

CM – Charles Munger. The excerpt is the quick outline notes that I wrote down during the meeting. I do not make the claim that the excerpts are accurate to the word used by Charlie Munger. I have tried to faithfully present the ideas from his talk/Q&A. I have skipped answers to questions for which answers did not seem, in my humble opinion, relevant to investing, thinking and overall trends. I am also not repeating answers and positions that I have heard/read from prior meetings and talks I have mentioned what the questions were about in the excerpt.

Charlie Munger started with what he termed his 'Socratic game of solitaire' on:-

1. General Investment Climate of the World
2. The Berkshire Hathaway phenomenon

On General Investment Climate of the world

Assets are out priced to a level including real estate, big companies. The last 20 plus years from 1981 to present have been easiest time for getting ahead.

Purchasing power has been down 60%. Endowment funds have been losing purchasing power. Eg: Yale.

Long-term return assumptions of Defined Benefit plans like the pension plans should be 4-5% instead of 8½%.

This has led to emergence of alternate investment funds like VCs and hedge funds. It is not easy to get 9% by paying fees to the 'experts'. It is a fluke that they did well before. They practice chicanery promising alpha by taking risk of earthquake levels.

In the interest of felicity to reduce expectations.

There is froth in lot of markets. The next candidate after sub-prime would be derivatives. Books are kept on the basis of "I'll be gone, you'll be gone". Over-optimistic assumptions in accounting. By the time the losses appear, the parties involved may not be around. It is a case of Gresham's law of "bad money driving out the good". There is a rush into various asset classes that results in pricing being high.

Why? Greed, envy, terrible accounting, lack of conservatism have a part to play. The engineering mindset that everything should stand the worst stress thrown out for the Chuck Prince mindset. As Sam Goldwyn (of MGM) would say "include me out". Charles Franco (??) of Columbia gives the best solution. "Systems have to be responsible". The actors should bear the consequences similar to paratrooper packing his own parachutes. Systems should be duplicating systems. (Implied redundancy).

Under present accounting, as your credit gets worse, better you look. (Referring to valuing liabilities at present value using discount rates including credit premium). Earlier, liabilities used to be 100% and you worried only about changes in assets.

Legal profession at Enron have let down. They were trying to wrestle the punch bowl from a couple of burly guys who were paying them well.

Fed should have limits on big bankers, if "too big to fail" has to be practiced. Greenspan overdosed on Ayn Rand and decided not to regulate many axe murderers. (Implied, if there was regulation and oversight, Fed could have prevented the current crisis). Trouble with excess liquidity is that it brings out the worst in human nature. Guaranteeing credit by Fed results in a sense of entitlement and moral hazard.

On Berkshire

Refers to the article in Financial Times on Warren Buffett taking a 2 and 20.

Berkshire Ethos has been 'making money with the shareholders than off them'.

Berkshire's success can be attributed to a lot of reasons:-

1. Seeing shares as part of enterprise
2. Decentralised operations. Low cost HQ, low bureaucracy, no common culture like an army. Not a lot of envy effects due to low cost.
3. Loss of key executives has been substantially none.
4. Avoided the minuses of the conglomerate system
5. Financial system of low leverage. Derivatives are "good until reached for" as in the case

- of Gen Re. Berkshire behaves in such a way as to not need credit.
6. Berkshire is an educational institution – a ‘learning exemplar’ (implies best practices institution).
 7. Academics cannot explain Berkshire using the efficient models
 8. Corporate duty is to “widen the moat” i.e strengthen the competitive advantage.
 9. Executives – “get the sons your fathers had”

Q&A Session.

Charlie went on to answer/duck 53 questions

Q1: Credit Default Swaps:-

CM: Issue 100 Million worth of bonds, and come up with 1 billion of CDS. CDS is a form of insurance against bankruptcy. It creates big incentives for someone to go broke. In the old days, one could not take out an insurance on another without insurable interest.

Q2: Solvency of large banks:-

CM: In light of Fed behavior, they are safe for now.

Q8: Inflation – ask to expand comments at Berkshire:-

CM: Due to competitive advantages of most of the operating companies at Berkshire, they will make more money if inflation happens.

Q10: Trade Deficits:-

CM: Even if there is a small chance of a big disaster, start using foresight.

Q13: Moody's – moat is narrower:-

CM: If any organization performs poorly and publicly, they will lose franchise and hence competitive advantage.

Q14: If he were starting today with 2 Million capital:-

CM: Look for mispricings in small areas

Q17: Fed's rescue policy

CM: Part 1 should be saving the system. Part 2 change the system.

Q20: Logistics companies

CM: Burlington Northern's replacement cost would be a high competitive advantage.

Q21: Commercial real estate:

CM: As the cap rate drops, values increase. Explosive returns. Real Estate leverage is responsible for the high returns.

Q22: Budget at Berkshire:

CM: None. Projections are of no use. Spend what needs to be spent.

Q23: Book Recommendations:

CM: Cialdini's “Yes” coming out in June.

Q24: Insurance Vs Asset Management business. Insurance float fluctuates by pricing environment:-

CM: Insurance average return is low. Money management is mainly, if you don't accept compensation.

Q25: How to learn:-

CM: Include various things. Stay away from extreme ideologies.

Q30: On learning history:-

CM: Quoting Cicero – “To be ignorant of what happened before you were born is to be ever a child.”

Q31: Developing Markets like Brazil

CM: Iron mining in Brazil and Agriculture are good places.

Q32: Health insurance:

CM: Focus has been on some big failures. No opinion on trends.

Q37: Wells Fargo – derivatives:-

CM: Lesser troubles than the industry due to culture

Q38: Developing world investments:-

CM: Exposure through Coca Cola and other companies.

Q39: If he were younger:-

CM: Work with somebody I like

Q40: Equity investments and valuation at market for insurance companies:-
CM: Used to be at lower of cost or market. Mark downs result in further mark downs like an auto-catalytic process.

Q41: Investing in funds:-
CM: Value vs. other funds – calling one value fund does not make it. Recommends low cost index funds

Q42: Dollar depreciation:-
CM: Current levels cannot correct deficit automatically

Q43: Medicare –
CM: Should be Low cost and constant improvement. Good things have been ignored. Compared to Europe, wastage of resources through intervention in hopeless cases exists.

Q44: Overseas moves by companies like Halliburton to Dubai.
CM: Move due to favorable tax treatments. No tax planning efforts at Berkshire.

Q46: WB's influence on CM:-
CM: WB talked him out of practicing law. They have been learning together ever since.

Q47: Fragility of US Economy:-
CM: Consumer debt expansion – continuous – makes him nervous. (Referring to debt payments)
Getting serfs is no idea of a good civilization

Q48: Followers of Berkshire:-
CM:- There are too many.

Q49: Energy drink market and Avoiding Bad Marriage
CM: Quoted Ben Franklin on marriage:- Keep your eyes wide open before marriage and half shut after.

Q50: Iscar and inflation:-
CM: Iscar sells to professional customers. Pricing power is not exceptional. Good operations management. Customers will do well during inflation.

Q52: Real Estate:-
CM: Zero or close to zero holdings. It is one of his quirks that he dabbled in the past.
Not sell an operating business that has problems that are manageable.

Q53: Amex, Visa and Mastercard
CM: Amex caters to upscale customers.

Q3: On Volume of Derivatives
Q4: Housing
Q5: System of control in Berkshire
Q6: On railroad regulations.
Q7: Rationality and benefits
Q9: Gen Re
Q11: Any difference in opinion between WB and CM – how resolved.
Q12: Theory Vs Practicability
Q15: California 'A' rated for bonds
Q16: War on Terror
Q18: Kraft
Q19: Treasury negative yields.
Q26: Derivatives at Berkshire
Q27: Oil Production peak – when?
Q28: Education system in CA
Q29: Swiss Re
Q33: Leverage and buying of securities by Fed. Transition of leverage from banks to Fed
Q34: Hyperinflation – impact on real estate and real asset prices.
Q35: Success
Q36: Wesco – any more operating company acquisitions
Q45: Insurance linked equities – impact
Q51: New Zealand Currency