out of it to justify the bother that would entail from owning and maintaining one. As it stands, he does benefit from his wealth in that he has the “ultimate luxury”, that is to do what he wants to do everyday and he’s having more fun than most 74 year olds. He doesn’t want to build a bigger house and he gets to work with people he likes. Apparently, they like him too as none of the 18 people who work with him at Berk HQ has left in 15 years. He also will not do a deal simply for the money as it would be as perverse as someone already very wealthy marrying for the money. What money has ultimately given him is the power to choose because the luxury to choose is what being wealthy is all about.

Mr. Buffett continued and discussed the middleweight boxing match he watched on PPV at $54.95. He didn’t think twice about the cost of it. He talked about how in the not too distant past the fight would have been limited to people at Madison Square Garden whereas the boxers there stood to gain the benefit from an audience of millions because of what society as a whole has enabled. Therefore he is, and he believes so should the boxers, be in favor of progressive taxes. That is they are able to make extraordinary incomes because of society and should be willing to contribute a greater share to maintaining it.

11) It is clear that you would never resort to earnings smoothing etc for Berkshire. But you do sell insurance products that have helped other companies smooth their earnings, or at least make their problems look less severe. Is there a contradiction in this?

The whole idea of insurance is that you pay a premium each year to protect for a disaster every 20 years. The nature of the product is smoothing earnings. You personally do this with your auto insurance. You pay $400 (or $350 if you call Geico!) to protect yourself. Sometimes companies have used it incorrectly, but this is not inherent in the insurance product. If you get into “no risk transfer” deals with insurance you can get called on it. Berkshire Hathaway has written the two biggest retroactive insurance deals. One when White Mountain bought One Beacon and the other when ACE bought Cigna. Each paid ~$1.5 billion to reduce charges for old bad cases. Berkshire Hathaway was much better equipped to handle the risk than ACE or White Mountain (who were both stretching to pay for the deals). All of our policies are finite. There have been some cases of policies with zero risk transfer in the U.S., but they were very limited in the last five years because auditors must now sign off that there is adequate risk transfer and it is not just for accounting purposes. Generally, there is an understanding and a long relationship between the primary insurer and the reinsurer. If the reinsurer gets killed, the primary does not take the business elsewhere. They just build that experience into next year’s quote. This is less prevalent now because it is less client orientated and more transaction oriented because of the introduction of brokers. There is no more relationship development, just a focus on the lowest price.

12) At our investment management conference a few weeks ago, one panel featured the CIOs from Barclays Global Investors, State Street and Vanguard, and we collectively discussed the use of derivatives in modern portfolio management. We understand you dealt with unknown exposures in a past acquisition, but wonder if you think in this environment certain institutions have the risk control and discipline to use derivatives to effectively mitigate their risks.

Berkshire uses derivatives. There is nothing evil about them per se. It is very hard to control risks without derivatives. But all mismarks on contracts are in the trader's favor, never our favor. These days, there is no money in plain vanilla stuff - the margins are too squeezed - so you get people writing very sophisticated derivatives.

Berkshire is still unwinding many of its positions. General Re had 23,000 contracts 3 yrs ago and 3000 are left. Derivatives are very tough for management. In situations like 9/11, with losses of unknown magnitude, anyone with big equity and big derivatives portfolio (when you don't know what's behind the derivatives) is in trouble. A big downgrade on the company would have followed with margin postings, etc. - trouble...

Another issue with derivatives is that the incentives of the guy writing the derivates are not aligned with the company. For example. one of the highest paid guys at Gen Re was the guy that wrote complicated contracts - and those contracts were not necessarily good for the company.

Finally, the problem with large derivatives portfolios is that they tend to be directly related to equity positions that company has. This interdependence means that billions of dollars on your balance sheet are dependent on others performance (other equity performance) - not on your own company performance.

"Derivatives are like AIDS - its not who you slept with, but who they slept with"

13) You often talk about the importance of investing only with people you like, trust and admire. However, you've bought companies only days after you became aware of them. How do you evaluate the owners and managers of a company before investing?

After mentioning that he's actually bought companies after only brief telephone conversations, Mr. Buffett admitted that "every now and then you miss", but added that "it's better than the odds of marriage". He went on to say that "sometimes you size up people better with more time", but he didn't sound like he needed much time to recognize the type of character he looks for.

The key question for him when evaluating the management of a potential acquisition target is "do they love the money or the business". His concern is that he monetizes the owner/manager's wealth and that may cause the latter, if he doesn't truly love the business, not to work as hard after he's sold out to Berkshire. He said he looks for the "obvious cases" of owners who truly love their businesses and added that he's mostly been successful (has had "a good batting average") in identifying them.

For those owners, their businesses are their life's work, which Mr. Buffett compared to a painting: "You spent all your life painting this painting. You can sell it to us and see it hanging in a place of honor in a museum. Or you can sell it to an LBO operator and see it hanging in a porn shop.

"I once bought a jewelry business over the phone. I could tell that the current owner was the 'right' type of person. The owner's great grandfather had started the company and I could tell that the owner really loved the business."

Mr. Buffett said that he can usually "size someone up in less than a day". The most import question he poses in buying a business and looking at management is, "do they love the business?" He phrased it in this way: "If you spend your whole life painting a picture would you rather have that painting on exhibit at the Metropolitan Museum of Art, or would you rather earn 5% more on the sale of the painting and have it hanging in a porn shop?"

He has had a great batting average in picking companies and people. But he says that "we can't tell with everyone and once in a while we make a mistake."

14) The profits of financial companies as a % of total US corporate profits is at an all-time high (~40%) -- is this just the result of the carry trade, which will end, or perhaps bogus use of derivatives, or is there something more structural changing?

15) On his fears about US dollar weakness:

The dollar is not overvalued on a purchasing power basis. Macroeconomics is not our usual game, however if some economic facts are screaming at us, we jump on them. We don't usually do junk bonds, however if you cast your eye about, you can always find deals. I don't feel like doing macro bets as much with other people's money as my own. We work with big currencies-- eight of them. I don't have a view about which will move most against the dollar. My view is that the dollar will weaken. Countries support their own currency-- Japan wanted to keep their currency down which kept the US currency up. I don't know if China or HK will decouple their currency from the US. I like to have earnings in other currencies because they convert into more dollars, however I keep most of our cash in dollars.

16) On probabilistic thinking: while we would all love to do it, how does one distinguish between true subjective probabilistic thinking and bias induced guesswork?

Of course we try to make decisions based on probability and not guesswork. I agree strongly with the thoughts in Robert Rubin's book (In An Uncertain World). It's all probabilities. The one time when Charlie and I have trouble doing this is when it comes to firing people. I hate doing that and I avoid it as much as possible. We had one manager at one of our companies who developed Alzeimer's disease. It took us a long time to see it, and after we saw it, it took us a long time to act on it. Fortunately, the company still did well even while he had Alzeimer's, so we've developed a new rule around here: Only buy businesses that are so good that someone with Alzeimer's can manage them!

We all think we're doing the former – probabilistic thinking.

Mr. Buffett said he tries to always use probabilistic thinking. That's what he likes about the insurance business and investments. We try to think through every decision that comes to us. Some decisions are simple probabilities.

However, Mr. Buffett added that we're human and probabilistic thinking is not always possible. Mr. Buffett said that when dealing with other people, such as firing someone, is a time in his case that he may stray from probabilistic thinking. An example was when

Mr. Buffett denied that one employee who ran one of his businesses had Alzheimer's for one year beyond when anyone else would have picked up on it. He said how hard it was for him to fire him, especially since he loved the person but he was just no longer good at the job. He, therefore, unintentionally postponed the decision. Mr. Buffett said he looked for countering evidence because he hates to fire a CEO he likes. He said he will tolerate a lot from someone who has been an associate. Mr. Buffett then joked that now he buys business that even a person with Alzheimer's can run!

One thinks they know when they're getting way from probabilistic thinking, but you can not always detect it.

Mr. Buffett recommended Bob Rubin's book in which he recommends ways to think in the economic world

He concluded that business is all probabilistic thinking but some thinking is better not being calculated, for example in relation to people you love and humans in general.

17) You said a year or two ago that the ratio of US corporate profits as a % of GDP was historically high, at 6%, and would likely fall. Since then, the ratio has gone up (nearing 8%). Has something structurally changed, or are you confident that the ratio will still fall back?

Mr. Buffett responded that he doesn't believe the 8% rate will be sustainable, and he views 6% as a more reasonable figure in the long-run. Moreover, he has trouble reconciling high corporate profits % (even at 6% level) with the corresponding figure of federal taxes paid by corporations, which is currently also at a very high level – 1.5% of GDP.

After a brief discussion of corporate profits and corporate taxes as a percentage of GDP, Mr. Buffett shared an interesting view on federal taxation. In a way, federal government owns a special class of stock (let's call it Class AA stock) in every corporation. For example, last year Berkshire Hathaway paid ~ $3.4 bil. to federal government in relation to this "stock." The more the company reinvests in its business, the higher next year's earnings and tax payments are – i.e. the higher the dividends and the value of the AA stock are). Moreover, at any point in time, the federal government can change the % of earnings to be distributed to it (i.e. change the tax rate). If the government would ever decide to "go public" with a security of future Berkshire Hathaway tax payments, that stock would be very attractive. Wall Street would love it. In fact, at 35% tax rate, that stock could be worth as much as the entire Berkshire Hathaway.