An Octogenarian and Nonagenarian Walk into a Room

May 11, 2016

SUMEET GOEL

Recently, I was lucky enough to be invited to be part of a group that would be attending the Berkshire Hathaway Annual Meeting in Omaha. How could I turn down the opportunity to attend what has been fondly referred to as the "Woodstock of Capitalism"? There was no way I wasn't going.

However, getting to Omaha from Los Angeles is not the easiest thing in the world. And of course my flight from LAX to DFW was delayed for several hours and by the time I made it to DFW, I had missed my connection. Despite my frustration with the situation, the American Airlines ticket agent made me chuckle as she tried to figure out how to get me to Omaha: "Sir, from Dallas I can get you to any number of other cities—Detroit, Cleveland, Chicago, Charlotte—even Des Moines. But for some reason, I can't get you on any flights from those cities into Omaha. What's the deal with Omaha? Is there something big going on there?"

Over the course of 48 hours, I, along with a phenomenal group of 25 professionals from all industries and walks of life, got to spend a few hours with a Berkshire Hathaway portfolio company CEO, a hedge fund investor who has been involved with Berkshire Hathaway for the past 20 years, and then 8 hours in a painfully uncomfortable chair, watching two maestros work the microphone.

For those of you that have never been, I would highly recommend finding a way to get there by hook or crook. It was an incredible experience.

What follows is Part 1 of a three-part series on my observations of the Berkshire Hathaway approach from these two enlightening days in Omaha. In Part 1, I'll cover Warren's investment philosophy and how it has changed over the years. Part 2 will highlight thoughts on Berkshire Hathaway's acquisition strategy and provide insight into how they work with their portfolio companies based on what I heard from Warren and Charlie during Saturday's session, as well as anecdotes from Berkshire Hathaway CxO's I was lucky enough to meet firsthand over the course of the weekend. Part 3 will conclude with final observations and musings from my time in Omaha, including Bill Gates' attention span and Warren and Charlie's philosophy about debate.

SETTING THE STAGE

The annual meeting takes place on a Saturday, following this rough agenda:

- 8:30-9:30 am: Berkshire Hathaway highlights movie
- 9:30 am-12:00 pm: Q&A with Warren & Charlie
- 12:00-1:00 pm: Lunch break
- 1:00-4:00 pm: Q&A with Warren & Charlie

Before the start, during the day, and afterwards, the large exhibition hall at CenturyLink Center has exhibits from all of the Berkshire Hathaway portfolio companies.

Seems like a pretty routine schedule, right? Well, except for the fact that in the cold, wind and constant sideways rain, people lined up to get in, starting at THREE AM. For doors that wouldn't open until 7 am. To get into an arena that holds 20,000 people and to see two old dudes answer investment questions. Let's just say that in this case, a picture is worth a thousand words. Check out the arena at 7:30 am. Two hours before Warren and Charlie arrived on stage:

TAKEAWAY #1: YOU DON'T NEED A DARTBOARD

At 9:30, Warren and Charlie come on to tremendous applause, and then after positioning the See's Candies box cover and Cherry Coke bottle the right way (the meeting was being streamed online for the first time ever—media impressions, baby!), Warren gives a quick update on quarterly results for Berkshire Hathaway with instructions to more or less ignore these things, as he doesn't look at anything on a quarter to quarter basis. Well, alrighty then.

The more interesting chart was his second one, which he shared towards the tail end of the morning session, and was the catalyst for what he called a "sermon" about investment advisors and hedge funds. In short, he is not a fan. In his mind, investors are better off sticking their money in a low-fee S&P 500 index fund instead of trying to beat the market by employing professional stock pickers.

The chart below illustrates the current results from his 10-year wager with hedge fund Protégé Partners. The bet pit the ten-year cumulative returns from five fund-of-funds picked by Protégé against a Vanguard S&P 500 index fund. The loser would donate $1 million to a charity of the winner's choice.

Protégé Partners Wager Results
For the Eight Years ended December 31, 2015

Year	S&P Index Fund	Hedge Funds
2008	-37.0%	-23.9%
2009	26.6%	15.9%
2010	15.1%	8.5%
2011	2.1%	-1.9%
2012	16.0%	6.5%
2013	32.3%	11.8%
2014	13.6%	5.6%
2015	1.4%	1.7%
Cumulative	65.7%	21.9%

Chart Source

From Warren: "It seems so elementary, but I will guarantee you that no endowment fund, no public pension fund, no extremely rich person wants to believe it. They just can't believe that because they have billions of dollars to invest that they can't go out and hire somebody who will do better than average. I hear from them all the time."

In the words of Warren:

- Consultants want to make money like everyone else. Who would pay them if they told you to "just buy an S&P index fund and sit for the next 50 years"?
- "There's been far, far, far more money made by people in Wall Street through salesmanship abilities than through investment abilities. There are a few people out there that are going to have an outstanding investment record. But very few of them. And the people you pay to help identify them don't know how to identify them. They do know how to sell you."
- A passive investor whose money is in an S&P 500 index fund "absolutely gets the record of American industry. For the population as a whole, American business has done wonderfully. And the net result of hiring professional management is a huge minus."

(For more of Warren's exact observations, check out the video online).

TAKEAWAY #2: EVOLUTION OF AN INVESTMENT PHILOSOPHY

Beyond that rant against investment advisors, as well as a shorter one against Valeant that we'll get to in a later post, the rest of the session was unrehearsed Q&A. Somewhere on the order of 40-50 questions were asked and, famously, neither Warren nor Charlie is told any of the questions in advance. Approximately one third of questions were given to them by journalists in attendance (reading questions submitted online), another third were from analysts in attendance, and the final third were from the audience of 20,000.

Warren is well known for his Annual Letter: one part business philosophy, one part retrospective discussion, one part future view, and a fair amount of humor. And he has been doing it forever. So it was not surprising to hear an audience question around a quote from the 1987 letter and how it seems to go against the grain of Berkshire Hathaway circa 2016.

Thirty years ago, Warren explicitly talked about wanting to invest in stable businesses with low/no capital requirements that eat up cash. Contrast that to today, where Berkshire Hathaway's two largest recent investments are 1) in highly capital-intensive industries on a day-to-day basis (e.g., Precision Cast Parts), and 2) just announced huge capital investment for future opportunities (e.g., Berkshire Energy which made an additional $30B capital investment in wind power).

Warren acknowledged the shift in strategy over time,

noting that Berkshire Hathaway companies generate $1B+ in cash every month (Google "insurance float" if you want to better understand why), so that cash needs to be put to use. The dramatic increase in cash forced a change in philosophy: "When something is forced on you, you might as well prefer it." And Charlie, who was quick with the one-liners all day long, added matter-of-factly, "When our circumstances changed, we changed our minds."

It was an interesting way of explaining things, and one that seems to hold particular relevance in the current political climate here in the U.S., with two presumptive Presidential nominees that have the highest combined unfavorability rating in history!

Look out for Part 2 next week, which will dig into Berkshire Hathaway's acquisition and portfolio company strategy.