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This past weekend we travelled to Omaha, Nebraska for the annual Berkshire Hathaway shareholder meeting, dubbed “Woodstock for Capitalists.” From 15 people at the first meeting in 1982 and a few thousand people at the first meeting Mike attended in the early 1990’s, participation has ballooned to over 37,000. The key moment of the weekend consists of Warren Buffett and his partner Charlie Munger conducting a six-hour Q&A session, packed with common sense investment advice and valuable insight into current economic developments.

Buffett and Munger have an uncanny ability to explain difficult problems in a way that nearly anyone can understand. Despite the fact that their solutions are logical and based on common sense (Munger stated: “Pragmatism is Berkshire’s universal theory. We are demonstrating the fundamental algorithm of life – repeat what works”), they typically represent unconventional thinking on Wall Street. This year’s meeting was both entertaining and informative. The annual Berkshire movie included clips of Buffett and Munger alongside celebrities such as Alex Rodriguez and the Desperate Housewives. The Q&A session covered over sixty questions divided among attendees drawn at random and three financial reporters. A few of our notes from the weekend:

- Results from Berkshire’s numerous operating subsidiaries in the first quarter of 2010 suggest that the economic recovery is gaining steam and is more broad-based than at the end of 2009.
- Buffett and Munger believe that the SEC’s case against Goldman Sachs is misguided (Berkshire owns Goldman Sachs securities). The crux of the case is that Goldman sold securities to investors that it had designed to fail and then bet against those investors without disclosing such information. Buffett pointed out that the investors Goldman dealt with were sophisticated banks and bond insurers who should have known better and that it is the counterparty’s job to determine whether or not securities are appropriate for investment purposes. Berkshire never gives a second thought to who may be on the other side of a trade or how a security was structured – they simply analyze the security’s investment prospects and move forward accordingly.
- In most cases, Berkshire avoids trying to forecast changes in the relative value of currencies (e.g. the dollar against the euro). However, Buffett and Munger are bearish on currencies as a whole because of their fear of future inflation. Weaning global economies off the medicine prescribed for the economic crisis may prove to be more problematic than the original illness. Countries like the U.S. have used their immense access to credit over the last half century to do many positive things, but the use of credit has been overextended and now represents a key global challenge. While there is no possibility of default if sovereign debt is denominated in the domestic currency, the prospects for “significant inflation” have increased.
- This will not be the last time economies witness financial mayhem. While some new regulation may be needed on speculative activities and derivatives, people will continue to make mistakes. The conventional wisdom taught at business schools over the last few decades was a leading cause of the financial crisis.
- Berkshire continues to operate a decentralized business structure focused on “widening the moats” of their various businesses. Berkshire only employs 21 people at their headquarters (amazing for an organization that employs 257,000 total), never engages compensation consultants, pays modest director fees and assigns the overseeing of risk directly to the CEO. Buffett and Munger generally let their businesses manage their own affairs, claiming that corporate management teams usually think they know more about strategy than they actually do and typically impose extra costs on their subsidiaries.
- Corporate managements’ short-term focus on meeting Wall Street expectations of quarterly profits is dangerous and unhealthy. Such attitudes can encourage unethical behavior and lead to inefficient decision-making. Berkshire generates larger long-term profits by accepting lumpier (as opposed to smoother) short-term earnings.

- Berkshire would rather own stocks than cash or bonds, but investors should only expect a “modest real rate of return” going forward. Equities represent the “best of a bad lot of opportunities.” Depressed interest rates greatly diminish the appeal of bonds and cash equivalents, making stocks look attractive on a relative basis. Investors should not expect the high levels of return seen in certain past periods from today’s market levels. The degree of undervaluation in Berkshire’s own portfolio is modest and has been much larger at times in the past. The best course of action remains “buying a good business at a decent price and forgetting about it for a long, long time.”
- As always, Buffett and Munger believe in the power of human innovation and the success of capitalism and are optimistic that standards of living will continue to increase at an acceptable pace.

We weren’t surprised by Buffett and Munger’s analysis of the challenges of government debt, the prospects for future inflation and the modest prospects for investment returns. Investor success is primarily impacted by two key variables – how their fractionally-owned businesses develop over time and the market prices at which ownership interests in the businesses were established. The need to balance increasingly challenging government budgets will likely lead to higher taxes and a greater threat of inflation, impairing the ability of businesses to grow real profits consistent with past results. Low levels of interest rates and fair equity valuation multiples erode the investor’s margin of safety on new purchases. It is important that investors

recognize the difficulty of generating future returns above those witnessed during historical bull markets. In such environments, investors must be disciplined enough to avoid accepting unjustified levels of risk in an effort to stretch for extra return. The future will once again present opportunities for investors to purchase well performing assets at attractive valuations. Until then, investors should focus on doing the best they can at an acceptable level of risk. This does not mean market timing or holding cash, but instead selecting securities based on an analysis of risk and return expectations relative to the investor’s opportunity set.

Above all, the success of Berkshire Hathaway is a testament to the importance of ethics in business and investing. Each year Buffett replays his 1991 testimony to a House of Representatives subcommittee concerning issues at then investee Salomon Brothers: “Lose money for the firm and I will be understanding. Lose a shred of reputation for the firm and I will be ruthless.” On Saturday, Munger reiterated that integrity “is the safest way to make money.” Berkshire’s extraordinary investing record has been generated without sacrificing personal ideals or a strict standard of ethical behavior. Munger concludes: “When it comes to managing money, take the high road. It’s far less crowded.”

Sincerely,

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