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An Actuary's Experience at Woodstock for Capitalists

By Steven Chen

Price is what you pay. Value is what you get.
—Warren Buffett

I was at Qwest Center, somewhere at the top level, near the last row of the seating section. The 2009 Berkshire Hathaway annual shareholders meeting was going to start in less than an hour, but the stadium was already full of people. I spent a long time securing a seat. In fact, I woke up at 6 a.m. in hopes of getting a good seat.

The Berkshire Hathaway annual shareholder meeting is a six hour Q&A session. Shareholders from all over the world come to Omaha to pose questions to Warren Buffett and Charlie Munger. In the past, there were usually a handful of questions directly related to Berkshire and its operations. Last year there were practically none. So this year Buffett wanted to steer the discussion back to Berkshire's business. Instead of taking all the questions from audience, half of the questions would be selected by three financial journalists from questions submitted through emails beforehand.

It is a tradition that the annual meeting starts with a movie. This year, the video had Warren caddying for Tiger Woods and giving him advice on playing golf. Then different Berkshire companies showed up in the movie. In another scene, Warren was selling mattresses, and the customer was asking why and he said something like, "Well, you know, after the rating downgrade, the board thought I'd better get to work." There were many parts of the video that were so funny that the audience burst into laughter.

The video then switched to the Buffett's congressional testimony on the Salomon Brothers scandal: "Lose money for the firm and I will be understanding. Lose a shred of reputation for the firm and I will be ruthless." That line inspired resounding applause.

When the movie was over, the Q&A session began. Most of the shareholders probably had written the questions out beforehand and read them into the microphone. Before they got to whatever they intended to ask, everyone offered thanks, usually to "Mr. Buf-

An Incomplete List of Berkshire Companies
- Borsheims Fine Jewelry
- Clayton Homes
- Dairy Queen
- GEICO Auto Insurance
- Iscar Metalworking Companies
- Marmon Holdings, Inc.
- MidAmerican Energy Holdings Company
- Nebraska Furniture Mart
- NetJets
- See's Candies
- Shaw Industries

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fett and Mr. Munger." Buffett was clearly the one who ran the show. But before he finished answering a question, he would always ask his partner, who was seated silently at the table, "Charlie, you have anything to add?" Munger would occasionally decline by saying "Nothing to add" or "Nothing on that one, either." It was so clear to me that the two value each other's opinion very much. Just like Buffett once said, "Charlie and I are Siamese twins practically."

1ST QUESTION: DERIVATIVES

The annual meeting started with some heat. The 1st question was in fact highly anticipated: it was about Berkshire's derivative business. Since derivatives had taken down AIG, people were worried who the next victim would be.

Carol Loomis from Fortune magazine asked whether Buffett thought large derivative positions were appropriate for a highly rated insurance company, given that he had referred to derivatives as financial weapons of mass destruction. Buffett started by saying that his job was to make money over time. Berkshire had arranged the derivative contracts to have very minimal collateral posting requirement. Even under the chaotic conditions of the fourth quarter of 2008, Berkshire only posted less than 1 percent of the market value. Furthermore, he recently repriced the derivative contracts. Now in order for Berkshire to make a payment, the S&P index had to fall below 950 instead of 1,500 with the tradeoff that the duration of those contracts were shortened to 10 years from 18 years.

Buffett's Favorite Book on Investing

In his book "The Intelligent Investor," Ben Graham—the father of value investing and Buffett's teacher—wrote the following. "Basically, price fluctuations have only one significant meaning for the true investor. They provide him with an opportunity to buy wisely when prices fall sharply and to sell wisely when they advance a great deal. At other times he will do better if he forgets about the stock market and pays attention to his dividend return and to the operating results of his companies."

However, he still believed that derivatives did pose problems to the world on a macro basis. He would only use derivatives if he believed that contracts were mispriced. Unfortunately, as a result of mark to market accounting, the value of these derivatives could swing by billions of dollars on a quarterly basis. But he believed odds were very good that the equity puts would end up making money. (In the first quarter of 2009, Berkshire posted a derivative loss of $1.5 billion. In the second quarter, it posted a derivative gain of $2.4 billion.)

He also felt that it was his duty to explain to shareholders the rationale for these transactions. In fact, in his 2008 letter to shareholders, he devoted an entire section of almost five pages to explain these derivatives.

DISCOUNT CASH FLOW MODEL

An audience member asked whether Buffett and Munger employed the use of complex free cash flow analysis to determine discounted cash flow and ultimate valuation. Buffett answered that if you needed a computer or calculator to understand a company then you should not buy the shares. It should be so cheap that it screamed at you.

Buffett further said that people relied too much on the false precision based on the projection of probabilities of X standard deviation events. Probability for certain events simply could not be calculated. Munger added that some of the worst financial decisions ever made were made based on fancy spreadsheets. People started to believe too much in their projections. He even joked that business school taught this so that they could have something to do.

BYD—HOT CAR COMPANY

Andrew Sorkin of the New York Times asked whether the Berkshire's latest investment on BYD, a Chinese car company, was a true value

> "Derivatives did pose problems to the world on a macro basis, they should only be used if the contracts were mispriced."

investment or a speculative venture capital investment. Buffett passed the question to Munger. He joked that Munger always got very excited talking about BYD so Buffet might have to calm him down. Munger started by saying that BYD was not an early stage venture capital company. What the company had achieved was a "damn miracle." BYD achieved a leading position in lithium batteries off a base of zero and then decided to go into the auto business with no experience. They were making cars basically from scratch—everything but the glass and the rubber. Munger also complimented the BYD CEO Wang Chuan-Fu and said that he was hiring the smartest engineers in China. He was not going to bet against 17,000 Chinese engineers. He had never in his life felt more privileged to be associated with something than he felt with BYD.

MidAmerican, a unit of Berkshire Hathaway, invested $232 million in BYD in September 2008. Since then, BYD's stock had surged more than five-fold. The company aims to start selling an electric powered vehicle in the United States next year.

HOW TO BE A SUCCESSFUL INVESTOR

Another audience member asked what Buffett would teach new value investors. He said that he would teach two things. First of all, an investor needs to know how to value a business. Secondly, an investor needs to understand market fluctuation.

Buffett reminded people to always stay in their circle of competence, that certain companies did not lend themselves to easy valuation. A good understanding of accounting is useful because it is the language of business. He believed that investment was simple but not easy. He then joked that you did not need extraordinary intelligence to succeed as an investor. If you have an IQ of 150, you can sell 30 points to someone else. Both Buffett and Munger considered modern portfolio theory, efficient market hypothesis and beta irrelevant to successful investing.

FINANCIAL CRISIS

It is not hard to imagine that a number of questions at the meeting were related to banks. One reason is that we are having one of the worst financial crises in our history. The other reason is that Buffett is one of the best industry experts. He has made long-time investments in American Express, Wells Fargo and US Bancorp to name a few. He did not even do any due diligence when he invested $5 billion in Goldman Sachs. When he was answering questions about banks at the meeting, he referred to the letter to shareholders written by Jamie Dimon, the CEO of JP Morgan, on at least two occasions. He thought the letter was very well written and provided lots of good insights.

I later read Dimon's letter, which is actually 28 pages long. This is an enormous amount considering that Citigroup's letter is only four pages and Bank of America's letter is only nine pages. In his letter, Dimon described JP Morgan's 2008 performance by line of business and reviewed many critical events such as the purchase of Bear Stearns. He also discussed where the industry went wrong and what the implications for the future might be.

Buffett's Letter to Shareholders

Buffett has been encouraging CEOs to write insightful letters to shareholders. Compared to most letters which are just fancy tables with meaningless graphics, Buffett spent lots of effort on his own annual letter and it is considered as a must-read in the business world.

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WHAT DO KIDS CARE ABOUT?

An 11-year-old boy from New Jersey asked how inflation would affect his generation and what the best protection against inflation would be. Buffett suggested that the best protection is your own earning power. If you are the best at what you do, you would command a given part of others goods and services regardless of inflation. The second-best protection is a wonderful business: a business that people will patronize regardless of inflation and does not require high capital investment.

TIME TO SHOP

The annual meeting was over around 3 p.m. I was actually feeling a bit tired. But I was also excited to visit the 194,300-square-foot exhibition hall filled with the products of Berkshire subsidiaries.

I started with Dairy Queen and got myself a Blizzard treat. Then I visited the Clayton house. Clayton was showcasing its new i-house. I checked out the bedroom, living room, bathroom and kitchen. It felt exactly like a conventional house but it was much cheaper.

There was a big crowd at the BYD station. Wang Chuan-Fu, the CEO, was there. He was smiling, shaking hands and answering questions. He looked really happy. Why not? BYD was not even known to many Chinese people, but now people living in Omaha know his company.

I also stopped by at the NetJets booth. NetJets pioneered the concept of fractional jet ownership. Buffett advertised this idea of "Come to Omaha by bus; leave in your new plane." Too bad I could not do that.

The most popular product was definitely See's Candy. Almost everyone had a bag. See's Candy even made two types of special boxes for the shareholders meeting with one type featuring a comic figure of Buffett on the cover and the other type featuring a comic figure of Munger. In the end, I noticed there were more Buffett boxes left.

CONCLUDING REMARKS

Paul Larson, the Morningstar newsletter editor, said that going to the Berkshire annual shareholders meeting was like going to church: "there may not be a whole lot of new information, but it is good to come here and to reaffirm the constant beliefs you have." □

Further Reading

Warren Buffett's Letters to Berkshire Shareholders
http://www.berkshirehathaway.com/letters/letters.html

Morningstar Woodstock for Capitalists 2009 Blog
http://socialize.morningstar.com/NewSocialize/blogs/berkshire/archive/2009/05/02/woodstock-for-capitalists-2009-blog.aspx

Matthews, Jeff (2008). *Pilgrimage to WARREN BUFFETT's OMAHA*, McGraw-Hill.