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.

An Octogenarian and Nonagenarian Walk into a Room Pt. 2

May 17, 2016

SUMEET GOEL

ACQUISITION STRATEGY

I was lucky enough to have spent time with a few Berkshire Hathaway portfolio company CxO's during my time in Omaha — from organized meetings to fortuitous seats on flights. What struck me most in these conversations was the consistency in their stories around joining the Berkshire Hathaway family.

One CEO had gone through an extensive 9 month sales process, driven by his equity sponsors — an amalgam of PE and hedge funds. And nothing came of it — no bids that were at an acceptable level. The CFO of the company happened to have a connection to Berkshire, and lobbed in a call when it was clear that they weren't going to go with any of the bidders from the process. That Berkshire connection asked the CFO to send over info on a Friday. On Monday, Warren called the CEO directly. On Tuesday, the CEO and CFO were in his office. On Wednesday, the CEO had a 1-page offer letter at the level required. The deal closed shortly thereafter. No request for the data room, no multi-month diligence process, no customer interviews, no back and forth on the price, no contingencies.

Now, two quick things to note: (a) I've sanitized the story above a fair amount for public consumption and (b) I'm sure that there was some diligence done by Berkshire Hathaway after Warren sent over the letter — I'm not naïve to think that such decisions are made based solely on a one hour meeting. But no matter how much salt you take the story with, it is still nothing like what any of us are used to.

Another Berkshire Hathaway CxO that I spoke with corroborated the story, saying that their company was acquired in much the same way.

One of my favorite quotes of the day occurred when Munger was asked about Berkshire Hathaway's lightweight diligence process that really focuses just on the CEO (the General Manager of the business in their mind) — why don't you spend the months and months on diligence like everyone else does? Munger's classic response: "How many people who have been happily married verified the birth certificate of their partner before they married?"

OWNERSHIP & EXECUTIVE COMP

Going hand-in-hand with this acquisition approach is their overall strategy on their portfolio. These guys are not private equity investors looking to turn companies in 3-5 years. They are true buy and hold investors. They want businesses with solid performance and strong cash flows (I assume to better feed the beast — another Mungerism: "In the whole history of Berkshire Hathaway, we've lived in a torrent of cash").

As such, Warren ignores EBITDA as a measuring stick for performance. He tends to focus on Operating Income in evaluating an acquisition as well as evaluating his own managers. The theory is that EBITDA misaligns incentives — the "BITDA" part encourages leverage, high capital expenditures and short-term earnings focus without thinking about long-term repercussions and long-term growth potential.

To that end, it sounds like CEOs get compensated according to that approach as well. As a Berkshire Hathaway CEO, there is no big exit, no big liquidity event down the road. There is typically no equity in the business; Warren and Charlie generally own it 100%. As a CEO you get your salary and you get a bonus, which is most often tied to the operating performance of your business. And when you do a bolt-on acquisition, the hurdle for your bonus is increased proportionally based on your purchase price as a multiple of that acquired company's operating earnings. (Again, details sanitized a bit here).

Of course this is a great incentive-aligning approach for Warren, and very well might work for the CEO who then operates in Warren and Charlie's orbit, and who will never want to leave...but may have adverse effects on the ability of that CEO to hire top tier talent, 1-2 levels down.

In this day and age, how does one of their consumer-facing companies hire a kick-ass head of e-commerce (and the team to support it) without some sort of back end exit opportunity? Not sure and something I will push on next year.

Separately from this, and something shared by the senior executives I spoke with, was that Warren asks his CEO for the same two things when he acquires a business. The first is an envelope with a piece of paper inside. On that paper should be the name of your successor if you get hit by a bus. If need be, that envelope will be opened and that name will be used. Again, not sure if Warren has an actual filing cabinet with 70 envelopes inside, but the visual and message it conveys is quite interesting.

The second item has to do with acquisitions. Warren asks to be informed about any acquisitions that the company takes on. Broadly speaking, a CEO has freedom to make acquisitions that they think are good for business at a price that they think is acceptable, but worth noting that because the CEO's incentive comp is based on a percentage of that purchase price, he is obviously incentivized to get as low a price as possible.

Also, we shouldn't be totally Pollyanna about this concept of freedom as one CEO noted that he shared details about a potential acquisition and his target price to Warren and was told by Warren that he shouldn't go above a certain (lower) number. Of course the CEO objected and suggested that they would lose the deal. Of course Warren told him that he was okay losing the deal. Of course the CEO was disappointed, but put in the offer at the "Warren price". And, of course…they got the deal.

Look out for Part 3 later this week, which will contain some final observations gleaned from my time in Omaha (Spoiler: Bill Gates makes an appearance).

An Octogenarian and Nonagenarian Walk into a Room Pt. 3

May 20, 2016

SUMEET GOEL

LIFE, OR SOMETHING LIKE IT

Warren and Charlie are business maestros. Everyone knows that. But listening to the two of them talk, I couldn't help but think about how their business advice also translates to the world in general. What follows is a few of these bon mots of wisdom, partnered with some of my general observations.

- Warren and Charlie aren't ones for heated debate. Because most people get into heated debate without fully considering the other side of the equation. Charlie: "If you disagree with someone, you should be able to state their case better than they can. Otherwise, you should keep your mouth shut." I loved this one as it struck home for me in this 2016 election year in particular. I have deliberately not engaged in political debate in real-life or online "conversation." I have my opinions and feelings on candidates, but I am far from an expert, and it's not like my points are going to change your mind. And sadly, long gone are the days of intelligent discourse on topics and it being okay to "agree to disagree"… I'm going to try and hew to Charlie's philosophy from here on out.

- You don't need to have an answer for everything. When discussing the impact of today's incredibly low interest rate environment and how that affects purchase prices for Berkshire Hathaway (they pay a bit more, but try not to pay too much more), the conversation turned to the persistence of these low rates, coupled with global economic situations like Japan's ongoing struggles. Rather than force an answer, Charlie quipped, "No one understands it. Our advantage is we know we don't understand it."

- Cows are not plastics. One of the audience questions was from a cattle farmer who asked, "Would you invest in cattle today?" I believe Charlie responded with, "It's one of the worst businesses I can think of."

- Words of wisdom about management, courtesy of Warren: "If you're looking for a manager you want someone who is intelligent, energetic, and moral. But if they don't have the last one, you don't want them to have the first two."

- Which way is up? The next time someone tries to opine on the future state of oil prices, I'm going to remember Warren's response to that same question, "We haven't the faintest idea what the long-term price of oil will be. We don't think we can predict commodity prices." I've heard others say the same thing, but people still try and predict. It's a fool's errand.

OTHER OBSERVATIONS

- No swag: This really surprised me. I've been to my share of exhibition halls and one thing has been consistent across all of them: some sort of swag. There was nothing for free here. You want some Dairy Queen ice cream? $2. A Geico gecko? That will cost you. Matching Warren & Charlie plastic duckies from Oriental Trading Company? $5.

  Nothing. I mean NOTHING was being given away. I made this comment to someone who knows the process well and he responded with, "Remember, Woodstock of Capitalism…" and a long-time and significant investor in Berkshire Hathaway noted that Borsheim's does some ungodly amount of their sales in this weekend alone.

- Long-term view: My sample size is small, but of the Berkshire Hathaway executives I talked to and about, the tenure of them was amazing. These are not folks looking to exit and get their next CEO gig. These are not COOs and CFOs looking to get their first CEO gig. These are not senior executives looking to move onto a bigger and better company. Again, the sample size is small, but from what I saw, these people are happy with where they are and who they work for. When a top flight CEO who could work anywhere talks about the personal note from Mr. Buffett that he keeps up on his refrigerator alongside the pics of the kids, you know the culture of Berkshire Hathaway.

- Consistency: The consistency of the Berkshire Hathaway CxOs that I spoke with was impressive. Again, unprompted, they all shared the envelope story from Part 2. They all shared how Warren lets them run the company as they see fit. He does not call on them; they send whatever info they want to send, when they want to send it. Some send a detailed monthly report, some do a quarterly two page letter, and I'm guessing others do it less frequently than that. I was a bit skeptical about this myself, so I asked one CxO whose company has a bit of exposure to the vagaries of the tech/internet markets and whom Warren bought prior to the 2000 & 2008 market busts, "How many times did he call during those downturns?" The answer: "Mr. Buffett has owned us for (x) years. The next time he picks up the phone and calls my CEO will be the first time." And he was dead serious. No matter how you slice it, that sort of belief structure and value system is impressive.

- Product Placement: If you've seen any pictures or video from the meeting, you can't miss the big See's candies box and Warren's Cherry Coke can, front and center. Product placement at its finest. Which brings to my next observation—here I disagreed with how Warren and Charlie handled a line of inquiry. When asked about their investment in Coca-Cola, despite the high levels of sugar and general harmful effects of the product, and them previously saying that they would never invest in a tobacco company for many of the same reasons, Warren essentially said, "I love Coke. I love the taste of it. Pffft."

  The longer answer was, more or less, I drink it because I like the taste of it. And no one forces anyone to drink products. It felt like what a spokesperson for big tobacco might say. And lest we imply that Coke is bad by his statement that no one is being forced to drink it, he followed up by saying he drinks several cans a day because it makes him feel good. And if you do what makes you feel good, you'll live longer. ("Coke! Live long and prosper!")

  I'm not sure what the right answer was here, but the evasive one was not the best one. I thought they could have taken a more direct approach, one in which they laid down that they are not the country's police and that they chose to draw the line where they drew it. Something along the lines of, "We have said that we are not going to invest in guns or tobacco or companies that price immorally. But given the extent of our investments, we can't be your watchdog. With 50% of the rail transport market, I'm sure that BNSF moves alcohol, tobacco and firearms. I'm sure Precision provides parts that go into military weapons. Our energy company might provide power to a company that you don't like. And Geico might insure drivers at a plant for a company you don't like. Where would you draw the line? We drew it where we drew it. We're convinced Coca-Cola is a good company. And their most interesting growth avenues are in water, non-caffeinated beverages, and snacks." And then, Charlie throws out the Mungerism he used during the Coke discussion, "If you always focus on the negative, people ignore the positive." Maybe my answer isn't politically correct, but from what I heard during that day, I think it would have fit in with the tenor of the dialogue a lot better, and been much more direct.

- Valeant: The conversation also turned to Valeant at one point. Warren said that he was approached by multiple people asking if he wanted to invest in Valeant and urged him to meet former Valeant CEO Michael Pearson. Buffett said he declined to do either of those things, and was wary of the company from the start, calling the company "deeply flawed". Charlie didn't pull his punches like Warren did, adding, "Valeant, of course, was a sewer. The directors deserve all the opprobrium they are getting." (Note: I can guarantee you that I will not be using words like opprobrium when I'm 92. If I make it to 92).

- Bill effin' Gates: Bill was front and center. Here's my grainy Zapruder shot of him and Warren talking before the start.

And what made me so impressed was not that Bill was there—he and Warren are very close as you all well know. What impressed me was that he was front & center—1st row, 1st seat—and for the entire day, he was laser focused on Warren and Charlie. He did not get out of his chair. He didn't check his phone. He didn't play his Zune. And when questions were asked throughout the arena, he turned around, looked at the audience member, focused on the question and then turned back for the response. Understand that this was essentially for seven straight hours. And about an hour into it, folks in my group of 25 started checking phones and iPads, stretching their legs, getting snacks and what not. Bill Gates did not move. After a while, I felt guilty; after all, if Bill effin' Gates can unplug and focus like that, shouldn't I be able to? Isn't he much busier than I am? Then again, he's Bill effin' Gates. And that's Mr. Warren Buffett. The ability of those two men to focus like they did is probably part of why they are who they are.

- He's everywhere: I really didn't appreciate the breadth of Berkshire Hathaway's holdings until this weekend. When Warren talks about investing in the American industry, he means it. Case in point. I bought a pair of shoes from Nordstrom Rack a month ago. A brand I had never heard of, Børn. Then, I'm walking through the hall and see a display for H.H. Brown. A company I had never heard of. They sell shoes. And one of the shoes looked familiar. And then I looked up. There ya go. I'm buying his products without even knowing it.
- 85 and in charge: This was the single most amazing part of the weekend and one that I will never forget. He is eighty-five years old. Just think about that for a minute. Think about the most aware, intelligent, healthy person you know over the age of 80. Now picture that individual sitting on a dais for seven hours straight, answering questions about 100+ companies, with no prep, and having instant recall of detailed data on every one. The minutiae of every one—one question asked about the delivery issues associated with a new furniture store they opened up in Texas—and he knew the exact issue. He just blew me away. The energy, the recall, the intelligence. If I'm half as good as that at 85, then I will have won the lottery. And I'm pretty sure Warren won the DNA Powerball. When I was invited to attend this meeting, one of the pitches (like I needed to be pitched) was that, "you never know when it might be his last meeting…" After this experience, I'm pretty darn sure that unless he gets hit by one of those buses, he'll be doing it for a long while.

FINAL THOUGHTS

In summary, I loved the experience. I now understand a little sliver of why people flock to Warren and why so many investors swear by him. And yes I plan on going back next year if I can. And yes, I went out and bought some BRK shares* as soon as I got home.

– Sumeet

* BRK.B, not BRK.A :)