



28 May 2012

Highlights from the Columbia Business School Dinner and Berkshire Hathaway Annual Meeting in Omaha, Nebraska on 4 & 5 May 2012.

Columbia Business School Dinner hosted by Bruce Greenwald with Thomas Russo, Mario Gabelli and David Winters talking.

For background, Professor Bruce C. N. Greenwald holds the Robert Heilbrunn Professorship of Finance and Asset Management at Columbia Business School and is the academic Director of the Heilbrunn Center for Graham & Dodd Investing. Described by the New York Times as "a guru to Wall Street's gurus," Greenwald is an authority on value investing with additional expertise in productivity and the economics of information.

Mario Gabelli, Thomas Russo and David Winters are all successful US based investment managers who each adhere to the value investing school of thought and process.

Greenwald started off the evening with a story about George Soros. A head-hunter called Greenwald for leads for someone to takeover management of Soros' portfolio. Greenwald inquired as to why they were looking for value managers and evidently it was revealed that Soros had analysed his entire career and realised he had made most all his money out "value plays" and that the losses on macro trading essentially wiped out the gains! (*Remember Soros made his first billion breaking the Pound.*)

Key points from the above participants:

- Biggest risk out there is global terrorism, followed by Government regulation in the likes of tobacco, alcohol, utilities, etc;
- With regard to the Euro Crisis which consumes most people's attention at present. European GDP is only down 0.5% so that is not even back to where it was two years ago. So one needs to maintain perspective;
- Greece is the size of Maryland;
- The US is an under-invested asset class. Mentioned US\$ 80bln had to be invested into US equities by pension plans alone;
- Prefer Switzerland to Europe (in general) – 7.0mln people, solid currency with great global companies;
- For example, a company like Nestlé can pass on inflation because of its franchise / brands;
- The beauty of some of the stocks these investors own is you do not have to do that much as they are global franchises with great management teams (e.g. Swatch, Novartis, SAB Miller, Philip Morris Intl);
- But you cannot earn a 2% management fee and 20% performance fee in stocks like this. However, you can sleep soundly and beat inflation;
- A lot of focus on Nestlé, 3% revenue growth, 3.5% dividend yield, any debt is offset by the L'Oréal stake. They could buy back their whole market-cap today and still report 50% of their earnings. (Additionally, the CHF has appreciated at +6% per annum versus the USD over the last 10+ years.);
- The prospects for Berkshire Hathaway are very good. In fact, it has really become a "special situation" as you can easily identify a "Sum-of-the-Parts" (SOTP) of US\$ 160,000 + per share.

Berkshire Hathaway Meeting – Saturday, 5 May 2012 (9:00am – 3.00pm)

The Berkshire Hathaway meeting was more insightful than 2011 as Charlie Munger ("Munger") was much more vocal and animated this year. His ability to cut straight to the point and distill an idea down to a few key words / sentences has to be witnessed to be believed. He truly has an extraordinary mind. Warren Buffett ("Warren") was his usual self and anyone worried about his prostate cancer can rest assured it is having very little (if any) impact.

As Munger rightly pointed out "I am 87 and I probably have more prostate cancer than him, but I don't let them test me for it! However, I am jealous of all the sympathy you keep throwing at Warren!"

I have broken all the key areas discussed into separate points to make it easier on the reader to follow as the meeting does cover a diverse range of topics in an ad-hoc fashion.

Advice:

In terms of offering advice to publicly listed companies they have invested in, they have not really done that. Although one must remember Warren has been on the board of a number of their holdings over the years so I am sure some advice was given in these meetings given the weight he carries. However, if they thought a company really needed their advice then they would move on. They noted their four largest investments they have held for 20 – 25 years, these companies have needed no advice.

Value of Berkshire Hathaway:

The buy-back is at 1.1x Book Value – this is a price where they feel Berkshire Hathaway is materially undervalued. If given the chance (and assuming they have US\$ 20bln in cash which Warren feels is the minimum they must have) then they would buy-back aggressively.

Share repurchases in general:

A lot of share repurchases are idiotic with little consideration given to the valuation. Berkshire will only buy-back for one reason and that is to increase remaining shareholder value.

US Banks versus European Banks:

US banks are in a much stronger financial position. The US Treasury and the Federal Reserve have a lot to be thanked for in the way they handled the crisis in their view.

The European banking system is gasping for air. The key problem is that European banks access a majority of their money via wholesale funding markets versus the US banks, which have large deposit bases. Mario Draghi - Head of the European Central Bank has pumped in Euro 1 trillion into the banking system in Europe. This is equivalent to 1/6th of all deposits in the US.

The risk profile of the US versus Europe is night and day. This is because the US has a federal union (of states) and its own currency. They also referred to Henry Kissinger's comment recently – "If I call Europe which number do I dial?"

Oil & Natural Gas:

You would not have thought the current 50:1 ratio between the price of oil and natural gas was possible.

Munger commented that he felt that the U.S. should use all of its thermal coal first as it was crazy to use valuable natural gas at these prices. (This refers to a number of power plants switching from burning coal to gas at present). He feels that these natural gas reserves are the most precious resource the US has and they should be leaving them to the next generation.

Gas is clearly worth more than coal and therefore his view on consuming the coal first. Additionally, he believes the US should continue to use up everyone else's oil reserves and preserve the US gas assets, irrespective of deficit financing.

GEICO Insurance:

GEICO continues to go from strength to strength. GEICO's carrying value is US\$ 1bln – it is probably worth US\$ 1.5bln. This highlights some of the undervaluation in the controlled businesses but in particular the insurance operations.

Business Schools:

Silliest stuff taught at business schools is the "fads" they have focused on in finance theory. Mathematically based with limited insight into the practicalities of investing. There are only two courses needed in finance – (i) *How to value a business* and (ii) *How to think about markets*.

Who reads options pricing or Modern Portfolio Theory?

The teaching of investments has totally drifted away from valuing businesses.

The "high priests" have to make themselves look smarter than everyone else and they try to do this with "smoke and mirrors". Munger then chimed in with a less than complimentary comment about Black Scholes and most other finance models.

Reinsurance:

Written far more business in NZ, Australia, Japan and Thailand post all the events because they believe rates are attractive (due to less competition).

They once again mentioned Christchurch and the fact the second quake cost \$12bln which given the size of the NZ economy is equivalent to 10 "Katrina's".

It was absolutely huge relative to total premiums in this market. They currently have \$10bln of coverage out in this market at present.

As a result of these events, the market for "Cat" business is significantly improving at present from a pricing perspective.

Utilities:

Cannot count on wind for base load, it's supplementary.

Spoke extensively about the opportunity set in front of Mid-American on the energy front. This is very clearly of interest to them as they can deploy large sums at reasonably attractive rates even taking into consideration that the returns are regulated.

Acquisitions:

Recently considered a US\$ 22bln acquisition and would have pulled the trigger could they have made the deal. They would have had to sell some stocks to settle but would not have used Berkshire stock. (They still regret using stock in the BNSF deal.) *Some suggested targets from other investors: Aflac, ADP and Illinois Tool Works.*

Warren's Prostate Cancer:

Non-event (in his opinion) and he feels fine.

Munger said that he "resented all the attention Warren was getting because he probably had more prostate cancer than Warren but he does not allow his doctors to test for it."

Advice to a young person today:

Buy businesses for "keeps" after managing money for other people to build capital.

Read Chapter 8 & 20 of the "the Intelligent Investor" – it is built into the market that stocks will trade at extremes.

Munger went on to imply that you have to treat stocks like inventory to get to the stage where they can buy businesses and hold stocks for the long term.

How do you value a declining business?

Munger – "They are not worth nearly as much as a growing business."

Warren – stay away, they never spend a lot of time valuing declining businesses. No "cigar butts" for Berkshire anymore but pointed out they had been in them when they started out (e.g. Diversified Retailing (1966) and Blue Chip Stamps).

What should we avoid?

Stay away from what you do not understand.

No interest in IPO's – priced for the vendor.

IBM vs. Google & Apple?

Chance of being wrong on IBM is less than for Google and Apple.

Munger – "What do we know about Computer Science?" ...he went on Google and Apple clearly have very strong market positions but he and Warren have the reverse of an edge with regard to those companies.

Why have you not bought a Forest Products Company?

They have looked at them in the past but to date have never found anything that met their returns target. There is no doubt the business is understandable but they have not found anything attractive at purchase price.

Risk:

Think about risk all the time. They are always focused on the worst-case scenario with a big margin of safety. They believe one of the biggest problems today in the financial markets is a lack of understanding of history.

Warren spoke of how he still has 7 pictures on the wall, which are all pages from financial history. He has had these from when he first set up shop.

Munger - Life in financial markets has no relativity to "Sigma's". *(Note: Sigma in finance refers to the standard deviation on the rate of return on an investment as a measure of the volatility of the investment.)*

Risk - contd:

Value at Risk (VAR) as it is referred to in the financial services sector is one of the dumbest ideas ever put forward. To explain risk Munger put forward the story of one Berkshire Director – Sandy Gottesman firing someone. The guy evidently asked - "How can you fire me?" Gottesman replied - "I'm a rich old man and you make me nervous."

The point of this story being that not enough bank / financial service executives think like this - they rely on formulas.

New Portfolio Managers – Todd & Ted - How are they working together and performing?

They both receive US\$ 1mln salary each.

Receive 10% of their outperformance over the S&P 500 over 3 years.

They each get paid 80% from their own performance and 20% from the others to encourage them to work together.

They now each run US\$ 2.75bln.

90% of the investment management businesses in the US would not be able to run on this model.

Warren added that you cannot put passion into someone but you can make it easier on them – which is what they have tried to do with Todd and Ted. He also said that they did not use compensation consultants to come up with this formula it was just common sense.

Munger added "Prostitution would be a step up for Compensation Consultants!"

Mistake Minimisation:

Learned from other people's disasters.

Continue to read economic history.

Look to value not headlines.

They don't have any discussion about the macro – if you go back to the financial crisis they did not deploy all their cash because they just did not know.

They think about the worst case all the time.

Also pointed out, when you collateralise things you put yourself at risk because you never know what tomorrow holds.

EBITDA (Earnings before Interest, Tax, Depreciation & Amortisation):

EBITDA is a joke! (A meaningless measure in their view.)

How about EBE – earnings before everything?

Gold:

Very hard for unproductive investments to be productive over time.

Newspapers:

May buy more newspapers, but will focus on those areas / papers where there is a strong sense of local community.

Amazon.com

Is terrible for most retailers.

Will affect everything that is easy to buy via a computer or iPad.

Wal-Mart:

Does not believe the earnings power of Wal-Mart will be materially impacted from the Mexican scandal 5 years from now. They do not believe there is something fundamentally wrong with Wal-Mart.

They reminded the audience that it is important to note that Berkshire will have an occasional hiccup as well. They have 270,000 employees and you can guarantee someone is doing something wrong.

Other:

Charlie Munger Interview on CNBC (prior to meeting):

<http://video.cnbc.com/gallery/?video=3000088395&play=1>

Warren Buffett on CNBC - Transcript (post meeting)

www.cnbc.com/id/47322740/CNBC_Transcript_Warren_Buffett_on_Squawk_Box

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