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Stock Strategist

Gems from the Berkshire Hathaway Meeting

by Pat Dorsey, CFA | 05-06-05 | 06:00 AM

I've attended the annual meeting of [Berkshire Hathaway BRK.B](#) for the past five years, and though the interplay between Warren Buffett and his partner Charlie Munger is always insightful, the pair were in rare form last weekend. Since the meeting is one long question-and-answer session, the quality depends somewhat on the questions that are asked, and some meetings are better than others. In my opinion, this year was the best I've seen--maybe the questions were better, or maybe Buffett and Munger are just getting more expansive as the years roll by.

I thought that I would pass along a few of the more insightful--and humorous--gems from Warren and Charlie. Note that this is not a comprehensive list--merely what I found interesting and had time to write down. Also note that I am not a good secretary and may not have recorded things verbatim. If you want the full experience, you'll need to buy a Berkshire share for yourself (we think they're a good deal right now, by the way, and the B shares are affordable) and head to Omaha in May of 2006.

Competitive Advantage

One of Buffett's biggest strengths as a communicator, in my opinion, is his ability to boil a complex issue down into a single pithy insight. For example: "It's not a great business when you have to have prayer sessions before raising prices a penny... The long-term strength of a business is closely related to its ability to raise prices without much agony... You can learn a lot about the durability of the economics of

a business by observing pricing habits."

This is a wonderful point for anyone who spends time (as we do at Morningstar) thinking about how companies build economic moats around their businesses. While there are exceptions--think [+](#) [Wal-Mart WMT](#) or [+](#) [Dell DELL](#)--you could do worse than use pricing power as a proxy for the strength of a firm's competitive advantage. Do you switch banks when yours jacks up a fee? Maybe, but probably not. Would you pass up a Budweiser or Coke for something else because the price of the cold frosty was a wee bit higher than your previous visit to the store? Again, you'd probably overlook it, as long as the price hike wasn't drastic. And when's the last time that [+](#) [Intuit INTU](#) cut the price of TurboTax?

Pricing power is not the end-all be-all of competitive advantage, but the lack of it is not something to be taken lightly. [+](#) [Boeing](#) and [Airbus](#) are great examples of this--you'd think that a global duopoly would have better economics, but at the end of the day, neither firm can ever afford to tell a prospective customer, "Here's our price, take it or leave it." The next time that you're unsure of how well a firm is faring relative to competitors, find out when the last time was that it raised prices on key products, or how much it has cut prices to keep customers. The answer might tell you quite a bit.

Simplicity and Discipline

Buffett: "There are no secrets in this business that only the priesthood knows... Successful investing requires a quality of temperament, not a high IQ...you must be able to think for yourself. Then constantly look for opportunities. You can't act every day, but you can learn every day."

As I have been in the past, I was struck by how simple Buffett's

general approach is--and how tough it is to have the discipline to carry it out.

Market Calls

Although Buffett frequently derides his ability to make big-picture calls on where the overall market is going, it was pretty clear that he and Munger are expecting a substantial turn for the worse at some point in the future. A couple of representative quotes, made at different times during the meeting:

Buffett: "Things do happen that change the landscape dramatically. [Gives examples of Long-Term Capital Management crisis in 1998 and speedy narrowing of junk-bond spreads a couple of years ago]... We've seen baby versions of this. And subsequently something has happened." Munger interjects: "There came bad consequences." Back to Buffett: "Corporate profits as a percentage of GDP are at an all-time high...if I had to bet, they'd be lower in the future...It's nothing to be bullish about, because we expect a reversion to the mean."

When discussing why he hasn't done much investing lately, letting many billions in cash pile up on Berkshire's balance sheet: "We'll get a chance to do something more screamingly intelligent in not too many years."

The caveat, of course, is that as Buffett has often reminded the public, timing is everything in this business, and the "chance" that he and Munger have been evidently waiting for may be many years off--or it may never come. As Buffett said during the meeting, when discussing the dollar, the trade deficit, and the current account deficit: "Predicting the timing of a future economic event is not easy. Predicting what will happen is easier, though."

Moreover, as Buffett said later in the meeting, "We've never decided not to buy a business we liked because of macro factors." In other words, keep turning over rocks to find good ideas, no matter what your overall view is of "the market."

Earnings Management

Buffett: "Companies that meet earnings expectations with great regularity are kidding investors, kidding themselves, or both."

Munger: "Unreasonable expectations from headquarters that earnings have to go up with regularity and no volatility, it's not just the kissing cousin of evil, it's the blood brother of evil."

I knew there was a reason I liked these guys.

CEO Compensation

In last year's letter to shareholders, Buffett wrote: "In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging."

He returned to this theme last weekend, inveighing against corporate directors who don't act independently: "I've been on 19 boards, and I've never seen a director to whom fees were important object to an acquisition or a CEO's compensation... Members of compensation committees act like Chihuahuas, not Great Danes or Dobermans. [Pause] I hope I'm not insulting any of my friends who are on compensation committees."

Munger's rejoinder: "You're insulting the dogs."

Humor aside, Munger also raised an interesting point about directors, making the point that if board fees are a material part of a director's income, he or she is very unlikely to object to anything

important at a board meeting. (Munger: "Is a man really fit to be on a board if he's not willing to leave at any time?") The implication seemed to be that boards would be better off with independently wealthy individuals, since the directors' fees would presumably not sway them from acting independently. Personally, I see their point, but it seems to me that paying directors in shares or options, rather than cash, accomplishes the goal of aligning directors' interests with shareholders'.

Random Notes

- There was much discussion about Buffett's views on the trade and current account deficits, most of which was territory already covered in his letter to shareholders
- There was also much discussion of real estate. Munger opined that "we have an asset price bubble in places like Laguna, California, and the suburbs of Washington, D.C." Also, there were at least three or four questions about real estate, or why Berkshire doesn't invest in real estate. I remember a lot of questions about why Berkshire wasn't investing in tech stocks at a meeting a few years back, and we know how that story ended. Could the frequency of shareholders' questions about why Berkshire doesn't own this or that type of asset serve as a contrarian indicator? I wouldn't bet against it.
- Berkshire Trivia: At one point, Buffett mentioned that some years back, he and Charlie went to Memphis to look at a business they were thinking about buying. They decided that it was the type of business in which they'd be comfortable owning shares, but not the whole thing. I immediately thought it might be UST, which makes smokeless tobacco among other things. According to some of my Buffettologist colleagues, however, the company was more likely Conwood, a much-

smaller firm which also makes smokeless tobacco ("Kodiak"), and which won a large antitrust suit against UST a few years ago.

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