University of Kansas : Warren Buffett Q&A

Notes by Professor Hirschey, University of Kansas (May 6, 2005)

Question: According to a business week report published in 1999, you were quoted as saying "it's a huge structural advantage not to have a lot of money. I think I could make you 50% a year on $1 million. No, I know I could. I guarantee that." First, would you say the same thing today? Second, since that statement infers that you would invest in smaller companies, other than investing in small-caps, what else would you do differently?

Yes, I would still say the same thing today. In fact, we are still earning those types of returns on some of our smaller investments. The best decade was the 1950s; I was earning 50% plus returns with small amounts of capital. I could do the same thing today with smaller amounts. It would perhaps even be easier to make that much money in today's environment because information is easier to access.

You have to turn over a lot of rocks to find those little anomalies. You have to find the companies that are off the map - way off the map. You may find local companies that have nothing wrong with them at all. A company that I found, Western Insurance Securities, was trading for $3/share when it was earning $20/share!! I tried to buy up as much of it as possible. No one will tell you about these businesses. You have to find them.

Other examples: Genesee Valley Gas, public utility trading at a P/E of 2, GEICO, Union Street Railway of New Bedford selling at $30 when $100/share is sitting in cash, high yield position in 2002. No one will tell you about these ideas, you have to find them.

The answer is still yes today that you can still earn extraordinary returns on smaller amounts of capital. For example, I wouldn't have had to buy issue after issue of different high yield bonds. Having a lot of money to invest forced Berkshire to buy those that were less attractive. With less capital, I could have put all my money into the most attractive issues and really creamed it.

I know more about business and investing today, but my returns have continued to decline since the 50's. Money gets to be an anchor on performance. At Berkshire's size, there would be no more than 200 common stocks in the world that we could invest in if we were running a mutual fund or some other kind of investment business.

Q: Since Ben Graham isn't around anymore, what money managers do you respect today? Is there a Ben Graham today?

You don't need another Ben Graham. You don't need another Moses. There were only Ten Commandments; we're still waiting for the eleventh (j/k). His investing philosophy is still alive and well. There are disciples of him around, but all we are doing is parroting. I did read Phil Fisher later on, which showed the more qualitative aspects of businesses. Common stocks are part of a business. Markets are there to serve you, not to instruct you. You can often find a couple of companies that are out of line. Find one; get rich. Most people think that what the stock does from day to day contains information, but it doesn't. It isn't just something that wiggles around. The stock market is the best game in the world. You can take advantage of people who have no morals. High prices inside of a year will typically be 100% of the low price. Businesses don't change in value that much. That is simply crazy. There are extreme degrees of fluctuation, and Mr. Market will call out the prices. Wait until he is nutty in one direction or the other. Put in a margin of safety. Don't find a bridge that says no more than 10,000 pounds when you have a 9800 pound vehicle. It isn't a function of IQ, but receptivity of the mind.

When investing you don't have to invest in all 10,000 companies available, you just have to find the one that is out of line. Mr. Market is your servant. Mr. Market is your partner and wants to sell the business to you everyday. Some days he is very optimistic and wants a high price, others he is pessimistic and will sell at a low price. You have to use this to your advantage. The market is the greatest game in the world. There is nothing else that can, at times, get this far out of line with reality. For example, land usually only fluctuates within a 15% band. Negotiated transactions are less volatile. Some get this; others don't. Just keep your wits about you and you can make a lot of money in the market.

Q: Do you expect the stock market premium to continue to be 6.5% over bonds?

I don't think that the stock market will return 6.5% over bonds in the future. Stocks usually yield a little more, but that isn't ordained. Every once in a while, stocks will get very cheap, but it isn't ordained in scripture that this is so. Risk premiums are mostly nonsense. The world isn't calculating risk premiums.

Best book prior to Graham was written by Edgar Lawrence Smith in 1924 called Common Stocks as Long Term Investments. It was a study that evaluated how bonds compared to stocks in various decades of the past. There weren't a whole lot of publicly traded companies back then. He thought he knew what he was going to find. He thought that he'd find that bonds outperformed stocks during periods of deflation, and stocks outperformed during inflationary times. But what he found was that stocks outperformed the bonds in nearly all cases. John M. Keynes then enumerated the reasons that this was so. He said that over time you have more capital working for you, and thus dividends would grow higher. This was novel information back then and investors then went crazy and started buying stocks for these higher returns. But then they started to get crazy, and no longer really applied the sound tactics that made the reasons given in the book true. Be careful that when you buy something for a sound reason, make sure that the reason stays sound.

If you buy GM, you need to write the price and the respective market valuation. Then write down why you are buying the business. If you can't, then you have no business doing it.

Quote from Ben Graham: "You can get in more trouble with a sound premise than an unsound premise because you'll just throw out the unsound premise".

Q: What was your biggest mistake?

First off, follow Graham and you'll be fine.

My biggest mistakes were errors of omission vs. commission. Berkshire Hathaway was also a big mistake. Sometimes the opportunity costs of keeping money in something (like a lousy textile business) can be a drag on Berkshire's performance. We didn't learn from the previous mistake and bought another textile mill (Womback Mills) 6-7 years after buying Berkshire Hathaway. Meanwhile, I couldn't run the one in New Bedford.

Tom Murphy, my friend, bought the newspaper in Fort Worth. The previous ownership of these entities owned NBC as well, but he wanted to divest the NBC affiliate - $30 million to buy, doing $75 million in earnings. It was really a pretty good company, but he wanted to sell it anyway. There wouldn't be many more of it. Network television stations don't require excessive brains to run. They add a lot of money to our bottom lines.

We have never lost lots of money in things, except in insurance after 9/11. We don't do the kinds of things that lose you a lot of money. We just might not be finding the "best" opportunities.

Don't worry about mistakes. You'll make mistakes. Get over it. At the same time, it's important to learn from someone else's mistakes. You don't want to make too many mistakes.

Side note: Warren once asked Bill Gates, "If you could only hire from one place, where would it be?" Gate's reply was Indian Institute of Technology.

Q: Could you comment on your currency position?

We have about $21 billion in about 11 foreign currencies. We have $60-70 billion in things that are denominated in US Dollars. We still have a huge US bias. If Martians came down with currency certificates and could choose any currency on earth, I doubt it would be 80% in US Dollars.

We are following policies that make me doubt that our currency will not follow a downward spin. We lost $307 million this quarter. The net gain since we started holding foreign currencies in 2002 is $2.1 billion. We have to mark these future contracts to market daily. If we owned bonds instead of sterling forward contracts, it wouldn't fluctuate around so much.

Identifying bubbles is fairly easy. You don't know how big they will get and you don't know when they will pop. You don't know when midnight will hit, but when it does, it turns carriages to pumpkins and mice. What markets will do is pretty easy. When they will do it is more difficult. Some people want to stick around for the last dance, and they thought that a bigger fool would be just around the corner tomorrow.

When we bought those junk bonds, I didn't know we would make $4 billion in such a short time. It would have been better if it wouldn't have happened so quickly, as we would have gotten a bigger position.

Q: When did you know you were rich?

I really knew I was rich when I had $10,000. I knew along time ago that I was going to be doing something I loved doing with people that I loved doing it with. In 1958, I had my dad take me out of the will, as I knew I would be rich anyway. I let my two sisters have all the estate.

I bet we all in this room live about the same. We eat about the same and sleep about the same. We pretty much drive a car for 10 years. All this stuff doesn't make it any different. I will watch the Super Bowl on a big screen television just like you. We are living the same life. I have two luxuries: I get to do what I want to do every day and I get to travel a lot faster than you.

You should do the job you love whether or not you are getting paid for it. Do the job you love. Know that the money you will follow. I travel distances better than you do. The plane is nicer. But that is about the only thing that I do a whole lot different.

I didn't know my salary when I went to work for Graham until I got his first paycheck. Do what you love and don't even think about the money. I will take a trip on Paul Allen's Octopus ($400M yacht), but wouldn't want one for myself. A 60 man crew is needed. They could be stealing, sleeping with each other, etc. Professional sports teams are a hassle, especially when you have as much money as him. Fans would complain that you aren't spending enough when the team loses.

If there is a place that is warm in the winter and cool in the summer, and you do what you love doing, you will do fine. You're rich if you are working around people you like. You will make money if you are energetic and intelligent. This society lets smart people with drive earn a very good living. You will be no exception.

Q: What is your opinion of the prospects for the Kmart/Sears merger? How will Eddie Lambert do at bringing Kmart and Sears together?

Nobody knows. Eddie is a very smart guy but putting Kmart and Sears together is a tough hand. Turning around a retailer that has been slipping for a long time would be very difficult. Can you think of an example of a retailer that was successfully turned around? Broadcasting is easy; retailing is the other extreme. If you had a network television station 50 years ago, you didn't really have to invent or being a good salesman. The network paid you; car dealers paid you, and you made money.

But in retail you have to be smarter than Wal-Mart. Every day retailers are constantly thinking about ways to get ahead of what they were doing the previous day.

Retailing is like shooting at a moving target. In the past, people didn't like to go excessive distances from the street cars to buy things. People would flock to those retailers that were near by. In 1996 we bought the Hochschild Kohn department store in Baltimore. We learned quickly that it wasn't going to be a winner, long-term, in a very short period of time. We had an antiquated distribution system. We did everything else right. We put in escalators. We gave people more credit. We had a great guy running it, and we still couldn't win. So we sold it around 1970. That store isn't there anymore. It isn't good enough that there were smart people running it.

It will be interesting to see how Kmart and Sears play out. They already have a lot of real estate, and have let go of a bunch of Sears' management (500 people). They've captured some savings already.

We would rather look for easier things to do. The Buffett grocery stores started in Omaha in 1869 and lasted for 100 years. There were two competitors. In 1950, one competitor went out of business. In 1960 the other closed. We had the whole town to ourselves and still didn't make any money.

How many retailers have really sunk, and then come back? Not many. I can't think of any. Don't bet against the best. Costco is working on a 10-11% gross margin that is better than the Wal-Mart's and Sams'. In comparison, department stores have 35% gross margins. It's tough to compete against the best deal for customers. Department stores will keep their old customers that have a habit of shopping there, but they won't pick up new ones. Wal-Mart is also a tough competitor because others can't compete at their margins. It's very efficient.

If Eddie sees it as impossible, he won't watch it evaporate. Maybe he can combine certain things and increase efficiencies, but he won't be able to compete against Costco's margins.

Q: What led you to develop your values and goals at an early age?

I was lucky because I knew what I loved at an early age. I was wired in a certain way when I was born, and I was lucky enough to stumble upon some books at a library at a very early age. In 1930, I won the ovarian lottery. If I had been born 2000 years ago, I'd have been somebody's lunch. I couldn't run fast, etc.

I was lucky. I had a terrific set of parents. My father was an enormous inspiration for me. The job when you are a parent is to teach them. Be a natural hero. They are learning from you every moment you are around. There is no rewind button. If your parents do what they say and their values match what they teach you, you are lucky. What I observed in the world was consistent with what my parents taught me. That was important. If you are sarcastic, and use it as a teaching tool to kids, they'll never learn to get over it. Those first few years they are very impressionable.

Q: Could you discuss your views on estate planning and how you will allocate your wealth to your children?

It really reflects my views on how a rich society should behave. If it weren't for this society, I wouldn't be rich. It wasn't all me. Imagine if you were one of a pair of identical twins and a genie came along and allowed you to bid on where you could be born. The money that you bid is how much you had to agree to give back to society, and the one who bids the most gets to be born in the US and the other in Bangladesh. You would bid a lot. It is a huge advantage to be born here.

There should be no divine right of the womb. My kids wouldn't go off and do nothing if I give them a lot of money, but if they did, that would be a tragedy. $30 billion will be generated from estate taxes, which will go to help pay for the war in Iraq and other things. If you take away the estate tax, that money will have to come from somewhere else. If not from estate taxes then you inherently get it from poorer citizens. Less than 2% of estates will pay the estate tax. They would still have $50 million left over on average. I think those that get the lucky tickets should pay the most to the common causes of society. I believe in a big redistribution. Wealth is a bunch of claim checks that I can turn in for houses, etc. To pass those claim checks down to the next generation is the wrong approach. But for those that think I am perpetuating the welfare state, consider if you are born to a rich parent. You get a whole bunch of stocks right at the beginning of your life, and thus you are sort of on a welfare state of support from your rich parents from the beginning. What's the difference?

At $100,000 a year, I can find 10 people to paint my portraits to find the perfect one. I have that kind of money. But that is a waste, as those people could be doing something useful. I feel the same way about my kids and other heirs. They should be doing things that help to contribute to society.

Q: What kind of impact will the demographic shift (i.e. baby boomers) have on the United States?

We aren't big on demographic trends. It's difficult to translate that information into profitable decisions. It is hard to figure out what businesses will prosper in the future, based on macro trends. See's candy is for anyone and Fruit of the Loom is for people who need underwear today. We want to be right on something that will work right now, not something that might work in the future. I doubt that Wal-Mart spends a lot of time on demographics. They instead focus on where to put the store and what to put on the shelves. I've never found those kinds of stats useful. People were all excited to go into stocks 6 years ago, but it wasn't because of demographic trends.

Warren then referred to a recent WSJ article written by Jeremy Siegel that discussed funds flowing out of investments because baby boomers will need to cash in their investments during retirement. He said he respected Siegel, but he doesn't find fund flows data useful.

Q: What would Berkshire be like if you hadn't met Charlie Munger?

It would be very different, but I could say the same thing about a lot of other people, too. I've had a lot (at least a dozen) of heroes, including my parents. Charlie and I didn't meet until 1959, although he grew up a half a block from where I lived. Charlie was 35 and I was 29. We've been partners ever since. He is very strong-minded, but we've never had an argument that whole time. I've never been let down once. It must be a terrible feeling to be let down by a hero.

Hang around people who are better than you all the time. You do pick up the behavior of people who are around you. It will make you a better person. Marry upward. That is the person who is going to have the biggest effect on you. A relationship like that over the decades will do nothing but good.

Q: Are investors more or less knowledgeable today compared to ten years ago?

There is no doubt that there are far more "investment professionals" and way more IQ in the field, as it didn't use to look that promising. Investment data are available more conveniently and faster today. But the behavior of investors will not be more intelligent than in the past, despite all this. How people react will not change – their psychological makeup stays constant. You need to divorce your mind from the crowd. The herd mentality causes all these IQ's to become paralyzed. I don't think investors are now acting more intelligently, despite the intelligence. Smart doesn't always equal rational. To be a successful investor you must divorce yourself from the fears and greed of the people around you, although it is almost impossible.

Do you think Ponzi was crazy? The tech and telecom madness that existed just 6 years ago is right up there with the craziest mania's that have ever happened. Huge training in capital management didn't help.

Take Long Term Capital Management. They had 100's of millions of their own money, and had all of that experience. The list included Nobel Prize winners. They probably had the highest IQ of any 100 people working together in the country, yet the place still blew up. It went to zero in a matter of days. How can people who are rich and no longer need more money do such foolish things?

Q: What effect does large institutional ownership have on stock price volatility?

Never has so much been managed by so few that care so much about what happens tomorrow. So much of the world of investing is people who are trying to beat indexes, and they have a willingness and eagerness to make decisions in the next 24 hours. This condition didn't exist years ago. It has created a "hair trigger" effect. An example of this hair trigger effect was Black Monday in '87. The cause was program trading and stop loss orders.

Q: What sectors are hurting? Is there a bear market coming?

Humans are still made up of the same psychological makeup, and opportunities will always present themselves. All these people have not gotten more rational. They are moved by fear and greed. But I'm never afraid of what I am doing. What are directors thinking [by not repurchasing shares] if the business is selling on a per share basis for one-fourth of what the whole business would sell for? They don't always think rational. I simply don't have that problem.

Berkshire owned the Washington Post, the ABC network and Newsweek. It was selling for $100 million based on the stock price. No debt. You could have held an auction, and sold off the companies individually for $500M total, but $100M was the price. In other words they were willing to sell us money that was worth $1 for $0.25. According to efficient markets, the beta was higher when the stock was at $20 than at $37. This is insanity. We bought what was then worth $9 million that is now worth $1.7 billion.

Q: How do you feel about divisions of conglomerates trying to horde capital?

Berkshire wants the capital in the most logical place. Berkshire is a tax efficient way to move money from business to business, and we can redeploy capital in places that need them. Most of the managers of companies we own are already independently rich. They want to work, but don't have to. They don't horde capital they don't need.

Q: How do you feel about the current real estate environment?

If you are buying to own a home, that is fine. Otherwise, it seems to be getting into bubble territory. We're not excited about real estate because generally there is not enough return at current prices.