

Whitney Tilson's 2006 Wesco Annual Meeting Notes

Part 2, Question and Answer Period

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Note: Words in [brackets] are my comments, edits or, when I missed something, my best guess of what Mr. Munger said. Part 1 of my notes, from Mr. Munger's opening remarks, were sent out earlier.

For my columns and notes on previous Berkshire and Wesco meetings, click [here](#).

MY QUESTION

[I asked the second question of the meeting and Mr. Munger gave a lengthy answer, touching on many of his favorite topics: the failure of corporate governance, the importance of good accounting – and the failure of accountants to uphold this, etc.]

My question: Hello Mr. Munger, I'm Whitney Tilson, a shareholder from New York. [Mr. Munger: "I know you well."] Thank you. My question relates to something you and Mr. Buffett said at the annual meeting last Saturday. Mr. Buffett spoke at length about the need for improved corporate governance and that large shareholders really need to step up and start behaving like owners rather than renters. I forget whether it was in the context of that question that you said something along the lines of activist hedge funds being a mixed bag.

It struck me that there might be some inconsistency in those statements because in the past two or three years, virtually every case in which I can think of in which a large shareholder acted like an owner – the only exception I can think of is in the case of Hollinger and Chris Browne and the Tweedy Browne folks, but even that was an accident and they hope never to be activists again – the only people who are behaving as you are calling on shareholders to behave are, in fact, these hedge funds. I know what you think about hedge fund fees and that they're likely to underperform as an asset class – and I wholeheartedly agree, despite running one of these creatures – but my question is: at least in the area of corporate governance, shouldn't you and Mr. Buffett be applauding this kind of behavior (while perhaps holding your nose about the fees these funds charge) and encouraging institutional investors and mutual funds to behave in this fashion.

Munger's reply: The reason I said it was a mixed bag is because I regard it as a mixed bag. Obviously, since Hollinger was a total kleptocracy [laughter] – I mean *total*; it was the most god-awful example of corporate misbehavior that you could imagine – and it was contrary to Tweedy Browne's interests to do what it did, when they cleaned up that mess by wading in big-time, they did the rest of us a favor. So that's the part of the mixed bag that's weighted toward the favorable side.

But if you take Carl Icahn's assault on Time Warner – if you think Carl Icahn really gives a damn about the shareholders of Time Warner... Tweedy Browne was revolted by the behavior and so they got on a real moral crusade. And they were right, and I applaud that. But a lot of other people just want to raise hell and they don't care if they're raising hell with admirable people or knaves – they're just trying to make money. That second class is I think a mixed bag that we don't need.

I don't think every corporation in America that could be, on a short-term basis, made to give shareholders a little jump in value...I don't think every single instance like that ought to be seized by the management or whether shareholders ought to have the power to run around and do it, particularly if they're the [wrong kind of people?].

I think I said on a previous occasion that some of these assaults remind me of Oscar Wilde's definition of fox hunting: he said it's the pursuit of the uneatable by the unspeakable. [Laughter] In other words, I think some of the hedge fund types are the unspeakable and even when they're on the right side, the other people are uneatable. But still it's not an elegant view. The Tweedy Browne thing was a huge blessing – I'd agree with that.

Corporate Management and Governance

Governance is a very tough subject and the truth of the matter is that corporate managements, from shareholders' point of view, run the gamut from being very valuable, so they add to the asset value of the business they supervise, to very negative, so that the asset value of the business should have a big discount. You know that perfectly well in your own life. One of our fellow value investors said the other day, considering the self-interested way that most corporate managers behave, you *ought* to get 30-40% more assets than you pay for to allow for the depravations of the people who are running the corporation. [Laughter] That's a very harsh thing to say, but it's true in many cases.

Compensation and Stock Option Abuse

There were *lots* of companies that had something like 50% of all of the outstanding stock subject to options. They couldn't help it. They were in the high-tech game, everybody else was paying in options, and they needed people like this woman who was making \$40,000 per week in options, so they paid in this currency and were just swept along by these crazy practices. Corporate compensation is a weird subject.

Stock Option Accounting: The Accountants Failed Us

Again, the accountants failed the rest of us. Never, ever should the accountants have allowed any stock option compensation not to go through the income statement, 100%, all of it. The Washington Post has a subsidiary where they created a phantom stock option plan in which somebody valued the subsidiary as a public company and the employees get options. But they account for that on a full-cost basis, not the way people are now accounting for the cost of stock options, which is to hire phony experts to come up with low values. They resented the fact that options had to be expensed, so they made very foolish assumptions so they could get the charges as low as possible. And they're

still lobbying to try to get Congress in some way to change the accounting back to its former knavish state.

Accounting Has Huge Consequences

Accounting has *huge* consequences because given the competitive pressures in life, you have enormous incentives to report every damn item of income they possibly can. People who are subjected to that kind of temptation need a disciplined supervisory structure, which accounting provides. I feel sorry for my individual friends in the accounting profession who haven't produced any income for years because of the malpractice fines, but the profession as a whole richly deserves the amount of trouble that it's had. It's *such* a thankless job to want to pull the plug. How many people are volunteering for that? It reminds me of the saying, "Whose bread I eat, his song I sing."

Sarbanes-Oxley

The Sarbanes-Oxley stuff did give us a little bit of supervision over accountants but what they're doing mostly is running around improving internal controls, which is a gold mine for the accounting firms. Companies need bodies and the accounting firms are billing those bodies at very high rates (despite the quality of some of them), so it's been a bonanza for the accounting profession. And I think better internal controls are ultimately good.

Implications of Bad Accounting: The Enron Disaster

But some of the big stuff is being ignored. I had fun once at the Stanford Directors' College [a program at Stanford University to train corporate directors on how to be good directors] – I asked them, "Name the time when that whole Enron thing could have easily been stopped?" People utterly failed – they should have done better. A whole bunch of experts paid thousands of dollars to come to the college, but not one person stood up with the correct answer, which is: that when Skilling got to SEC and talked them into allowing them to front-end all future profits from long-term arrangements to deliver natural gas and the income immediately went to the trading desk. This triggered a whole daisy chain, with all of its misery and terrible example. And all they had to do is make that one decision right instead of wrong. What I've said is totally obvious, but I don't know how many other people realize it – and this is a smart bunch. It's so *easy* to realize how all of this sin and error could be fixed by proper accounting. Yet the skilled people like Skilling and Arthur Andersen went to talk to the skilled regulators who are the accountants at the SEC and they made the exact wrong calls.

There's a lot to be fixed in the world. To the extent that this is an educational meeting, I think the story I've told you is giving you a real educational lesson. It would have been *so easy*...yet the method they chose was so insane. I'll give anybody with any understanding of traders and trading culture and management consulting and management consulting culture, how could *anyone* believe that that kind of accounting would be anything but a disaster?!

There's so much skill in exposition in this stuff. Look at [Johnnie Cochran](#). There's just a huge amount of skill in exposition. And part of being a wise person is resisting the other

person's expository – to know nonsense when you see it. If you're like me, you can conceal your contempt for the person even as they speak. [Laughter]

I think we can offer a certain forgiveness. It reminds me of the [?] who was confronted with the scandals of the Catholic church. He said, "Well, I've had my scandals too. It just happens because of our different doctrines. Most of mine are heterosexual." [Laughter] And I said, "Well, I can understand why the Catholic church got into so much trouble, because of all of the religions, they're the one that's most into forgiveness. A person can be redeemed. How about you?" And he said, "Oh Charlie, I forgave every single one [because of what's it's like to live somewhere else?]." Well, that's the wonder of forgiveness. [Laughter]

COMMENTS RELATED TO BERKSHIRE HATHAWAY

Comments on the Reinsurance Business

I think the reinsurance business is a very difficult business. And it's a very tempting business, in which a guy writes you really large checks in advance. That kind of field will lead to a lot of dumb stuff and a lot of calamities. It takes exceptional skill to do well in reinsurance over the long term. Few people can do it.

So you might ask, Why do we think we can do it? Well, we're not everybody else. [Laughter] If you stop and think about it, that's the only logical answer. The only other alternative is that we're nuts, a possibility you'll have to consider. [Laughter]

What is Berkshire's Formula for Pricing Super-Cat Insurance?

The answer is, there is no formula. Ajit [Jain] and Warren are like father and son in how they interact. They're like a couple of bridge players. Anything they want to do is okay with me. You should be so lucky to have Ajit Jain and Warren Buffett doing this for you.

What Investment Hurdle Rate Do You Use in Your Models When Deciding Whether to Make an Investment?

We don't do a lot of involved math with schedules of investments. Certainly we expect a decent return or we don't do it. We use a lot of experience and do it in our heads. We distrust others' systems [and complex models] and think it leads to false confidence. The harder you work, the more confidence you get. But you may be working hard on something you're no good at. We're so afraid of that process that we don't do it.

How Do You Judge Managerial Talent: the Paper Record or Your Own Judgment? And How Did You Judge Eitan Wertheimer?

The paper record is usually a better indicator of talent. The paper record of this man is so extraordinary that it couldn't have been created by an ordinary human being. If you

add to that the man's obvious character and intelligence – who isn't looking for that? You also want to get a fair price of course.

Eitan said he learned some things from us. He's one of the smartest men I've met in my whole life. I can't imagine he'd learn anything from me.

When You Bought Iscar, Did You Consider That One of Israel's Greatest Companies Is No Longer Israeli Owned and Controlled?

You gotta understand that these people picked us. All we did was say yes. [Laughter] We think the kind of people who seek us out have such marvelous judgment that they're the kind of people we want to be in business with.

Details on Iscar

That was a very intelligent question and I'm going to give you a very intelligent answer: I'm not going to answer. [Laughter] All I'm going to say is that we are very happy with the acquisition and the price we paid. It's not rudeness. We want Iscar to be run like it has been in the past. They want to be private and quiet and we have a tradition of respecting this.

Do You Have Difficulty Reading Financial Statements of Foreign Companies?

We've been looking at financial statements for a long time. We feel, in some cases anyway, that we know what a foreign financial statement is telling us. Generally, would we would we feel more confident in our own currencies, etc.? Yes. But we feel that we can understand them [foreign financial statements].

Difficulty Investing in a Foreign Culture

Of course it's more complicated to make a decision in a foreign culture. But I think you can discern a great business in a foreign culture. [But you have to be careful.] I was amused when the dictator of Indonesia said, "What look like embezzlement to you people looks like Asian family values to us." [Laughter]

Why Doesn't Berkshire Just Buy 100% of Wesco?

It's complicated. You people, because you like the value system, have bid the price of Wesco above the liquidating value of the business, so we can't merge it into Berkshire. There are a lot of irritating conflicts. But I like you and I don't feel guilty because you can always sell your stock for more than [Wesco's] liquidation [value]. It has its disadvantages [but they're not insurmountable].

Comments on Berkshire's Float

We love having the float at Berkshire. If we didn't have it, Berkshire would be worth less than it is. It will grow more slowly in the future. There isn't that much float in the world [for Berkshire to continue growing it at such a high rate] – it's not a huge market. Float's very desirable thing. We don't think it's a model that will help you in other investment opportunities.

Why Haven't You Invested More in Foreign Stocks?

We've light on foreign stocks for our entire history, but we were still able to get the company [Berkshire] from \$10 million [in stock market value] to over \$100 billion, so there were worse tragedies that we missed foreign stocks. I don't know a lot about foreign stocks. I do think that there have been opportunities in some foreign countries that if we'd looked at them closely we would have wanted to invest. But every one that I can think of that looked intriguing was way too small to be of interest for Berkshire – they weren't the great big ones.

Overall, I don't have many regrets here – I think the United States has been a better place to be than, say, England for the past 30 years.

Buffett's Decision to Sell the South Korean Stocks He Bought

Warren's entitled to do whatever he wants with the sell decisions. Anyway, he was more interested in finding an inefficient market than he was in making the money. [Laughter]

Why Didn't You Invest in K-Mart or Tyco?

I didn't think about K-Mart. As for Tyco, I thought about and I passed, but I don't want to tell you the reason.

Impact of Lead Paint Liability?

Berkshire has one subsidiary, Benjamin Moore, that's been making paint for a long, long time. But it's a tiny part of Berkshire and my guess is that this issue is not meaningful.

The Morality of Investing in PetroChina, Which Is Helping the Government of Sudan, Which is Behind the Genocide in Darfur

You've raised a subject about which I know absolutely nothing. But all major oil companies that work in the Third World run into the problem of having to work with governments that are doing bad things. This is a classic problem.

I think it would be very hard to invest in oil at all without encountering some of these issues. Under those circumstances, what do you do if you're the company? Not go in? Or if you're already in, pull out?

I don't think, by and large, that passive shareholders of companies need to have fits if a company they're invested in is doing something somewhere that you and I wouldn't approve of.

USG

USG of course was a great success story. It benefited greatly from the great construction boom, and it worked out deal to deal with its asbestos agony. They now have a plan to exit bankruptcy. I think management has done a hell of a job.

Do You Think One Has Lived a Better Life If One Builds Wealth By Owning Businesses Rather Than Buying Stocks?

The answer is HELL YES! If all you do is make yourself rich through buying passive stakes, [you haven't lived much of a life]. Making your way as a professional poker player in Las Vegas – it pays the bills but is not a great moral beacon.

Obviously we think the pattern and life [of owning businesses] is better. Gin rummy behavior [of rapidly swapping] colleagues and businesses changing. No one admires that with wives and many of us spend more time with our businesses than wives. So constantly changing businesses [is nuts]. I don't consider this as good a life as the one we're living. Maybe [our behavior] is just serving our personal idiosyncrasies, but I say we're entitled. [Laughter]

But You Sold US Airways

Yes, but US Airways was not a subsidiary. We had some representation on the board, but did not control it. [That being said,] had we controlled it, we still would have sold it. It was out of control. But the sales we've made over the years are tiny and few.

Macro- and Micro-economic Considerations When Buying Companies

We simply try buy things for less than they're worth. We're not making microeconomic decisions or forecasts. We predict they [the companies we buy] will swim better, but we're not betting on the tide.

If we found a good business tomorrow, we'd buy it. We've been doing that all along. I'm not good at predicting macro things.

Since Size Hinders High Investment Returns, Why Don't You Focus on Managing Your Own Assets, Rather Than Berkshire Hathaway's?

Since my own assets are in Berkshire, so I don't have much choice, do I? [Laughter]

Is Your Salary of only \$100,000 Per Year Fair?

Yeah, it's fair. I like to think that it's more than fair, but what the hell. [Laughter]

Berkshire's Influence as a Role Model

[The questioner addressed him as "Mr. Buffett," to which Munger replied, "My name is Munger. [Laughter]]

Obviously, with the annual meetings and writing what we write, we're trying to have some influence on other people. But in terms on changing other people, I think the influence is tiny. It's very hard to change people when the incentives are in the opposite direction. I know many people who've bought lots of copies of [Poor Charlie's Almanack](#) and given it to their children and grandchildren in the hope of influencing them [but I don't think it's had much impact]. If that worked, there'd be a line from here to Denver [to attend the Wesco meeting]. [Laughter]

ADVICE ON INVESTING

Lessons from Losing Money in the Munger Partnership in 1973-74

That is a very good question. When I operated a partnership, I got hit in 1973 and 1974, which was the worst collapse since the 1930s. So I got hit with a once-in-50-years-type event. It didn't bother me with my own money, but it made me suffer the tortures of hell as I thought through the loss of morale of the limited partners who had trusted me. And the agony was compounded because I knew that these assets were sure to rise because they could be liquidated for more than I'd bought them for in due course. But the individual securities were traded in liquid markets so I couldn't mark them up from the trading price because the opportunity cost for my partners was set by the trading price. I would say that was pure agony. The lesson from that for all of you is that you can have your period of pure agony and live through it for many decades. It's a test of character and endurance.

I don't think any fully engaged young man wouldn't have gotten into the pain that I did in 73-74. If you weren't aggressive enough and buying on the way down and having some agony at the bottom, then you weren't living a proper investment life. I wouldn't quarrel with anyone who was more cautious and less aggressive than I was. But what got me into the agony was buying things for far less than what I was sure I could liquidate them for in due course. I don't think it was wrong, but it was agony.

More Comments on Activist Investors

Enormous blocks of stocks are held by employee pension plans with an ax to grind. Other groups of activists [have their own agendas]. It would be nice if the people who would be natural activists would be the type of people we'd want [to act on behalf of all

shareholders, but they're not]. I think the world is better when the Predators' Ball days waned. Generally speaking, shareholder activism is naturally going to be done by a group that many of you won't admire.

Lamenting Best Minds Going Into Hedge Funds

Somehow we've created a perverse system of incentives. At Samsung, their meeting of engineers is at 11pm. Our meetings of engineers [meaning our smartest citizens] are also at 11pm, but they're working to price derivatives. I think it's crazy to have incentives that drive your most intelligent people into a very sophisticated gaming system.

A rich system can endure a lot. If 10% of our people over age 60 want to spend X hours per week playing Texas Hold Em, we can afford it. But it's not good. But do we want our auto industry to just crumble away and somebody else's to take over because they do it better? I don't think it's a good outcome. I don't think we can stand a diversion of our best minds to hedge funds.

How to Pick a Good Money Manager

There are a lot of honorable people out there and a lot of charlatans. If you don't have expertise in the field, it's hard to do – I don't have a one-sentence formula for doing that. I always prefer a system in which people are eating their own cooking, so look for a money manager who has almost all of his net worth alongside yours in his fund. This was Warren Buffett's rule when he ran the Buffett Partnership. Another rule is to avoid things with a high commission: avoid *anything* sold by *anyone* on a high commission!

Thoughts on Value Investing

Some people come to our annual meetings to figure out how to make money. We've always believed in value investing – just try to get more value than you're paying for. There are a lot of ways to do this – it could even be investing in another manager. Or you could invest and hold for 30 years.

But nobody could make a living if that's all they practiced. You need some mumbo jumbo if you're going to be a witch doctor. You need some song and dance. [Laughter]

Investor Irrationality

Copper stays low for decades and we finally get a shortage of it, and all of a sudden it's in the stratosphere. I've seen housing prices collapse when the population is leaping. Once prices start galloping, people buy real estate like they buy stocks in Saudi Arabia or Kuwait – because they're doing up. A whole class of day traders became condo flippers. It really happens – thousands of them.

But you always have stock markets where prices stay low for long time. This is good for people like you. This is why you can afford to fly long distances to come to Pasadena [to hear me and learn about value investing].

Learn at the Temple of Rationality

All you have to do is keep trying to learn at the temple of rationality and do things [when it makes sense]. I'm quite prosperous even though I didn't invest in K-Mart's bankruptcy. You can miss a lot. We bought 4% of Freddie Mac [many years ago] yet none of Fannie Mae. How could the same mind have done that?! It wasn't very smart.

But despite the many cognitive mistakes [we've made], we're a lot richer now than we were then. I think you need to constantly remember the mistakes of omission. We're very good at this. Nobody remembers them – nobody thinks less of me for missing K-Mart – but I think about it every day. It's a very [useful discipline to have].

[Chris Davis](#) [of [Davis Advisors](#)], who's not here, has a temple of shame for mistakes. [It's a wall in his office in which he hangs stock certificates of the worst stocks he's ever invested in.] But this is inadequate. You need the temple of shame squared – great things you almost did and, had you been a little more rational, should have invested in. You'll be a lot better investor if you do this. You ought to remember boners of both kinds. Reality doesn't distinguish – either way, in 10 years, you're poorer. So why not celebrate your mistakes in both categories?

Efficient Market Theory

We didn't get any courses [on value investing] into [the curriculums of] major universities for the first 30 years [in which investing was taught], but it's shifted a bit in the past 10 years. The flat earth people [meaning the believers in the Efficient Market Theory] are only now about 75-80% [of the faculties].

RISKS IN THE FINANCIAL SYSTEM

Derivatives and Accountants Selling Out

This world of derivatives is another place the world has gone absolutely bonkers by the standards of the past. You take Fannie Mae – a big, clumsy, dumb bureaucracy to start with – and they're in this great privileged position where they got enough of a government halo so that their borrowing costs were lower than other people's. And they created this marvelous intermediary system where they were able to take an override on the safe mortgages of the world. They could raise earnings 20% per annum for a decade or so, but that wasn't enough. They wanted to make sure that they earned 15-20% every quarter than they earned in the previous year's quarter. And so they listen to the siren song of the professionals who invented these mad derivatives. And of course there was a lot of leverage in the bargain.

When they tried to clean up Fannie Mae, the new CEO complained that spent hundreds of millions of dollars on experts just trying to understand what's already on the books. You get people investing weird things, complex things for other people to gamble in. And those silver-tongued salesmen going into leading institutions, with wonderful slide shows showing how everything's going to work way better for them – weird things get done. What happens, of course, is that the same derivative trade that's put on, the accountant for Firm A says that the firm made \$8 million, and the accounting firm for firm B says its client *also* made \$8 million, and it's the same trade. I've never met anyone in the accounting profession that's bothered by this. They go around and *check* to see if the retailer owes some money to a wholesaler – they want to make sure that it's the same on both sides. But on derivatives, the accounting profession has sort of given up – it gets complicated. I don't think given up is the right word: They sold out. You'd think they'd learn by now and put more integrity into the system. But telling people to do something unpleasant when they're making a lot of money out of it...it's too hard. I likened it in some previous discussion to what doctors have to do when someone's on life support. The religions of the world say it's perfectly alright to withdraw the tubes – you can withdraw artificial help. But when you do it and the patient shrivels up like a prune, the guy who pulls the tube out feels like a murderer. He's not – it's the correct thing – but that's what he feels like. I think that's the way the accountants react to the situation when \$8 million of profit is being booked by each side of the same trade. He can't pull this plug. He doesn't want to think about the consequences.

Maybe there's some more kindly explanation. [Laughter] I'll give our accountant [who was sitting on the stage next to Munger] the opportunity if he wishes to participate in this discussion and explain why the accountants are doing what they're doing. [Short pause] He says he has nothing to add. [Laughter. (That's Munger's oft-repeated line from the Berkshire Hathaway annual meeting.)]

More on the Risk of Derivatives

I regard the counterparty risk as extreme. But no-one cares about this because the accounting statements assume it away. If you look at the trading sheets on Wall Street, there's no line for counterparty risk. The person who is supposed to think about this would be very unpopular [if he tried to add this]. Pulling away the punch bowl at the party has never been a way to prosperity and popularity.

If you look at derivative markets enough, you think it was scandalous. That doesn't mean it can't go on for along time, however. Look at Japan. Great civilizations can withstand a lot of terrible behavior. It's a good thing. Lord knows, we'll need it.

Look at Berkshire's Gen Re derivative book. It was valued at \$400 million on the balance sheet [but when he reached for the money, it wasn't there]. Imagine an balance sheet item labeled: "Asset – good until reached for"! [Laughter] [My comment: In fact, Berkshire has taken hundreds of millions of dollars in losses as it's run off this derivatives book – during a benign time in the markets, when no-one else was trying to

run off their book! Can you imagine the utter chaos that would ensue if, say, JP Morgan Chase tried to run off its \$40+ *trillion* derivatives book?!

Final Comments on Derivatives

If we have a hell of a mess due to a big derivatives blowup, the country will survive it. Did we need derivatives to get to their current huge size? [Of course not.] [People argue that because] it lays off risk, it therefore it must be wonderful. That is not the Munger mindset. If you're lucky, we'll see who's right.

Danger of Ballooning Consumer Debt

There's no question that huge ballooning credit practices in other places have caused crashes. For example, South Korea had a huge crash from irrationally ballooning consumer credit. But I can't predict whether the troubles I foresee will come soon or later. All I can predict is that there is considerable danger.

Risk of a Hedge Fund Blowup

There will be some repeat of Long Term Capital Management in some place – you can count on that. There's a lot of real brainpower at a lot of these firms and some are making a lot of money by being very shrewd. The problem is envy and imitation. The result will be like what happened with early stage venture capital in Silicon Valley. Envy will lead to a flood of money and then a disaster.

Should One Be Worried About Having Cash in a Brokerage Account?

I think a cash account at the really strong brokerages is safe enough. You have other better things to worry about. As for margin accounts, with hedge funds using leverage, there will be troubles there. You'll notice there's an uproar at Refco. You do not want to have a margin account at a dubious firm. And personally, I wouldn't want 100% of my assets in a brokerage account at even the strongest financial firm in America. Margin debt I'd be very goosy about right now.

How Fearful Should We Be About a Major Meltdown?

Every period is weird in its own way, but this period is extra weird. I could add the twin deficits to what I said earlier [about the things that worry me]. Yet economy is [rolling along]. I think it's almost always a mistake to think that a great civilize can't take some more [bad behavior]. I have friends who are building bomb shelters and the like [which is going overboard in my opinion]. I'm all for being reasonably cautious, like [John Arrillaga](#) [who Munger discussed in his opening remarks]. I haven't had any debt for a long, long time. Neither has Warren – not any significant debt anyway; maybe a blip.

But I think the rationality you're talking about is pretty sure to work. It won't save you from a terrible accident or the death of a child, but character and rationality will save you from a lot.

It's all about not trying to get the extra zero on your portfolio's total value when you die. It's playing the game all the way through with both character and rationality. It doesn't do any good to [have good motives?] if you're a horse's ass [?]. [Laughter]

COMMENTS ON BUSINESS AND ECONOMIC MATTERS

Backdating Stock Options

I think backdating stock options is embezzlement. I would argue that if it happened, it was criminal.

But I would bet that the people who did it think it was god's work. [They probably said to themselves:] "If options are great, then this must be even greater!" I'll bet there's no sense they did anything wrong. It's hard to believe that the human mind can play such ghastly tricks.

How to Change Corporate Directors' Behavior

The only thing that will change corporate directors' behavior is if they look ridiculous in the press. Otherwise the CEO could be an ax murderer. [Laughter]

Is Home Depot's CEO [\[Bob Nardelli\]](#) Being Paid Too Much in Light of the Company's Stock Decline Since He's Been CEO?

Generally I don't think management should be blamed if the stock market goes crazy for a certain period of time. If it went up 35 times earning and then declined to 25 times earnings, how is that the CEO's fault? Lou Simpson bought that stock and I don't think he'll want to comments on the situation at Home Depot. I'm not in a position to judge if the CEO's compensation is reasonable or not, but I wouldn't be surprised if it was.

Corporate Compensation

I don't know how we're going to fix corporate compensation. To have the CEO rewarded in a way that's so extreme [is terrible].

Future Oil Prices

I think eventually the price will be higher than it is now, but what will happen in the meantime I don't know. I'm not an expert on the price of oil, but I think it will get harder to extract hydrocarbons and demand for them will go up.

I think future generations will curse us for using hydrocarbons for our cars when they need them to grow food to eat.

Views on Naked Shorting

One of the nice things about being an old man in a secure place is that I don't have to think about many things and naked shorting is one of them. My jihad calendar is full enough. [Laughter] I'm sorry, that's all I have to say.

Book Recommendation: Fortune's Formula

I like that book that I recommended [a while ago] in which the guy that explained all of these weird guys at the horse races – a value investing thing with a lot of math in it. What was the name of it? [Fortune's Formula](#). It's a very worthy book and you all ought to read it.

In Hong Kong, people are crazy about horse racing and everyone bets on the races, yet somebody was actually able to develop a lot of algorithms such that, in spite of the croupier's take, he was able to make a lot of money. Some of that is going on in a lot of these hedge funds. Some guy can develop a lot of algorithms and can outwit the other guys' algorithms. But it's not for me...

Comments on the Kelly Formula, Which Is Detailed in Fortune's Formula

[Munger had trouble hearing the question and asked the questioner to repeat it more slowly, saying, "Keep in mind you're dealing with a slow-witted old man."]

The first time I read that sizing system, my take is that it seemed plausible to me, but I haven't run that formula through my head – and I won't. You couldn't apply it to the investment operations I've run [I think because of Berkshire's size], but the gist of it in terms of sizing your bet makes sense. Whoever developed that formula has an approach to life similar to mine.

If you could flip a coin and get a 4-to-1 payoff [if you called it correctly], would you invest your house, your net worth, everything? I don't think so. You only get to live once.

[The person who asked the question answered, "Maybe" [Laughter]]

All I can say is that you remind me of a man who once worked for a contractor I knew. He was very bold and aggressive. The contractor said, "Old Charlie is going to become a millionaire – several times." [Laughter] I think we've identified another Old Charlie. But at least you're asking the right question and at least you said maybe.

Generally speaking, I'm closer to you when you said maybe, at least I was when I was your age.

Unrealistic Return Assumptions of Pension Funds

Both Warren and I have said that to predict 9% returns from those pension funds is likely to be wrong and it is irresponsible to allow it. They do it to delay bad news. Look at Berkshire and our paper record, which is obviously much better [than the investment track records of the pension fund managers]: we use 6.5%. For example, the Washington Post has the best record [of virtually any pension fund, yet it assumes a 6.5% annual return]. Do you want to believe the predictions of the people with the best record or do you want to believe the people who are acting in the way [Demosthenes](#) predicted when he said the wages of profit are [?]. In other words, what a man hopes is what he believes.

Housing Bubble

The weirdest things I see are in really good coastal properties. It can't keep bubbling up like it has been. But when and how it will collapse I don't know.

Housing Bubble and Likely Future Low Returns from Real Estate

Recently someone paid \$800 per square foot for the air rights to build a piece of property in Manhattan. This is driven by the prospect of selling condos for high prices. The condo selling game has already crested in Las Vegas and Miami. In Los Angeles, I don't think it's quite crested, but certainly you're seeing weird prices.

I'm not sure it's crazy. In other words, if you have an apartment building, after costs of maintaining it, assuming no rent control ever, you might earn a 4.5% annual return [if you pay today's prices for it]. I'm not sure that that's crazy. It's not as good as the kind of stocks Berkshire would own, but it's not crazy. We may be in that kind of world [of low returns]. That's already happened in Europe where apartment buildings already have 3% yields. Stranger things have happened...

Interest Rates and Inflation

I have never believed that interest rates have a perfect correlation to inflation. I think there's some relation, but it's complex and not easily quantifiable.

Class Action Litigation

It doesn't affect Berkshire because we don't offer Directors & Officers coverage, though we do cover product liability. There's a lot of abusive litigation in the silicosis field. The asbestos lawyers just rewrote the same complaints. [It reminds me of the class action lawyer who, faced with a judge who wasn't friendly,] said, "By god, I'm getting tired of this harassment and by god I'm going to take my witnesses and go to Chicago!"
[Laughter]

The behavior of the class action lawyers [who sue companies] may be quite inappropriate, but the behavior of the people in the corporations may be quite inappropriate as well.

Municipalities' Bad Accounting for Future Pension and Healthcare Liabilities

They've gotten very lucky thanks to the accountants. [My comment: Unlike corporations, which have to account for such liabilities on their balance sheet and in the footnotes to their financial statements – at least in part (there's massive abuse and understatements here) – a loophole in accounting rules has allowed cities and states across the country to make promises of pension and healthcare payments to municipal employees' unions totaling hundreds of billions of dollars in present value, yet this doesn't have to be disclosed or reserved for. The accounting loophole was recently closed and I predict there will be hell to pay as municipalities have to suddenly come up with this money.] If that [continued bad accounting] doesn't work, then they'll have to go to Plan B: increase taxes. I predict that whatever disgusts you in this field will continue for a long time.

Newspapers

I think their future is way worse than their past.

Dividend Payout Ratio of the S&P 500

I don't really have a big opinion on the dividend payout ratio of the S&P. To me, it's within hailing distance with being reasonable...That's all I have to say. [Laughter]

ADVICE ON LIFE AND OTHER

The Importance of Being an Exemplar

I think people have a duty when they rise high in life to be exemplars. A guy who rises high in the Army or becomes a Supreme Court justice is expected to be an exemplar, so why shouldn't a guy who rises high in a big corporation act as an exemplar and *not* take every last penny?

It's not a problem we've had at Berkshire, but look at how far it's spread. We have about two imitators. [Laughter]

The Future of American Civilization

I've said that American society is *near* its apex. It could be just before or just ahead of that point. Other people are more optimistic; Warren is more optimistic than I am. We've had the most incredible generations. Do you think it can go from generation to generation, from apex to apex? The historical record would give you some caution.

Whether the good behavior and values will outweigh the bad, I don't know. On my way over here, I stopped to watch the concrete being poured for a new Wesco building. The design is sound. The system for putting it together is sound. The skill of the crews is sound. The inspection process is sound – every single pour of concrete is watched by an inspector paid by the city of Pasadena, and he's a good, competent man. He watches to make sure every bar of rebar is correct. This building will outlast the pyramids. This system is a credit to our civilization. In contrast, look at the same process in Latin America or Japan, where guys take bribes.

There is a lot that is right in our country. In a recent five-year period, not one passenger died on a major airline. Imagine if other engineering systems were as good. A lot of pilots are recovering alcoholics, yet the system is safe enough to get us around this.

United States Fiscal and Trade Deficits

Regarding currency and oil – this is a very sophisticated crowd [laughter]... Regarding currency, the United States is very peculiar running such a large trade deficit and a fairly big fiscal deficit. [I couldn't hear his remarks for a few sentences here.] The absurdity of this kind of thing...I'd rather not run such a big fiscal and trade deficit. If we have a war, I'd rather add a blank space on tax returns, asking people to pay 10% more for a national emergency. It wouldn't be compulsory, but if you don't pay, we'll publish your name. [Laughter] I'd be in favor of that kind of stuff. Maybe I'd [be great?] for the [United Jewish Appeal](#) [an extremely successful fundraising organization, in part because it's very public about who makes big donations – and if you're a wealthy Jew, you're shamed if you're not on the list].

But my ideas aren't winning. They're odd, of course. I'm not predicting ruin, but I think it would be more conservative to behave differently.

China's Growth and Future Pollution

China's vast growth of GNP of 9-10% per annum is a remarkable thing. I think the government will be smart enough to let the tiger grow and then there will be a big pollution problem – and the United States will be way less important relative to other nations than it is now.

Best-Loved Ideas That He's Destroyed Recently

[In last year's [annual meeting](#), Munger talked about the importance of destroying at least one of your best-loved ideas each year, so a shareholder asked which of his best-loved ideas he's destroyed in the past year.]

I had more scorn for fixed income arbitrage in the past than I do now. I was also more hopeful about troubles in the Middle East than I am now. So I've destroyed some of my optimism in favor of more realism. I don't think there's a man or woman in the room

that thinks they have a better grasp of what going on in the Middle East [now than they did previously]. Doesn't matter what you think of this administration.

The ability to destroy your ideas rapidly instead of slowly when the occasion is right is one of the most valuable things. You have to work hard on it. Ask yourself what are the arguments on the other side. It's bad to have an opinion you're proud of if you can't state the arguments for the other side better than your opponents. This is a great mental discipline.

Reflections on Looking Back at His Life

I wouldn't have done a lot in my life different. I think I've been a very fortunate man and I don't think I should be complaining about how my life has worked out.

The other day, I was looking back at Berkshire over the past 10 years, since it was recently the 10-year anniversary of the Berkshire B shares. Sure, the rate of growth has come down, but we have added *a lot* of value and that's with a tough strategy the past few years. So generally speaking, I have no regrets.

The only regret I have is that I'll soon be dead. [Nervous laughter] I deal with it through humor. Some people deal with it through religion; I deal with it through humor.

[My comment: Munger has in the past spoken many times about the reality that he won't live forever, usually in a light-hearted way, but this was the first time I felt he was really serious. It was a poignant moment, as a great man shared with his wife (Nancy, who was in the front row), family, friends and most ardent admirers his sorrow that he sees the end of his road approaching. That being said, his mind is as sharp as ever and he clearly relishes his life, so I think he's got quite a few good years left!]